Brett Arends's ROI

Opinion: Think you can rely on the 4% rule in retirement? Think again.

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By Brett Arends

The greatest screen couple of all time as Those Worried Retirement Savers COURTESY EVERETT COLLECTION

VBIAX +0.41% TMUBMUSD10Y 1.658%

Wouldn't it be great if we could predict the future?

Then we'd know exactly how much we needed to save to have a safe and comfortable retirement. We'd know how long we would need to make our money last. We'd know how much we would need to spend each year. And, crucially, we'd know how much our investments would earn each year.

Alas, for the real world! We don't know how long we're going to live (which is the argument for lifetime annuities). We don't know what will happen to inflation (which is the argument for inflation-protected Treasury bonds, or would be if they weren't already overpriced). And, no, we don't know how much our investments will earn each year.

I'm always amazed at the confidence with which people who work in Money, Inc. claim they can make forecasts. What they don't know, or don't tell us, is that those forecasts are based on some very sketchy assumptions.

Among them: That the future will look like the past. And especially like the 'American' past.

Our country drew a royal straight flush during the 20th century. Our major international competitors destroyed themselves in wars. Our remaining enemy posed such a threat that the whole country got behind huge public investments in technology and infrastructure that transformed the economy: We can thank the Cold War for the federal highway system, the space race, the internet and plenty more. Oh, and our 'old world' rivals helped us out by letting everyone with "get up and go" er… get up and go. How much of America's spectacular rise came from the flood of immigrants that hit these shores between 1870 and the 1920s?

With all this, it's not really surprising that U.S. stock market returns were among the best in the world for a century — the Great Depression notwithstanding.

What does this have to do with our retirement planning?

Plenty.

The so-called '4% rule' is a mainstay of retirement thinking. It says that we are almost guaranteed to be OK in retirement if we keep our money in stocks and bonds, withdraw 4% of our portfolio (or less) in the first year of retirement, and thereafter just raise the withdrawals in line with inflation. (This usually assumes a typical 'balanced portfolio' of 60% stocks and 40% bonds, such as, for example, that tracked by the Vanguard Balanced Index Fund **VBIAX**, +0.41% and many others.)

Do that, goes the argument, and we're 95% likely or better to make our portfolio last for 30 years.

It's an argument that many have taken to heart. It's become a standard rule of thumb for retirement planning.

The problem? It's based entirely on those wonderful numbers from U.S. stock markets over the past 100 years. The 4% rule assumes that your stocks (and bonds) will do as well in the future as they did for the happy investors of yesteryear.

The risk here is obvious. If we don't get those happy returns, the 4% rule can fail. And now Javier Estrada, a finance professor at the IESE Business School in Barcelona, Spain, has run the numbers.

He's looked at how the 4% rule would work if we ended up with the returns typical for the rest of the world. He looked at 120 years' worth of data for 22 different countries.

And it's not good.

The "failure rates" for a 4% strategy, he writes, "differ widely across countries (and) time."

And how. The strategy failed less than 5% of the time in the USA, meaning that 19 times out of 20 people who pursued this strategy were able to make their money last at least 30 years without having to cut back.

The failure rate of the same strategy in Italy? Er…67%.

In France and Germany it was more than 50%. In Japan, about 36%.

Even in Great Britain and Switzerland the 4% rule would have failed more than 20% of the time. And using data across the world, Estrada calculates the overall failure rate for the 4% rule would have been 22%. In other words, one time in five retirees would find themselves forced to scale back their standard of living to get their money to last.

We've already seen, courtesy of AQR's Cliff Asness, how much of the recent boom in U.S. stock prices is the product of circular reasoning (the more prices rise, the more attractive they must be).

We also know that bonds with today's low yields cannot, mathematically, produce returns to match the past, when bonds had higher yields (if you know how to squeeze 5% a year out of a 1.6% bond **TMUBMUSD10Y, 1.658%**, please let us all know).

There is, alas, no simple answer. Maybe we should be optimistic about future returns. Or maybe not.

But given that nobody ever suffered in old age from having too much money, it makes more sense to err on the side of caution. That means spending less, saving more, investing better and working longer.

Hope for the best but plan for the worst, as Jack Reacher likes to say.

We want to retire in a warm-weather lakefront town with lots of cultural offerings — where should we go?

Brett Arends

Brett Arends is an award-winning financial writer with many years experience writing about markets, economics and personal finance. He has received an individual award from the Society of American Business Editors and Writers for his financial writing, and was part of the Boston Herald team that won two others. He has worked as an analyst at McKinsey & Co., and is a Chartered Financial Consultant. His latest book, "Storm Proof Your Money", was published by John Wiley & Co.