FINANCIAL POST

July 23, 2013

Setting a new retirement income target - maybe you need to save less than you think

By Fred Vettese, Rona Birenbaum, Special to Financial Post

Estimates on what percentage of your pre-retirement income you will spend in your elder years vary widely and may be drastically overestimated. The...

Setting your savings target is one of the most important yet least understood questions in retirement planning.

Expert estimates on what percentage of your pre-retirement income you will spend in your elder years - which crucially determines how much you need to save - vary widely. Some suggest you need to save enough to give you an annual retirement income of 70% of your pre-retirement income.

We think you need much less to get by, perhaps even half that 70%.

If you take into account that spending habits are very different before and after retirement for most people, we think 70% is vastly overstated.

Before retirement you will go through a variety of expensive phases: buying a home, paying off the mortgage, going to work everyday and saving for retirement itself. Consider these special expenditures as 'investments.'

What is left over we will call regular consumption - food, shelter, transportation, entertainment, home maintenance, insurance, etc.

If one has sufficient income, regular consumption should remain about the same after retirement. The ‘investments,' however, tend to go away. This is a critical piece of information, often missing from financial planning exercises.

It means your retirement income target should be the percentage of your total pre-retirement pay allocated to regular consumption, not the entire pre-retirement pay as many calculate.

Obviously, the ‘investments' differ from person to person. Some people don't have children. Some rent instead of buy. Still, the formula is the same in all cases and provides a useful way to approximate one's retirement income target.

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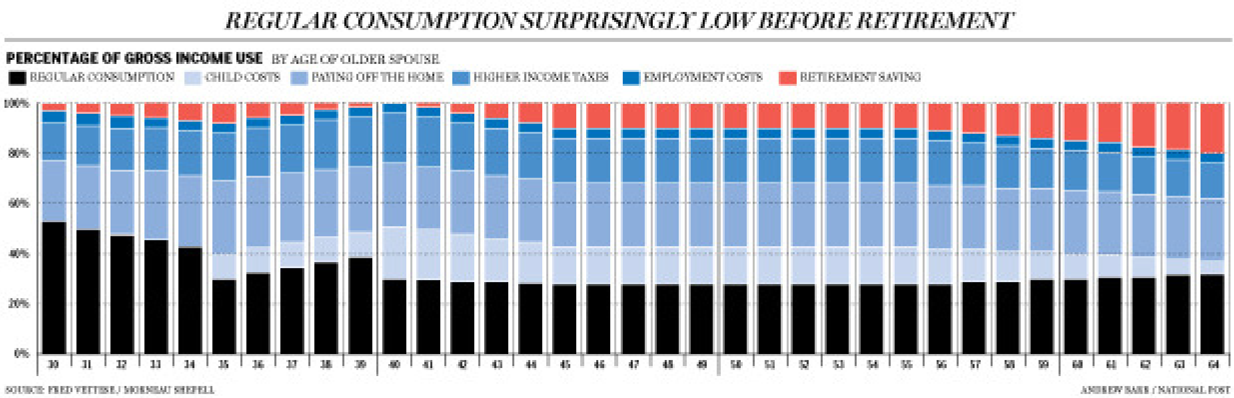
We know that spending on children ramps up with each child born and further depends on whether the parents have plans for daycare, private schools and summer camps, to name but a few child-related expenditures.

As another example, the income dedicated to paying off a house may fall off in the latter part of one's career but not always; many couples decide to trade up or add on a vacation property and take out a bigger mortgage to do so. Finally, for higher-income people, income tax rates can be significantly higher during their working years though how much higher depends on the level of RRSP contributions made.

We looked at a real life example of a higher-income couple with two children. In their case, as in many others, retirement saving starts low, falls further with the birth of a second child, then starts rising as retirement nears. Employment costs remain a near-constant percentage of pay for the couple's entire working career. The cost to pay off a home is a similar percentage of pay in all years though the cost is broken down into three phases - saving for the down payment, paying off the mortgage on the first house, and finally trading up and paying off the mortgage on the second house.

Child costs start at age 35 in this case, rise with the birth of a second child, then fall away as the children reach adulthood.



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When we calculated regular consumption as a percentage of total gross income during their working years, the shocker was how low it was. It averaged out to just 30% of gross income over the 25-year period preceding retirement.

Assuming mortgage payments finally end by retirement, this same 30% also is a rough estimate of this couple's retirement target.

It still needs to be adjusted for income tax paid after retirement, though that number will be surprisingly small, and also for any special expenditure the couple has in mind such as more travel, eldercare or continued support for grown-up children.

For this couple, the adjusted target is estimated to be 35% of final pay.

This couple's retirement cash flow is secure for a number of reasons. They began contributing to RRSPs early, they both belong to an employer-sponsored retirement savings program, and they increased their retirement savings as their income grew. Moreover, they set their expected investment return conservatively low. They will also have significant equity in their mortgage free home at retirement, which will be available in the event that they live beyond age 90.

The savings target won't be this low for everyone: Some people pay off their mortgage early and then start spending more than they did in the early part of their working life. Some couples have no children. In general, the target will be higher for households with lower income, fewer children and those who rent instead of owning their home.

Still, most people who go through this exercise of quantifying all their expenditures will find the percentage of their income dedicated to regular consumption is lower than they think, so their retirement income target will also be lower, perhaps much, much lower.

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References

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