Investing in Context

Understanding the 4% Rule and what it tells us about sustainable retirement income

- **The 4% Rule is a popular 'rule-of-thumb' that suggests you can safely withdraw 4% of your retirement savings each year and increase that withdrawal in line with inflation, with little risk of running out of money during a typical 30-year retirement.**
- **Your personal retirement income strategy will depend on things like your tolerance for investment risk, your age at retirement, the income you need when retired and whether you have any other sources of income.**

When we are saving towards retirement, it helps to have an idea of how much income we will be able to replace using those savings once we stop earning. While the State Pension will provide some income from our late sixties – currently 67, it's likely that we will want to supplement that with additional retirement savings of our own. This short guide explores the topic of withdrawing a retirement income and sheds some light on several essential concepts.

What is the 4% Rule?

The 4% Rule is a popular 'rule-of-thumb' that helps us estimate what level of income we can withdraw sustainably from our retirement savings. While on the surface, the 4% Rule is a simple idea, there is considerable research and analysis to back it up. The 4% Rule has been widely adopted as a guide, since the early 1990's when William Bengen, the financial planner who originally published the research, used historical market data to assess the likelihood of retirees running out of money.

Planning the right retirement income strategy for your own situation is nuanced however. There are various personal and financial factors to bear in mind. Your personal retirement income strategy will depend on things like your tolerance for investment risk, your age at retirement, the income you need when retired and whether you have any other sources of income. Financial factors like market performance and the prevailing rates of inflation in retirement will also play a significant role in how long your retirement savings will last.

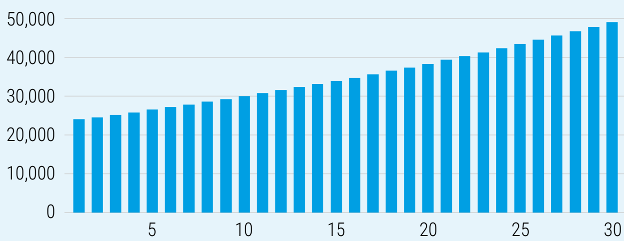
Example:

Alex has accumulated £600,000 in his retirement savings.

£600,000 x 4% = £24,000.

The 4% Rule suggests Alex can expect to safely withdraw an income of £24,000 in the first year of retirement and increase that by inflation annually thereafter. In our chart, we have used 2.5% annual inflation for illustration purposes only.

Alex's income rises with inflation



How the 4% Rule Helps

- It offers a useful starting point for further discussion and refinement
- It is simple and gives a sense of what your retirement savings may provide as a sustainable income when you retire
- It has been widely researched and mathematically modelled using decades of market data
- It provides a basis for inflation-proofed income in retirement, meaning your buying power is maintained

> Retirees can safely withdraw 4% of their portfolio each year and increase that withdrawal in line with inflation, with little risk of running out of money during a typical 30-year retirement.

Source: Determining Withdrawal Rates Using Historical Data, William P Bengen, Journal of Financial Planning, October 1994

4% Rule Limitations to Keep in Mind

- The original research was based on the historical performance of US stocks and bonds. Past performance is not a guide to future performance and actual returns will be different
- Your investment approach before and after retirement needs to be tailored to your individual circumstances. It will need to take account of your risk appetite when investing, your ability to withstand falls in your investments' value, other sources of income, at what age you wish to retire etc
- Your retirement income needs are likely to change through your retirement. Retirees typically spend more in the early and later years of retirement than they do in the middle years. The 4% Rule does not account for this
- The 4% Rule, in many cases, has proven to be too cautious leading to retirees accumulating significant sums in addition to their drawn income

Your Financial Adviser Can Help You By:

- Monitoring the long-term sustainability of your income in retirement and advise on adjustments
- Tailoring your withdrawals to your personal circumstances and market returns over time
- Adapting your investment strategy as markets evolve and income needs change

In Summary

The 4% Rule is a useful guide for consideration. It has some historical substance behind it and offers a realistic starting point when considering income levels in retirement. It's not a comprehensive analysis of your individual circumstances.

Factors such as market returns, particularly in early retirement, inflation, income needs and your risk appetite, as well as your capacity to absorb losses will all influence your income in retirement.

Developing a robust, personalised and suitable retirement income strategy has many facets and requires experience and skill to get right. That's where a financial adviser can really help.

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