

Can I retire?

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You are thinking about retirement someday. If you are over 50, you are thinking about it a lot. But how do you turn those thoughts into concrete plans?

You need answers to two basic questions:

1. How much do you need annually for retirement living expenses?
2. How can you build an income stream to generate an amount that will keep up with the cost of living?

The answers to these questions are interrelated: the higher your annual needs, the more resources you will require.

Question 1 – How much annual income do you need to live?

The best place to start is with your current expenditures. If you haven't already prepared a budget, you need to analyze where your money goes and compare those expenses to your current income. Has your debt been increasing (in which case, you are probably living beyond your means!) or have your savings been growing?

When you retire, you will want to have paid off your debt, preferably all of it, including your mortgage. Otherwise, you will face two problems. One is that you will have a claim (reduction) on your assets. The second is that you will have to withdraw from your saving to pay these debts. Any money you withdraw from retirement accounts will be taxable. So you will be both decreasing your capital and raising your tax rate at the same time.

If you have enough capital, you won't need to save, unless you choose to. Studies of expenditures in retirement have generally determined that retirees need 70% to 85% of pre-retirement income to maintain their standard of living. Being free of work-related expenses and Social Security taxes, you will, however, no longer need to save for those costs, and you may be in a lower income tax bracket. On the other hand, you may face higher medical care expenses, or have plans to travel or provide gifts to your children. Despite your starting from a higher level of capital, your particular circumstances may alter the 70% to 85% number significantly. For example, your needs could change if:

- You plan to move to an area with a lower (higher) cost of living.
- Your expenses have been higher lately because of temporary expenditures (such as college tuition).
- You are planning increased expenditures in retirement.
- You plan to work at least part-time in retirement.

If you have estimated a preliminary number, you can proceed to step two, even if you come back to refine your estimate of your retirement cost of living.

Question 2 - Where does your money come from in retirement?

When you retire, by definition you will eliminate or at least reduce your dependence on employment income. How will you replace that income?

Retirement income can come from a variety of sources, such as:

- Annuities from pension plans or insurance companies
- Distributions from tax-favored retirement plans or IRAs
- Distributions from after-tax savings
- Social Security benefits



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Some of these sources may be available at different times: Social Security is available at age 62 (with reductions) or at ages 65-67 without reduction, depending on your year of birth. If you retire before 62, your benefits must be deferred and more of your income must come from other sources until Social Security funds become available.

Don't ignore inflation

You ignore increases in the cost of living at your own peril. Even at a 2% annual rate of inflation, prices would be 22% higher in 10 years, which means that your dollar would only go 82% as far as it did when you first retired. If inflation were instead 4% per year, prices would be 48% higher in 10 years, and your dollar only worth 68% as much.

The effect of inflation is significant because, among the most common sources of income in retirement, only Social Security is indexed for inflation. Some government pensions still provide cost-of-living adjustments, but that feature is becoming less common. Most retirees need to plan for increasing distributions from their retirement assets (after carving out the part that comes from Social Security) in order to keep up with inflation.

Social Security

For earners whose careers comprise 35 or more years of covered employment, Social Security provides benefits that vary with average wages. The benefits favor lower paid workers, with no additional benefits added for earnings about the maximum taxable wage base. The following simple table shows the percentage of final pay that is replaced by Social Security, for single workers retiring at the Social Security Normal Retirement Age (SSNRA):

- Low-paid (\$25,000) – 48%
- Median (\$41,000) – 40%
- Maximum (\$106,800) – 24%

To maintain previous living standards, a low paid worker will need to provide 22% to 37% of his income from non-Social Security sources, and will need to take inflation into account. The worker at the highest taxable wage bracket will need to generate 46% to 61% of pre-retirement income from other sources. Since no additional benefits are earned for compensation above the taxable wage base (\$106,800 in 2011), higher-paid earners' Social Security benefits replace even less of final earnings; at twice the wage base (\$213,600 in 2011), Social Security only replaces 12% of final earnings. Most retirement income for these individuals will need to derive from other sources.

Social Security provides additional benefits for a married couple. The benefits are reduced if they draw them before the SSNRA, which ranges from ages 66 to 67 for workers whose retirement dates are still ahead. For more information, you should review the annual statement that Social Security provides, or use one of the calculators available on Social Security's website at www.ssa.gov.

Next step – what do you need?

After carving out the expected Social Security benefit, you need to take into account any pensions or purchased annuity benefits. Because these benefits rarely include inflation protection, their real value will decline as inflation erodes the nominal payments.

Financial planners may have the tools to project your income over a variety of future scenarios. If you only see a financial planner once in your life, this is the time to do it. If you are a do-it-yourselfer, you can also find helpful calculators on the web. One place to start might be with your 401(k), 403(b) or IRA provider's website. Look for the key words "retirement calculator".



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Our goal is not to provide you with a detailed blueprint, but rather with an overview of the challenges in generating retirement income and some rough idea of what is needed. What is not provided by Social Security and pensions must come from savings, either tax-deferred or after-tax. The basic problem to address is how to make annual withdrawals without outliving your savings. There is no easy and certain solution, because the future is uncertain. Experts in the field have tested various strategies and determined that an annual withdrawal rate of 3% to 5% of your assets will afford a good chance of not outliving your retirement resources. Put another way, you would need 20-33 times your needed annual income at the start of retirement, in a balanced portfolio. Suppose you are a maximum earner, and your pre-retirement income is \$106,800 in 2011. If you calculate that you need 50% after Social Security, that amount translates into a starting nest egg of \$1,068,000 to \$1,762,000. For a median worker, who needs 35% after Social Security, the range would be \$287,000 to \$474,000.

The lower the withdrawal rate, the more confident you can be that you will not outlive your assets. Of course, future ill health or a depressed economy could damage your plans. But as President Eisenhower once said: plans are nothing, planning is everything. The process of thinking through your retirement future and reviewing and revising your plans frequently in retirement gives you the best chance of enjoying your life and meeting your goals.

About the Authors

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Paula received an AB in English from Cornell University's College of Arts and Sciences and her master of business administration in finance from Cornell's Johnson School of Management. She is a registered investment advisor, holds Series 2, 6, 26, and 63 registrations and insurance licenses in multiple states.

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For More Information

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