Retirement Readiness Report

Helping older employees get ready to retire successfully

A free report for employers, unions, and pension funds, produced by RetirementWORKS®, Inc.

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Welcome to the fortieth issue of the *Retirement Readiness Report,* offered as a free resource, to help you think about how your organization supports the transition into retirement.

We encourage you to contact us at any time if you have ideas, criticisms, or other comments about this publication, or wish to update your email address (or be added to or removed from the list).

If you missed issues #1 thru #39:

They're available at: http://www.retirementworks2.com/support.asp?id=newsletter

Next:

Family relationships and family finances in retirement

Retirement and the 4% rule

One of the most common canards in the retirement planning game is ñThe 4% Rule.ò According to this handy rule of thumb, retiring employees can pretty safely withdraw 4% of the balance in their retirement savings the first year, and then increase that amount each year by the current inflation rate.

This rule has been around for over a decade, in some form or other, and has achieved an unusually iconic status in that amount of time ï probably because it is easy to understand, plausible enough, and based on very arcane calculations and simulations that few financial advisors really understand.

Also, itôs baloney.

Worse than that: itôs tainted baloney. It might make your retirement sick, and maybe even kill it.

We would even go so far as to say that anyone who presents the 4% Rule as actual advice cannot be trusted. Thatôs *our* 4% rule, and in this issue of the *Retirement Readiness Report*, we explain why.

First, where did this rule come from? Why did people start taking it seriously in the first place?

The rule originated in the innocent desire to answer a simple question: when you retire with a pot of money, how much is it safe to withdraw every year?

The old answer to that question was even simpler than the 4% rule: live off the income from your savings and investments, but never touch the principal. Usually this was coupled with the idea of investing very conservatively. Under these guidelines, you donôt have to worry how long you live, because the money will never run out.

There were some problems, though.

Many (today, probably most) investment specialists feel that it is inappropriate to be conservative in retirement. Partly this is just professional bias, but there is also some honest (if confused) thinking about how today's longer lifespans might justify more aggressive financial strategies. Also, there has been some sentiment that dying with one's principal intact is kind of pointless, and even hurtful: why live below your means, just to leave a big pile of money to someone else who might not need it nearly as much as you do?

So they created mathematically clever models to show, under thousands of randomized scenarios, how you could spend more money and still have very little chance of running out before you die. (Usually that means about a 5% chance, by the way — which is a larger risk than a lot of people are comfortable with.)

This mostly sounds reasonable, though. So what's the problem? Actually there are two of them.

First, and most obviously, most retired people will not require the same amount of money every year for the rest of their lives. Some years they will have extra expenses and need more, while other years they may have some extra income and need less from their savings.

More significantly, most people's needs change over time in permanent ways. Someone in the household dies, there's a move to another residence, health deteriorates, maybe a child or grandchild moves in, they decide to change their lifestyle in some serious way — there are dozens of reasons financial needs can change over time, temporarily or permanently

"Watch out for people suggesting more aggressive investments and 4% withdrawals. Either they don't really understand how retirement finances work, or they don't want to bother giving retiring employees the kind of analysis and advice they truly need."

So the most fundamental problem with the 4% Rule is that it answers a nonsensical question: what kind of steady withdrawal is sustainable? Our point is: who cares? It's not going to happen that way!

But even if it were, the 4% Rule is built on such a weak foundation that it probably should be the 1% or 2% Rule.

The 4% figure was actually something of a compromise. Different organizations and individuals did their own calculations of what you could do with a moderately ambitious portfolio, and came up with values ranging from about 3% to 5% annual withdrawals, or even more, depending on how they set up their analytical models. The average was about 4%, so that's the number most professionals settled on.

But in the last year or two, the assumptions that went into these models have been analyzed more deeply and found wanting.

One study noted the assumption in all of these models that there would never be any extraordinary expenses, and put forth a revised analysis to take this error into account. It found that 4% was too risky, and something around 3% would be safer.

A different study questioned the assumption in all the previous models that the level of risk and reward in the U.S. stock market over the past 80 years or so is really typical, and can be expected to recur over the next few decades. This study looked at investment results in other countries, and found that U.S. experience in fact was outside the norm. If more truly typical data is taken into account, once again the 4% rule is found wanting, and 3% is closer to the truth.

So these two studies came to similar conclusions in different ways, but they took into account very different and unrelated defects. So if you take *both* into account, it should be something more like a "2% Rule".

A third recent study, which was published just last autumn, came out with about a 2.5% withdrawal rate – but again, without fully taking into account the defects presented in the other two studies just referred to. So even 2% is probably still not a safe withdrawal rate, and the true rate is somewhere between 1% and 2%.

But if that's all you're withdrawing, why not go back to investing conservatively and living off the interest? You can afford just as much spending, and still keep your nest egg intact.

Of course, this still leaves the question, though, of why you'd want to die with your funds intact. The best reason is that the principal can be used if you need long-term assisted living and/or nursing home care before you die. Nursing home care typically costs about $73,000 a year even for a semi-private room, according to the brand new study from Genworth Financial. A few years of that will put a big dent in most retirement accounts, or even wipe them out entirely. Having your principal intact when you get to that point can make all the difference.

So watch out for people suggesting more aggressive investments and 4% withdrawals. Either they don't really understand how retirement finances work, or they just don't want to bother giving retiring employees the kind of analysis and advice they truly need.

Recommended Reading for Employees Getting Ready to Retire

Moving Forward on Your Own – A Financial Guidebook for Widows, by Kathleen M. Rehl

$19.95, Rehl Financial Advisors, 2010 (available from Amazon).

Notice: We do not sell books, or have any financial stake in recommending them.

Kathleen Rehl is both a widow and a Certified Financial Planner, so she is well qualified to provide advice to the fairly substantial number of older employees who become widowed in the latter years of their career, or the early years of their retirement.

In addition, most of the financial advice in this book, and much of the non-financial advice, also makes sense for people who become divorced or separated in their older years, because: (1) the event is often unexpected; (2) more commonly for women than men, they are left without much detailed knowledge of their own household's finances, and (3) they, too, are going through a grieving process comparable to that of widows.

Rehlõs book is, in fact, targeted mainly to women. Wisely, she starts out discussing emotions and grief. It truly is necessary to get past the initial shock, and to continue to deal constructively with the loss, if one is to take hold of oneõs new financial responsibilities and make choices that wonõt lead to future regrets.

As she narrows in on financial issues, Rehl also addresses other deep concerns. Yes, she provides a very helpful list of specific steps that widows need to take to bring their lives and finances into order. But she also helps them address their financial feelings, their life values, their own past history with money, and their consequent ñmoney style.ò

From there, she launches into a series of more specific topics, many of them with stories and many of them with worksheets.

In the end, this book is both inspirational and practical, soothing and motivating, a source of contemplation and a spur to action.

Keep it in mind for employees and retirees who might be in need of this kind of support.

Featured Website

For New Widows and Widowers

www.RetirementWorks2.com/pdfs/For_New_Widows_and_Widowers-ALL.pdf

If an entire book like Kathleen Rehlõs is too much for the widows and widowers in your organization, this shorter document is probably the next best thing.

In the space of only four pages, it covers the most essential points ï dealing with the emotional and personal issues, itemizing the most urgent practical steps that need to be taken, then listing the less urgent items to be taken care of a little further down the road.

Helpfully, it also discusses some of the things that new widows and widowers should *not* do, such as making impulsive major changes in their lives very soon after their spouse or partnerõs death, or succumbing to scam artists who might target them.

This paper also provides a link to our Retirement Readiness page on Intimate Relationships., which includes a section on becoming a widow or widower. That page links to additional web pages and books that can be of help.

Although there is no substitute for oneõs own personal integrity and grounding, or for the loving support of other relatives and friends, there are, regrettably, many problems that have to be taken care of, some of them very quickly, when oneõs life partner is suddenly no longer there.