DOES THE 4-PERCENT RULE STILL APPLY TO TODAY'S RETIREMENT?

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People often turn to general rules of thumb to help them simplify the complications of life and provide them with certainty in a world full of risk. Determining how much of your assets to draw down in retirement without running out of money is a complicated issue with many variables to consider.

One popular rule of thumb is called the 4-percent rule, which generally asserts that you should withdraw 4 percent of your portfolio balance the first year of retirement and then adjust that amount slightly each year for inflation. For example, the 4-percent rule would dictate that you withdraw $4,000 in year one for every $100,000 you have in retirement assets, and then increase that amount each year to adjust for inflation.

Assuming you have a retirement portfolio of stocks and bonds, you should be able to continue withdrawals for roughly 30 years. The 4-percent rule may be easy to understand and follow, if everything goes well.

But the simple rule might not work in a complicated world. As a research fellow for the Alliance for Lifetime Income and an economics and finance researcher at Johns Hopkins, I've studied the 4-percent rule. There are various risks to consider with retirement income, so it's important to think beyond a simple rule and consider ways to mitigate these risks. One method is to purchase an annuity as part of a retirement plan. An annuity can provide retirement income that is protected from these potential pitfalls.

Now, let's discuss the risks:

LONGEVITY RISK: Many retirees are living longer. According to the Social Security Administration[1], one out of every four 65-year-olds today will live past the age of 90 and one in 10 will live past age 95. Hence, if you retire at 65, you may need to plan on your retirement portfolio to provide you with income well past 30 years of retirement. Annuities can be purchased with an option for providing income for as long as you live, which mitigates some longevity risk.

[1] SSA.gov, Benefits Planner: Life Expectancy, accessed February 2019

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MARKET RISK: As we all saw during October, markets can be very volatile and can have significant up and down swings. Since the 2008-09 market crash, there have been eight market corrections[2] when the S&P 500® dropped at least 9.8 percent. There's no guarantee that the markets will continue to rise in retirement, increasing the risk that the 4-percent rule won't be sufficient to guarantee necessary income in retirement. An annuity can be added to a retirement plan to provide a predictable income stream no matter how markets perform.

INFLATION RISK: A little inflation is good for the overall economy. But even low inflation takes its toll over time. If inflation averages 3 percent per year, prices will double in 24 years. Too much inflation will require you to withdraw more than 4 percent each year just to maintain your standard of living as prices increase. Too little inflation usually means the economy is weak and interest rates are low, so your retirement assets may not generate the returns necessary to continue withdrawals at a rate consistent with your standard of living.

HEALTH RISK: How's your health? The risk of rising healthcare costs is significant. Medicare premiums[3] continue to rise, along with the overall cost of healthcare. Will you need to pay for assisted living in retirement? Healthcare cost risk is one of the largest unknown factors when evaluating whether the 4-percent rule is an adequate rule of thumb for today's retirees. Again, with an annuity you know exactly how much income you will be earning for a specific number of years (or your entire life), so you have more flexibility when planning for inflation in healthcare or other areas.

PORTFOLIO RISK: This is another factor to consider when evaluating how the 4-percent rule applies to today's retirees. The rule is generally based on a mixed portfolio of stocks and bonds. Some suggest a 50/50 split while others suggest your portfolio be 60 percent stocks and 40 percent bonds if you have a higher tolerance for market volatility, or perhaps 40 percent stocks and 60 percent bonds if you have less tolerance for market volatility.

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However, given that people are living longer and may need more retirement income, they might need to generate higher average returns with a portfolio that is more heavily weighted in equities, which basically means taking on more risk.

Adding a product like an annuity to a retirement portfolio can lock in enough retirement income to pay for must-haves (housing, utilities, food), leaving other money to invest relatively aggressively to generate higher returns. Additionally, the annuity may alleviate the stress of withdrawals from the portion of the portfolio that does not have guarantees.

FINAL THOUGHTS

Whatever your retirement goals, the bottom line is life is complicated and retirement is complicated, as well. Rules of thumb are designed to simplify decision making, but could end up doing more harm than good. It's important for consumers to talk with an experienced financial advisor to walk through all the various retirement risks and options available to design a diversified and strategic portfolio to help mitigate those risks. A portfolio of stocks, bonds and annuities could help retirees balance risk and return as they save for and enter retirement.

[2] Yardeni Research, *Market Briefing: S&P 500 Bull & Bear Markets & Corrections,* February 26, 2019

[3] Centers for Medicare & Medicaid Services, *2019 Medicare Parts A & B Premiums and Deductibles,* October 12, 2018

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