Retirement Savings Strategies

How much money will you need to live comfortably in retirement? That's a question only you can answer, but there are some rules you can follow when finding your "number."

Setting a Savings Goal – Your "Number"

A common approach in finding the dollar amount you'll need in retirement is to estimate your income from Social Security and any pension plans, and then calculate the gap between what you'll have and what you'll need. But current events tell us Social Security is headed for insolvency, which is likely to result in a reduction of future benefits. And even if you are lucky enough to have a pension plan through an employer, there is no guarantee that it will be fully funded in the future – a lesson some city and state retirees are learning today. A more conservative approach is to assume that you will be 100% responsible for your own income in retirement. Any other funds will then be a bonus.

Your financial goal for retirement should be enough to cover your income needs for at least 30 years you stop earning an income. As you transition from work and into retirement, your savings should be producing a meaningful income from risk-free cash investments such as bank CDs or money market funds. As you progress through retirement, you will spend a combination of principal and interest, with the goal of slowly spending your savings down during your remaining years.

What would be a typical savings goal? Provided you live a modest lifestyle and have paid off your home and other major expenses before retirement, a goal of $1,000,000 or $2,000,000 is reasonable. At 5% interest, disbursed tax free from Roth 401(k) and IRA accounts, a $1,500,000 account would offer an income of $75,000 per year, excluding any income from Social Security or other sources. That's over $6,000 per month for a single person, double if you have a partner with similar savings. With major expenses paid, $6,000 per month would likely provide a comfortable income in less expensive parts of the country. If you live in an expensive metropolitan area and are not willing to move during retirement, your goal may need to be higher – $3,000,000 or more.

But here's the catch - when considering retirement investing goals, you'll also want to keep in mind that prices will have been *rising* while you were saving because of inflation. So that $1,000,000 30 years in the future may be more like $400,000 today. And that $6,000 per month will likely be more like $2,400 today.

To increase income in retirement, you can choose to withdraw some of the principal in addition to the interest. With a 30-year withdrawal window (based on a much longer than average life expectancy of 95), you could also choose to withdraw 1/360th of your principal per month – yielding an additional $2,800 (that's a little of $1,100 in today's money). Of course, the more principal that is withdrawn, the lower the interest paid. A good case can be made, however, for taking a bit more income in your early retirement years in order to take advantage of likely better health. The decision is ultimately up to you.

Please keep in mind that the savings goals mentioned here are not appropriate for every person or situation. Your needs may be less or more.

Charting Your Course

In the example above, we set an arbitrary goal of $1,000,000 to $2,000,000 saved by retirement. Now that we have a goal, the question is how to get there and what investment risks are acceptable in reaching that goal.

Your investment plan is tied directly to the amount of risk you are willing to take with your savings. At one extreme, you may want to completely avoid risk by investing in very safe investments – bank CDs, money market fund, or savings bonds. The problem with a no risk strategy is that your potential rewards are limited by the lack of risk.

Saving $2,000 per month over 40 years is simply not an option for most people, especially in their 20s and 30s, so those people seek to make higher returns by investing in stocks. For example, a person could could invest as little as $200 per month in stocks and still end up with over $1,000,000 at retirement – that's just one fifth the overall investment of the person who played it safe and a much higher return. If someone invested

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nearly $1,000 per month in stocks rather than cash savings, they could retire not with $1,000,000, but with $3,250,000, assuming the historic stock market rate of return (which is *not* a sure thing by the way).

So why would anyone ever invest in anything other than stocks? The rate of return we cite in these calculations is based on the historical average rate of return for stocks, and while the past may be a useful guide, nothing can predict the future. Some years may offer returns greater than 8.5% and other years may have a negative return. And even for those with longer-term time horizons, stocks don't always offer the best return. For example, those with an investment in a fund of the 500 largest US stocks (the S&P 500 index) in the decade between 2000 and 2010 would have actually *lost* 25% of their investment, meaning that those in the safest investments made much more money. On the other hand, the same group of stocks increased by over 400% in the decade between 1990 and 2000, far outpacing the gains of safer investments.

Putting it all Together

Because of the unpredictability of non-cash investments, experts typically recommend the practice of asset allocation – putting part of your money in safe investments and part in more risky investments. Asset allocation plans may be considered aggressive, balanced, or conservative. A person just starting their career with a lifetime of earnings ahead may choose an aggressive plan by allocating 75% or more of their total investment in stocks. A person in mid-career may choose a more balanced asset allocation by putting half of their portfolio in stocks and divide the rest between cash and bonds. A person approaching retirement with the goal of preserving capital may choose a conservative approach, with most of their portfolio invested in cash and bonds, with a small fraction in stocks.

By diversifying your investment portfolio, you are taking *appropriate* risks based on the number of years before retirement.

As you can see, reaching a financial goal for retirement is not quite as easy as simply investing $200 per month for 43 years. Your asset allocation will change over time – ideally taking advantage of the higher returns made possible by increased risk, but never endangering your financial security as you approach retirement. One major benefit to continued employment is increased earning power, so many people save more money per month as they approach retirement and in order to reduce their financial risks.

A Note on Fees

When saving for retirement, individuals often invest in "mutual funds." These are groups of stocks that may be managed by a professional or they simply track an "index" of stocks – a group of stocks based on a variety of criteria including market capitalization, industry, etc.

When choosing a fund, pay close attention to the fees they charge, including the *expense ratio* and *load percentage.* Expense ratios are annual fees that are charged regardless of whether the fund makes or loses your money – typically around 1% per year. Loads are fees charged upon deposit and possibly withdrawal.

The effects of the expense ratio are striking when you consider long-term gains. For example, assuming historically average stock market returns, someone who saved $200 per month for 43 years would have a nest egg of over $1,050,000. But what happens when you subtract an average management fee? Rather than $1,050,000, the total becomes just $721,000 – a difference of $329,000 (or 31%).

Since few professional money managers consistently beat the index averages, many experts suggest investing in low-fee index funds.

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