

Does the 4% rule actually work?



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The 4-per-cent rule is a way to establish how much income retirees can safely draw from their savings. It was the brainchild of a financial adviser named William Bengen, who wrote about it in 1994.

Under the rule, one can draw 4 per cent of savings in the first year of retirement and then increase that amount in future years by the rate of inflation.

For instance, someone who has \$1-million in savings would withdraw \$40,000 in the first year and if inflation was 2.5 per cent, \$41,000 in the second year. And so on.

But does the 4-per-cent rule actually work?

To answer that question, I looked at historical 25-year periods starting with 1950-1974 (see chart). I chose 25 years because that is typically how long retirement lasts for most people.

Some live longer, of course, so it is important to have some assets remaining after 25 years; say about half of the original savings. While half may seem excessive, remember that the purchasing power would have been seriously eroded by 25 years of inflation.

For each 25-year period, I assumed the retiree invested in a 60/40 asset mix – 30 per cent in U.S. stocks, 30 per cent in Canadian stocks and 40 per cent in Canadian bonds – and earned the same annual returns as the core indexes, less one percentage point for fees. I also used the actual inflation in each 25-year period to determine how withdrawals increased from one year to the next.

The chart shows what rate of withdrawal would have been the most accurate in each period. While the 4-per-cent rule would have been best in two periods, retirees could have drawn much more in the other four periods; up to 7.5 per cent.

This suggests that 4 per cent is too conservative if it is used without any further adjustment, at least in the case of a 60/40 asset mix. Historically, higher equity weightings allowed for a higher withdrawal rate, though not without some risk.

So, what should current retirees do? Based on a 60/40 asset mix, you might start by withdrawing 4 per cent or even 5 per cent. But check with your financial adviser and/or a good retirement income calculator to recalibrate the amount of withdrawal on a regular basis.

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