

A Retirement Nest Egg Built To Last

For most Americans, retirement planning is ultimately focused on accumulating a “nest egg” of savings and investments to generate enough income to pay for a comfortable lifestyle.

To find out how large a nest egg you will need, you must first estimate your “retirement income gap” which is simply the difference between how much you'll need (discussed in a previous article) each year to enjoy the lifestyle that you want, and the amount of income that you expect to receive from sources including Social Security, employer pensions, and part-time work. This gap will need to be filled from your personal savings and investments.

For example, using today’s dollars, let’s assume you plan to retire at age 66 and determine you need \$75,000 per year (before taxes) to enjoy a comfortable retirement and your only expected income is \$25,000 from Social Security. This means your investment portfolio will have to generate \$50,000 every year after inflation for as long as you live. Using Social Security as the only income source simplifies the calculation because the benefits are automatically adjusted each year for inflation.

So how large a portfolio is needed to generate \$50,000 annually in inflation-adjusted dollars for as long as you live? Since running out of money is the number one concern for most retirees, much attention has been focused on this subject. The research has been directed specifically toward determining a “sustainable portfolio withdrawal rate”. This is the maximum amount (expressed as a percentage) that can be withdrawn from your retirement assets each year with reasonable confidence that the portfolio will provide lasting income. If you can estimate the sustainable withdrawal rate, you can easily calculate the size of the portfolio required.

Research beginning with a 1994 seminal study conducted by Bill Bengen (a California financial planner), suggests that based upon historical (1926-1975) inflation rates and investment returns, a retiree's portfolio consisting of approximately 60% stock and 40% fixed income should, with a reasonably high probability, last for approximately 30 years if you initially withdraw 4% of your balance, and continue withdrawing that same inflation-adjusted dollar amount each year. Using this 4% guideline, if you determine that your retirement income gap is \$50,000, you will need a portfolio of approximately \$1,250,000 (\$50,000 divided by .04) at the beginning of your retirement to fill that gap.

A caveat is in order here. While the 4% guideline can provide future retirees a target to shoot for, it is dependent upon several variables that differ from person to person and are impossible to predict with any accuracy. The best you can do is to make reasonable and conservative assumptions regarding how long you plan to live in retirement, what investment returns you expect to earn from your portfolio during retirement and what you expect inflation to be.

For those who want a high degree of confidence that they will not run out of money, it makes sense to be conservative about your future assumptions. Therefore if you expect a retirement period longer than 30 years, or future investment returns to be lower than historical returns, or future inflation to be higher than historical inflation, you should reduce your portfolio withdrawal rate below 4%. This means you will need a larger portfolio at retirement. Remember, the higher the withdrawal rate, the greater the chance the portfolio will not last as long as you need it to.

In future articles we will revisit this concept of sustainable withdrawal rates and discuss sensible ways to adjust these spending rules to improve your chances of enjoying a financially secure retirement.

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