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How does 4 percent rule work for retirement?

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Most financial advisers will counsel their clients to begin taking around 4 percent of any given investment portfolio at the onset of retirement.

This recommendation comes from multiple financial studies over the last couple of decades that show that a 4 percent withdrawal rate from a balanced portfolio (roughly half stocks and half bonds) has been sustainable for at least 30 years the majority of the time.

So, this approach is typically applied to people who retire in their 60s and who are expected to live into their nineties. Those that retire in their 70s can take a higher distribution rate and so on.

We know that these studies are retrospective (knowing the future continues to be difficult), and mostly based on domestic stocks and bonds. There are some more recent studies (again looking backwards) that suggest adding more asset classes (real estate, foreign securities, etc.) may allow a higher distribution rate.

We also know that we may not be able to extrapolate even recent past performance to the future. For example, interest rates are at generational lows, suggesting that it will be very hard to get returns from fixed income anywhere close to what they have been over the last 30 years.

Given all these facts and the definite uncertainly about the future, we still have to start somewhere. So if you are retiring without an earned income in your 60s, using a balanced portfolio for investments along with an initial 4 percent withdrawal rate makes sense.

But then what? How do you adjust your withdrawals in the future? There are several formulas to follow, with no clear winner. One popular glide path adjusts the “next year” distribution by the rate of inflation, regardless of what the portfolio is doing. So, a $1 million portfolio could distribute $40,000 year one, and $41,200 the second year if inflation was running 3 percent.

Another formula proposes that you take 4 percent of whatever the year end value of your portfolio is. If your portfolio has higher prices, you can spend more, and vice versa. This is a similar approach to how required minimum distributions from IRAs are done. You could

even use the IRA tables as a template for taking distributions from a non IRA account.

I tell the families that I work with that it is a constantly adjusting process. Our portfolios contain a buffer that will allow at least a couple of years of distributions without having to sell assets at sale prices. Still, a prolonged bear market may require even more adjustments than are present in a rigid formula.

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