Retirement Spending: How Much Can You Afford?

By Cooper J. Howard Rob Williams - December 8, 2014

Key Points

- How much can you spend each year in retirement?
- One guideline is the 4% rule—where you withdraw 4% of your portfolio in the first year of retirement. Then, take out that first-year dollar amount plus enough to account for inflation each subsequent year.
- The 4% rule is a simple rule of thumb—but likely needs adjustment to fit current market conditions and your situation.
- To determine retirement spending that you're comfortable with, consider your time horizon, asset allocation, and confidence level—then stay flexible.

You've worked hard to save for retirement. Now you're ready to turn your savings into a paycheck. But how much of your retirement spending will come from your portfolio? If you spend too much, you may need to reduce your spending or be left with a shortfall later in retirement. But if you spend too little, you may not enjoy the retirement you envisioned.

One widely known and frequently used "rule of thumb" for retirement spending is known as the "4% rule." It's a reasonable place to start. But we think that you should take a more sophisticated and personalized approach when thinking about your baseline spending in retirement.

Begin with the 4% rule

The 4% rule was first proposed in 1994 as a "safe withdrawal rate" from a retirement portfolio. It works like this:

- Withdraw 4% of your portfolio in the first year of retirement.
- Then, take out that first-year dollar amount plus enough to account for inflation each subsequent year.

If you follow this same plan for 30 years, there's a very high chance you won't outlive your money. This sounds great, and it's a good place to start. But it may not fit your situation.

What you should know about the 4% rule

There are a few caveats about the 4% rule you should be aware of:

- **It applies to a specific portfolio composition.** The rule applies to a portfolio that's 50% stocks and 50% bonds. Your portfolio composition may differ significantly. We generally suggest that you reduce your exposure to stocks as you transition through retirement. So, if you're in the later stages of retirement, you may not have a 50/50 mix of stocks and bonds.

- **It includes a very high level of confidence that your portfolio will last for a 30-year period.** The rule uses a very high confidence level (effectively 100%) that the portfolio will last for a 30-year time period. In other words, it assumes that in nearly every scenario the hypothetical portfolio would not end with a negative balance. This may sound great in theory but it means that you have to spend less in retirement to achieve that level of safety. You may be comfortable with a lower level of confidence, say a nine out of ten (or 90%) chance of never ending with a negative balance in retirement. This would increase the amount you could spend per year.

- **It assumes a 30-year retirement.** Depending on your age, a 30-year time horizon may not be possible. The remaining life expectancy, on average, for a 65-year-old male in the U.S. today is just over 17 years, and just under 20 for a 65-year-old female. For a couple both aged 65, on average at least one member of the couple will enjoy a 25-year retirement, to nearly age 90, according to estimates from the Social Security Administration. If you are already retired or older than 65, your planning time horizon may be different. The 4% rule, in other words, won't apply.

- **It doesn't need to be a rigid rule.** As you can see, the 4% rule won't apply in every situation. However you slice it, the biggest mistake you can make with the 4% rule is thinking it's a rigid rule that you have to follow to the letter. It's a place to start, mostly as a guideline on how much to save for retirement. After that, you need a personalized plan, based on your situation, investments, and risk tolerance.

Retirement spending is a moving target, and very few people will—or need to—apply a single spending rate through their whole retirement.

Ask yourself these three questions to help determine your personalized spending rate

Instead of following a one-size-fits-all guideline, here are a few questions to address so that you can settle on a more personalized spending rate.

- **How long do you want to plan for?** Obviously you don't know exactly how long you'll live, and it's not a question that many people want to ponder too deeply. But to get a general idea, you should consider carefully your health and life expectancy, using data from the Social Security agency or your family history.

- **How will you invest your portfolio?** People invest in stocks for future growth, and to support spending needs later in retirement. Cash and bonds, on the other hand, can provide stability and be used to support current spending needs. Each asset class serves its own role, so a good mix of all three—stocks, bonds, and cash—is important.

- **How confident do you want to be that your money will last?** Think of a confidence level as the percentage of times where the hypothetical portfolio did not run out of money, based on a variety of assumptions regarding future market performance. For example, a 90% confidence level means that, after running 1,000 simulations using different returns for stocks and bonds, 900 of the hypothetical portfolios were left with money at the end of the designated time period—anywhere from zero dollars to *more* than the portfolio started with. We think a 75% to 90% confidence level is acceptable and sets a more comfortable spending limit for more people. But weigh the pros of spending more against the cons of ending with a zero portfolio balance. And stay flexible if conditions change.

Putting it all together

Once you've considered your time horizon, how your portfolio is invested, and how confident you want to be that you won't run out of money, you have a few options.

We suggest discussing a comprehensive retirement plan with an advisor, who can help you tailor your personalized withdrawal rate. Then update that plan regularly.

To give you a general idea before you complete a retirement plan, use the table below to get an estimate of a sustainable spending rate. Note that the table shows what you'd withdraw *this year* only. Then increase the amount by inflation each year thereafter—or re-review your spending plan based on the performance of your portfolio.

Choose a withdrawal rate based on your time horizon, allocation, and confidence level

	Asset Allocation			
	Conservative	**Moderately Conservative**	**Moderate**	**Moderately Aggressive**
90% Confidence Level				
30 years	4.1%	4.2%	4.2%	3.9%
20 years	5.6%	5.7%	5.5%	5.2%
10 years	10.3%	10.3%	9.8%	9.4%
75% Confidence Level				
30 years	4.3%	4.7%	4.8%	4.8%
20 years	5.9%	6.2%	6.2%	6.2%
10 years	10.7%	10.9%	10.8%	10.7%
50% Confidence Level				
30 years	4.6%	5.3%	5.7%	6.0%
20 years	6.2%	6.8%	7.2%	7.5%
10 years	11.1%	11.6%	12.0%	12.1%

Source: Schwab Center for Financial Research, using Charles Schwab Investment Advisory's (CSIA) 2014 20-year long-term return estimates and volatility for large-cap stocks, mid/small-cap stocks, international stocks, bonds and cash investments. CSIA updates their return estimates annually, and withdrawal rates are updated accordingly. See the disclosures below for a summary of the Conservative, Moderately Conservative, Moderate, and Moderately Aggressive asset allocations.[1] **Past performance is no guarantee of future results.**

What are Schwab's guidelines for sustainable retirement spending?

We assume that investors want the highest reasonable spending rate with a 75% to 90% confidence level. If that's the case, look at the recommended allocations and initial withdrawal rates—boiled down from the table above—below.

Schwab's recommended allocations and withdrawal rate

Planning time horizon	Asset allocation	Initial withdrawal rate (for a 75% to 90% confidence level)
30 years	Moderate (60% stocks/40% bonds and cash investments)	4.2% - 4.8%
20 years	Moderately conservative (40% stocks/60% bonds and cash investments)	5.7% - 6.2%
10 years	Conservative (20% stocks/80% bonds and cash investments)	10.3% - 10.7%

Source: Schwab Center for Financial Research. Initial withdrawal rates are based on scenario analysis using CSIA's 2014 20-year long-term return estimates. They are updated annually, based on interest rates and other factors, and withdrawal rates are updated accordingly.[1]

Here are some additional items to keep in mind:

- If you are regularly spending close to or above the rate indicated by the 50% confidence level (as shown in the first table), we suggest spending less.
- Review and update your allocations and withdrawal rates annually.
- Rather than just interest and dividends, a balanced portfolio should also generate capital gains.
- We suggest that most investors allocate enough to cash investments and short-term bonds or bond funds to support two to four years of withdrawals. This approach—often called “bucketing”— provides a cushion to support spending and help weather market downturns.

Stay flexible – nothing ever goes exactly as planned

Our analysis—as well as the original 4% rule—assumes that you increase your spending amount by the rate of inflation each year regardless of market performance. However, life isn't so predictable. If the market does poorly, you may not be comfortable increasing your spending at all. If the market does well, you may be more inclined to spend on some "nice to haves." And let's not forget major medical issues or family events that could derail your original spending plan.

The takeaway

The transition from saving to spending from your portfolio can be difficult. There will never be a single "right" answer to how much you can spend from your portfolio in retirement. What's important is to have a plan and a general guideline for spending—and then adjust as necessary. The goal, after all, isn't to worry about complicated calculations about spending. It's to enjoy your retirement.

I hope this enhanced your understanding of a sustainable spending rate for retirement. I welcome your feedback—clicking on the thumbs up or thumbs down icons at the bottom of the page will allow you to contribute your thoughts. (If you are logged into Schwab.com, you can include comments in the Editor's Feedback box.)

[1] The tables show sustainable initial withdrawal rates calculated by simulating 2,500 random scenarios using different confidence levels (i.e. probability of success), time horizon, and asset allocation. “Confidence” is calculated as the percentage of times where the portfolio's ending balance was greater than $0. The initial withdrawal amount, in dollars, is then increased by a 2.5% rate of inflation annually. Returns and withdrawals are calculated before taxes and fees. For illustration only. The analysis uses Charles Schwab Investment Advisory’s (CSIA’s) 2013 portfolio-level geometric average annual returns and standard deviations, as follows:

Average annual returns and standard deviation

	Average annual returns	Standard deviation
Conservative	3.8%	5.5%
Moderately Conservative	5.0%	8.8%
Moderate	6.2%	12.1%
Moderately Aggressive	7.4%	15.5%

Asset allocations for Schwab model portfolios are as follows:

Schwab model portfolios asset allocation

	Equity	Fixed income	Cash
Conservative	20%	50%	30%
Moderately Conservative	40%	50%	10%
Moderate	60%	35%	5%
Moderately Aggressive	80%	15%	5%

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