You have worked hard and are ready to turn your savings into a paycheck. But what is the best way to spend your money? For years, many used the 4% rule to ensure that they wouldn't run out of money, but this may not be the best choice anymore. The 4% rule can leave you missing out on opportunities and experiences that you wanted to enjoy during retirement and doesn't account for the years that you may spend more or less. Let's examine the 4% rule and alternatives that you can use.

What is the 4% Rule?

The 4% rule assumes that you withdraw the same amount of money from your portfolio every year, and then adjust for inflation. The formula is relatively simply: you add up all your investments and withdraw 4% of that for your first year of retirement. In the following years, you adjust the dollar amount for withdrawal to account for inflation. By following this formula, people usually have a high chance of not outliving their money within a 30-year period.

Why the 4% Rule Doesn't Work

The 4% Rule is Rigid

The 4% rule doesn’t follow normal human spending behavior. The rule assumes that you will only spend 4% of your investments every year, which is not typical behavior, especially for those that just recently retired. This isn’t how many retirees spend their retirement. In most cases, expenses will change from year to year, and the amount you spend may change throughout retirement.

Assumes a 30-Year Retirement

As people continue to stay in the workforce longer, many won’t have a 30-year retirement. 30 years may not be needed or wanted, depending on when you decide to retire. Some may have more, and some may have less. This can lead to you outliving your money or having a huge pile of money that you never spent when you pass. Of course you should plan for a long retirement, but in most cases, a 30-year plan is not needed.

Assumes You Have a 50/50 Bond to Stock Allocation

The rule assumes that you have 50% invested in stocks and 50% invested in bonds. The truth is, everyone’s investments are going to be unique, so this allocation makes it difficult to drag and drop this rule on other portfolio constructions. Charles Schwab suggests diversifying your assets across a wide range of asset classes and types of stocks and bonds, and that you reduce your exposure to stocks and bonds as you transition into retirement.

The 4% Rule is Based on Historical Data

Although history can be a good guide for the present and future, history rarely repeats itself exactly as it occurred. We don’t know what the future holds, so making restrictive spending decisions in retirement can lead to a lot of regret.

Assumes that you Want a 100% Level of Confidence of Not Running Out of Money While Alive

Since it assumes you want 100% level of confidence, it is intentionally overly conservative. You would need to spend less in retirement to ensure that you meet that 100% confidence level. If you don’t want or need a 30-year plan, then you be conservative with your money for no reason other than leaving a large pile of money for your children when you pass. You may not want a conservative retirement plan, so it’s important to explore all your options.

The 4% Rule Does Not Factor in Portfolio Performance

Your portfolio might perform great some years and worse other years. If you're not adjusting your income on portfolio performance, you might leave too much money on the table or take on too much risk.

The 4% Rule Does Not Include the Effect of Taxes or Fees

Depending on how your assets are located – if they are in tax free accounts, tax deferred accounts, or taxable accounts – they will change the distribution rate that you can manage. It can cause problems following a 4% rule without any regard for where your assets are situated. That means that any taxes that you may incur will have to be taken out of that 4% for the year, leaving you with less money to spend.

The 4% Rule Creates More Questions Than Answers

Following a rigid system that creates more questions can cause a lot of questions in the future. You don't want to ask, "What do I do now?"

Alternative Options for Retirement

Spending Guardrails

This strategy predetermines when spending adjustments would be made. The Spending Guardrails strategy typically works in confidence levels between 70-90 percent. If you set your confidence level to 90%, but the probability of success falls to 70%, then consider decreasing spending to raise the probability of success. If the probability of success rises to 99%, then consider increasing spending to lower the probability of success.

This strategy allows for flexibility by giving retirees margins in which they need to stay in. By having a minimum and maximum set for your spending, you are able to choose where you fall within your probability of success. Most financial advisors suggest staying 70% probability of success or higher to make sure that you have enough money throughout your retirement. This strategy relies on how well your portfolio is doing and allows for adjustments that fit your lifestyle.

Retirement Bucket Strategy

This strategy divides your savings into different “buckets” based on different timeframes. A short-term bucket holds easily accessible cash for immediate needs, while a long-term bucket keeps growth investments for later years.

The money you use in the first several years might be in certificates of deposit (CDs), treasury notes, or municipal bonds.

This strategy can be useful to ensure that you have enough money for your retirement. However, the downside of this strategy is that you could possibly hinder some of your investments’ growth since you’ll have some years of expenses in cash and not in investments.

Bottom Line

There is no perfect retirement plan. You need to understand the tradeoffs of any strategy and their ability to adapt to changing economic and personal situations. While the 4% may work for some, it has been proven to be outdated and there are more reasonable options out there for you.

A retirement withdrawal strategy can be as simple or complex as you like, but you must consider your goals to ensure that you make the most out of your money and retirement. It can be helpful to review your strategy annually to make sure that your plan still aligns with your long-term goals.

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