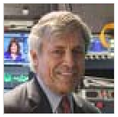

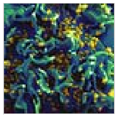

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Say Goodbye to the 4% Rule

If the conventional wisdom no longer holds about spending in retirement, what are the alternatives? Here are three of them.

By KELLY GREENE

Can your nest egg last your whole lifetime? It's getting tougher to tell.

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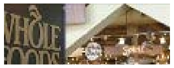
Conventional wisdom says you can take 4% from your savings the first year of retirement, and then that amount plus more to account for inflation each year, without running out of money for at least three decades.

This so-called 4% rule was devised in the 1990s by California financial planner William Bengen and later refined by other retirement-planning academics. Mr. Bengen analyzed historical returns of stocks and bonds and found that portfolios with 60% of their holdings in large-company stocks and 40% in intermediate-term U.S. bonds could sustain withdrawal rates starting at 4.15%, and adjusted each



year for inflation, for every 30-year span going back to 1926-55.

Well, it was beautiful while it lasted. In recent years, the 4% rule has been thrown into doubt, thanks to an unexpected hazard: the risk of a prolonged market rout the first two, or even three, years of your retirement. In other words, timing is everything. If your nest egg loses 25% of its value just as you start using it, the 4% may no longer hold, and the danger of running out of money increases.

If you had retired Jan. 1, 2000, with an initial 4% withdrawal rate and a portfolio of 55% stocks and 45% bonds rebalanced each month, with the first year's withdrawal amount increased by 3% a year for inflation, your portfolio would have fallen by a third through 2010, according to investment firm T. Rowe Price Group. And you would be left with only a 29% chance of making it through three decades, the firm estimates.

That sort of scenario has left many baby boomers who are in the midst of retiring riddled with angst. "The mind-blowing aspect of retiring is all these years you're accumulating and accumulating, and then you need to start drawing down, and you have no idea how to do that," says Al Starzyk, a 66-year-old retired printing executive in Williamsburg, Va.

So, if you can't safely withdraw at least 4% a year from a balanced portfolio of equity and bond funds, what do you do? Here are three alternative approaches that retirement specialists say may work better to ensure your

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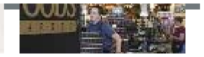

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When the Old Math Doesn't Add Up

In many past periods, retirees could get a lifetime of income from their nest eggs by taking out 4% the first year and adjusting the dollar figure annually for inflation.

But here are four scenarios in which that approach can come up short:

A BIG DROP IN THE EARLY YEARS. For your money to last 30 years, you want investment profits to exceed withdrawals in the initial years. If you hit a bear market in stocks right off the bat, as was the case for people who retired in 2000, your odds of running out of money increase.

DISMAL STOCK RETURNS OVER TIME. Stocks are typically the biggest driver of portfolio returns. So a long period of anemic returns could mean that portfolios don't last long enough.

A HOSTILE BOND MARKET. Most retirees count on bonds for steady income and to offset the riskiness of stocks. The current bond market is problematic on both counts: bond yields are near record lows and when rates rise, investors will see bond holdings go down in value.

RAMPANT INFLATION. Your withdrawals would cover the rising cost of living, but would your portfolio suffer a fatal blow? Periods of high inflation are tough on bond investments and initially may be tough on stocks as well.

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money lasts as long as you do:

Use annuities instead of bonds

Pairing the most plain-vanilla type of annuity—called a single-premium immediate annuity—with stocks, retirees can generate income more safely and reliably than if they use bonds for that piece of their portfolio, says Wade Pfau, a professor who researches retirement income at the American College of Financial Services in Bryn Mawr, Pa.

To arrive at that conclusion, he plotted how 1,001 different product allocations might work for a 65-year-old married couple hoping to generate 4% annual income from their portfolio.

Using 200 Monte Carlo simulations for each product allocation, and assuming returns based on current market conditions, the winning combination turns out to be a 50/50 mix of stocks and fixed annuities, Mr. Pfau says. If inflation accelerates more than the markets now expect, inflation-adjusted annuities would become more attractive, he adds.

"There is no need for retirees to hold bonds," he says. Instead, annuities, with their promise of income for life, act like "super bonds with no maturity dates," he says.

But immediate annuities have one big drawback: The buyer loses access to his or her savings in exchange for those guaranteed payments. In other words, if you have a sudden long-term-care need or some other type of emergency, there's no way to recapture a large chunk of cash. As a result, some retirees and their advisers are using variable annuities with guaranteed income benefits instead. These annuities allow investors to withdraw more than the set annual amount in an emergency.

Mark Cortazzo, a certified financial planner in Parsippany, N.J., typically recommends that people preparing to retire figure out their basic, nondiscretionary annual expenses and use a variable annuity with guaranteed benefits to make up for whatever portion of that total won't be covered by Social Security and any pensions. That way, they can pay their bills throughout retirement and afford the risk of investing much of the rest of their savings in stock funds, he says.

"If they've got a guaranteed check that's covering their needs, it's a lot easier for them to stick it out when there's a storm coming" in the stock market, Mr. Cortazzo says.

Follow the tax man's tables

One way to manage retirement withdrawals is to use life-expectancy tables such as the one the Internal Revenue Service uses to establish required minimum withdrawals from individual retirement accounts. This works almost as well as more-sophisticated modeling done by retirement-research experts at Morningstar Inc., those experts say.

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IRA distributions don't have to start until age 70½, but the IRS publishes life-expectancy numbers for earlier ages as well in Appendix C of Publication 590 at [irs.gov](irs.gov).

Here's how it works: Using your nest-egg balance as of Dec. 31 of the previous year, you would look up your age in the IRS table and divide your account balance by the life expectancy given for that age. Let's say you saved $1 million and retired at age 62. Your life expectancy, according to the IRS, would be 23.5 years. So, you would divide $1 million by 23.5, arriving at a withdrawal amount of $42,553. If your account balance grew the following year by 5% to almost $1.01 million, you would withdraw $44,287 (the new balance divided by your 63-year-old life expectancy of 22.7 years). But if your savings shrank 5% to $909,575, you could withdraw only $40,069.

The downside is that the withdrawal amount will fluctuate. But you would have a reasonable shot of outlasting your savings, particularly for people with life expectancies of less than 25 years, says David Blanchett, Morningstar's head of retirement research.

And while your withdrawal amounts could shrink in any given year, this is a more flexible approach than one being recommended by some retirement-planning pros: lowering the initial withdrawal rate to the 2% to 3% range and then adjusting for inflation each year. With 4% a stretch for many retirees to live on, even with the help of Social Security, 2% could prove impossible. The life-expectancy approach may also result in withdrawals of less than 4% in some years—or even every year—but it doesn't call for withdrawals below 4% every year regardless of what the markets do.

Peg your withdrawals to stock valuations

If stocks are pricey when you retire, suggesting lower returns over subsequent years, you should be cautious about how much you pull out; it's clearer sailing if stocks are at bargain prices. Hence, the approach devised by Michael Kitces, research director at Pinnacle Advisory Group Inc. in Columbia, Md. He determines what he considers safe withdrawal rates by using the P/E 10 for the Standard & Poor's 500-stock index. The P/E 10 is a measure of current stock prices relative to the companies' average inflation-adjusted earnings over the past 10 years.

When using a portfolio of 60% stocks and 40% bonds, he found that three rules worked for determining an initial withdrawal rate for 30 years of retirement and adjusting withdrawals each year for inflation. Mr. Kitces says he focused on returns during the first half of a projected 30 years of retirement, because preserving your nest egg for the first 15 years means you would be in good shape for the rest.

His rules: If the P/E 10 is above 20, in which case he considers the market overvalued, you would withdraw 4.5% in the first year of retirement, adjusting that initial amount for inflation every year thereafter. If the benchmark falls between 12 and 20, where he considers the market fairly valued, the initial withdrawal would be 5%. If it's below 12, or undervalued, you can pull out 5.5% the first year. (If you aren't comfortable taking out that much, you might use lower percentages but incorporate the same approach.)

You can track the P/E 10, based on research by Robert Shiller, a professor at Yale University, at multpl.com/shiller-pe. The current number is 23.4, meaning a first-year withdrawal of $45,000 if you're starting retirement now with a $1 million nest egg.

Ms. Greene is a staff reporter for The Wall Street Journal in New York. Email her at kelly.greene@wsj.com.

The Readers Weigh In: Could You Live on 4% of Your Nest Egg a Year?

This is a joke, right?!

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Not with all the state and property taxes in Washington state.

—HeiDi

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—Abby Marks

Try taking 4% of portfolio value at start of each year. Blindly taking initial withdrawal plus inflation is not prudent.

—me

95% of Americans need to learn to save better. Schools need to teach real-life classes.

—M D

A version of this article appeared March 4, 2013, on page R1 in the U.S. edition of The Wall Street Journal, with the headline: Say Goodbye To the 4% Rule.

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