Personal Finance 101

FINANCIAL E-BOOK

Retirement Planning

RETIREMENT AHEAD

What Are Your Retirement Assumptions

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You often see the commercials on television today asking the question, "What's Your Number"? What they are really referring to is the notion of how much money do you need in order to be able to retire. It's funny that most people we talk to today don't really call it retirement. They really think about the term of making work optional. This means having the ability to do what they want when they want irrespective of money.

We have always thought about our 'work optional' number being the amount of money we actually need on a debit card when we retire to maintain our standard of living the way we want it when we go 'work optional'. The mistake that we see in many financial plans is that the assumptions made by the clients or their financial advisors are way too aggressive. Making a set of aggressive assumptions can often make it appear that you will be able to retire comfortably, when in reality the sum of all of those assumptions may leave you grossly underfunded. So, how can your assumptions make your retirement planning fail?

1 Inflation

Most financial plans that we see have the ability to make an assumption on inflation. Over the 50 year period from 1956 to 2006, inflation ran at a rate of 4.09%, and over the 20 year period from 1986 to 2006 inflation ran at a rate of 3.09%. (source: heartsofthegods.com). The majority of financial planners use a whole number of 3% for inflation because it has been low as of late. Using a 3% vs. a 4% for inflation assumption can mean literally hundreds of thousands of dollars difference in your retirement planning projections. The conservative assumption to use would be 4%. If you are using 3%, this may leave you with a tremendous shortfall in retirement if we go through a higher inflationary period over the next 50 years.

2 Tax Rate

There are typically two types of tax rates which are your marginal rate and your effective rate. Your marginal tax rate is the tax rate on the very last dollar of income that comes into your household. The effective rate is you overall tax rate on your money. Most financial plans that we see often show a tax rate of 20%. You want to make sure your assumptions take into consideration your overall effective tax rate, state tax rate, and local/city tax rate (if applicable). Often, people assume they will be in a lower tax rate when they retire because they will make less money. However, tax rates may be higher or lower when you retire irrespective of how much money you make. In addition, do you really plan to have a lot less income when you retire?

3 Rate of Return

Financial plans often have to assume a rate of return on your money from now until you retire, and what return you will earn after you retire. First, you want to make sure all returns are considering what will happen on an after tax basis. Second, be certain you aren't using double digit returns on your pre-retirement rate of return as that will be very aggressive. Third, you need to be sure you move the post-retirement return to be a couple of percentage points below where your pre-retirement as you will likely dial down your risk. You should be 100% certain that plan you put in place really matches your risk tolerance.

4 Social Security

Do you believe Social Security will be here at the level it is today? Most financial planners assume you will earn maximum Social Security and start taking it at normal retirement age. A conservative financial plan will assume you don't get Social Security. The more aggressive plans will assume you get the full boat of Social Security at normal retirement age.

5 Savings and additional resources

The last piece of this is being realistic about what financial resources you can commit (lump sum or monthly savings) to your retirement goals. Some financial plans we have seen show savings increasing by 3 or 4% per year. If you build this assumption into your plan, your retirement numbers will look easier to achieve. However, you need to make sure you and your financial planner follow through on increasing those savings practically every year.

A retirement plan isn't an exercise that can be done once and then looked at every 5 to 10 years. In fact, the day you put your plan together it will likely change dramatically a year later due to stock market rates of return, tax law changes, or changes in your personal situation. Having a set of conservative assumptions in your plan will give you more margin for error over time. If your assumptions are too aggressive, you may feel like you are on track and then fall woefully short of your goals. Is it time to revisit your retirement assumptions?

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