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Beware the 4% Rule

By Steven Lewis

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I was listening to the radio after a long day at the office when I heard a question posed to a very popular financial radio personality: "Is a 6% annual withdrawal rate too high for me to consider taking out of my portfolio to supplement my retirement income?" The radio host replied, "No, not at all. If you maintain a good amount of growth stock mutual funds, which have averaged over 10% a year, you will be fine." Unbelievable! I would be horrified to find any financial consultant worth their salt agree with the above statement – in fact, the Wall Street Journal made a good case for not relying on the very common 4% 'rule.'

Unfortunately, advice like this is all too common for well-intentioned investors seeking guidance from all kinds of so-called "reliable" sources. The problem out there today is that the mainstream answers being levied into the consciousness of many investors are just not accurate, and the answer to the caller's question above is just plain ignorant. If history is our guide, there has never been one mutual fund that has ever averaged 10% in any sample that carries a 10+ year time horizon. Investments do not move in a total return fashion nor an annual fashion; rather, they move in a daily annualized fashion. Secondly, money in the market does not move linearly in all circumstances, right? Losses in a portfolio are a dollar for dollar linear reduction of your account's value. Consequently, money does not move up in the same manner. Allow me to be a nerd for just a moment and state the correct mathematical terms involving the movement of money: Losses are linear, and growth is **logarithmic.**

For example: Let's imagine an individual invests $100,000 of his IRA into several stocks and mutual funds. At the end of the first month, he notices that he has lost 30%, which brought his portfolio down to $70,000 ($100,000 x .30 = $30,000; $100,000 - $30,000 = $70,000). The market turns around the next month and returns 30% back to the investor. Has the investor gotten back to $100,000? No! The investor's new balance is a mere $91,000 ($70,000 x .30 = $21,000; $70,000 + $21,000 = $91,000). The truth is that the investor needs to attain an additional 9.89% to get back to his original $100,000 investment.

Let's go back to the caller from the radio and assume they follow the radio personality's advice. Let's also assume the above example involving a 30% market depreciation of his portfolio. And lastly, let's assume the caller withdrew his annual 6%. His linear losses would be 36% (not including any mutual fund or management expenses and/or commissions charged against the account). The result would mean the caller would need a gain of 56.25% to get back to $100,000. Ouch!

I will go on the record and state that the radio personality who offered that opinion to the caller was ill-informed.

The question is, is it possible to withdraw regularly from a portfolio to allow more income for retirement or otherwise? Sure! But one must be realistic about the amount of the desired withdrawal. Secondly, one must realize that it comes with some caveats or requirements:

1. Abandon the notion that a buy and hold investment strategy is the only way to go. It is not. If there is one reality a buy and hold investment strategy may provide, it is that you can expect a portion of your portfolio to be ineffective every year.
2. Seek literal active management strategies. Also, seek sectors that are outperforming their relative indices, such as the S&P 500 (i.e., the health care sector has within it many industries, like pharmaceuticals, managed health, health care devices, etc.).
3. Understand that cash is a viable asset class. It is a great place to retain a portion of your portfolio during volatile times.
4. Consider replacing any mutual funds with exchange-traded funds (ETFs). With these funds, there are no share classes and front or rear loads. Also, they are remarkably inexpensive.
5. Apply a stop price (a pre-determined selling price) to any and all equities (stocks, closed-end funds, and ETFs) to reduce your market risk.
6. Read the fine print when provided with any kind of performance chart. Do not rely solely on online charts, such as YahooFinance.com.
7. If seeking a financial consultant, understand their differences and limitations. Ask the tough questions and request examples of trades being made on their clients' behalfs. How did they manage difficult and volatile years like 2008 and 2018?

It is imperative for you to understand that not all financial consultants are created equal. This includes, but is not limited to, radio personalities who pose themselves as consultants. Consequently, broad-based generalizations made by someone across the desk from you or on the radio need to be taken with a grain of salt. If investment management is something you are seeking, do your due diligence and interview financial professionals thoroughly. Remember: It is your money you are considering to entrust with that consultant.

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