Why 2 Percent Is the New 4 Percent for Investors

In today's low-return environment, retirees can't safely take 4 percent annually from their portfolios.

The 4 percent rule has long been the standard for retirement savers, but some experts say investors should consider cutting back to 2 percent.

By Joanne Cleaver | Nov. 18, 2015, at 10:11 a.m. + More

Financial advisor Jennifer Landon has a pretty good idea of what a new client assumes as to how much she can withdraw each year from her retirement savings. That would be 4 percent, because the so-called "4 percent rule" has been a default planning tool for nearly three decades.

But that rule, forged in the previous era of low volatility and high interest rates, is out of date in today's low interest-rate environment, says Landon and other retirement planning experts.

In the current environment of low rates and low returns, a retiree would quickly eat capital by following the 4 percent rule. That's why advisors and analysts are coaching those near or in retirement to instead focus on how much money they need to cover basic living expenses, rather than simply expecting to spend 4 percent.

"If the 4 percent rule is too aggressive, we will look outside the box," says Landon, who is based in Idaho Falls, Idaho.

Perhaps ironically, the 4 percent rule was originally conceived to rein in the expectations of retirees in the go-go early 1990s, says Wade D. Pfau, professor of retirement income with the American College in Bryn Mawr, Pennsylvania.

"When it was developed, people assumed that the stock market delivered 7 percent every year, after inflation," Pfau says. But if retirees spent at the same rate that their portfolios were earning, they were in danger of spending too much when the market dipped, thus undermining their long-term income.

The 4 percent rule bolstered financial advisors' recommendations to curb spending so that, over the long run, portfolios would at least grow a bit even as retirees reaped earnings.

"It's not just about the average portfolio return," Pfau says. "If you have bad returns early on and great returns later, you've already dug a hole by taking distributions and then it's too late. … Now, we have low interest rates, and if you are spending 4 percent, you're spending your principal."

Pfau says that 3 percent is a "safer assumption when you are managing long-term market risk." And 2 percent would be safer yet, but might be unnecessarily conservative, he says.

Pfau also says that many financial advisors use software that is grounded in the historical 4 percent assumption, and that predicts a 95 percent success rate of sustained income using the rule. "With the market assumptions I use, the 4 percent rule gives more like a 60 percent to 70 percent success rate over a 30-year retirement," he says.

But even trimming a few points from your income estimates can crimp your retirement lifestyle, says Julie Murphy Casserly, president of JMCWealth, a Chicago-based financial advisory. "If you assume a 3.6 percent withdrawal rate, you get income of $36,000 a year on assets of $1 million. Most people think they can't live on that."

One strategy involves building a "front-end bond ladder so that the first five to 10 years of expenses are covered by bonds that are maturing so you don't have to sell stock for the first 10 years," Pfau says.

Annuities play an essential role in several strategies sketched out by the advisors.

Lock in an annuity that delivers a guaranteed 8 percent for a decade, to buy time for your investment portfolio to accumulate, assuming that your portfolio is sufficiently diversified and is likely to deliver the income you need, Casserly says. She recommends an indexed annuity with an enhanced income rider.

Landon and Pfau say simple, straightforward annuities can provide a guaranteed stream of income that retirees top off with fluctuating income from an investment portfolio. The idea is to structure guaranteed income using low-cost annuities. Landon says that if at least that floor is designed to guarantee at least a 4 percent return, you can probably tolerate a return of 2 percent from your investment portfolio, at least for a while.

"Figure the annuity to complement your Social Security so that then it's not so catastrophic if the 4 percent rule doesn't work out for you," Pfau says.

Annuities "are nowhere close to perfect," says Landon, but they at least provide a baseline so that "you don't have to worry about running out of gas on the road to retirement. It's already structured."

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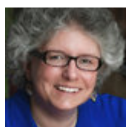

Joanne Cleaver is a widely published business author and journalist. Follow her on Twitter @jycleaver.

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