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Despite Decades of “Interesting Times” Portfolio Withdrawal Rates Have Remained Steady

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“May you live in interesting times,” is a quote that is believed to have originated as a Chinese wish or curse. While 2020 has been an interesting year, it’s not the only year that’s been full of “interesting times.” The past twenty years have had many setbacks. When you reflect on the past two decades you can understand why this Chinese quote can be thought of as a curse rather than a wish.

We rang in the new millennium with the tech bubble burst and recession, and then entered the second decade with the ramifications of the housing bubble pop that led to the great financial crisis/recession of 2008. And we all know how the third decade has started. If this pattern continues to repeat, we might want to skip 2030.

Not surprisingly, these three major events coincided with painful bear markets. Each bear market was unique in time and depth, being as short as 30 days to as long as 30 months with losses ranging from 34% to 56%. The pandemic crash has the distinction of being the shortest and shallowest of the three, even though it felt worse because a 34% drop in 30 days can cause you to think that things have never been this bad.

Being the end of the year and what appears to be the beginning of a triumph over Coronavirus, it seems like a good time to consider long term financial planning and specifically withdrawal rates from investments and how economic conditions might affect them. About thirty years ago, an accomplished financial planner by the name of William Bengen did some yeoman’s work and developed what is now known as the 4% rule. The concept is if you spend no more than 4% of your portfolio’s initial balance, then it should last you for the remainder of your lifetime while allowing you to enhance your draws to account for inflation. This is the bottom line when it comes to investing; how to maximize a lifestyle without depleting assets to $0. Leaving a residual estate to the next generation or some charitable preferences are not priorities under the 4% principle.

There was no time that the allowable draw rate dropped below 4.5% if you retired in between 1926–1990. The news gets even better: The average draw rate for each thirty-year period turned out to be 7%.

In the bleakest days of a crash you can begin to question everything you’ve accepted as investing gospel that preaches having a financial strategy that includes owning a diversified portfolio with a risk allocation that fits your investor profile. Even though you may have held your portfolio draw rate down to a reasonable figure, when you’re drawing funds from your investments at the same time the market is dropping fast, you might begin to worry that the sustainability of your portfolio is not going to stand the test of time.

Here’s some good news that will alleviate some of the doubts that stressful markets can create: The work on the 4% rule did not end 30 years ago, it goes on today and Mr. Bengen is still actively testing and updating his research. Additionally, the 4% draw rate might be best named the 4.5% draw rate, because based on Mr. Bengen’s work there was no time that the allowable draw rate dropped below 4.5% if you retired in between 1926 – 1990. The news gets even better: The average draw rate for each thirty-year period turned out to be 7%. Think about that for a minute.

The previous description of the past 20 years highlighted some tough spots, but 1926-1990 included “interesting times” such as the Great Depression, WWII, a presidential resignation, the Mideast oil crisis and late 70s hyper-inflation, just to name a few. If portfolios were able to sustain draw rates in excess of 4.5% during those years, we should stand a good chance for the next 65 years.

It might be best to leave well enough alone and end the topic here, but to keep people from thinking that there is financial planning heterodoxy being

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A Diversified Portfolio is Critical to Success

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promoted in this newsletter by simply encouraging people to spend more, we'll address investment allocations, inflation, market valuations and life expectancy. These all have their roles to play in a successful financial plan.

You can't impose a withdrawal rate on your portfolio and expect it to achieve sustainability if your investments are too conservative or poorly structured. A diversified portfolio is critical to achieving success because it helps to smooth your returns in markets that deliver anything but consistent performance. Comprehensive diversification is closely linked to using enough stock exposure to drive investment returns.
The 4.5% rule was based on the assumption that 50% in stocks is employed and that level of risk is fixed for 30 years. Changing investment strategy creates a risk for failure and it is regrettably not an uncommon occurrence.

In Bengen's most recent work, he cites inflation as a major variable that has meaningful implications for affordable withdrawal rates. If inflation runs high, you are faced with the choice of either increasing your draws or making do with less. Making matters more challenging are environments when we have high inflation and high stock valuations. High valuations for stocks means they are expensive and that causes their future return expectations to be lower. You can make a reasonable case that lower stock returns and higher inflation is what we might face over the next 30-year period. Stocks are considered very expensive compared to historical averages and central banks have been frantically printing money to push inflation higher. However, stocks have been considered expensive for most of the past 25 years and the S&P 500 has delivered above average returns.

Thanks to modern medicine, life expectancies have steadily increased. But long life expectancy can cause a financial plan's success rate to drop, unless you remain vigilant about your spend rate. Or, put another way, it's not too bad to "live in interesting times," but things might be easier if you don't experience too many of them.

Market Snapshot:

CAPE Ratio Used to Predict Withdrawal Rates Warns About Overspending

By: Michael Alexenko, CFA

CAPE stands for cyclically adjusted price to earnings ratio, and was developed by Professor Robert Schiller. The CAPE is the valuation method used to project future portfolio withdrawal rates in the studies done by William Bengen and others in the financial planning profession. What does the current CAPE tell us about future portfolio withdrawal rates? The short answer is that the current CAPE is too high and this would predict that those now entering retirement may need to stay closer to the lower end of withdrawal rates levels as opposed to the higher average experienced from 1926-1990. In the shorter term, we have a global economy that is emerging from recession, we have a government determined to spend, a Federal Reserve committed to money printing and companies showing accelerating profit growth. These are all positive short term indicators for market performance. Also, because of the abnormal drop in corporate profits and extraordinarily low interest rates the CAPE possibly is distorted by the unusual conditions, which may mitigate some of the restrictions that a high CAPE has meant historically. Alternatively the CAPE is likely not the best measure of what happens in the next twelve months, but better suited for what happens in twelve years and beyond. If this is true then some of the policies being pursued today might be laying the groundwork for some future "interesting times."