CAN I AFFORD TO RETIRE?

by Karen P. Schaeffer, CFP

Courtesy The National Institute of Transition Planning, Inc.

A recent survey indicated that over 80 percent of us believe we will be financially secure in retirement. We may be kidding ourselves. The same survey found that fewer than 35 percent of pre-retirees had even tried to calculate how much money they will need in retirement. One thing is clear; your financial comfort depends on good financial planning before deciding to leave the workforce. Want to know if you can afford to retire? Take the time to determine how much money you will need. Financial planners call this cash flow analysis. It may be the most important step you take toward a successful retirement.

Cash flow analysis always starts with a look backwards. You need to know how you really spent your money before we can estimate how you will probably spend it in the future. Gather your data from 2011. Your tax return, final pay stub, bank and credit card statements tell most of the story. The idea is to determine how much money you made and how much you kept. The difference is what you spent in 2011. If you describe yourself as someone who is financially comfortable, we have our first clue on how much you will need in retirement. If you struggled last year, living paycheck to paycheck, we need to look more closely at what you actually do with your money. Track your discretionary spending over the next three months. Discretionary expenses are those items we buy beyond the basic food, clothing, and housing necessities. Don’t get too bogged down in trying to figure out how to categorize a particular expense. The idea is to find out just how many dollars you burn through in a year and whether or not that feels like an adequate standard of living.

The next step is to estimate your cash flow in retirement. Don’t rely on what surveys indicate. This is personal. Compared with your cash flow while working, salary gets replaced by pension or pension plus Social Security in retirement. Many expenses drop off like contributions to TSP, IRAs and the cost of commuting. However, if you really think about what you will be doing in retirement, you will find that several expenses actually increase for retirees. Stan Hinson, retired Washington Post writer, was shocked to see how he underestimated how much he and his wife would need in retirement. He learned, a little too late, that retired people have something the workforce doesn’t: time to spend money. It’s pretty interesting to see just how expensive we can be when we have all day, every day, to spend. Try to determine how much of your routine standard of living will be covered by the pension (or pension plus Social Security). Everything else will come from what you’ve saved before retirement.

Add all your money in savings accounts, savings bonds, TSP, IRAs, and other investments to arrive at your total “nest egg.” Even if you want your last check to bounce, you have no guarantee how long you will live or how much your future investment returns will add to the nest egg. Consequently, common sense tells us that we better get used to reviewing cash flow, nest egg and personal health factors at least once a year. As a general guideline, retirees requiring up to 5% [$5,000 a year from a $100,000 next egg] are in good shape, assuming the nest egg is still conservatively invested for growth in the early retirement years. While the definition of conservative growth differs from advisor to advisor, it always means significant money in stocks (like the C, S and I fund of the TSP), and probably in the range of 40-60%. Hate to take market risk with your nest egg? Better not plan to spend more than 2.5% of the nest egg each year because it is very unlikely to grow as fast as inflation raises the cost of everything you need to buy.

Often the first attempt at constructing an estimated retirement cash flow indicates a need to spend more than 5% of the next egg. Good news, sound planning before retirement allows time to improve the picture by making more money, spending less on lower priorities or modifying some other standard of living expense. Every little step today helps keep the retirement years golden.