October 2008 – Retirement Savings

Of all the elements that go into discussions we have with clients regarding financial objectives and risk tolerance, one of the most common is:

Do I have (or will I have) enough financial assets to maintain my lifestyle when I retire?

The common questions we all have are:

- How much savings do I need?
- How much can I take out of my savings each year after I retire and not run out of money?
- How do I get from where I am today to where I need to be?
- What happens if I leave a good job and retire with what I think is enough and then the market goes down 20%? What happens to my plan?

All of these questions raise serious issues.

4% Rule

A rule of thumb is that you can generally take out about 4% a year and still have a relatively small chance of running out of money before you die. (We always thought that observation is a little strange. Is dying a better alternative than running out of money? Most of us really don't think that is true). Assuming you decide that you will follow the 4% rule, then it is fairly simple to calculate how much you need.

For example, if you believe you will need $60,000 a year in total and you expect to receive $20,000 a year in social security then you need to withdraw $40,000 from your savings. That would mean you would have to have $1 million in savings (4% of $1 million = $40,000).

Savings Vehicles

Once you determine how much you need then you can begin to appreciate how powerful and important pensions, IRA's and 401(k) plans are. Generally by being able to save on income taxes and by not paying taxes on interest, dividends, and capital gains you will be able to attain your savings goal more quickly.

Inflation

It is important to understand that any retirement plan must consider inflation. Social security is indexed for inflation so you don't need to worry about that. However, in my example if you take out $40,000 in the first year of retirement you should plan on taking out about 3% more

each year after that. Thus, in year 2 you take out 1.03 times $40,000 or $41,200. In year 3 you take out 1.03 times $41,200 or $42,436, and so on. This means that you should try to build a portfolio of investments that earns a return over time that keeps pace with inflation.

Volatility and Bad Luck

But what happens if after all of your planning, you reach the day of retirement, you retire and implement your plan and a year later the market and your assets are down 20%?

There are multiple ways you can solve or hedge against this problem. You might build a cushion to provide for bad luck and bad timing. This could mean working a little longer (postponing your retirement date) or continuing to earn some non-investment income during retirement (such as continuing to do some part-time work). You would also probably want to modify your investments so they would not be susceptible to going down 20%. To achieve this you would need to diversify and invest in other types of assets such as Treasury Inflation Protection bonds. You would also want to examine your spending habits to see whether some modifications are in order. Finally, you might review your non-income producing assets that could be converted into liquid, income-producing investments (e.g. you may want to downsize your house and convert the resulting equity into liquid investments or perhaps liquidate another non-productive real estate holding). Home downsizing can be a very efficient option since any resulting gain from the downsizing would not be subject to income tax (under current tax law).

One of the best investments you can make is in yourself. When we retire, we are protected from some inflation. Generally, our housing costs are behind us as is the cost of raising and educating children. These are two large components of inflation. However, as we age, health care costs are where we are particularly vulnerable to inflation. By promoting a healthy lifestyle and by focusing on our nutrition, exercise and regular medical check-ups we can have a significant impact on those costs. In fact, we believe that an annual medical physical is the single best investment you can make regardless of your age.

Final Note

We are not pleased with the performance of our economy and with the stock market during the past year. Nonetheless, we believe that keeping a substantial portion of your investments in equities continues to be the best way to reach your goals of having sufficient financial assets for retirement. We continue to be very grateful for the opportunity to assist you in these efforts.

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