July 1, 2013

Retirement Series: The Million Dollar Question

For people for whom retirement is their top priority, the question sitting in the back of their minds is: how much do I need to save in order to retire (comfortably)? In the retirement planning field, sometimes this is called the "million dollar question."

Do you need a seven-figure sum to live through retirement? Rather than making blind guesses, in this letter, let us walk through the process of how a financial planner tackles this seemingly mind-boggling task.

You, and your planner, will need to take the following into account.

1. Your retirement dreams – knowing what they are is a critical part of building a solid retirement foundation.
2. Your current age
3. Life expectancy and health situation
4. Income
5. Investment strategy

The further away one is from retirement (20-year-olds to 40-year-olds), the more the goal is to save as much as possible and in a tax-efficient way. My personal view is that over-saving should not be a concern (under-saving, on the other hand, has been a chronic problem in America), but it should be done in a "smart" way, utilizing both taxable and tax-deferred vehicles. Maximizing 401(k) contributions and taking advantage of company match, using the Roth IRA for tax-free withdrawals down the road is a good place to start.

A planner can always start with a good, but rough, estimate based on how much one would likely to live off of, with the expected rate of inflation taken into account, as well as expected years of retirement (life expectancy), and any other big-ticket items. After estimating these numbers, he/she would run them through a financial calculator or planning software that would return with the "magical million dollar number"!

Example:
Steel Young, 35, is married with two young children and makes about $50,000. His wife, Mary, brings home another $40,000. Annual expenditures total $75,000, leaving them with $15,000 for savings and discretionary spending. How much would they need if both of them were to retire at age 67?

Table 1: Retirement projection for hypothetical couple, Steel and Mary Young*

Annual expected expenditures** (today's dollar):	$75,000
Rate of inflation:	3%
Years of retirement:	30
Total savings needed by age 67 (future's dollar):	$1,470,000
Annual savings to reach retirement goal:	$13,000

*Rate of return assumption = 6%
**During retirement

For Steel and Mary the "magical million dollar number" is $1,470,000. A good financial planner, however, will be reluctant to make this a definite, quantitative forecast for the following reasons 1) circumstances will change: marriages and divorces, births and deaths, job changes, and whatever life may throw at you. 2) Standard of living tends to increase with age, as career advancements and job promotions, along with inheritance, will lead to a better lifestyle which is likely to make the current estimate meaningless. 3) Most importantly, the risk factors surrounding younger folks are different and often neglected. In other words, priorities among them require some careful short-term planning such as building up an emergency reserve and insurance planning. Either way, since a large portion of their spending is non-discretionary – housing, food, education, child care, transportation, insurance and taxes – saving $1,000 a month (Table 1), for an average-wage-earning family, seems like a far-fetched pipe dream.

Nonetheless, the analysis still paints a clear picture of the importance of retirement planning (and saving).

How different would the planning process be for people closer to retirement? While the process has little variation, the data with which a financial planner works can produce more accurate and meaningful results. Consider the following example: Bob Dole, 59, a small business owner. Divorced with four adult children, he is contemplating retirement and wonders if he already has enough. Here is a glimpse at his assets and liabilities:

Table 2: Financial information of Bob Dole.

Company retirement plan:	$1,500,000
Roth IRA:	$250,000
Taxable account:	$150,000
Residence and other real estate:	$3,000,000
Mortgages:	$1,000,000
Business:	$1,000,000

Simple math tells us that Bob's net worth is close to $5 million. If he spends $120,000 a year and expects that to remain unchanged throughout retirement until he turns 94, he would need to have close to $2.6 million today. Bob could retire today!

At this point, the financial planner would prefer to focus on Bob's retirement goals to figure out what he *really* wants to accomplish. This goal-based planning not only probes in depth of the lifestyle one desires but also prompts the respondent to give serious thought about life values. Besides the indispensable living expenses (in Bob's case, he and the planner would compile a detailed retirement budget), goals that often come up the most include traveling, philanthropic intentions, health care and leaving inheritance or legacy for future generations. Table 3 summarizes a list of Bob's retirement goals and their importance.

Needs		
10	Retirement - Living Expense Bob Retired (2016-2049)	62 / 2016 $120,000
9	Charitable Donations When Bob retires Recurring every year until end of Bob's plan	$10,000
8	New Car When Bob retires Recurring every 6 years until end of Bob's plan	$40,000
Wants		
7	Travel When Bob retires Recurring every year until end of Bob's plan	$5,000
5	College - Grandson's College 4 years starting in 2029 Attending College - Average All	$26,832
5	College - Granddaughter's College 4 years starting in 2032 Attending College - Average All	$26,832
Wishes		
3	Leave Bequest End of Bob's plan	$1,000,000

Table 3. Bob Dole's retirement goals.

Once an agreement on goals and objectives has been reached, then a bona fide analysis can be run to yield really useful results and discussion points, which would include portfolio withdrawal strategy, Social Security strategy, and asset rebalancing (Figure 1).

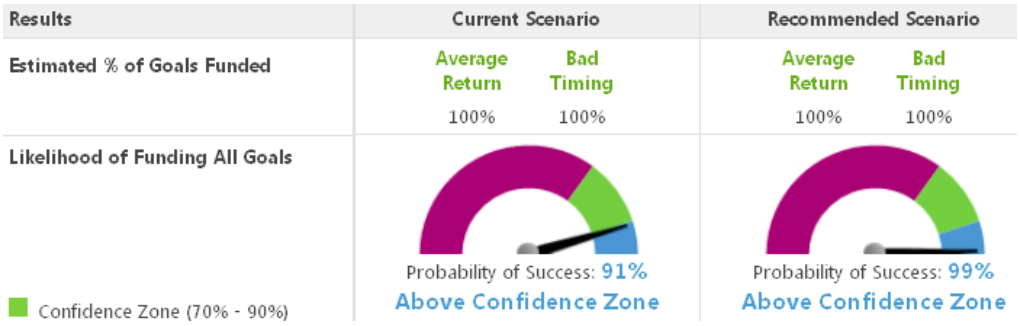

Figure 1. Bob Dole's retirement planning results.

This plan is completely customized and catered to Bob's (or your) personal situation. Because of the proximity to the actual retirement, many of the unknowns that presented themselves in the Young's case above have been resolved. For example, Bob should know exactly how much his Social Security benefits will be, the kind of lifestyle and the budget for retirement, his health conditions and the need for planning for a large-than-average health-care related expenditure, and more. Furthermore, by accounting for all of his goals—needs, wants and wishes—Bob has absolute clarity as to which of the goals are realistic and reasonable and which ones will fall short and need to be reconsidered.

Whether you are a few days or many decades away from retirement, you are encouraged to dream big, plan early, and follow through on it. Let us know today how we can help!

- Henry Yu, CFP®