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HELP CLIENTS SECURE THEIR RETIREMENTS

Scot Blythe / February 13, 2013

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In the early 1990s, investors could count on two things: stocks would outperform bonds over the long run; and they could withdraw 4% a

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year from their retirement portfolios for 30 years.

Those assumptions may no longer hold. For one thing, bonds returned more than stocks over the past 30 years. And that's renewed calls to make bonds the foundation of retirement portfolios, even in the accumulation phase — a position championed by Boston University finance professor Zvi Bodie in a series of exchanges with Wharton School finance professor Jeremy Siegel, who originally proposed the stocks-for-the-run thesis.

But bonds will falter as interest rates rise. And, despite two stock market crashes, there is little evidence suggesting the equity market is undervalued.

All this uncertainty challenges the 4% withdrawal rule. It might seem better to let an insurance company bear the risk, through annuities providing a certain income for retirees.

But with interest rates at rock bottom, insurers are unable to provide usable products — certainly not without hiking their fees to compensate for bearing the investment risk. And even with guaranteed income, retirement expenses may not behave as expected.

For those already retired, that's not a big deal, says Cathie Hurlburt, a financial planner with Assante Financial Management in Vancouver. They grew up in the Great Depression and most keep enough slack in their portfolios to compensate for contingencies.

For the next generation, it could be crunch time. Many have debts or spending patterns their parents would have considered imprudent. But they do have wealth. Unfortunately, argues Hurlburt, they confuse capital with income and so dive into tomorrow's nest egg to fund today's new car or kitchen.

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RETIREMENT ISN'T JUST A NUMBER

The 4% rule, originally suggested by American financial planner William Bengen in the Journal of Financial Planning in 1994, seems to have bested the passage of time. He based it on the historical performance of a portfolio split equally between U.S. large caps and Treasuries. But can retirement really boil down to a number?

Unlikely. Rates of return are not the only variables. To maintain a constant real spending rate, inflation has to be added to an initial 4% withdrawal rate. So the worst-affected retirees aren't those who lived through the Depression.

Instead, it's those who lived through post-war prosperity and retired close to a stock market peak in 1969. Their retirements coincided with sharp inflationary ramp-ups that forced them to move the 4% withdrawal rate to 12% to maintain their lifestyle (that's 4% plus 8% inflation).

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In inflationary times, then, retirees have been forced to spend more. That required liquidating capital, since stock market returns were flat from 1966 to 1982, and real-return bonds did not yet exist. Or, they could have adopted simpler lifestyles, and substituted lower-priced goods for higher-priced ones.

There were three occasions in the 1960s and 1970s when the 4% rule failed, noted John Ameriks, who leads Vanguard's Investment Counselling and Research group, in a 2010 blog post. To be sure, the great bull market may have helped replenish their portfolios, but the damage was already done.

And what about those who retired in 2000? Equity markets have since collapsed twice, but inflation is low. Bengen, in a recent article, says these retirees have a good chance to make it to 2030.

For people retiring now, there's a chance the rule won't hold. Much depends on the year of retirement, as well as changing patterns of spending. That's why some planners shy away from standard planning software to make projections. A 30-year horizon has worked so far. But much depends on how markets perform.

And then there's just the unpredictable rhythms of life. Before financial planners can make a decision

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about the reliability of future income projections, they have to take into account the unexpected. It can come on either side of the balance sheet. For example, there may be a sudden medical emergency.

Moshe Milevsky, a finance professor at York University's Schulich School of Business, says, "Most of this by definition is unmodellable. All we can really do is have contingencies in place. But if a huge disaster hits, their reserves aren't going to be enough."

In other words, there is no absolute margin of safety, barring insurance. Here, Milevsky argues, people may have to draw on their social capital and turn to friends and family to make up shortfalls.

On the other side of the balance sheet, Hurlburt is reluctant to count home equity — people promise to downsize, but don't, and if they do, their new abode, although smaller in size, costs as much as their former one did.

"If there's a trust fund where they're just waiting for the step-mother to die, I will probably give her a very long life expectancy and do my best to conservatively plan for income to come later than it might come otherwise."

William Sharpe, who won the Nobel Prize for Economics, suggests the 4% withdrawal rate may be too low. In a 2010 paper, he wrote, "If a retiree adopts a 4% rule, he will waste money by purchasing surpluses, will overpay for his spending distribution, and may be saddled with an inferior spending plan." He posits retiree spending should be constant and non-volatile, and any attempts to finance such a plan with risky investments, such as stocks, is a bad idea.

IT'S ABOUT SAVING, NOT SPENDING

Wade Pfau, who teaches economics at the National Graduate Institute for Policy Studies in Tokyo, says it's not what you can safely spend in retirement, it's how much you save beforehand. He began looking at savings rates because the 4% rule didn't seem universal over history and geographies.

Pfau says the 4% withdrawal has worked out for Canada and the U.S. so far, but it fails in many other countries. Among them are Germany, Italy, Japan, as well as Belgium and France.

So he proposes determining safe savings rates rather than safe withdrawal rates. Pfau bases his savings projections on a portfolio, split half between bonds and stocks, and intended to replace 50% of pre-retirement income. That portfolio, like Bengen's, is meant for a 30-year retirement drawdown.

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Protecting the portfolio against extreme market events may require higher savings rates than many clients expect — in some cases as high as 30% annually.

Pfau also questions whether stock returns will repeat. Price/earnings ratios are currently elevated compared to historical averages, suggesting lower future returns to equities. Similarly, bond yields are at historic lows, which implies that the total return on a traditional 60/40 portfolio will be much less than it has been.

"With these assumptions, failure rates for the 4% rule are quite shocking," he says. "With 50% stocks, the 4% rule can be expected to fail 47% of the time. Retirees are pushed toward 100% stocks to minimize failure, and even that failure rate is 39%."

SO IS IT WORTHWHILE FOR ADVISORS TO USE THE 4%?

It provides a baseline, suggests Scott Plaskett, CEO of IRONSHIELD Financial Planning in Toronto. But there's also a flaw, which consists in the treatment of spending from open accounts versus registered accounts, he explains. There are different tax consequences.

"What I'm seeing is that people who, for the first 10 years in retirement [...] are living on their non-registered capital." That's a problem, because the 4% rule originally used tax-deferred accounts.

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Kathy Clough, a portfolio manager at PWL Capital in Toronto, remains cynical about formulaic solutions: what a client can spend has to be monitored annually. Citing Pfau, she says, "The range of withdrawal rates that's based on this study goes anything from 0.5% in Japan to 4.4% in Canada. I'm skeptical of it. There are too many variables in the whole discussion."

For her part, Hurlburt says, "A long time ago when the Canadian Association of Financial Planners existed, we had planning guidelines. You couldn't do planning with a greater than 4% real return. So if inflation was at 2%, then you could tap your rate of return out at 6%. But if you were using a 2% inflation rate and a 10% rate of return for clients, we would fail your plan."

Some pension plans should have been failed on that basis, such as GM's. Instead, they were bailed out.

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But retail clients can’t depend on government bailouts. And it could well be that they have a comfortable retirement with the 4% solution. But they won’t get there without advice.

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