

How Can I Manage to Retire?

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What do survey results demonstrate about the savings of people who are approaching retirement? How much income is needed after retirement? What resources are needed to provide retirement income? In previous articles, we have looked at retirement planning from these angles.

In this article, we will take the insights provided earlier and apply them to several hypothetical situations, to understand what it might take to turn unpromising prospects into a successful retirement. Yogi Berra, the famous Yankees catcher, was reported to have said that it's tough to make predictions, especially about the future. The further out you forecast, the harder it is to foresee, but there is no way of avoiding such forecasts when planning for retirement, which is an inherently long-term scenario. Long-term planning depends on making assumptions, such as how much investments will earn, or how much your salary will grow. For each of our examples, we made a number of assumptions, which are detailed at the end of this article. Reasonable people will differ in their outlook, and you may feel that some of the assumptions are not relevant for your situation. Nevertheless, we offer these projections as a starting point for retirement planning.

For simplicity, each of our illustrations is based on an individual's situation. Circumstances will be different for families, depending also on the need to support children, and whether there are multiple earners within the family. Also, each of our illustrations ignores the effect of taxes, which may vary according to income levels and the availability of tax-favored savings, such as in a 401k or 403b plan.

What we found

- Based on the examples shown here, we believe that many people who are approaching retirement must find a way to sharply reduce expenses and increase savings in order to retire at age 65
- Delaying retirement beyond age 65 is helpful, but needs to be paired with additional savings to make retirement feasible
- Part-time work or relocation to lower cost regions may also help prospective retirees in balancing resources with needs
- We also show the savings rates that are needed at various ages and salary levels in order to provide an adequate retirement income (with Social Security)
- Assumptions about future events are very important in projecting retirement needs. Changes in key assumptions can lead to quite different results in the projections.

How these examples were constructed

In each example, we have assumed that an individual could maintain his standard of living (Target Income) if he could replace 75% of his pre-tax gross income in the year before retirement, adjusted for inflation in future years. Suppose that an individual is one year away from retirement at age 65, and his current pre-tax gross salary is \$100,000. He has contributed 10% of his yearly earnings into his employer sponsored savings plan and has accumulated a sizeable nest egg. To maintain his standard of living we estimate that his savings plus Social Security would need to provide him with an annual Target Income of \$75,000 per year (75% of his final pre-tax gross salary of \$100,000). The 75% reflects that it is no longer necessary for him to save the 10% per year, and that working expenses and taxes are reduced. Further, we assume that his savings at retirement are invested in a balanced portfolio and that he withdraws 4.5% per year.

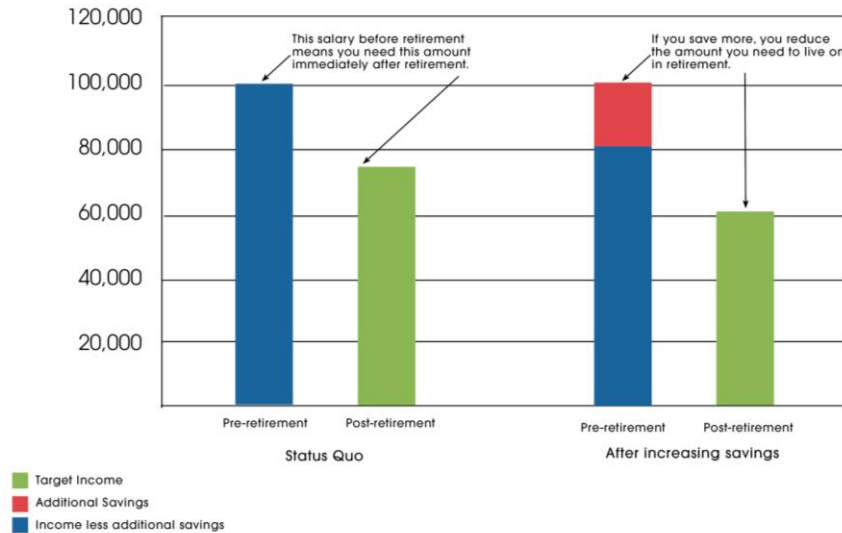
Below are examples illustrating individuals who have not saved enough for retirement. In the first column is the shortfall, compared with 100% of the Target Income if no remedial actions are taken. In the next column, we show the additional savings that are required to reach the Target Income under the same assumptions. The additional savings reduce preretirement income enough so that the combination of savings (planned and additional) plus Social Security is sufficient to provide the Target Income. In other words, additional savings



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increase retirement resources and reduce retirement needs until they balance. The additional savings are generated by reducing how much he spends – he is living on less and therefore needs less in retirement. We also show the effect of delaying retirement on the needed additional savings. In each case, we show the percentages of the Target Income coming from each source and the deficiency, if any. In our examples, we varied the ages and current salaries.

The graph below shows what happens when you free up savings from current income (in this case, 20% of your total income). By saving more, you live on less. By reducing your income needs prior to retirement, you also reduce your income needs when you retire.



Case One – No Savings, but still time – age 45

Current age: 45
 Current salary: \$85,000
 Current savings: \$0
 Current planned savings rate: 8%
 Planned retirement age: 65

Suppose somebody is 45 years old, and is making \$85,000 per year in a new job, but has not saved anything for retirement until now. She did enroll in her employer's 401k plan, and is now saving 5% of her income, and gets a 3% matching contribution (8% in total). She would like to retire at age 65. Can she?

Item	No changes	Increase savings	Increase savings, delay retirement
Planned Retirement Age	65	65	67
Target Retirement Income	\$123,000	\$99,000	\$111,000
Additional Savings Required	N/A	19.3%	15.2%
<u>Percentage of Target Income from</u>			
Social Security	35.0%	43.4%	47.5%
Planned savings	13.4%	16.6%	18.1%
Additional savings	0	40.0%	34.4%
Deficiency	51.6%	0%	0%



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At age 65, she will have less than 50% of the needed resources for retirement. If she still wants to retire at that age, she needs to save an additional 19.3% of her salary for the next 20 years, on top of her current 5% rate of savings. If she can do so, she will be living on less of her pay, to build up the required amount. That's a big number. But what if she delays retirement? If she retires at age 67, the additional savings rate needed will drop but only to 15.2% of pay.

Case Two – Less time, some savings – age 50

Current age: 50
 Current salary: \$100,000
 Current savings: \$50,000
 Current planned savings rate: 8%
 Planned retirement age: 65

Item	No changes	Increase savings	Increase savings, delay retirement
Planned Retirement Age	65	65	67
Target Retirement Income	\$121,000	\$91,000	\$105,000
Additional Savings Required	N/A	24.7%	19.6%
<u>Percentage of Target Income from</u>			
Social Security	32.7%	43.4%	46.9%
Planned savings	14.3%	19.0%	20.2%
Additional savings	0	37.6%	32.9%
Deficiency	53.0%	0%	0%

In this example, it's a little later in the game, but the individual has some savings. The status quo leads to a slightly worse outcome than in the first example. How can she retire? The answer is that she has to find a way to raise savings by a daunting 24.7% of pay in order to make her retirement dream come true. Unfortunately, this is a goal that few people will be able to reach, as it requires too much of a cut back. What if she changes her retirement age to 67? The required savings drops to 19.6%.

Case Three – Getting close and not prepared – age 55

Current age: 55
 Current salary: \$125,000
 Current savings: \$200,000
 Current planned savings rate: 12%
 Planned retirement age: 65

Item	No changes	Increase savings	Increase savings, delay retirement
Planned Retirement Age	65	65	67
Target Retirement Income	\$128,000	\$91,000	\$107,000
Additional Savings Required	N/A	28.6%	22.1%
<u>Percentage of Target Income from</u>			
Social Security	29.0%	40.7%	43.0%
Planned savings	22.3%	31.2%	32.4%
Additional savings	N/A	28.1%	24.6%
Deficiency	48.7%	0%	0%



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Our third prospective retiree, age 55, has \$200,000 already saved, with 12% going into his 403b and earning \$125,000 annually. We find that he will replace just over half of his Target Income. The additional savings needed will be 28.6%. If he delays retirement until age 67, the savings needed will drop to 22.1%.

Case Four – On the threshold – age 61

Our fourth and last example is someone aged 61, earning \$90,000 and with \$500,000 saved. His current savings rate is 15% per year. What is the outlook for retirement at age 65?

Current age: 61
 Current salary: \$90,000
 Current savings: \$500,000
 Current planned savings rate: 15%
 Planned retirement age: 65

Item	No changes 65	Increase savings 65	Increase savings, delay retirement 67
Planned Retirement Age	65	65	67
Target Retirement Income	\$75,000	\$64,000	\$76,000
Additional Savings Required	N/A	14.2%	5.1%
<u>Percentage of Target Income from</u>			
Social Security	39.0%	45.5%	47.3%
Planned savings	43.2%	50.3%	50.6%
Additional savings	N/A	4.2%	2.1%
Deficiency	17.8%	0%	0

There is not much time to correct what is a modest deficiency, but the solutions are not as stark – free up an additional savings of 14.2% (with the greater effect being retirement budget tightening) or put off retirement for two more years, which reduces the additional savings needed to 5.1% of salary.

Other tactics

The strategy of increasing savings is the most powerful one because it also reduces living expenses. Unfortunately, we do not believe that many pre-retirees will be able to put such a radical change in place. Besides increasing saving or delaying retirement, some combination of the following actions could contribute to the solution:

- Working part-time in retirement
- Reducing living expenses - we have assumed a 75% target for post-retirement income, but that target could be reduced by moving to a less costly area or downsizing your home.
- Increasing the annual withdrawal rate above 4.5%, although the higher the withdrawal rates, the greater the danger running out of funds in the future.

How much do you need to save at each age in order to be prepared?

Although we have focused on illustrations in late career, younger participants can take away a lesson, too. The earlier you start to save, the less difficulty you will have later. How much do you have to save, as a constant percentage over your career, in order to retire at age 65 (taking Social Security into account)?



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If you are just starting to save towards retirement, here is a rough guideline showing how much of your annual income needs to be saved each year, based on income levels, in order to meet retirement targets:

Starting Age	Initial annual compensation at starting age						
	25,000	50,000	75,000	100,000	125,000	150,000	200,000
25	7%	9%	11%	12%	13%	13%	14%
30	9%	11%	13%	14%	15%	16%	17%
35	11%	14%	16%	17%	19%	20%	21%
40	13%	17%	19%	21%	22%	24%	25%
50	19%	24%	29%	31%	34%	36%	39%
55	20%	28%	34%	38%	42%	45%	48%
60	21%	33%	43%	48%	53%	57%	61%

You will notice that the amounts needed generally increase with age and with salary, the first for the shorter period for saving and earning interest, and the second because the Social Security formula provides smaller proportions of final pay as salary at retirement increases. For low paid earners close to retirement, Social Security produces a large portion of retirement income, reducing the savings needs.

How we developed our projections

As we discussed above, our illustrations are based on the following assumptions:

- Wage increases after 2011 will be 3.5% per year
- Savings balances will earn 7% per year
- You need 75% of your preretirement income to live comfortably in retirement
- You have a full career for purposes of Social Security
- Social Security benefits are not changed by legislation
- You have no other defined benefit pension benefits
- Unless stated, projections apply to an individual
- Taxes are not explicitly considered
- A 4.5% per year withdrawal rate from retirement assets is assumed

As noted, changes in these assumptions will affect the results. For example, if you assume a higher return on savings, say 8% per year, the amount that will need to be saved will be lower, because balances will accumulate to larger amounts. If expected future salary increases are higher, say 4% annually, the savings needed will be higher, because projected salary at retirement and thus target income is higher.

The first steps

Your own situation may be very different from the examples shown here. You may be part of a two-income family. Or you may not be able to find enough tax-favored savings to meet your retirement goals; tax effects may be important. Perhaps you have dependent children and more expenses connected with raising them. Each of these situations makes the projection of your retirement needs and resources more complicated, and must take more factors into account. You may wish to engage the services of a certified financial planner, who is capable of modeling complex circumstances and providing expert advice.



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You are not alone. The ramifications of inadequate preparation for retirement will have tremendous effects on saving, spending and working for millions of older American workers. If you do have a problem meeting your retirement goals, the worst response to do is nothing. Just small steps in the right direction, such as increasing your savings, cutting expenses and planning to work longer may be very helpful, even if the solution is not complete.

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For More Information

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