

HOW MUCH MONEY DO YOU NEED TO RETIRE?

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BY MARK KEEN

FOUR STEPS TO FINANCIAL SECURITY



How Much **MONEY** Do You Need to **RETIRE?**

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IT'S SAID, THE BEST TIME TO START PLANNING FOR RETIREMENT WAS 20 YEARS AGO; THE SECOND BEST TIME TO START IS TODAY. IN OTHER words, it's never too early or too late to start thinking about retirement.

Unfortunately, with all the negativity flowing out of the various media outlets, bombarding us with everything that can go wrong, and telling us how unprepared we are for retirement, many are paralyzed by the mere thought of retiring one day. In addition to negativity, there's propaganda about how complicated and difficult it is to get retirement planning right.

A word of advice as you think about retirement: Don't overcomplicate it. Focus on the big picture. Tune out the noise, and keep things simple.

To that end, I offer a simple framework for estimating how big a piggy bank you'll need to retire. With a handle on this number, you can begin formulating a savings strategy, or use it as a check point to adjust your current strategy. Who knows? You may find you're better prepared than you thought.

The process for determining how big a nest egg you'll need may be summarized in four steps:

- STEP 1:** Estimate retirement income
- STEP 2:** Estimate retirement income needs
- STEP 3:** Calculate retirement income gap
- STEP 4:** Estimate how much money you need

How Much **MONEY** Do You Need to **RETIRE?**

The amount of money you need to have saved to retire is related to how much you'll spend to support your desired lifestyle. More specifically, it's directly related to how much money you will be withdrawing from your portfolio each year, a figure I'll refer to as the income gap.

Using the income gap, you can ballpark the amount of money you'll need to have saved in order to support your desired lifestyle.

STEP 1

ESTIMATE RETIREMENT INCOME

Begin with income from guaranteed sources, such as pensions, annuities and Social Security. This is not the time to include income from investments. We'll get there in Step 4.

As a federal employee, you'll have one or more sources of retirement income. For those in the Civil Service Retirement System (CSRS), your primary guaranteed income source will be your CSRS annuity. CSRS employees also may have earned enough credits through private-sector employment to qualify for Social Security. If this is your situation, you'll need to understand the effect your CSRS employment, and the Windfall Elimination Provision (WEP), will have on any potential Social Security benefit.

If you're in the Federal Employees Retirement System (FERS), you'll have your FERS annuity and your Social Security benefit. The FERS is designed as a three-part retirement system, with the Thrift Savings Plan (TSP) accounting for the third part. However, recall that at this point we're focusing only on guaranteed income sources. The point of the four-step process is to determine how much you need to save in accounts such as the TSP.

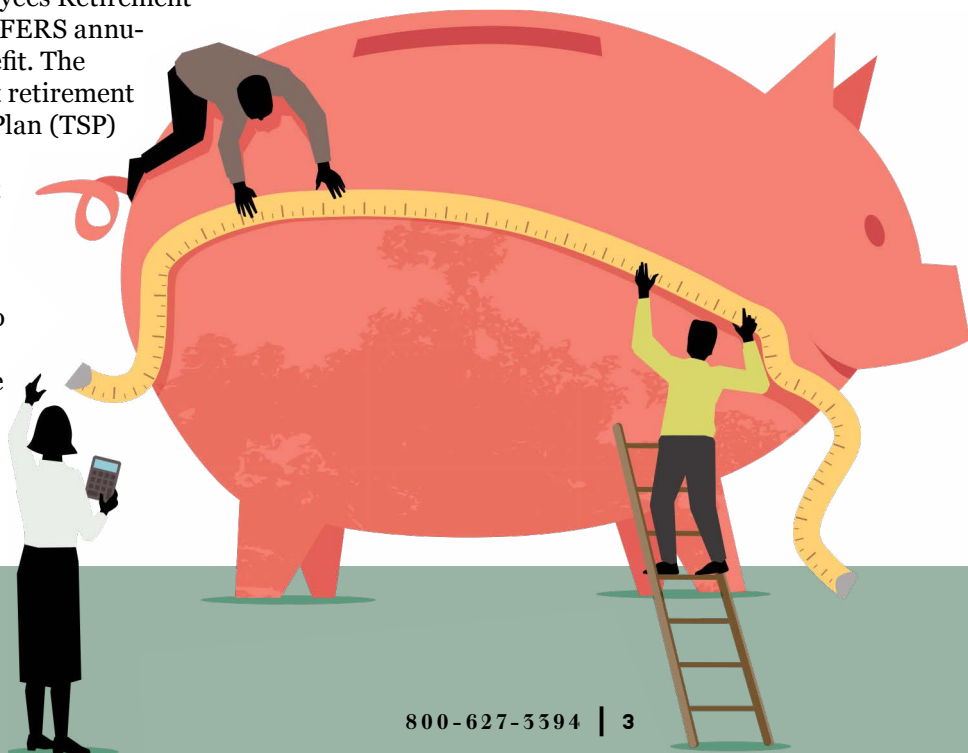
CSRS and FERS annuities are based on defined formulas, so in

most cases, you can easily come up with an accurate estimate of your federal annuity. You may create a spreadsheet and run the calculation yourself, or there are several resources and online calculators you can use as well.

To determine your Social Security benefit, you may go to the Social Security Administration (SSA) website and download your Social Security statement. Alternatively, you may use one of several calculators on the SSA website to estimate your benefits. In fact, for CSRS employees who also have earned a Social Security benefit, the SSA website has a calculator to estimate your WEP-adjusted benefit.

If you're married, be sure to account for the guaranteed income of both spouses, including any Social Security benefits a spouse is entitled to, even if he or she didn't earn a Social Security benefit of his or her own.

You'll also want to make sure to put your income sources into future dollars. The Social Security benefit reported in your Social Security statement is shown in today's dollars, but by using one of the SSA calculators, you may estimate your benefit in future dollars. If you're close to retirement, this may not be a big deal. However, if retirement is years away, you'll want to take this into consideration. Likewise, when estimating your federal annuity, you'll want to factor in wage growth (including raises



and cost-of-living adjustments) if you're years away from retirement.

STEP 2

ESTIMATE RETIREMENT SPENDING

With a handle on retirement income, it's time to work on retirement spending. If you're one of those odd breeds that actually tracks spending and works within a budget, that's a great place to start. Simply make a few adjustments for expenses that will stop or start in retirement and you're well on your way.

If you don't track your spending (like most people I work with), that's OK. There are ways to estimate what you'll spend in retirement that don't involve a dirty six-letter word (budget). Are you going to nail down spending to the dollar? No. But, will you be close enough for a 30-year projection? Absolutely. Remember, simplicity can be empowering.

For example, some may find a replacement ratio useful. A replacement ratio is the gross retirement income you will need, stated as a percentage of your gross preretirement income. The generally accepted rule of thumb is you'll need about 70 to 85 percent of your gross preretirement income in retirement to maintain your standard of living.

Replacement ratios take into consideration the fact that a retiree needs less gross income in retirement due to four factors:

- Taxes go down after retirement due to extra

deductions and lower taxable income

- Social Security and Medicare taxes end at retirement
- Social Security benefits are partially or fully tax-free
- Saving for retirement is no longer needed

Perhaps the best-known work on the subject is the "2008 Replacement Ratio Study: A Measurement Tool for Retirement Planning" by Aon Consulting in partnership with Georgia State University. This tool uses replacement ratios based on various preretirement income levels, which account for factors such as Social Security, taxes and savings rates relevant to each income level.

As with any rule of thumb, there will be factors that vary from person to person. If you understand how the replacement ratios are constructed, you may fine-tune them based on your own circumstances to produce a more accurate figure.

For example, Aon's replacement ratio for someone at the \$75,000 preretirement income level is 77 percent. When calculating this replacement ratio, Aon takes into consideration the average savings rates for someone at this income level. If this is your income level, but you save 15 percent of your pay, then your replacement ratio will be about 10 percent lower than Aon's.

Another alternative to detailed budgeting is calculating what I refer to as your total lifestyle spending (TLS). The philosophy of the TLS is if your income isn't going to employment taxes (FICA taxes, or your required contribution to the federal retirement system) or savings, then you're spending it. If you use the TLS, you'll be capturing all spending, including every dollar spent on medical insurance, housing and income taxes, even the money spent on those pesky little expenses you forgot to write down in that budget.

Again, customize the TLS as necessary. For example, if you plan on increasing your travel in retirement, add the additional expense to your TLS. Or, if your mortgage will be paid off by the time you retire, subtract your payment from your TLS.

Budgets do bring awareness, which is always a good thing. However, it's not productive to get

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sidetracked from retirement planning because you're worried about first logging where every dollar is being spent. It's more important to have a general idea of how much you're spending, rather than where every dollar is going when planning out a three-decade retirement. The TLS helps you stay on track by focusing on the big picture.

STEP 3 CALCULATE THE INCOME GAP

Armed with your retirement income and retirement spending, you're now ready to calculate the income gap. This is done by simply subtracting your retirement spending from your retirement income.

If your pension and Social Security income exceeds what it takes to fund your lifestyle, congratulations – you may now insert thumbs in ears, wiggle your fingers, and taunt all those folks who said you needed at least \$3 million to retire. Actually, if you consider the value of your pension and Social Security income, you may very well have the equivalent of at least \$3 million in the bank.

If the result is a negative number, it's not a huge concern. This simply means there's an income gap and you'll need to withdraw money from your savings to support your lifestyle. Moving on to step four, we can use the income gap to ballpark how big a nest egg you'll need to do so.

STEP 4 ESTIMATE HOW MUCH MONEY YOU NEED

How much money you need depends on how you'll be raiding the piggy bank. There's really only two approaches. The first is to manage your money and take withdrawals; the second is to transfer the risk to an insurance company and buy an annuity for lifetime income.

If the withdrawal strategy is your thing, it's important to understand how much you can

safely withdraw from your portfolio without running a high degree of risk of running out of money. You may have heard of the 4 percent rule, which was derived from the work of William Bengen, a retired financial adviser who developed this rule of thumb. Through his studies, Bengen concluded that for the typical 30-year retirement, a retiree can withdraw 4 percent from their initial balance at retirement and adjust that amount each subsequent year based on inflation.

Given today's persistent low interest rate environment, the 4 percent rule is hotly debated, but like any rule of thumb, it may serve as a useful starting point. When deciding what the appropriate withdrawal rate is for you, there are several factors to consider. For example, the 4 percent rule was conceived for a 30-year retirement, but if you're retiring in your 50s, your retirement time horizon is longer than 30 years and your safe initial withdrawal rate will be lower than 4 percent. Or, if you're retiring in your 70s, your safe initial withdrawal rate may be higher than 4 percent.

Another factor is how much of your investment withdrawals will cover discretionary and non-discretionary expenses? If they'll largely go to cover discretionary spending, you'll have the flexibility to cut back in tough times, which means it may be possible for you to start off with a higher initial withdrawal rate.

Do you expect income to increase or decrease in the future? For example, are you retiring at age 62, but delaying Social Security until age 66? If so, your withdrawals will be higher in the first four years before your Social Security kicks in. In this case, the withdrawal rate at age 66 is relevant, not the withdrawal rate at age 62.

Let's say 4 percent is right for you. To determine how much money you need in your piggy bank, you simply divide your income gap by 4 percent.

The second approach to raiding your piggy bank is buying an annuity. Although there are several choices and options when buying an annuity, the process is relatively straightforward. You may contact insurance companies or an insurance agent, and request a quote for how much money you need to invest in an annuity to

generate your required income.

When buying an annuity, there are several factors to consider: 1) whether you need a single life annuity or a joint life annuity to provide income to a surviving spouse; 2) whether you want level or increasing payments; and 3) whether you want any death benefit protection.

It's important to understand the pros and cons between the withdrawal and annuity strategies. Without a doubt, the withdrawal strategy provides the most control and flexibility. You will have the ability to withdraw more money if needed, and if everything goes well and there's money left in the bank when you die, that money will pass to your heirs.

When you purchase an annuity, you're giving up control of your money. The money is no longer available if you happen to need extra cash, and when you die, no money will pass to your heirs. It is possible to add optional benefits that may provide limited access to cash and benefits to your heirs, but adding such a benefit will reduce the initial annuity payout.

The downside to the withdrawal strategy is there is no guarantee you won't run out of money – even if you stick with a safe withdrawal rate. On the other hand, you cannot outlive the annuity income, which is its biggest benefit. Furthermore, the annuity's initial payout will generally be higher than the withdrawal strategy's initial payout.

The difference between the two strategies may be boiled down to control versus guarantees. In the end, it's never an either/or choice. The right strategy for you may be a blend of the two options. In fact, several current research studies suggest retirees may generate higher lifetime income and greater wealth by using a combination of the two strategies.

KEY CONSIDERATIONS



TAXES

At the federal level, pension income and traditional TSP withdrawals generally will be fully taxable as ordinary income. Social Security, on the other hand, is a tax-advantaged income source. Up to 85

NARFE RESOURCES

For a more detailed discussion, including examples and tools to help with this process, check out the “How Much Money Do You Need To Retire?” webinar recording, which may be found on the NARFE Federal Benefits Institute, a members-only section of www.narfe.org.


percent of Social Security benefits may be included as taxable income, but depending on your other income, it's quite possible that the percentage will be much lower.

Furthermore, many states offer significant tax breaks to retirees as well. For example, many states don't tax Social Security benefits and many states permit you to exclude a certain amount of retirement income from taxes. (See NARFE's annual state tax roundup, p. 36.)

Take the time to understand how taxes will impact you in retirement and make the appropriate adjustment to your retirement spending in Step 2. You may be surprised by the impact taxes have on how much you need to save for retirement.

RETIREMENT SPENDING TRENDS

Many of the rules of thumb related to retirement, including the 4 percent rule, are predicated on the assumption a retiree will spend more money each successive year. In reality, retirees tend to spend about 1 percent to 2 percent less on average (in real dollar terms) each year.

The four-step process offered here is a simple way to ballpark what it will take for you to be able to retire and may be helpful in setting expectations for your retirement savings. It also may be useful in helping to understand your preparedness for events, such as the need for long-term care, and whether you're in a position to self-pay for retirement or may want to consider transferring the risk to an insurance company. 

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