The 4% Withdrawal Rule

This formula provides some guidance for retirement.

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Everyone seems to have a different perception of retirement and at what age to enter into it, but I think we all agree that there will eventually be a time in the future at which each of us will no longer be generating earned income, necessitating that we be able to live on cash flow from our investments and Social Security. If we listen to financial advisors, we know that the more we save each year, the sooner we start saving, the longer we work, and the less we draw from our investments after retirement, the better off we will be.

Given all the financial questions we might have regarding retirement, the one that is most difficult to answer with any degree of certainty is: "In retirement, how much can a person safely withdraw from his/her investments each year and not run out of money?" Regardless of whether you are just starting out in practice, at the mid-point of your career, or nearing retirement, you should be addressing this question; otherwise, you will have no idea when you can safely retire or how much you should be saving along the way.

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The reason this question is so difficult for doctors—or even financial advisors—to answer is that there are five significant unknowns affecting this decision that can have such a wide variation of value. Because of this, CPAs and financial advisors tend to be ultra-conservative when they calculate a potential withdrawal rate—a strategy that leads to results which convince most doctors that they will never be able to safely retire. These unknowns include: 1) the amount of money one will have saved by the time of retirement, 2) the projected

Continued on page 144

4% Withdrawal Rule (from page 143)

rate of return on all investments, 3) the individual's expected lifespan following retirement, 4) the amount of the Social Security payment one will be receiving, and 5) the expected rate of inflation going forward. At the time of retirement, the amount saved and the amount of Social Security income are no longer "unknown"—leaving the three remaining variables to consider.

Each of these will have a different impact on the amount one can safely withdraw yearly. When I am faced with a financial decision that has multiple variables such as this, I typically put together a spreadsheet with integrated formulas to use for testing the impact of each variable to see which ones will have the biggest impact on the final outcome. This is often an eye opener—leading to a different strategy than initially expected.

If you are looking for an "easy" yardstick for determining withdrawal rates from investments upon retirement, most financial experts recommend using the "4% rule." This "rule" was derived in a 1994 study by financial planner William Bengen. After testing a number of different withdrawal rates, his determination was that 4% was the highest rate of withdrawal that would hold up (i.e., not run out of money) over a period of at least 30 years. Utilizing this rule, a retiree withdraws 4% from all of his/her investments targeted for retirement in the first year; however, to maintain purchasing power, while keeping pace with inflation, s/he needs to increase the dollar amount of withdrawal each year.

When looking at its impact in the early years, inflation may not seem like a "big deal". For example, if one has $1,000,000 invested and follows the "4% rule," s/he would withdraw $40,000 the first year. Assuming a 4% inflation rate, s/he would only increase this to $41,600 in the second year. Continuing on with this "rule" shows the limitations on income, even when one has amassed $1,000,000 by retirement age. For most doctors, $1,000,000 will probably not provide them with the same lifestyle they enjoyed while working. A desire to maintain a certain lifestyle will make them take options into consideration—either working for more years or withdrawing more than 4% each year—hoping for the best. Setting a plan is made even more difficult by the fact that most financial experts think that the 4% withdrawal rate is too generous—especially if a significant market decline were to take place in the early years—or "worse yet," the retiree is healthy and lives longer than average.

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While most doctors understand the financial impact and risks of low market returns or saving too little, what is not as well understood is the impact that inflation can have on withdrawal rates. At the end of the day, all retirement planning comes down to how much one will be able to safely withdraw each year and not run out of money. Understanding the impact that the inflation rate can have is where you need to start your financial planning. As mentioned above, in the early years, inflation appears to make little difference. In our example, the 4% inflation rate increased the withdrawal rate by "just" $1,600 in the second year. The small impact made by inflation on the withdrawal rates in these early years can be misleading; one tends not to see the significant impact that this rate will make over the long-term.

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Consider that the average life expectancy for a 65-year old male is 84.3 and that one in four of those sixty-five year olds will live beyond age 90. A modest 4% inflation rate over an 18-year period will double the amount of withdrawal needed in the eighteenth year of retirement, and an 8% inflation rate will quadruple the necessary amount. Using the 4% rule, a retired doctor who needs to draw $100,000 a year in addition to Social Security in order to "make ends meet" would need to start with $2,500,000 in retirement investments and savings. When we factor in a modest 4% inflation rate, this same doctor would need to draw $200,000 a year by the eighteenth year—and, $400,000 a year if the inflation rate were to rise to 8% over that time period. While it might be tempting to put much of one's retirement money into "secure" investments, it is important to recognize that predictable investments with guaranteed returns (such as annuities) have no growth potential and offer no protection against inflation.

Given that longevity and good health are the single greatest "risks" to outliving one's retirement savings, it is important to be mindful of our five variables at all ages. Four considerations that should be included in everyone's financial planning strategies are the following:

Strategy One: Maximizing Social Security is a bigger factor than one

Continued on page 146

4% Withdrawal Rule *(from page 144)*

might think. Most doctors will qualify for the maximum amount which, in 2017, is $2,153 a month for those who start withdrawing at age 62—or, $3,538 a month for those who wait until age 70. At 70, the $3,538 amount comes to $42,456 a year and is the equivalent of having another $1,061,400 in retirement savings when using the 4% rule.

Strategy Two: Owning a home greatly lessens the impact of inflation. Given that inflation has a major negative impact on housing costs, it is critically important to own your home, even if you have a mortgage. In the early 70s, those who retired and sold their homes for what seemed to be a fortune could barely afford rent following a period of double-digit inflation a decade later.

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Strategy Three: Working beyond age 65 provides compelling advantages. While most recognize that working more years gives them more time for their retirement savings to grow, it should be noted that doing so also provides the opportunity to increase the rate at which one can safely withdraw money after retirement.

Strategy Four: Working part-time after age 65 offers an ideal option for transitioning into retirement. There are mental as well as financial issues doctors face when they retire fully. Working part-time keeps one relevant and reduces the amount s/he needs to withdraw from savings in the early years of retirement—affording the ability to withdraw at a higher rate when fully retired. Earning $40,000 a year working part-time is equivalent to having another $1,000,000 in savings. **PM**

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