IFB345: Listener Q&A - How to Utilize the 4% Rule for Lasting Wealth

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we have episode 345. Today we're going to answer some great listener questions we got. So with that, before I dive in, if you have any burning question you want to ask us, you can send it to newsletter@investingforbeginners.com you can also send them to us via Spotify on their podcast app. You can also go to Twitter at IFB Underscore podcast and send us questions there as well. And we'll go ahead and answer those for you on the air. So with that, let's go ahead and dive into the first question. So we got hi, guys.

Dave [00:00:37]:

I have listened to your podcast from episode one, and today I was listening to episode 338. It has been a great companion for me, and I have learned a lot. I'm not sure if you've been asked this question, when you reach a big enough portfolio size to live off the 4% rule and a theory, never run out of money. How often should you plan to withdraw? Every month, every six months or a year. Also, Andrew, best of luck in your marathon experience. I've run one for years, and I recommend you read born to run by Christopher McDowell. It might help with your training. Again, thank you, guys for sharing your knowledge with the world and keep up the good work.

Dave [00:01:11]:

All the best, Enrique. Speaking of that, Andrew, would you like to tell everybody out in a few words how much fun you had training and running in your marathon and how it went?

Andrew [00:01:20]:

I guess three words. I finished.

Dave [00:01:23]:

Okay. Congratulations. That's quite the comp.

Andrew [00:01:26]:

It was brutal. I have so much respect for anybody who's ever done one, because you can train and then you get punched in the face. Somebody really smart said that, right?

Dave [00:01:40]:

Yep. I think it was Mike Tyson. Everybody has a plan until you get punched in the face.

Andrew [00:01:44]:

There you go.

Dave [00:01:46]:

Perfect. So, getting back to Enrique's question, so what are your thoughts on portfolio size? 4% rule? How much do you need to withdraw those kinds of things?

Andrew [00:01:55]:

Sure. So thanks for writing in, Enrique. Appreciate all the encouragement. The 4% rule. If somebody hasn't heard what that is before, it's basically the idea that you take your average stock market investment, and we know over the history of the stock market, the market has grown around 10% a year, above and below that average. But over a very long term, you can count on around 10%. So if youre someone in retirement and you have a mix of stocks and bonds, for example, if you have, I dont know, half of your portfolio in stocks, then instead of earning 10%, maybe youre earning 5% a year on your portfolio, that you can take that 4% of the 5% and live on that, and you still have a nest egg thats either staying the same or increasing by that extra 1% every year. And so thats where the 4% rule kind of comes from, is this idea that you have a nest egg thats sustaining itself using the gains from the stock market.

Andrew [00:03:03]:

And its not that simple. You want to talk to financial planner to figure out how do you structure that? So youre not getting whipsawed by stock market volatility, but thats the general idea behind the 4% rule.

Dave [00:03:16]:

Robert.

Andrew [00:03:17]:

So as far as when to withdraw, theres going to be a lot of different factors. Your taxes can come into play a lot of times, everybodys tax bracket can be different. And how you withdraw can also affect your tax bracket. And then if youre trying to withdraw using dividends only or if youre trying to sell some stock, that can play a factor, too. So I always try to say one of my sweet spots, I feel like, is being in the wealth accumulation phase, not so much in the wealth harvesting phase. And so if you are in that retirement part of your life and youre trying to withdraw from your portfolio, I would definitely find a professional and talk to someone who can look at your tax situation, who, who can look at your portfolio holistically and try to figure out how to give you that nest egg that sustains and do it in the right way with the right moves for your portfolio and your finances.

Dave [00:04:15]:

Yep. Great advice. And I think the particular attention to taxes and the impact on your portfolio is something that really needs to be considered, because depending on how you have your, where you have your retirement funds set up will dictate a lot of those moves, because, first of all, traditional IRA is going to require you at certain stages of your life to withdraw a certain amount from those particular accounts. And that may have a bearing on what you do with other accounts, either with a Roth IRA or just, or brokerage accounts or other retirement accounts. And so you have to kind of take all those things into consideration. And if you have a mixture of, let's say, just for example, you have a 401K that you have traditional funds in, as well as Roth funds in, those have to be treated a certain way. And if you have a brokerage account that has the same mixture, then you have to consider those as well. And then let's say you have a pension plan or some other retirement funds for maybe something crazy like a 403 b or something from earlier in your life.

Dave [00:05:21]:

Those are all considerations that have to be calculated into that, those ratios, because, again, the government, they want their cut. They've waited 50 years for you to pay taxes on that money. They want their cut. And so the traditional is going to have. They're called required minimum withdrawals, or RMD's. And they have a formula to calculate those. When I worked in the bank, they had a calculator that we would be able to fill out for customers, and that would give them, you know, a guideline of how much they had to work with. And depending on what it was, even if it was just a savings account or a CD, they still had to follow those rules for the withdrawal.

Dave [00:06:04]:

So it wasn't just brokerage accounts. So those are all things you have to keep in mind, and then your taxes have to be worked in there as well. The beauty of the Roth is you don't have to pay the taxes because you've already paid them. But the drawback to the traditional is you will have to pay taxes because you haven't paid taxes on that money yet. And so, I mean, that's kind of.

Andrew [00:06:25]:

The way you have to think about it.

Dave [00:06:26]:

And so the 4% may all come from one account, and the other accounts, you may have to figure other ways. And just because you're in retirement doesn't mean that you don't want your portfolio to continue to grow. So that could have some bearing on as well. So you may have to choose different investments that you're comfortable taking out of this one and not this one. If this one, you know, if Johnson and Johnson is part of your portfolio and they pay a dividend, and that contributes a lot to your income, you may want not want to reduce that one. Whereas maybe Amazon is in your portfolio and they don't pay a dividend, you might want to consider, you know, taking money from that particular investment. So there's a lot of different things. There's a lot of moving parts in all this.

Dave [00:07:08]:

And so it needs to be, I think the advice that Andrew gave at the beginning, before my little long diatribe here, is the talk to a professional. Have somebody help you manage this so that they can help you work through some of these moving parts to make it as best you can.

Andrew [00:07:26]:

Something I found that would probably be encouraging to people getting close to retirement. We had James Canal on our show back in 2022, and he specializes in this. He's founded this firm called Root Financial Partners. We had them on the show, and something he had mentioned was that people actually have more money than they think he gets and sits down with people, asks them whether your goals, whether you're trying to achieve with your retirement. What does the ideal retirement look like for you? And he says that a lot of people actually don't spend enough because they don't have the right plan. And so I thought that was really interesting, that your enjoyment of retirement could be actually a lot higher than you might think it is right now with your numbers, but definitely need to talk to somebody. So I don't know. I just clicked on his website because it's been a while and it's funny.

Andrew [00:08:18]:

The first thing that pops up on his homepage, it says, three big tax mistakes every retiree makes. So there you go. Like, right? You don't want to make a tax mistake. Talk to James.

Dave [00:08:28]:

Yep, exactly. I will put a link to his website in our show notes. So if anybody has any questions or these are things that they're contemplating, you could be a good resource for them. Yeah. All right, awesome. So let's move on to the next question. So this is from Martin. And he says, I am new to the personal finance sphere and discovered my educator 403 B with core bridge, has a weighted expense charge of 1.62%.

Dave [00:08:54]:

My question is, what should I do about the outrageous, fee heavy 403 B? Stop contributing and move the month to the brokerage account? Or is there another recommendation? When I retire, I look forward to rolling the 403 B into an IRA and working part time, earning 24,000 annually. So thanks for your help. This is a great question for Martin. So what are your thoughts on this question? And you have a little experience with this education anyway?

Andrew [00:09:23]:

Very little. Can you explain, maybe the basics of 403 B and, you know, Ira just briefly for beginners?

Dave [00:09:30]:

Yeah, absolutely. So a 403 B is a retirement account that nonprofits can set up, and it's, in essence, a 401K. So it's something that a teacher, for example, can be a part of and contribute to a retirement fund. And in some cases, they can have a match. It's. It's probably rare, but you can have a match, but it offers a lot of the same benefits that you would get with a 401K. For example, you can have money contributed before taxes or after taxes. You can with a 403 B.

Dave [00:10:03]:

I think the requirements to take money out are a little looser than they are with a 401K, but those are the primary reasons for it. And an IRA is an individual retirement account. And it comes in two flavors, if you will. There's a traditional, which is money that you put in before taxes, and you pay the taxes when you retire. And then there's a Roth IRA or individual retirement account which you don't pay tax or you pay, I'm sorry, you pay taxes on now and then when you start taking withdrawals in retirement, you do not have to pay the government any money. So those are the main, there are requirement limits and those change annually. So if you're really curious about that, I would definitely Google is your friend and you'll be able to determine exactly what those amounts are. Yeah.

Andrew [00:10:46]:

So I guess, you know, the whole expense charge of 1.62% on this 403 b, what are your thoughts on that?

Dave [00:10:54]:

That's really high. That's really, really high. You talk to somebody that has their own podcast about this kind of idea and he mentioned to you that this is typical for 403 bs is to have very high charges or fees on the funds that you can invest in.

Andrew [00:11:13]:

Yeah. So I was on the teacher money show with Sean Morgan and he had me as a guest and we were talking and obviously tries to help teachers with their finances as much as he can. And he related the sad reality that a lot of 403 B people are these salesmen that will come into the cafeteria and bring you their box of donuts or whatever it is and then lock you into this super high b plan that just completely leeches off of everything youre trying to work for with your retirement. And so 1.62%, that doesnt sound like a lot if youre new to the personal finance game. But compounding that over a long period of time, that's a huge, huge expense compared to what's an index fund expense ratio.

Dave [00:12:06]:

Oh gosh. I think a high one, one that's considered high now is maybe 0.5%. That's considered high. I know Vanguard has some that are like 0.07% ranges.

Andrew [00:12:19]:

Yeah.

Dave [00:12:20]:

Ridiculously low.

Andrew [00:12:21]:

Yeah. Yeah. 1.6%. That's a lot. And it definitely adds up over the years. And so unfortunately, that's kind of the reality of that game. If that's something you're trying to avoid, I would definitely check out Seans podcast again. That's the teacher money show.

Andrew [00:12:37]:

But the way that people are going to navigate their options is all going to be different. So I guess maybe going to martins question here. He mentioned his age in the question. A few other things we didn't talk about, but this idea of if you are stuck and your only option is this high expense 403 b, what does somebody do with that money? Do they take it into a brokerage account? Do they just put it in the 403 b. Are there other options? What would be your first take on that?

Dave [00:13:07]:

Robert? My first take on that was, I guess initially would be I would move it to the brokerage account because to your point, the expense charges would add up over a long period of time and it would make it harmful to my account. And I'd be air quote, leaving money on the table by utilizing that, where even though there's tax implications for putting it in a brokerage account versus a 403 B, I still feel like those fees could be outweighed by the taxes or vice versa. So I would probably choose to put it in a brokerage account. But I think, you know, again, it depends on your financial situation, your age, what kind of income you get, and what kind of tax bracket you're in. Those would be the things that would kind of leap to mind for me. So what's the right answer?

Andrew [00:13:59]:

I think first and foremost, if you can get yourself into a Roth, I would max out a Roth IRA or traditional IRA. You max that out first because that's not dependent on an employer whatsoever. Martin mentioned in his question. He already does that, so that's a moot point we're trying to read. But I just want to stress that, take full advantage of that first, because there are not outrageous fees with one of those, it's you pick the fund and you pick what fee you want to pay on those. As far as everything you were mentioning with the nuance of what's the better solution, we ran some numbers before going on there just to give you some ideas, examples. So if you're in like a 22% tax bracket, you know, in the beginning you're winning with the 403 B because you're not paying any taxes. Whereas if you're putting in a brokerage account, you're paying that 22% in taxes, right? So the 403 B wins in the beginning, but because of the fees that are getting added on year after year after year, in about 20 years, the person who just paid the taxes in the beginning and then had a higher compounding because they weren't paying those fees, that person would win.

Andrew [00:15:14]:

So that's a 20 year time horizon. But if your tax bracket's like 10%, then the person with the brokerage account wins in eight years. And then if your tax bracket's like 35%, it takes 22 years until the heavy fees of the 403 B make an effect. So like you said, it really depends on your age, how long you're going to be compounding the money and what your tax bracket situation is. But just as a general rule, the younger you are, the longer you are compounding, the worse the impact of that 1.62%. And that's kind of how I would try to think about it.

Dave [00:15:56]:

I think thats the perfect way to think about it. And the sad thing is that thats probably a normal amount. Theres probably some out there that are charging 2.5%, 3%, very similar to what a lot of mutual funds back in the day used to charge. And that was a common rate. So, to your point, if you do decide to go the brokerage account route, you can still invest in funds, you can still buy index funds, etfs, you can even buy mutual funds if you want. Just pay attention to the, as I think we've illustrated here, pay attention to the expense ratio. That can really add up really fast. And, again, it may seem like not a lot, but it will make an impact.