

The Cost of Retirement

Retirement is expensive. How much money you will need each year when you stop working depends on your individual circumstances and the kind of lifestyle you expect to live. Your estimate will be the starting point of your retirement plan and will drive many of the other planning decisions you make, including those regarding Social Security benefits, your retirement date, and how much you need to save in the interim. There are two ways to arrive at this important number.

The most popular method is called the Income Replacement Ratio. It is the percentage of your working, pre-tax income needed to maintain your standard of living in retirement. It is based upon industry and academic studies of retirees and generally indicates that most seniors need between 70% to 90% of their pre-retirement income. The assumption being that income and FICA taxes, and retirement savings contributions that consume 10% to 30% of a person's income will be reduced or end in retirement. It also assumes that work-related expenses that decrease in retirement will be offset by expenses such as health care that will likely increase. For example, if you have an annual gross (pre-tax) income of \$50,000 before retirement, using the 90% rule of thumb would indicate you will need \$45,000 per year in retirement.

The advantage of this approach is its simplicity, since it eliminates much of the work required to make projections about future expenses. Although it can be used as a starting point for those in their 20s and 30s, for those nearing retirement, this "one size fits all" approach is seriously flawed because it does not account for your individual circumstances. Some people with modest incomes may need 100% while others with larger incomes may need less. Some are content with modest hobbies while

others plan for expensive travel. There are those who enter retirement debt free, while others may still be carrying mortgages and other liabilities. The point is using this approach can cause you to save too little or even too much for retirement.

The second and more rigorous approach requires more work, but should result in a plan more tailored to your personal situation and lifestyle. Start by preparing a cash flow statement that identifies your current spending and then adjust for expenses you anticipate will change when you enter into and transition through retirement. Because it is impossible to estimate with accuracy many future expenses including health care costs, use your best estimates and avoid getting caught up in the details.

Whichever approach you use, be sure to account for inflation and taxes. Inflation presents one of the greatest threats to a retiree's lifestyle because it significantly reduces their purchasing power over time. If \$50,000 provides a comfortable retirement today, assuming an annual inflation rate of 3%, you'll need over \$67,000 in just 10 years to maintain the same lifestyle.

While your taxes may decrease once you stop working, they will still consume a portion of your income and investments. If you need \$50,000 to pay your bills and you estimate your tax rate (federal and local) at 25%, you'll need to earn over \$66,000 from your retirement income and investments.

Being able to retire on your own terms is a dream for most Americans. This first step to turning that dream into a reality requires just a little of your time and a few calculations. You will find it is worth the effort.

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