



Investment Insights

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How Much Is Enough? II

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This is part two of the two part series examining the holy grail of financial planning questions: how much is enough? At what point can you feel reasonably assured that you have enough money to support you for the rest of your life? While this is a highly personal question whose answer depends greatly on your own lifestyle expectations and needs, too often numbers are thrown around in the press and by commentators that may have no particular relevance to your own situation. In part one of this series, we walked through the process of determining need (i.e. the income needed to support your lifestyle goals in retirement). Now we'll figure out the resources you'll require to meet those needs.

Once you've established with some degree of accuracy your income need in retirement, you can work backwards and figure the amount of money (asset base) you'll need to have. Remember, you may have multiple sources of income in retirement, so your savings are probably only one piece of the pie. On average, retirees in America receive 40% of their income from Social Security, 20% from employer-sponsored pension plans (a rapidly declining number), 20% from employment (this trend is increasing rapidly), and 20% from personal savings. If you know you won't have income from one or more of these sources (i.e. you don't have a pension plan at work), you will need to add that slice of the pie to the amount coming from personal savings. For example, if you have figured that you'll need \$72,000/year in retirement, you should expect to generate approximately \$14,400 (20% of \$72,000) from your savings. If you don't have a company pension, you need to draw \$28,800 from savings. If you want to get specific, plug in your expected Social Security benefits from your most recent Social Security statement, and specifics on any company pension plan, and see what the shortfall is that will need to come from savings. The more specific and personal information you use in this process, the better.

Let's say that you have now determined that you will need to generate \$28,800 per year from your savings to support your retirement. At age 60, you expect that you'll live 30 years in retirement. Although life expectancy is roughly 78 years, it's better to err on the side of being overly optimistic or run the risk of running out of money. In fact, if you are a man aged 65, you have a 25% chance of living past age 92, according to the Society of Actuaries 2000 Mortality Tables. A female aged 65 has a 25% chance of living past age 94!

To determine the lump sum amount of savings you would need to support income of \$28,800 for 30 years, we can tap the knowledge of T. Rowe Price and Fidelity, who produced two widely-quoted studies investigating this question. The basic conclusion is that you can expect to draw 4% of your portfolio value in the first year and increase that for inflation (give yourself a pay raise) every year over a 30 year period and, if invested properly, run little risk of going broke (the calculated “odds” are less than 1 in 10). This is a simplified version of what is a very critical and complex process of investing, monitoring, and adjusting your finances, and it is often best to seek out professional help at this point to minimize the risk of making irreversible mistakes that could negatively impact your retirement. In my own practice, I’ve spent many years studying withdrawal rates and investment portfolio design just to address this one step in the process.

Using the 4% withdrawal assumption, the required amount of savings to meet the need of \$28,800 is thus \$720,000 ($\$28,800/0.04$). If your need is \$28,800 in after-tax income, the savings need is just north of \$1 million. Obviously, you can plug your personal numbers into this formula to come up with your answer to the “How much do I need?” question.

Again, this is a simplified but personalized way to attack this issue, with the goal being to give you a leg up over the “rule of thumb” calculators and such that often provide wildly inaccurate information. Amazingly, on average only one in five people ever goes through this exercise, so consider yourself among the enlightened and informed. For help in developing your own financial plan, seek out the assistance of a financial planning professional who has the knowledge and expertise to guide you through this complex and critical process.

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