How to Build a Better Retirement-Spending Plan Than the 4% Rule

If you withdraw a certain percentage of your assets based on life expectancy, plus some tweaks, you can avoid some of the drawbacks

By

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Most retirees are familiar with the 4% rule.

It's the guide many financial pros have extolled for decades for the decumulation phase of retirement—the time when you finally start tapping the money you've spent decades (ideally) saving and investing.

Withdraw 4% of your portfolio in the first year of retirement, then adjust that amount for inflation every year thereafter. If your portfolio starts out at $1 million, for instance, you spend $40,000 the first year, then $40,000 plus inflation the next year, and so on.

The rule was devised in 1994 by financial adviser William Bengen after research showed that retirees with a balanced stock-and-bond portfolio who followed that math wouldn't have run out of money over any 30-year period since 1926—even when economic conditions were bad.

It's pretty simple. Maybe too simple.

The 4% rule has some blind spots. It assumes a 30-year retirement, but some retirees will need their money to last longer than that. It also assumes the markets will perform as well as they have over the past century. As a result, researchers have been lowering or raising the figure for years. Investment research firm Morningstar revises its estimate annually; it was 3.3% in 2021 and 3.9% this year. Bengen himself has said that a safe number could now be 4.7%.

The rule's deeper problem is its rigidity. Your portfolio amount could double in a market boom during retirement and the rule would still limit you to the same inflation-adjusted amount, which would be unnecessarily frugal. More concerning, your assets could fall by a third and the rule wouldn't tell you to curtail your spending. You would have to liquidate a bigger portion of your portfolio to withdraw the prescribed amount. If that happens a few years in a row, you run a real risk of eventually outliving your money, despite what the historical data say.

The good news is that there are ways to make retirement spending more responsive to how long you're likely to live and how markets perform. Use the 4% rule as a reference point, rather than have it be the full plan.

Your life expectancy matters

Instead of spending a fixed inflation-adjusted dollar amount every year, you need to factor in your life expectancy and the size of your portfolio and then adjust accordingly.

You divide your current portfolio balance by the number of years you can expect to live, and spend that much in the coming year. The following year, you do the math again with your new portfolio balance and your new remaining life expectancy. (You can find your life expectancy at your current age in the Social Security Administration's life tables, which are updated annually. Keep in mind that tables don't apply to any specific person; they don't factor in health issues or family medical history. You may want to be conservative and go beyond your life expectancy, or take a chance and reduce it.)

If you're a 70-year-old woman, for instance, your remaining life expectancy is about 16 years. So you would divide your portfolio into sixteenths and spend one of them this year. A year later, you would recalculate using your new balance and your new life expectancy, and so on. This allows your spending to rise when your portfolio is up and fall when it's down.

This actuarial approach lessens the chance you'll run out of money, and it lets good market returns flow through to higher spending.

Spending too much—or not enough

But it introduces a new problem: too much fluctuation in your spending.

If markets drop 30% in a bad year, your spending drops by roughly 30%, too. If markets surge in a year when the life tables say your remaining expectancy is five years, the formula tells you to spend a fifth of your portfolio—probably far more than you need or want.

The fix is to put guardrails on the actuarial approach, using the 4% rule as your anchor. You set an upper and lower band around it—say, 3% of assets on the low end and 6% on the high end. Each year, you do the actuarial calculation and check the result against the band.

If the implied withdrawal rate falls inside the guardrails, you're fine. If your spending would exceed 6% of your portfolio, you cap your spending at 6%. If your spending would fall below 3%, you spend at least 3%. The guardrails work like a financial thermostat. The 4% rule sits near the center of the band as the familiar reference point most retirees already know.

But if markets fluctuate a lot, you could still be in for a shock. Say markets fall sharply and the guardrails tell you to cut spending by a quarter to get back inside the band. That could be wrenching for a lot of retirees.

So here's a third fix: a shock absorber, like the ones some actual roadside guardrails have.

You cap year-to-year spending changes at, say, plus or minus 5%. Even if the guardrails say to cut more aggressively, you never cut by more than 5% in a single year. Same on the upside. Your spending won't swing chaotically between feast and famine.

Essential vs. discretionary

The trade-off for the shock absorption is that in a deep, sustained downturn, your portfolio will be exposed to more drawdown than a stricter rule would allow. So the shock absorber works best for retirees with some cushion above their essential spending.

That points to the next refinement.

None of the changes so far distinguish between the spending you *have* to do and the spending you would *like* to do. If you feel any of these strategies leaves you too vulnerable to market swings or a surprisingly long life, you can calculate the expenses you absolutely need to cover—food, healthcare, rent and the like—and pay for those with guaranteed income such as Social Security benefits or an annuity.

Then you can apply a dynamic withdrawal strategy, with the guardrails and shock absorber discussed above, to the spending that remains. You can afford to take more risk, and probably earn higher returns, with your discretionary portfolio because you know the essentials are covered.

None of these refinements is perfect. Each retiree has personal factors that could change the math, and the account order above will have exceptions in particular tax situations. There are software tools that run the calculations back and forth until they converge on an answer for a given person's circumstances. Realistically, though, most people won't use such tools routinely, if at all.

A dynamic strategy—with the 4% rule as a reference point—is practicable without specialized software. And it should help you enjoy your nest egg and not outlive it.