HOW MUCH DO I NEED IN RETIREMENT?

One of the most difficult questions we are asked is "How much do I need in retirement?".

This is impossible to answer, as every individual and couple will have different expectations of how they will spend their retirement. Obviously those planning on European travel twice a year will need considerably more income than someone who has the caravan hooked up to travel around Australia. We find that some clients need more income in retirement than when they were working, as they suddenly have considerably more free time on their hands which translates to more opportunity to spend.

It is therefore like the length of a piece of string. We have clients who live quite happily on $40,000 per annum in retirement, while others struggle on $100,000. Clearly the lifestyle that is lived pre-retirement has a huge influence on the post-retirement lifestyle, together with the cost of that lifestyle.

The first step is, nonetheless, to at least get a ballpark 'post retirement budget' put together. Some costs (such as rates, health insurance, home insurance, etc.) are unlikely to change in the move from pre- to post-retirement. However, other variable costs (heating, petrol, travel, etc.), could change significantly. The first step is to at least prepare an estimate of how much you are likely to need.

Once this is done, the important question then becomes one of "How much do I need to save before retirement to finance my desired amount of retirement income?". The answer to this question is also never straightforward and depends on a range of factors.

FACTOR 1

Can you rely on Commonwealth/state superannuation pensions to help fund your retirement income?

If a couple has a target of (say) $60,000 annual income in retirement, the amount they need to save could be greatly reduced if they are eligible to receive a government pension (such as CSS/PSS/DFRDB/ UniSuper).

Many of our clients are fortunate to have been members of generous defined benefit schemes over their working life and are now receiving, or will receive, an indexed pension in retirement. If this indexed annual pension is (say) $40,000 net of tax, then the challenge is to fund only the $20,000 difference between the net pension and the value of the desired income.

The same consideration needs to be given to the possibility of an age pension from Centrelink. Although this maybe a little difficult to predict (as it depends on assets and income levels), any income from the age pension system will reduce the need to create retirement income yourself.

FACTOR 2

At what age will you retire?

Although it is an obvious comment, the earlier you retire the more money you will need. The life expectancy of a 55-year-old female is 31.49 years, and 22.47 years for a 65-year-old (ALT 15-171). The earlier you retire, the earlier you will start drawing on your accumulated savings, so the more you are going to need. The problem is exacerbated when one has a much younger spouse, as couples must generally plan around the longer life expectancy within the couple.

FACTOR 3

What is your attitude towards depleting your capital?

This is a very interesting point, often with very conflicting opinions within couples. Say, for example, that you have $500,000 available to produce retirement income. Income is actually a bit of a misnomer, in that you do not spend income, you spend money. The money that you spend could be the earnings on the $500,000, or it could be the earnings plus some of the $500,000 principal. There is certainly no right or wrong on this question. We regularly see clients who insist that they have given the kids a sufficient head start in life and what is

theirs is now theirs to spend. One client rather eloquently put it when he stated 'If the cheque to the funeral home does not bounce, I will have under-spent in retirement.'

We also see many clients who insist that their capital remains intact, to be used as an inheritance down the track, or as a safety net to cover possible aged care costs. In these circumstances, we must also ascertain whether clients wish to keep the balance itself intact or keep the balance intact in line with inflation. Under the latter position, it is not enough for clients to keep their $500,000 intact and live on earnings alone, as part of the earnings must be added to the capital to ensure that the $500,000 maintains its real (indexed) value in future years.

Obviously, these three alternatives (run down principal, maintain amount of principal or maintain current value of principal) will have a huge impact on the amount of principal required as a starting point.

FACTOR 4

What tax will apply?

Tax to investments is like a sea anchor to a racing yacht. If the investments are subject to tax, then a higher level of return must be achieved to have the desired net return. Fortunately, under current tax law, it is possible for most people to eliminate tax on retirement income by using account-based (allocated) pensions. But it is important to appreciate that if investments are outside of this environment and subject to any tax, the potential tax loss must also be taken into consideration.

FACTOR 5

What risk tolerances are you prepared to exercise?

In the short term, the weather is difficult to predict but, in the long term, the climate is more reliable. This is the same with investing.

Year in, year out, we have no idea of what lies ahead in investment markets. Markets are said to be efficient and therefore will react daily to economic and political news. In the short term, returns could be positive or negative and there is no way of knowing what lies immediately ahead.

However, just as weather normalises in the long-term to climate, so too do investment returns normalise over the long term. Although we have no idea what the share market will return next year, we can be relatively confident of a likely range of returns over (say) the next 10–20 years. When you start dealing with longer timeframes, more normal patterns emerge.

Over the longer timeframe, investment returns can be somewhat more predictable. However, the choice of investment strategy over this longer timeframe will have a considerable bearing on the long-term investment return. This, in turn, will have a bearing on the depletion of capital over time. For a set required income, if an individual decides to 'shut up shop' the day they retire (by moving everything into very conservative investments), they will require a larger amount of principal than an individual who maintains a more growth-focused strategy in retirement. This decision will also have a bearing on the type of products they use in retirement.

Summing up

The best way to attempt this is to come up with a multiple of desired dollars. How much a person's desired dollars will be is going to depend predominantly on:

- how much they want to spend each year; and
- what other income (such as dividends, a Commonwealth pension, rent, etc.) will contribute to this desired spending level.

The difference between these two amounts is the desired dollars or, put simply, the amount of income they need to generate each year. Once this figure is known, we can then work out the capital that is required to generate these desired dollars.

Obviously, we must make certain assumptions here otherwise the permutations will make the exercise meaningless. For the sake of comparison, we will assume that the risk tolerance used is in the middle of the scale, with the equivalent of a 'balanced' portfolio (similar to the asset allocation in the default CSS fund).

Piggybacking on this assumption, we can therefore use the same long-term earning assumptions as used by the Department of Finance (DoF) for the CSS Default Fund. In their latest assessment (2017 report), DoF consider this to be 2.5% above inflation, with an annual inflation rate of 2.5%.

The other important consideration is the correlation between retirement age and life expectancy for males and females (ALT 15-17), as shown here.

Age	Male life expectancy	Female life expectancy
55	28.35	31.49
60	24.02	26.93
65	19.86	22.47

Because of these differences, it is better to express these numbers on the basis of ***life expectancy at retirement***, rather than ***age of retirement***.

Note: In calculating these figures, the income drawn is assumed to increase to maintain its value.

Life expectancy	Exhaust capital	Maintain capital	Maintain indexed level of capital
15 years	12	24	41
20 years	15	25	41
25 years	18	26	41
30 years	21	27	41

Earnings 2.5% above inflation

Now let's put these numbers into perspective. Say, for example, that a 60-year-old male and his 60-year-old female spouse intend retiring. They do not receive any ongoing form of income other than what they will generate through their investments. They have identified themselves as desiring $60,000 of annual income.

Their life expectancy is approximately 25 years each (him 24.02 and her 26.93), so we can use the 25-year factors. Based on these factors, this couple will require around $1,080,000 (18 x $60,000) of income producing capital if they are comfortable exhausting their capital over their retirement. To maintain their capital, they will need $1,560,000 (26 x $60,000), while to maintain the indexed value of their capital they will require $2,460,000 (41 x $60,000). See our Fact Sheet titled ***Transfer Balance Cap*** for details on limits to amounts that can be held in the pension phase.

There is obviously a lot more to the equation than this. For example, if we assume that the age-pension age is 67, then 7 years into retirement, both husband and wife may be eligible for a part age pension (depending on assets and income).

If the couple are looking to exhaust their capital, it may well be that by the time they turn 67, their assets will have fallen to a level that qualifies them for a part age pension. This, in turn, means that they need to draw less on their investments once they start receiving the age pension, so the investments will last longer.

However, a far greater consideration is the earning base. As stated previously, the factors outlined above are based on an annual earning rate of 2.5% above inflation for an average balanced investor. It is interesting to look at how the numbers change if we vary this assumption by 1.5% either way.

Earnings 4% above inflation

Life expectancy	Exhaust capital	Maintain capital	Maintain indexed level of capital
15 years	11	18	25
20 years	14	19	25
25 years	16	20	25
30 years	17	20	25

Earnings 1% above inflation

These figures show the significant difference that investment returns make over the longer term. To achieve an annual income of $60,000, the same couple, (assuming that they wish to maintain their capital) would require $1,560,000 (as previously shown) based on a 2.5% real rate of return. This increased to $2,280,000 if they become ultra conservative in retirement and earn only 1% above inflation. On the other hand, if they can achieve an annual rate of return of 4% above inflation, they require only $1,200,000.

This underlines one of the most important concepts associated with retirement. Over the years the superannuation industry has often set age-based default investment strategies within funds. Put simply, unless you state otherwise, the older you get the more conservative your portfolio becomes.

What is important to appreciate is that retirement is not necessarily 'it' in terms of your investments. Certainly, if the day you retire all of your funds are withdrawn to pay off a mortgage, this is clearly a prudent strategy. However, for the vast majority of retirees, the funds they have established at the point of retirement will be used to provide an income stream for another 15-30 years. Over this extended timeframe, being totally conservative to the point of retirement will only result in lower long-term returns, meaning less income or a faster depletion of capital.

The BL&A three bucket approach, as explained in the document ***Using the BL&A 'Bucket Approach' to investing***, works on the concept that funds to be used later in retirement should continue to be invested for the growth at the point of retirement. The key, however, is to ensure that there are sufficient funds available for the short and medium term (first and second buckets) to allow funds in the third bucket to be invested for the long term.

Companion documents

Using the BL&A 'Bucket Approach' to investing

Transfer Balance Cap

1. Based on the Australian Government the Treasury data from the Australian Life Tables 2015-2017 published in November 2019