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Safe withdrawal rates in retirement - an Australian perspective

Angela Ashton | PortfolioConstruction Forum | 12 March 2014

"How safe are safe withdrawal rates in retirement? An Australian Perspective" by Michael E Drew and Adam N Walk, Financial Services Institute of Australasia, March 2013

It seems that almost in response to Boyd Craig's query on PortfolioConstruction.com.au a few weeks ago, a paper has emerged that looks specifically at withdrawal rates in the Australian context.

Written by our colleague's north of border[1], Michael Drew and Adam Walk, the paper specifically considers whether the much lauded (at least overseas) 4% safe withdrawal rate rule works here in Australia.

Life all good questions, the answer turns out to be "It depends".

The 4% rule, which is primarily used in the US and has a 30-year history in US academic literature and practice, was based on, and has been revalidated repeatedly, long-term returns of US stock and bond markets. The little research that has been done on withdrawal rates outside of the US is similarly based on these long-term returns. Studies use various sources, but most international studies use the data put together by Dimson et al[2], which stretches back to 1900.

Over that period, Australian markets have done exceptionally well. In fact, the Australian share market has been the best performer of the 19 countries in Dimson et al's data series. And we don't just win by a little bit - $1 invested in 1900 in Australian equities would now be worth $2,459. In the worst performing country, Italy, that $1 would now be worth $6[3]. To provide a bit more context, in the median country (Netherlands), that $1 would now be worth $193. The US gave the third best returns over the period. In the bond market, Australia was around the middle of the pack (ninth of 19) while the US was sixth.

And therein lies the rub, as they say. These fantastic long-term performances have underpinned the ability to provide good withdrawal rates from any superannuation lump sum for long periods. Many Australian advisers have traditionally used withdrawal rates for retirees of 5% or 6% over a 20 year period. The combination of strong returns and lower life expectancy meant this generally worked.

However, even given this strong performance, a 4% withdrawal rate is not fool-proof. According to Drew and Walk, over 30 years (as opposed to 20 years), a portfolio with 50% stocks and 50% bonds/cash, a safe withdrawal rate of 4% actually led to 'failure' (running out of money) about 18% of the time. For a 75% stock portfolio, failure occurred about 5% of the time.[4]

So, issue question becomes whether we expect returns in Australia to continue to be as strong as in the past. If we don't, then we can't expect that the 4% rule will work as well in Australia in the future.

Drew and Walk conclude that the 4% rule is a good initial benchmark for use with clients – but that it does need finessing before it can be applied to any specific situation.

On a related note – and something we have identified in prior articles – here in Australia, the legislated minimum withdrawal rates from account-based pensions are generally much higher than 4%. In fact, they start at 4% for those under age 65 and move to 14% for those aged 95 and above. The Federal Government is effectively forcing superannuants to withdraw more than they should withdraw from their retirement funds. According to research from Colonial First State, most retirees would withdraw less if they could. Drew and Walk would appear to support that as most sensible.

Apparently, the Federal Government is looking at the issue. However, as Challenger's Jeremy Cooper has pointed out, the Government does not want the funds to remain in a tax advantaged setting as it creates a significant drag on the Federal Budget. It is in the government's best interests for funds to be withdrawn sooner rather than later.

So, in summary, some of the important points to take away from this local study on safe withdrawal rates include:

- For Australian retirees, the legislated minimum withdrawal rates from account-based pensions should not be used as the default spending. In fact, to do so would very likely lead to a retiree running out of money. Ideally, retirees should be saving or re-investing some of the legislated minimum withdrawal.
- Australia has had extraordinary rates of returns from growth assets over a long period. If you think this will continue, a 4% withdrawal rate in retirement will work far more often than not, even over 30 years. However, there is still a chance of failure and this is a matter for discussion with clients.
- None of the academic work takes into account the effect of the age pension. Nonetheless, given that the age pension is not a certainty, it may be best to not consider it, at least at the academic level.
- There is a lot of more work to be done in product and software development to ensure we can fully cater for the portfolio construction and income needs of retirees.

Read "How safe are safe withdrawal rates in retirement? An Australian Perpsective"

1. I am a Brisbane native, so I have special rights to mention this without being considered negative.

2. First compiled in the Dimson, Marsh and Stauton book called "Triumph of the Optimists"

and updated annually in the Credit Suisse Global Investment Returns Yearbook.

3. I am so glad my parents migrated from Italy!

4. It is not 100% clear in the study how this has been calculated (boot strapping, or using full data paths). This is likely to have some impact on the results and their usefulness. I have emailed the authors, but have not as yet heard back.