What Is the 4% Rule for Withdrawals in Retirement and How Much Can You Spend?

What Is the 4% Rule?

The 4% Rule is a practical rule of thumb that may be used by retirees to decide how much they should withdraw from their retirement funds each year.

The purpose of adopting the rule is to keep a steady income stream while maintaining an adequate overall account balance for future years. The withdrawals will consist primarily of interest and dividends on savings.

Experts are divided on whether the 4% withdrawal rate is the best option. Many, including the creator of the rule, say that 5% is a better rule for all but the worst-case scenario. And some caution that 3% may be safer in current interest-rate conditions.

KEY TAKEAWAYS

- The 4% Rule suggests the total amount that a retiree should withdraw from retirement savings each year.
- The rule seeks to establish a steady and safe income stream that will meet a retiree's current and future financial needs.
- The rule was created using historical data on stock and bond returns over the 50-year period from 1926 to 1976. Some experts suggest 3% is a safer withdrawal rate with current interest rates; others think 5% could be OK
- Life expectancy plays an important role in determining a sustainable rate.

Understanding the 4% Rule

The 4% Rule is a guideline used by some financial planners and retirees to estimate a comfortable but safe income for retirement.

An individual's life expectancy plays an important role in determining if the rate will be sustainable. Retirees who live longer need their portfolios to last longer, and their medical costs and other expenses can increase with age.

History of the 4% Rule

The concept of the 4% Rule is attributed to Bill Bengen, a financial adviser in Southern California who created it in the mid-1990s, and has since complained that it has been over-simplified by many of its adherents. He said that the 4% rule was based on a "worst-case" scenario and that 5% would be a more realistic number.

The rule was created using historical data on stock and bond returns over the 50-year period from 1926 to 1976, focusing heavily on the severe market downturns of the 1930s and early 1970s.

Bengen concluded that, even during untenable markets, no historical case existed in which a 4% annual withdrawal exhausted a retirement portfolio in fewer than 33 years.

Accounting for Inflation

While some retirees who adhere to the 4% rule keep their withdrawal rate constant, the rule allows retirees to increase the rate to keep pace with inflation. Possible ways to adjust for inflation include setting a flat annual increase of 2% per year, which is the Federal Reserve's target inflation rate, or adjusting withdrawals based on actual inflation rates. The former method provides steady and predictable increases, while the latter method more effectively matches income to cost-of-living changes.

While the 4% Rule recommends maintaining a balanced portfolio of 50% common stocks and 50% intermediate-term Treasurys bonds, some financial experts advise maintaining a different allocation, including reducing exposure to stocks in retirement in favor of a mix of cash, bonds, and stocks.

Advantages and Disadvantages of the 4% Rule

While following the 4% rule can make it more likely that your retirement savings will last the remainder of your life, it doesn't guarantee it. The rule is based on the past performance of the markets, so it doesn't necessarily predict the future. What was considered a safe investment strategy in the past may not be a safe investment strategy in the future if market conditions change.

There are several scenarios in which the 4% rule might not work for a retiree. A severe or protracted market downturn can erode the value of a high-risk investment vehicle much faster than it can a typical retirement portfolio.

Furthermore, the 4% Rule does not work unless a retiree remains loyal to it year in and year out. Violating the rule one year to splurge on a major purchase can have severe consequences down the road, as this reduces the principal, which directly impacts the compound interest that the retiree depends on for sustainability.

However, there are obvious benefits to the 4% Rule. It is simple to follow and provides for a predictable, steady income. And, if it is successful, the 4% Rule will protect you from running short of funds in retirement.

Pros

- It's simple to follow
- Provides predictable, steady income
- Protects you from running out of money in retirement

Cons

- Requires strict adherence (doesn't respond to lifestyle changes)
- Is based on a 'worst-case' scenario of portfolio performance
- 5%, not 4%, may be a more realistic number

The 4% Rule and Economic Crises

Actually, the 4% Rule may be a little on the conservative side. According to Michael Kitces, an investment planner, it was developed to take into account the worst economic situations, such as 1929, and has held up well for those who retired during the two most recent financial crises. Kitces points out:

The 2000 retiree is merely "in line" with the 1929 retiree, and doing better than the rest. And the 2008 retiree—even having started with the global financial crisis out of the gate—is already doing far better than any of these historical scenarios! In other words, while the tech crash and especially the global financial crisis were scary, they still haven't been the kind of scenarios that spell outright doom for the 4% Rule.

This is, of course, not a reason to go beyond it. Safety is a key element for retirees, even if following it may leave those who retire in calmer economic times "with a huge amount of money left over," Kitces notes, adding that "in general, a 4% withdrawal rate is really quite modest relative to the long-term historical average return of almost 8% on a balanced (60/40) portfolio!"

Meantime, some experts—pointing to the recent low interest rates on bonds and savings—suggest that 3% might be a safer withdrawal rate. The best strategy is to review your situation with a financial planner, starting with how much you have saved, what your current investments are, and when you plan to retire.

Does the 4% Rule Still Work?

The 4% rule was created to meet the financial needs of a retiree even during a worst-case economic scenario such as a prolonged market downturn. Many financial advisers say that 5% allows for a more comfortable lifestyle while adding only a little more risk.

How Long Will My Money Last Using the 4% Rule?

The 4% Rule is intended to make your retirement savings last for 30 years or more.

Does the 4% Rule Work for Early Retirement?

The 4% Rule is focused on preparing for retirement at age 65. If you're hoping to retire early or expect to keep working past age 65, your long-term financial needs will be different.

The Bottom Line

For most people, managing their retirement savings is a balancing act. If they withdraw too much too fast, they'll risk running out of money. Not withdrawing enough money can deny them the full benefit of their hard-earned savings.

For those who want a rule of thumb to follow, the 4% Rule is an easy-to-use choice.

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Updated January 20, 2022