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How Much Is Too Much?

By KELLY GREENE

How much can you withdraw from your nest egg each year without running out of money before you die?

Never has more been riding on the answer. The nation's 78 million baby boomers started turning 65 this year—and nearly 30 million of them have a "defined contribution" retirement plan such as a 401(k) account, according to the Employee Benefit Research Institute.

The market's wild swings in the past few years have made it impossible for new retirees to figure out with any certainty how much of their nest eggs they can tap each year.

How Four Retirement Strategies Would Have Fared

Here's how a $2 million portfolio would have looked at the end of 2010, assuming you had started withdrawing 4% a year in 2000 and increased that amount by 3% annually for inflation—with the following variations. (The portfolio held 55% stocks and 45% bonds.)

Account status	Portfolio value (millions)	Monthly withdrawal	Odds of success
Sticking with 4% withdrawals	$1,338,312	$9,228	29%
Reducing withdrawals 25% for three years after bear-market bottoms	1,544,453	5,970	84
No inflation adjustment for three years after bear-market bottoms	1,409,470	7,960	69
Switching to 100% bonds after first bear-market bottom	1,082,676	9,228	0

Source: T. Rowe Price

"It's like bowling," says Sheryl Garrett, founder of the Garrett Planning Network, which has about 320 planners. "If you retire when the market goes up for a few years, you're going to be sitting pretty—like when you get a strike or spare and then keep doing well. But if you have a few bad years in a row, you're in trouble."

Before the 2008 market meltdown, some financial advisers encouraged people to pull as much as 7% from their retirement portfolio each year. The rationale: If withdrawals equal the average return on investments, then the size of the portfolio would stay about the same. With stocks returning about 10% annually since 1926, the idea didn't seem farfetched.

But as investors learned to their dismay in the past decade, any one year's returns can vary wildly from the average: The Dow Jones Industrial Average fell from 2000 to 2002, rose to a record high in 2007 and then plunged 34% in 2008.

If a new retiree pulled 7% from a $2 million nest egg each year starting in 2000, he or she would have been left with only $394,634 by the end of last year—and might need to stretch that two decades or longer.

A more conservative strategy, the "4% rule," hasn't panned out for some retirees, either. Devised in the 1990s by William Bengen, a financial planner in El Cajon, Calif., the rule—4.15%, to be exact—quickly spread through the retirement industry.

Mr. Bengen analyzed historical returns of stocks and bonds and found that portfolios with 60% of their holdings in large-company stocks and 40% in intermediate-term U.S. bonds could sustain withdrawal rates starting at 4.15% (adjusted each year for inflation) for every 30-year span going back to 1926.

Jonathan Carlson

Assuming $3 million in savings and average inflation of 3%, you could withdraw $124,500 the first year, $128,235 the second year, $132,082 the third year, and so forth.

But timing is everything. If you had retired Jan. 1, 2000, with an initial 4% withdrawal rate and a portfolio of 55% stocks and 45% bonds, your portfolio would have fallen by a third through 2010, and you would be left with only a 29% chance of making it through three decades, according to investment firm T. Rowe Price Group.

In the wake of the 2008 market meltdown, advisers have been scrambling to tweak their withdrawal recommendations. Trade publications are crammed with new research on drawdown strategies, and advisers and academics are revising, republishing and blogging so frequently that it is hard even for financial planners, let alone investors, to keep up.

Staying Vigilant

Whichever strategy you use, one thing is clear: "You can't just set it and forget it," says Christine Fahlund, a senior financial planner at T. Rowe Price. She encourages people to examine their portfolios and adjust their withdrawals at least once a year.

Michael Obsatz, a 70-year-old retired sociology professor in St. Paul, Minn., already has had a wake-up call. He and his wife retired in June 2007 and adopted a 5.1% withdrawal rate. By February 2009, their portfolio was so battered that they needed to take out 8% a year to keep the income the same. At that point, the Obsatzes cut their monthly withdrawals by one-tenth—a $325 hit.

"We're more cautious on where the money's going," Mr. Obsatz says. "But we were able to maintain our reserves."

Before you can think about your "asset-drawdown" approach, you need to get your "asset accumulation" strategy in order. Investment adviser Charles Farrell has developed a quick ballpark gauge of how much you will need to save for retirement: Multiply your current gross income by 12. A more time-intensive, but more accurate, way to do it is to make an inventory of your living expenses so you know how much you actually will need.

Next you need to determine how long the money should last. Ultraconservative, ultrahealthy people might assume they will live to 95 or 100; others can assume less.

With your targets in mind, here are some new approaches to withdrawal rates based on your risk tolerance and expectations for the future.

The Accordion Strategy

The best withdrawal rate, say some advisers, is one that can scale up or down significantly based on market events.

Ms. Fahlund of T. Rowe Price suggests sticking with a variation of the 4% rule, but with a caveat: You will have to take a serious pay cut when the stock market tanks.

Her firm's research found that a retiree who started making portfolio withdrawals in January 2000 would have had the best outcome in the past 10 years by reducing those withdrawals by 25% for three years after each bear-market bottom.

For example, a retiree with a $1 million portfolio (55% stocks, 45% bonds) who had taken that advice would have seen a drop in value to $772,227, with monthly withdrawals by December 2010 of $2,985, maintaining an 83% chance of making it last 30 years. But a retiree who continued withdrawals as planned, taking out $4,614 a month by the end of 2010, would have been left with $669,156 at that point.

Henry K. "Bud" Hebeler, a 78-year-old former top executive at Boeing who retired more than 20 years ago, has seen the limitations of the 4% rule through his work developing Analyze Now, a retirement-planning website, and also in his friendships with peers.

Using his own calculator based on data from 1965-95, he found that 3.4% is the top "safe" withdrawal rate for a retiree with a 40% stock and 60% bond allocation, assuming investment fees of 1.3%.

But Mr. Hebeler advises redoing that calculation every year to make sure you still are on track—and ensuring you can cut spending to make up for market losses if you aren't. (To run the numbers, go to analyzenow.com.)

The Pessimist Plan

A number of experts are warning that even 4% withdrawals may be too high early in retirement, because depleted savings would have a tough time recovering from steep losses.

If future years see a continuation of the slow economic growth and deep market troughs of the recent past, the largest initial withdrawal a retiree could take from a balanced portfolio of stocks and bonds without running out of money for 35 years would be 2.52%, according to researchers at Ball State University in Muncie, Ind.

The $50,400 annual withdrawal from a $2 million nest egg might seem miserly. But upping it to 4% carries an 18% chance of "portfolio failure," meaning the money would run out in 35 years, says Manoj Athavale, an associate finance professor at Ball State. If you want to make the money last 30 years, you still would have a 14% chance of failing, he adds.

Another prediction is even bleaker. For a 60% stock, 40% bond portfolio meant to least 30 years, the maximum starting withdrawal rate for 2010 retirees should have been just 1.8%, meaning $2 million in savings would yield just $36,000 a year.

Wade Pfau, an associate professor at the National Graduate Institute for Policy Studies in Tokyo, came up with that depressingly low target, though he says he hopes 1.8% is "too low."

That is the result he got after looking at market valuations, dividend yields and bond yields at specific retirement dates for 30-year periods from 1883 to 1980, and then applying more recent values to the same equation.

"I don't think for most people 1.8% is at all realistic, but it's because in the past 15 years the variables are so different from anything they've been in the past," he says.

So, what would Mr. Pfau do if he were retiring now? Would he withdraw only $36,000 from a $2 million account balance? "If I could afford it, I would draw something like 3% and be cautious so I could reduce my withdrawals later if I had a bad sequence of returns early in retirement," he says. "You just try to stay flexible."

(You can run your own retirement assumptions in his spreadsheet at wpfau.blogspot.com.)

Embracing Some Risk

Two certified financial planners and a finance professor have come up with a system that manages what they call the "probability of failure." Rather than trying to ensure a 100% chance of having enough for 30 years, they adjust the withdrawal rate to keep the possibility of running short within a specific range that increases as the retiree ages.

Wayne MacDonald, a 69-year-old retired computer programmer in Roseville, Calif., has been working with one of those planners, Larry Frank Sr., for about 10 years. At first, he says, he pulled almost 5% from his savings each year, making for a 14% chance of failure. In 2008, he cut his spending, and now withdraws about 3%, reducing his chance of failure to 5%.

"When the market starts going badly and we hit one of these trigger points, Larry will call up and say, 'Hey, maybe we don't want to take anything out of the main fund and let it ride,'" he says.

Mr. MacDonald's accounts are structured so that his withdrawals go into a three-year reserve fund, so "it gives us three years' breathing time for the market to go back up," he says. Now that he and his wife are in their late 60s, "the possibility that [our savings] won't make 30 years doesn't bother me nearly as much."

Michael Kitces, research director at Pinnacle Advisory Group, favors a simpler approach. He determines safe withdrawal rates using the "P/E 10" for the Standard & Poor's 500-stock index, a measure of stock prices relative to 10 years of earnings that he considers a good predictor of long-term results.

Using historical returns and assuming a portfolio of 60% stocks and 40% bonds, he worked out three rules for determining a "safe" initial withdrawal rate and then adjusted for inflation annually. Why only 15 years? "What matters is what happens in the first half of your retirement. If things go well in the first half, you can't wreck it," he says.

His rules work like this: If the P/E is above 20, meaning the market is "overvalued," withdraw 4.5%—the lowest rate he requires, though he may lower it "if we go another seven or eight years and the S&P 500 hasn't made much headway," he says.

If the P/E 10 falls between 12 and 20, or what he terms "fairly valued," increase that rate by 0.5% to 5%. And if it is below 12, or "undervalued," increase it by 1% to 5.5%.

So how has his approach fared recently? For people who retired two to three years ago, "it's gone fantastically. Volatility that recovers quickly doesn't hurt in the least," Mr. Kitces says. "What's problematic is long, persistent periods of time when we're not making any headway."

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