

Retirement Rules of Thumb

What are the "Rules of Thumb" for Retirement?

With the aftermath of the Great Recession still wreaking havoc on many American's financial position, many consumers and professionals are questioning just how much they need to save for retirement. This brief reviews a few common rules of thumb and suggests how consumers might take - or leave - the advice.

Save for Retirement First, then Payoff Credit Cards, then Put Aside Funds for Emergencies

This is a rule based on solid logic. Because of the value of accrued interest over time saving for long-term retirement goals at an early age is generally a good plan, especially if savings can be put aside without stretching your budget to the point where you need to borrow for daily expenses. It is also a good strategy to maximize any employer matches or tax benefits from retirement savings accounts.

Despite all these valid reasons to save for retirement first, paying off high cost credit card loans may actually be a sensible first strategy. Given a credit card with 20% annual interest there is hardly any better return on investment than paying off that debt. With the exception of getting employer matching funds, paying off a consumer loan reduces interest costs and frees up debt service for savings. So in many cases it makes sense to pay off debt at the same time as saving, and depending on the interest rate on credit cards and the size of employer matches it may make sense to pay off debt first.

Putting aside funds in an emergency fund is a wise strategy. In the event of a job loss, a few months' cushion can help smooth tough times. When unexpected expenses arise, an emergency fund can help you avoid using a high cost consumer loan. The problem with

an emergency fund, or precautionary saving as it is sometimes called, is that it can be too easy to access. It needs to be set aside for true emergencies and hard to tap unless it is truly needed. Nevertheless, it is an important strategy for financial security, and can serve as insurance against needing to use high cost credit or even cashing in retirement funds. Putting emergency savings as a third order goal also has the danger of facilitating procrastination.

Just starting out? Consider the "one-third" approach to savings: First payoff any high interest credit cards. Next, put one third of your savings towards each paying off other consumer debt, building an emergency fund and saving for retirement. When the first two goals are reached (all consumer debt is paid off and you have 3 months in emergency funds), then put all your effort into retirement savings. You can use this approach on raises, tax refunds and bonuses too.

Save 10% of Your Total Gross (Pre-tax) Income

This is based in part on the default savings rate built into many retirement plans. For someone in their 20s or 30s the 10% rule may in fact work fairly well, assuming an average rate of return invested in something like a low-cost mutual fund. Saving 10% of your (pre-tax) income from age 25 to 65 would create a nest egg which could last another 20 years when combined with Social Security. But the later you start the more you need to save. For someone in their 40s or 50s saving 20% would be a safer strategy. Likewise this strategy is based on relatively modest rates of inflation and higher investment returns than may be viable. What is valuable about this rule is its simplicity. No fancy formula or investing technique — just plain old not spending and putting money aside for later. Of course, if saving 10% means you have to rack up credit card or

other loans, this strategy is rapidly undermined. The key is being able to set money aside and not offset the savings with higher debt.

Your Net Worth Should Equal Your Age Times Your Pretax Income Divided by 10.

If you are 40 years old and have \$100,000 in annual income, then by this rule your net worth should be \$400,000 ($40 \times 100,000 / 10$). \$400,000 would be from all sources of earned wealth, net of all debt. It might include home equity (after paying off the mortgage), retirement accounts, businesses and investments, but excluding personal property. This rule of thumb is easy to calculate as a benchmark and is useful since it varies by age. The larger the gap between what you have in net worth and the benchmark rule, the more you need to focus on savings strategies. It is also important to consider carefully what parts of your net worth you are willing to spend in retirement. Selling a home or liquidating a business may not be something you are willing to do. If not, then more is required in retirement accounts.

Parents paying for their kid's college tuition while also saving for retirement may find this rule becoming more out of reach. Ideally their net worth will grow rapidly after they are done paying for college and can divert what they were paying to savings.

Save 12 Times Your Current Income

This is a simple rule of thumb is useful at middle and older ages after your income has stabilized, and based on the assumptions that in retirement you spend 5% of the principal balance of savings each year while investing the remainder. This will result in about 80% income replacement in retirement, when combined with expected Social Security benefits.

Of course many retirees find their expenses do not decline as much as they expected in retirement. Health care, travel and hobbies may require more spending than planned. Given rising medical and other costs, some people may need 100 percent of the income

they had their last few years working while in retirement. It also is useful to factor in pension income and Social Security. These programs will produce 30% to 50% income replacement for many workers. (Even if Social Security is not significantly redesigned in the coming years it will continue to payout at about two-thirds or more of current levels and will not 'go bankrupt' as is commonly believed.) Another factor to consider is receipt of any inheritances. Do not make the mistake of counting on a large and unexpected inheritance to shore up your retirement savings, but do be sure to use any inheritance to further your savings goals rather than to boost current consumption.

Save 20 Times your Expected Annual Expenses in the First Year You Plan to Retire.

This rule is based on spending — not income — and as such, is an important distinction from income-based rules. In retirement what matters is how much you spend — not how much you used to earn. This rule is sometimes described as saving 20 times annual expenses and in other applications 25 times. The 20 times rule is based on first estimating expenses after subtracting any pension and Social Security payments (as estimated by calculators such as www.socialsecurity.gov). Assuming a retirement of about 20 years this nest egg would let you spend 5% of the balance while investing the remainder at modest rates of return.

For example, if you think you will need \$50,000 a year, plan on \$20,000 from Social Security, you would need 20 times 30,000 or \$600,000. A more conservative approach is to estimate this rule of thumb based on 25 times annual spending. Of course spending more or less of your savings balance each year will result in relatively shorter or longer retirement periods. This simple rule is powerful and does provide a target for savings goals.

However, future expenses can be challenging to estimate. Big ticket items like housing, automobiles and insurance may shift in retirement. Housing expenses can dramatically increase or decrease.

Downsizing a home for example, might both free up savings and reduce monthly expenses. Moving to a retirement community might increase expenses. For most people expenses will be higher in their first year of retirement than in their 15th year since they may not be as active. On the other hand, many of us have the potential to incur significant out of pocket medical expenses we might not otherwise predict. Imagining life “post retirement” much less estimating what their living expenses might be is hard. Focusing on income is sometimes a lot easier if that amount is keeping you afloat now.

Borrow for Your Kid's Education, Save for Your Own Retirement

There are several variations on this rule, including borrowing for a car, a house or other items rather than using potential savings. The logic goes that there are lots of sources of loans for education, so putting money into a child's college fund should not happen until retirement savings is maximized. The basic logic here is accurate — there are a myriad of low-cost loans available to finance education (or automobiles) — and the accumulation of compound interest over decades might be more valuable than the interest saved by not using credit.

One potential flaw in this rule is that there may not be widespread availability of low-cost education loans in the future and many parents object to loading their adult child with student loan debt. Setting aside a college fund may also convey a message to children about the importance of education and the expectation of attending college. Having savings opens up more options for a potential student as it reduces the financial impact of self-funding or assuming all the costs as debt. Moreover there may be state income tax preferences for using tax advantaged college savings accounts.

Invest X% of your portfolio in stocks, where X is equal to 100 minus your age.

For example, if you are age 40 you should invest 60% of your investment in stocks, with the remainder in bonds. This rule is

based on the assumption that as you approach retirement you should be weighted more heavily in less volatile investments than stocks, which may have a down period during retirement and reduce your ability to live securely. This rule of thumb is useful in that it helps describe the risks that investments incur and how investors might want to calibrate risk taking as they get older.

But this rule is so simple that exceptions to the rule are rife. The one-for-one linear relationship between age and stock ownership proportions does not reflect how most people consider risk. People in their 40s and 50s who are 15 years or more from retirement might choose to be more heavily weighted in stocks than the calculation would suggest. Likewise people in early retirement might want to be less heavily weighted.

One of the challenges with this approach to asset allocation is that there are a variety of stocks and stock funds, and many alternatives to stocks or bonds, including real estate and other assets. A recent innovation, the target date mutual fund, is used in some retirement programs. It follows a general form of this rule and removes the burden of annually recalibrating investment percentages.

A useful variation of this rule is to use 125 minus your age, not 100. As people live longer this formula will keep you more fully invested in equities. This introduces more risk, but the long run potential of equities can also offer more growth to keep up with resource needs in retirement.

Save More Tomorrow

One reality of human nature is that we all like to put things off, especially things that require current sacrifices in return for far off rewards. Think about dieting or exercise — the same is true with personal finance — we always think we can save more, and intend to do so later. One way to ensure that you will commit to future savings is to make a deal with yourself that whenever you get a raise at work you will take half the new additional income and put it in savings. You

probably will not notice the change since you will be enjoying the other half of the raise. The same goes for a tax refund or other payments. Commit yourself today so that 'future you' saves more. You might even put it in writing and post it in your house where you can see it. Or start something now (no matter how small) just to get started. Perhaps take the amount you were thinking of saving *next* year, divide it in half, and then divide it into a monthly payment to start right away.

Beware of Transitions

Your nest egg is at risk every time you change positions at work, move between jobs, get married, divorced, have children, move, or a number of other significant life events. Be thoughtful about your financial routine and make sure you keep saving as much or more than before. These life events often trigger a cascade of spending and ill-planned decision-making which can haunt you for a long time. Transitions may also be opportunities. A new home may free up cash flow for savings. Adding a spouse can add income. A new job might offer better benefits or a larger savings match. Even negative events like a divorce can be managed carefully to minimize legal costs and avoid a run up in debt. But most people focus on the event and ignore the financial implications; do so at your peril. Make sure you always have enough insurance of all types in place. Review you homeowners, personal liability, disability, and life insurance every few years. There is no point in saving for retirement if your savings are at risk of an unfortunate accident, disability, or death.

Summary

All these rules of thumb are based on average withdrawal rates and average life spans. But what happens if you happen to retire just when the average investment return takes a dive? You have a much higher risk of outliving your savings. Even if you get

lucky and the market performs in your favor, you still face the risks of outliving your savings. Having enough to retire at 65 and live to 85 is one thing, but what if you live to 100? None of us knows how long we will live; the longer you survive the more you need to have saved or the less you will be able to spend. Your spouse's expected life span is also important to consider, as well as being adequately insured. Long term care insurance, for example, can protect your assets from the catastrophic costs of assisted living expenses. It is important to review insurance needs and policy options in the context of savings goals and investment choices.

One key take away from these rules is that managing your personal financial goals — even long term goals like retirement — is something you can do without sophisticated models. Many people turn to costly financial professionals who essentially follow variations of these same rules. Financial professionals offer more than advice on how much to save, however, and can help consider a wider range of topics such as insurance, estate planning and managing unusual assets like a small business. An advisor can also help you stick to your plan when times are tough, as well as facilitate a common understanding of financial issues between spouses. But for some people, rules of thumb, a little patience, and keeping up with the personal financial news can be an effective do it yourself strategy.

Recall these are all "rules of thumb" and not intended to be precision estimates or hard and fast advice. But these rules of thumb are rooted in some basic principles of personal finance and are worthy of consideration. The most important role for rules like these is to help shape a more thoughtful discussion of retirement savings and financial goals. Having a goal — even a rough one — is better than having no goal at all



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