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What is a Reasonable Retirement Savings Percentage?

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What is a reasonable percentage goal for annual retirement savings? This is a difficult question because there are so many factors. For example, age, rate of return, consistency of savings, present amount saved, unexpected withdrawals, healthcare costs, lifestyle costs now and at retirement, housing costs in retirement, Social Security expectations, and marital status in retirement are all factors. What we do know with certainty is that the required annual savings rate is higher than most people think. Consider the following study of the effect of saving 10% and 15% per year on an inflation-adjusted basis. Inflation was estimated at 3% and the investor was credited a 6% average rate of return. While many professionals would argue for a rate of return above 6%, this is approximately 2.5 times the actual investor return from 1986-2015 according to a DALBAR study reported by Bloomberg on Dec 31, 2015. Social Security estimates were obtained from www.usa.gov/retirement. This page has a retirement calculator that takes you to page where the federal government's Consumer Financial Protection Bureau gives you an estimate of Social Security Benefits based on a given birth and the highest annual work income. For simplicity, the spouse was assumed to be the same age as the worker and without significant earnings so that the spousal Social Security benefits were 50% of the worker's benefit. Annual savings increases each year with the rate of inflation. Retirement Income in this study is defined as withdrawing 4% of the retirement account/year in the first year of retirement. Here are the results.

Retirement Replacement Rate

	Starting at			
	25	**35**	**45**	**55**
10% Single				
$ 50,000	64%	53%	44%	38%
$100,000	58%	46%	38%	31%
$150,000	52%	41%	32%	26%
$200,000	48%	37%	28%	22%
10% Married				
$ 50,000	80%	69%	60%	54%
$100,000	71%	59%	51%	44%
$150,000	62%	51%	42%	36%
$200,000	56%	45%	36%	30%
15% Single				
$ 50,000	80%	63%	50%	41%
$100,000	74%	57%	44%	34%
$150,000	69%	51%	38%	29%
$200,000	64%	47%	34%	25%

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	Starting at			
	25	35	45	55
15% Married				
$ 50,000	96%	79%	66%	57%
$100,000	87%	70%	57%	47%
$150,000	79%	61%	48%	39%
$200,000	72%	55%	42%	33%

Conclusions from the Chart

1. The required savings rate to produce adequate retirement income is much higher than people, including industry professionals, think. One common rule of thumb is that people should aim to replace 80% of their pre-retirement income. In this study, age 35 was the latest anyone could start saving for retirement and come close. Only a married couple making a mere $50,000/year and saving 15% of their income each year almost made it. This would be a rare couple indeed.

2. The American retirement plan is based on the “three-legged stool.” Worker savings is one leg. Social Security is a second leg. Employer contributions are the third leg. The savings rate in the study was a combination of worker and employer contributions. The results show that both the worker and the employer contributions for the average American are woefully inadequate.

3. The study demonstrates the importance to the Social Security System. For better or worse, in the real world, Social Security is a critical safety net for American society. With such low replacement rates, Social Security payments are a critical element of the overall American retirement system.

4. The replacement rate decreases as a worker’s income increases. If Marie Antoinette was alive today, she would probably say, “The nice thing about being poor is that it doesn’t cost much.” One reason lower income people have higher replacement rates is Social Security benefits give a higher replacement ratio for lower income situations. Since most financial professionals’ clients have higher income, our clients face an even greater challenge. Counterintuitively, it takes a larger and larger annual savings rate to maintain lifestyle as income increases. In other words, it is harder for a high income person to fund his or her retirement at an adequate replacement ratio than it is for a low income person.

5. Time is of the essence in retirement savings. This is especially critical to keep in mind as the college debt crisis grows and attracts more attention. Serious retirement preparation cannot wait until children graduate from college. All elements of society must begin to address this issue. Unfortunately, democracies are ill-equipped to deal with long-term, slow moving crises.

6. The replacement rate being so low from income using the 4% withdrawal rule will mean more families will need to consider annuitizing some portion of their retirement savings. The most obvious downsides of this approach are the loss of control of the assets and the potential for significant loss of purchasing power from inflation over time. This also means lower net inheritances to fund future generations and their retirement. Mark Twain said, “Frugality is a virtue, especially in an ancestor.” Increased annuitization will mean fewer Americans in the future will have virtuous ancestors by Twain’s definition.

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7. The high savings rate required to accomplish a modest goal will generate significant motivational barriers. Many people will baulk at the required rate and want to do nothing. Attention will be needed on making retirement savings more simple and automatic, while more attention is paid to the end game and increasing contributions from both workers and employers.

8. Every single aspect of this study points to the importance of financial advisors at every point in life. The American financial environment has become too complicated and high stakes for simple and lackadaisical financial management. Things will not work themselves out on their own. People in America can get a Ph.D. without ever being taught to balance their checkbook. This has to change.

So, what is the percentage to save for retirement?

In one sense this is the wrong question. Retirement calculations should start with the goal amount in mind and work back to the contribution rate. Another problem with this question is that it does not take the client's age or current retirement savings balance into account. With those things in mind, if people will have a total retirement savings of 7-10% starting in their 20's and increase it to over 10% in their 30's, they should be on a good track. People in their 40's and up need to start with a higher percentage. One very helpful behavioral finance method is to sign an automatic escalation agreement at work so that there will be a higher retirement savings percentage over time without the worker having to revisit the issue each year.

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