

Sunday, June 17, 2007

THE WALL STREET JOURNAL

(Courtesy of the Fort Worth Star Telegram)

Are Your Finances Ready for Retirement?

By GLENN RUFFENACU
AND KELLY GREENE

Research shows that almost half the people who put numbers on paper—who actually take the time to estimate how much money will be coming in the door during retirement and how much will be going out—end up changing their savings plans. And yet, most of us don't make the effort.

First, there are the emotional aspects. For most of our adult lives, we've had the "right" to spend our money as we wish. Suddenly, in retirement, we have a finite amount of resources. Second, retirement has many unknowns: life expectancy, health costs and inflation, among others. How are you supposed to know what your expenses will be?

What follows are two of the most straight-forward approaches to estimate how much money you'll need in retirement and to determine whether your nest egg is sufficient. The first takes about one minute and gets you in the ballpark. The second approach takes a bit longer and gets you a seat behind home plate.

One-Minute Drill:

This method was developed by Charles J. Farrell, a tax attorney in Denver. It is based on the idea of replacement ratios. First, to calculate your annual budget, multiply your current gross income by the replacement ratio of 0.8. This means we're estimating that you will need a "salary" in retirement that amounts to 80% of your pre-retirement income. Then, to calculate the size of the nest egg needed in later life, multiply your current gross income by 12.

Let's see what this math would look like for a couple — we'll call them Andrea and Scott — who are a year or two away from retirement and are making about \$80,000 (combined) a year: Multiplying that income by 0.8 shows they will need \$64,000 a year in retirement. Multiplying \$80,000 by 12 shows they will need a nest egg of 8960,000.

It's important to note that we start with a big assumption: that the average American can, in fact, live comfortably on 80% of his or her pre-retirement income in retirement itself. While the rule of thumb has long been that most of us will need about 70% to 80% of our pre-retirement earnings once we leave work, this assumes that about 20% to 30% of our money while we're working goes to things like taxes, transportation

and savings and that all those bills will drop off in retirement. In recent years, though, some financial planners have begun arguing that we actually need 100%—or more—of our pre-retirement income in later life because, if anything, expenses increase in retirement: for travel, home improvement and health care, among other items. (As one financial planner told us, “I have yet to see a client who, the day he or she retired, started living on 30% less than the day before.”) As you might imagine, research supports both sides of the argument. The Employee Benefit Research Institute found that more than half of - current retiree (55%) had replacement ratios of 100% or more in retirement. Conversely, some of the best research on replacement ratios, done by Aon Consulting and Georgia State University, has found that the “average” retiree (making about \$60,000 a year before retirement) needs about 75% of that income after leaving the workplace.

For his part, Mr. Farrell, the Denver attorney, reasons that if individuals entering retirement have paid off their major debts, including a mortgage, and if they already were saving about 10% of each paycheck during their working years (as almost all financial advisers recommend), then 80% of pre-retirement income should suffice in later life. For the moment, let’s accept that figure and finish examining his math. So now you know what your yearly “salary” should be, but where does that money come from?

Stock/bond mix (percent)

Again, we need to make some assumptions: first, that your nest egg will earn between 4% and 5% a year in retirement (after inflation) and, second, that you can safely withdraw 5% of your savings each year. So, let’s return to our couple — Andrea and Scott — who are making \$80,000 a year before retiring. If they have managed to build a nest egg totaling \$960,000, a 5% withdrawal yields \$48,000. Add to that figure a minimum of \$16,000 that our retirees will collect each year from Social Security (that’s a rough calculation from the Social Security Administration) and — voila! — you get \$64,000, or 80% of pre-retirement income.

The numbers above, as you may have already figured out, don’t account for pensions, annuities or other sources of income. Most important, the math doesn’t account for your particular needs and expenses.

Building a Budget

In order to figure your retirement finances more precisely, let’s turn to a framework developed by a Baltimore-based mutual-fund company. While we don’t have room to get into all the details here, you take the time to tote up your expected expenses and sources of income — and then revisit both categories as needed to bring them into alignment.

Expenses

Expenses can be broken down into as many categories as you wish. Our framework has five: essentials, discretionary, special, debt and reserves. Essentials are fairly self-explanatory (housing, food, transportation), as are discretionary (travel, entertainment,

gifts). “Special” would include major purchases (like a recreational vehicle) or major investors, so clients, like Andrea and Scott’s desire to help with their grandsons’ college education. Debt includes mortgage payments, car payments and the like. And reserves (a critical but often overlooked category) include savings for future purchases, like a car, new furnace or new roof on the house.