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How much is enough for your retirement?

Like anyone who writes about retirement issues, I have long known that most people underestimate the magnitude of funds needed for their golden years. It's not that we make bad judgments about how to prepare for retirement; it is the adoption of faulty assumptions that does the harm.

There are *three* deadly retirement planning mistakes that, combined, can dramatically ruin our chances of achieving a comfortable retirement.

1. We underestimate how long we're likely to live

Many people estimate the amount of retirement funds they need based on their life expectancy (the number of years one is likely to live and only a hardy few survives beyond). In fact, life expectancy is a measurement that actuaries use to estimate the point at which half the people of a certain age will still be living. So, a life expectancy of 85 for a 65-year-old means that half of all aged 65 will die at or before 85, while the other half will live longer and in many cases, much longer. For example, a 65-year-old has about a 30% chance of living to 90 and a 4% chance of crossing the century mark.

This lack of understanding means many don’t have a clue on estimating how long and much we need to support ourselves upon retirement. People who retire at 62 assume that their assets have to last them for 20 years are going to be wrong half the time. They could be entering their nineties with depleted retirement funds.

To make things worse, experts themselves don’t know better. Many financial planners who do retirement planning for their clients simply ask them how long they expect to live or what they think their life expectancy is. This is the same approach adopted by many retirement planning software and free DIY retirement planning websites offered by financial institutions. But many do not have the slightest clue that the answer they give is going to impact significantly the validity of their retirement analysis. It is akin to a doctor asking a patient how many of days of antibiotics supply he needs.

I strongly believe that one of financial advisors’ key roles is to educate the clients on the right assumptions to use in their financial analysis. For example, we could factor in the clients’ parents or grandparents life expectancy into estimating the clients’ life expectancy. Usually, anything below 90 years old would not make very much sense to me. Even using 90, we need to caution our clients that longevity is increasing along with the advances in medical sciences and the odds for women are higher due to their biologically better resistance to many diseases.

2. We underestimate how much income we need after retirement

In order to know how much we must save during our career and how to invest those savings, we must first decide how much income we need upon retirement. Your target income for retirement is one core assumption of your retirement analysis and which everything is built upon. Most financial planners again ask the poor client to simply supply a figure; most clients would respond by plucking a figure from their mind. They have underestimated the cost of healthcare, holidays and motor expenses. For instance, they would claim that their car loan has already been fully paid. What they do not realise is that, in Singapore, they have to repurchase the COE once it expires.

Most people would ask for a retirement income of $3000 to $4000 a month. This might seem quite sufficient to most people. However, when I calculate in term of the percentage of their pre-retirement income, it works out to be below 30% of their average annual income, since a lot of them are drawing more than $10,000 a month toward the end of their career. Now we can always argue about what is the correct benchmark to use. If your house is fully paid for, and you remain in excellent health, do not live in an affluent district and prefer a low-cost retirement which involves minimum holidays and overseas vacations, 30% may be a reasonable target. But I doubt most retirees are able to live with a 30% pre-retirement income.

Not that many people have a choice. Most retirees today have savings that are lesser than 10 times of their annual pay. Their retirement savings would deplete very soon if they maintain their pre-retirement spending patterns. Therefore, when my clients seek advice on retirement planning issues, I would usually tell them that we are not planning for the first 10 years of their retirement but the second or third 10 years, since most people would usually have enough for the first 10 years. The harsh truth is that many tend to overspend during the initial years, leaving little for the later years.

The big question then is, *how much should a young executive in his 30s save every month for his retirement*, since it is difficult to estimate his income prior to his retirement and consequently his retirement income needs. My suggestion is, forget about retirement analysis, or if you do one, stick to a general analysis and take the result with a pinch of salt. No matter what the outcome is, I can guarantee that you would get a completely different set of results if you perform the analysis five years from now. The result of a retirement analysis is only as good as the assumptions used, and these assumptions would evolve and change according to your career development and visibility.

What is the sum you should save for retirement then, since a retirement analysis cannot give us a definite answer? The answer to this question, even through it may seem over-simplified, is “as much as possible”. It is always good to start a race in the lead rather than play catch up later. A rule of thumb would be at least 20% of your gross income should be set aside for good for your long term financial goals. Ideally, even up to 60% of your income!

3. We overestimate how much we can withdraw from our portfolio without depleting it

Most of us know that we have to be prudent about withdrawals from our retirement portfolios if we don’t want to outlive our savings. However, determining the withdrawal rates so that your money lasts requires more than a basic understanding of post retirement investing.

The traditional financial planning assumption about retirement income generation goes something like this: you make 8% on average, withdraw 5% per year, your account balance and income will grow by an average of 3% each year. Your children will receive a windfall when you die. I believe that the maximum a retiree should withdraw from his portfolio should be about 4%.

One fatal problem with the traditional assumption is that it does not account for the variability of returns in the real world. We know from past experience that projecting average returns forward in a straight line is totally inappropriate. The real world that we face is much more complicated and risky than what a “straight line” return indicates.

Down years in the market will have a double whammy effect. Not only does your portfolio lose money because of negative returns, it also shrinks from the withdrawals. This means you would have less capital to benefit from a market rebound. A withdrawal rate that’s fine in a bull market may deplete your nest egg much faster if the market turns bearish, especially if that happens early in your retirement. Average returns count for nothing if your retirement precedes a period like 1994-2003 when your nest egg stood a high chance of self-liquidating. For example, if you retire in 1994, invest your whole nest egg in the Singapore Stock Market and make a withdrawal of 5% a year, today you would have close to nothing left.

Another important factor to consider is inflation. You’ve got to plan on increasing the amount you withdraw from your portfolio each year. When a financial advisor talks about withdrawal rates, what they mean is an inflation-adjusted withdrawal rate. The average inflation rate in Singapore in the last 20 years has been about 2.3%. Using that, the initial amounts you withdraw on the first year of your retirement have got to increase by 2.3% every year to maintain your standard of living. The ‘actual’ inflation could be much higher if you factor in what I call ‘lifestyle’ inflation. For example, I used to drink Kopi-O at coffee shops at 50 cents a cup. Today, I drink coffee at Starbucks, paying between $3 for a cup of basic coffee to $6 for an ice-blended designer coffee. Today, we are talking about paying for your mobile phone bills, broadband bills and cable TV, which did not even exist 15 years ago.

In conclusion, retirement planning is complicated by uncertainty. Most of the factors that determine success or failure are beyond our direct control. Retirees cannot control or predict market returns, interest rates, or even their own mortality. So our focus should be on the things that we can control, which is to devise a conservative investment strategy that will yield the highest probability of success.