

How Much You *Really* Need to Retire

You may be better prepared than you think. We help you find out where you stand.

By [Jane Bennett Clark](#), From *Kiplinger's Personal Finance*, October 2014



Read the headlines about retirement readiness and you'd think that at least half of us had forgotten to go to class, do our homework or study for one of the biggest tests of our lives. When exam day arrives, we're totally unprepared.

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But what if it's just a bad dream and we wake up to find that we are on track after all?

In fact, researchers are suggesting that assessments of Americans' retirement readiness are too dire and that most of us are in pretty decent shape. How so? Some studies underestimate people's ability to catch up on saving after the kids are grown or overstate the level of income workers need to replace in retirement, says a report by Sylvester Schieber, the former chairman of the Social Security Advisory Board, and Gaobo Pang, of benefits consulting firm Towers Watson. Others neglect to factor in resources outside of employer-based retirement plans, such as IRAs and home equity, or the relatively high benefits that Social Security pays low-wage earners.

Part of the disconnect is that retirement benchmarks are created for large segments of the workforce rather than individuals, says Schieber. "If you're designing a plan that's trying to cover 10,000 people or even 1,000 people, you're going to have to make some assumptions about how they behave. But every household's circumstances are different." Families whose situations don't fit the assumptions, he says, "can't rely on that rule of thumb for a road map to success."

No one disputes that some portion of the population—maybe 20%—will arrive at retirement vastly unprepared. "Those are households with lower wages and lower levels of education who have struggled with basic savings skills, or people who have suffered terrible economic hardships," says Stephen Utkus, director of the Vanguard Center for Retirement Research. But overall, the black-and-white, ready-or-not assessments of past years have given way to "a more nuanced view of preparedness," he says. "You have to look under the covers—it's person by person."

Taking a closer look is key to your own retirement planning. Before you conclude that you've fallen short of the mark or that you don't dare spend an extra dime of your retirement funds for fear of running out, decide what you really need based on your own finances and expectations.

Calibrate your saving

You've probably already gotten the memo to stash 10% to 15% of your annual income (including any employer match) in your retirement account, starting with the first month of your career and ending with the last. That strategy not only lets you take advantage of the magic of compounding (a no-brainer way to build savings), but it also encourages the habit of saving and keeps your contribution level in step with pay raises. At the end of a 40-year career, you should have enough in the kitty to see you safely through a 25- or 30-year retirement.

Straightforward as the plan may be, however, it fails to acknowledge the bumps and potholes that inevitably show up on the path from young adulthood to retirement age. Kids constitute a major detour, says Schieber. "People who have a child are probably going to be consuming differently and saving differently than if they don't have children and don't intend to have children," he says. Other savings off-ramps include buying a house, paying off student debt and suffering a job loss.

How to choose between setting aside money for, say, college or a house and saving for retirement? "When I talk to people who say they are going to stop saving for retirement and start saving for college, I suggest they adjust downward, not stop," says Utkus. Easing up on retirement savings for a few years shouldn't slow you down too much if you've fueled your accounts early on.

Eventually, kids grow up, mortgages get paid off, and income rises. By the time you're in your mid fifties, you may be able to free up 20% or more of your annual income for retirement savings. And once you hit 50, you can make an annual catch-up contribution of \$5,500 to your 401(k) in addition to your maximum annual contribution (\$17,500). You can also add \$1,000 to your IRA on top of the annual max of \$5,500.

Still, keep in mind that a late-life crisis, such as a health problem or forced retirement, could affect or even destroy your ability to recoup. Letting your savings grow over time remains the recipe for retirement readiness, says Thomas Duffy, a certified financial planner in Shrewsbury, N.J. "When you make tomato sauce, you have to let it simmer. Money's the same way."

Assess your target

Retirement planners generally recommend that you have enough savings at the end of your working life to replace 70% to 85% of preretirement income. The targets take into account that you'll no longer be saving for retirement, getting dinged for payroll taxes or covering work-related expenses, such as commuting costs. To get you to an 85% replacement ratio, Fidelity recommends that you save eight times your final salary, minus Social Security and any pensions.

Some planners go further, suggesting that you aim to replace 100% of your preretirement income, on the theory that what you'll save in some categories, you'll spend in others. "Even if you're not paying payroll taxes, that cost will likely be offset by a new hobby or travel. Or if you're staying at home more, you'll want to remodel. There always seems to be something," says Leslie Thompson, a managing principal at Spectrum Management Group in Indianapolis, which advises clients on retirement planning.

But maybe your hobby involves reading by the fire, not skiing in Vail. Or maybe your mortgage will be paid off, or you'll move to an area where the cost of living is much lower than where you are now. Given that your biggest spending years are when you're raising kids, you might get along just fine with 60% of your preretirement income. A recent survey by T. Rowe Price showed that three years into retirement, respondents were living on 66% of their preretirement income, on average, and most reported that they were living as well as or better than when they were working. If you scrimp to meet a benchmark designed for somebody else, "you could be over-saving now and shorting your current lifestyle," says Duffy.

Then there's a retirement asset you are likely to have in abundance: time. Maureen McLeod of Lake Como, Pa., retired last year from her job as a professor at Commonwealth Medical College, in Scranton. Now, she says, "my husband and I don't eat out as much, by choice. At the grocery store, I shop around a little more and compare prices, so I'm spending less on food. We're not so rushed." The fresh sushi she routinely picked up during the workweek? She buys it once a week, on senior discount day.

McLeod's experience echoes research done by Erik Hurst, of the University of Chicago, and Mark Aguiar, of Princeton University. They report that people save on food costs in retirement not because they are eating less or buying hamburger instead of steak but because they have more time to compare prices and prepare meals. The time payoff extends to other activities, such as shopping for travel bargains or taking on household chores you might once have paid someone else to do.

Crunch your own numbers

To get a handle on how you'll spend your time and money in retirement, make a detailed analysis of what your expenses are now, says David Giegerich, a managing partner of Paradigm Wealth Management, in Bridgewater, N.J. He recommends starting the process about five years before you turn in your office keys. "In the first two years, don't try to clip coupons, and don't stop going out to dinner," he says. "Live your life so you can get a realistic picture of what you're really spending."

Among the obvious expenses: housing, utilities, food, gas, clothing, and entertainment. The not-so-obvious? "Even if you retire your mortgage, you still have to pay property taxes and homeowners insurance," says Thompson. Other off-the-radar expenses include annual payments for insurance premiums and future big outlays for, say, a new car or a major trip. "People say, 'This is a one-time-only thing.' But there tend to be a lot of one-time-only things," says Thompson.

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Inflation is a factor you can't ignore. It eats away at what you've set aside to cover expenses. Says Duffy: "I take a trip to Colorado once a year to ski. That's probably \$2,000 for a seven-day trip in 2014. How much will it cost 15 years from now after inflation?" (Answer: \$3,116, based on an annual 3% inflation rate.) You can estimate the impact of inflation on your own expenses by using the calculator at www.buyupside.com. Once you've assessed current and future expenses, add up all your sources of future income. Social Security, based on your top 35 years of earnings, will be a significant piece of the pie, more so for low earners than for high earners. It replaces 56% of income for those at the low end of the wage scale and 28% for those at the high end. (For an estimate of your Social Security benefit, go to www.ssa.gov.)

Include in your calculation any defined-benefit pensions you've accumulated, as well as other sources of income—say, from rental property or an annuity. Then match total household expenses with total income. "In most cases, there's a deficit," says Ken Moraif, a certified financial planner and founder of Money Matters, in Plano, Texas. The shortfall is how much you'll need to fill in from retirement accounts and other savings.

The beauty of this exercise is that it gives you a chance to adjust the plan, or your expectations, before you quit your day job. Say the difference between your projected spending and income is \$25,000 a year. Multiply the amount by 25 (based on a 25-year retirement) and you get \$625,000. "That's your magic number," says Moraif. The return on investment would presumably offset inflation. If you're not on course to have the money by the time you retire, you'll need to save more or spend less in retirement.

Or you can decide to work longer. Not only does that strategy allow you to accumulate more savings and shorten the time in which you'll be tapping your accounts, but it also makes it easier to put off taking Social Security, producing a bigger paycheck later. You get an 8% increase in benefits for each year you delay claiming, until you reach age 70. (This idea makes sense only if you have an average or longer life expectancy. If not, take your benefits and enjoy.) Social Security offers numerous other options for maximizing benefits. (For more information on obtaining a customized report for your own benefits, go to kiplinger.socialsecuritysolutions.com.)

Don't ignore the equity in your home as a source of income or a way to pay unexpected expenses. A reverse mortgage is one way to tap home equity (see section below).

Add up health costs

One expense that won't go down in retirement is health care. In 2012, premiums and other out-of-pocket expenses represented 14% of household budgets for Medicare enrollees, according to the Kaiser Family Foundation—almost three times the health spending of non-Medicare households. Fidelity estimates that a couple who retire at 65 will need an average of \$220,000 to cover out-of-pocket health expenses, not including the cost of long-term care.

But hold the panic attack. Fidelity's number represents the total a 65-year-old retired couple might pay over their average life expectancy (82 for the man, 85 for the woman). It is not the amount they would need on day one of retirement. Most retirees with health coverage spend about \$5,000 a year (or \$10,000 per couple) on Medicare and medigap premiums and other out-of-pocket expenses. That's not peanuts, but the cost is factored into your salary-replacement ratio. You aren't tasked with saving an additional \$220,000 on top of it. And [health care](#) expenses aren't unique to retirement. You probably devote a significant part of your budget to those costs now.

The first step in doing your own cost calculation is to review your health coverage. If you'll have retiree health benefits from a former employer, you're lucky—those benefits are increasingly rare. Most retirees rely on Medicare, including Part A for in-patient hospitalization and Part B for doctor visits; many also buy Part D policies for prescription drugs and a medigap policy to fill holes in Medicare coverage. Dental and vision care are among the expenses for which you'll have to buy separate insurance or pay out of pocket. That's also true of long-term care. Medicare covers very little of this expense, so if you don't have long-term-care insurance, consider buying it. Pricy and imperfect, it nonetheless provides some protection against one of the biggest potential financial shocks in retirement. The median annual rate for a private room in a nursing home is \$87,600, according to the Genworth 2014 Cost of Care survey. The median annual cost for assisted living is \$42,000. (See [Options for Covering Long-Term-Care Costs](#).)

While you're taking stock, also consider your health status and life expectancy. Chronic conditions, including cancer, can mean that you'll pay much more than the average out-of-pocket amount over your lifetime. Ironically, robust health exacts its own price. "Some people think, I'm healthier than average, so maybe my health care costs will be smaller," says Bill Hunter, director of Personal Retirement Strategy and Solutions at Bank of America Merrill Lynch. "But the danger is, healthier people live longer, so they're paying those premiums for a longer time."

Where you live also plays into your retirement math problem. Premiums for policies that supplement Medicare, and for Medicare Part D prescription-drug coverage, vary according to coverage level, the part of the country you live in and the companies offering them. (To see the range of plans and costs in your area, go to the [Medicare Plan Finder](#).)

Expect to bring in a decent income in retirement? If your modified adjusted gross income was more than \$170,000 (for married couples filing jointly) or \$85,000 (single filers) in 2012, this year you'd generally pay a monthly surcharge that raises the Part B premium from about \$105 a month to as much as \$336. For Part D, the surcharge adds up to about \$70 a month to the premium in 2014.

Calculate withdrawals

Arriving in retirement with a big stash of cash presents yet another conundrum: How much can you withdraw each year without running out of money? Two decades ago, financial planner William Bengen addressed that question, running scenarios that used a diversified portfolio of 50% stocks and 50% bonds. His conclusion: If you withdraw 4% in your first year of retirement and take the same dollar amount, adjusted for inflation, every year thereafter, you should have money left in your account after 30 years.

Many retirement planners still rely on that formula, not only because it has generally worked over time but also because it helps new retirees manage their wealth. "People say, 'We have \$1 million. We're millionaires. We can spend whatever we want.' The reality is, if you spend 10% a year, you have a high likelihood of running out of money well before your nineties," says Stuart Ritter, a vice-president of T. Rowe Price Investment Services.

On the other side, diligent savers can be too conservative when it comes to tapping their accounts. "If you spend only 1% of your assets a year, forget about visiting your grandkids—you're never leaving your house," says Ritter. The 4% rule strikes a middle ground, he says. "It gives people a starting point."

That said, benchmarks designed to take the long view don't turn on a dime based on the current investment climate. Retire in a bear market and you could cripple your portfolio by taking that initial 4%; retire at the beginning of a bull run and a few years in you might safely bump your withdrawal to 5%. Retirees who are invested mostly in bonds might be better off starting with a withdrawal of 3% or less in this low-interest-rate environment. Retirees who are heavily in stocks should be mindful of potential corrections when they set their withdrawal strategy; if stock prices appear to be at their peak, you might want to take a smaller percentage to hedge against a future downturn.

Rather than blindly follow any benchmark, use it as the basis for devising your own plan, says Thompson, either on your own or with help. Betterment.com, an online investment service, gives its clients a tool that lets them tailor their withdrawal strategy to their goals and risk tolerance. Says product manager Alex Benke, "You can specify a lifetime horizon, and if you want a very high chance of success in terms of having your money live as long as you do, we'll tell you over that amount of time how much you can safely withdraw from your account." Betterment recommends that clients check in on the plan once a year. "As the variables change," says Benke, "the advice changes."

What if you wake up on the first day of retirement and discover you got a few things wrong after all? You'll adjust, says Utkus. A standard of living that substitutes weekend getaways for lavish trips, and dinner out once a week instead of twice, "may actually be quite satisfying. I'm talking about people who can meet basic living costs and are thinking about how they manage the rest of their budget."

Also remember that no one strategy or formula represents the complete solution, says Giegerich. "Retirement planning is a blending. It's a symphony, not just the horn section."