Iowa State University
Extension and Outreach

Retirement Income: How Much Do You Need?

When it comes to estimating retirement income, it's a temptation to throw up your hands in despair, feeling you can't possibly guess how much money you'll need. The uncertainties can be overwhelming. You may be asking yourself, "How much money will it take? Will I have enough? I don't want to think about it, I just hope it's enough. How can I really plan anyway?"

RETIREMENT:

SECURE YOUR FUTURE

Don't let uncertainty about the future prevent you from planning for retirement income. Research indicates that those who do even a small amount of retirement planning typically achieve substantially more total assets.[1] A good estimate, even if not perfect, is far better than no plan at all.

Determining the income you'll need for retirement is a straightforward process. When you take the time to work through the process, you greatly increase the likelihood that you will be financially ready when you retire.

Your retirement plan won't be perfect, since you can't foresee the future. You *can*, however, make your best judgments about future needs and investment returns, and use them to guide your saving and investing. You'll feel greater peace of mind when you know that your savings are on track to take you to your goal.

Tools for the Process

Financial planning for retirement requires a few basic calculations, including:

- adjusting expenses for inflation,
- calculating how much your existing investments will be worth by the time you retire,
- determining what size nest egg will provide you with the ongoing income you'll need during retirement, and
- computing the additional monthly investment (if any) needed to accumulate that nest egg.

SECURING YOUR FINANCIAL FUTURE SERIES

PM 1818A / June 2014

This publication outlines a five-step process for assessing retirement readiness. The financial calculations needed can be carried out in several ways.

1. The extension publication, *Retirement: Secure Your Future – Money Math*, PM 1819—store.extension.iastate.edu/Product/PM1819, provides the tables and equations you need to follow this process and do the calculations on your own. It also includes examples that illustrate the process.
2. If you are familiar with the use of a financial calculator, you can perform the calculations on your own.
3. A financial professional can take you through the process. See "Choosing an Investment Adviser" box.
4. Computerized planning tools are available for your personal computer or via the Internet. See Resources on page eight.

Even if you use a financial professional or a computerized process, it is essential that *you* understand the process used to project your retirement needs and savings. When you understand how your choices interact, you can make informed decisions about how much to save/invest, what savings/investment instruments to use, when to retire, and what lifestyle to expect.

Before You Start

The financial planning process for retirement will be most effective if you have accurate information on the following factors.

- An estimate (in today's dollars) of the retirement income needed to provide for your needs and support the lifestyle and activities you desire in retirement. See the *Retirement Expenses worksheet*—PM 1818B, store.extension.iastate.edu/Product/PM1818B, for a guide to estimating retirement expenses.
- The age you plan to retire.
- A realistic estimate of your life expectancy. Base your life expectancy estimates on statistical averages and your knowledge of your own health and family history (hint: to be safe, plan on a long life).
- Financial investments already in place for retirement, their current balances and historic rates of return.
- Fixed income sources you can expect in retirement, estimated in today's dollars. These include Social Security benefits, defined company pensions, and rental income (see box on page 3 for details about fixed income sources).

Step One—Determine your annual income target *(the income you wish to provide from your financial investments)*.

Step One is to determine the amount of annual income you want your investments to yield. To do that, use your estimate of retirement expenses (in today's dollars), and your estimates of retirement income sources. Subtract your fixed income sources (Social Security, defined benefit pensions, rental income) from your total retirement expenses. The result is your **income target**, the annual income (in today's dollars) you wish to provide from your financial investments.

Step One Example

a. Estimated Annual Retirement Expense		$25,000
b. Fixed Retirement Annual Income Sources		
Social Security	$ 10,000	
Defined Pension	$ 0	
Rental Income	$ 0	
Other	$ 0	
Total Annual Fixed Income Sources		$10,000
c. Annual Income Target to Generate		$15,000

Resources for Choosing an Investment Advisor

- The Iowa Securities Division has several investor education publications available at the following URL: *www.iid.state.ia.us/investor_education*. Scroll down the page and click on the publication title.
- FINRA – Financial Industry Regulatory Authority – Selecting Investment Professionals *www.finra.org/investors/smartinvesting/gettingstarted/selectinginvestmentprofessional/*
- Securities and Exchange Commission – Investment Advisers: What You Need to Know Before Choosing One *www.sec.gov/investor/pubs/invadvisers.htm*
- National Extension System – Choosing Financial Professionals *www.extension.org/pages/10899*

Fixed Sources of Retirement Income

- **About company retirement plans**

  A traditional company pension, called a defined benefit plan, would be included in your list of fixed income sources for retirement. These pensions are defined as a specified percentage of your pre-retirement income.

  In recent decades, many companies have shifted to a defined contribution plan, which means that the employer and the employee contribute certain amounts to an employee's fund. The investment of those contributions is determined by the employee, typically in some type of mutual fund(s).

  In this financial planning process, include a defined benefit pension as a fixed income source in Step One. Include defined contribution pensions, which are invested specifically according to your investment preferences, as part of your retirement investments in Steps Four and Five.

- **About Social Security**

  Social Security has provided a base retirement income for generations. Many younger adults question whether Social Security will be available for them when they retire, due to the financial strain that the baby boomer generation will put on the system. Most experts predict that Social Security will continue to exist, although eligibility or benefits may be more limited.

  A personal projection of Social Security retirement benefits, based on an individual's actual earnings history, is available by choosing "My Social Security" at *www.socialsecurity.gov*. A careful review will enable you to clearly understand the benefits available to you and also to ensure the accuracy of the report.

  For more information, contact the Social Security Administration at 1-800-772-1213 or online. *www.socialsecurity.gov*

- **About rental income**

  Real estate is an important component of retirement income for many Iowans. Farmland values can generally be expected to appreciate over the long term at rates at least equal to inflation, but selling price at any given point in time can vary dramatically. Likewise, return on investment (i.e., farmland rent) is affected by a variety of market forces. When real estate investment of any kind is a component of retirement planning, it is important to understand factors and trends that may affect the return.

  How you factor in real estate investments as part of your financial planning for retirement depends primarily on how you plan to generate income from the real estate. If you plan to retain ownership and use the rental income as a source of retirement income, then include the rental income as a source of fixed income in Step One. If you plan to sell the land and live off the proceeds from the sale, then include the value of the land as a current asset in Step Four.

Step Two—Adjust your annual income target for inflation.

Due to inflation, it is almost certain that goods and services will cost more in the future than today. Whether your retirement is 10, 20, or 30 years away, you'll need to adjust your income target to account for the effects of inflation. Step Two is to adjust your annual income target for inflation. To calculate the adjustment, use the inflation table in PM 1819, a financial calculator, a computer program, or a financial adviser.

Before you can make the inflation adjustment, you'll need to decide what rate of inflation you expect. For years, it was general practice to plan for five percent annual inflation over the long term. However, recent years of low inflation have led some experts to use four or even three percent in planning for future goals. The rate you use will affect your income target. For example, a $10,000 per year income target in today's dollars will be equivalent to $16,300 in 10 years if inflation is five percent a year. If inflation averages three percent annually, then that $10,000 would equal $13,400 in 10 years. A cautious planner might use four or five percent inflation, but it also may be realistic to use a lower rate.

People who retire in their 60s may live well into their 90s, so a prudent retirement plan also allows for the effects of inflation during retirement. If you are preparing for the possibility of a 30-year retirement, a simple way to calculate that adjustment is to target the midpoint, 15 years into retirement. (See the example for Step Two.) Using this method, your inflation-adjusted income target will be roughly an average of the amount you'll need over the entire retirement period.

Don't be intimidated by the large numbers you see when you adjust for inflation. If retirement is distant enough for inflation to have a big effect, then those intervening years also will produce investment returns that have an equal or greater effect on your assets.

Step Two Example

a. Annual Income Target	$15,000
b. Time until retirement	20 years
c. Half the length of your retirement	15 years
d. Time until mid-retirement (b + c)	35 years
e. Projected rate of inflation	3%

$15,000 per year today, at 3% inflation, after 35 years equals $42,208 per year. (Determine this value by using PM 1819, a financial calculator, a computer program, or a professional advisor.)

Note: If the inflation adjustment in this example was made only for the first year of retirement, the result would be about $27,000, a serious underestimate of expenses over the course of a 30-year retirement.

Step Three—Figure the lump sum that will yield the annual retirement income you need.

When you know the annual income you want your investments to produce, you can calculate the lump sum you'll need to produce that amount of income throughout your retirement. That's Step Three. Use the Lump Sum Needed to Provide Future Income table in PM 1819, a financial calculator, or get help from a computer program or a financial professional. In addition to the desired annual income amount, you also need to decide what rate of return you expect from your investments during retirement.

Step Three Examples

To generate annual income of $42,200 over a 30-year retirement, with investments in retirement yielding an average annual return of 6%, you'll need a lump sum of $580,000.

Note: A 6% return is used here as an example. Select the rate of return for your own calculation based on the type of investment, its past performance, and your expectations for its future performance. In general, low-risk investments earn lower rates of return and higher returns only come with increased market risk.

Step Four—Figure current assets available for retirement income.

You may already have in place a good portion of the lump sum you need, particularly if you started investing for retirement in early adulthood. Step Four is to identify your existing investments, including your 401(k), other defined contribution employer retirement plans, IRAs, and other financial accounts earmarked for retirement along with any real property that you intend to sell to finance your retirement. List the current values and the rate of return you expect from each asset. Then use the inflation table in PM 1819, a financial calculator, a computer program, or a financial professional to help you calculate how much they will be worth by the time you retire.

Step Four Example

List assets that can be expected to provide retirement income.

Asset	Current Value	Expected Average Rate of Return	Potential Value after 20 Years
401K account	$45,000	6%	$144,000
IRA	12,000	7%	46,000
40 acres	90,000	3%	163,000
Total expected value of current assets at time of retirement			**$353,000**

Step Five—Find additional investment needed.

When you know the size of the lump sum that will generate your annual income target (Step Three) and have calculated the future value of assets you already have in place (Step Four), then you can determine how much additional investment is needed. That's Step Five.

To calculate how much you need to save per month in order to reach your goal, use the table for Payments to Reach a Future Goal in PM 1819 or another financial tool. Compare the monthly savings needed with what you (and your employer) are already contributing; this tells you how much extra (if any) to save in order to reach your goal.

Step Five Example

a. Lump sum goal (Step Three)	$580,000
b. Lump sum already in place (Step Four)	–353,000
c. Additional sum to generate by retirement year (subtract b from a)	$227,000
d. Monthly investment to accumulate additional amount (c) in 20 years with investment earning 6% *(use financial tools for this calculation)*	$490
e. Amount already being contributed monthly by self and employer to retirement investments	$400
f. Subtract e from d. This is the approximate additional monthly savings that will enable you to reach your financial goals for retirement.	
Desired monthly savings increase	**$90**

After completing step five, examine your plan carefully, looking at your projected retirement spending and the assumptions you made about age of retirement, rate of inflation, and return on investments before and after retirement. Consider whether those assumptions are realistic, and whether the additional savings needed is manageable within your current budget.

If you wish, redo your retirement calculations using different assumptions. Examples: What if inflation was higher or lower? What if your investments earned less(or more)? What if you needed to retire earlier? What if you wanted a higher retirement income?

If the results of step five are unrealistic, meaning that you are unable to reach your retirement goals, consider options to improve your projected outcomes. For example, you might work two more years before retirement, or you might shift some investments into higher-earning, though more volatile, mutual funds.

Step Six—Act on your plan.

The final step is to act on your plan. Seek information to help you put your plan into action, and stay informed about opportunities and issues that may affect retirement planning. It also is wise to review your plan every one to three years so that you stay on track toward your goals.

Retirement Income Planner

Use the worksheet below to record your own retirement planning figures, following the steps outlined in this publication. Where marked with an asterisk, you will use publication PM 1819 (Money Math), a financial calculator, or a professional adviser to calculate your own figure.*

Step One—Determine your annual income target *(the income you wish to provide from your financial investments)*.

a. Estimated Annual Retirement Expense $______________

b. Fixed Retirement Annual Income Sources

Social Security $_____________

Defined Pension $_____________

Rental Income $_____________

Other $_____________

Total Annual Fixed Income Sources $______________

c. Annual Income Target to Generate (Subtract b from a) $______________

Step Two—Adjust your annual income target for inflation.

a. Annual Income Target (See Step One, c) $______________

b. Time until retirement ____ years

c. Half the length of your retirement ____ years

d. Time until mid-retirement (b + c) ____ years

e. Projected rate of inflation ____ %

f. Inflation-adjusted annual income needed $_____________*

Step Three—Figure the lump sum that will yield the annual retirement income you need.

a. Annual Income (See Step Two, f) $______________

b. Number of years you'll be retired ______

c. Expected investment return during retirement _____________%

d. Lump sum needed $_____________*

Step Four—Figure current assets available for retirement income.

List assets that can be expected to provide retirement income.

Name of Asset	Current Value	Expected Average Rate of Return	Potential Value after __ Years
___________	$_____________	_________%	$___________*
___________	$_____________	_________%	$___________*
___________	$_____________	_________%	$___________*
___________	$_____________	_________%	$___________*
___________	$_____________	_________%	$___________*
___________	$_____________	_________%	$___________*

Total expected value of current assets at time of retirement $______________

Step Five—Find additional investment needed.

a. Lump sum goal (Step Three) $______________

b. Lump sum already in place (Step Four) – ______________

c. Additional sum to generate by retirement year (Subtract b from a) $______________

d. Monthly investment to accumulate additional amount (c) in ___ years with investment earning __ percent return prior to retirement. $_____________*

e. Amount already being contributed monthly by self and employer to retirement investments $______________

f. Subtract e from d. This is the approximate additional monthly savings that will enable you to reach your financial goals for retirement.

Desired monthly savings increase $ _____________

RESOURCES

Financial calculators are available on many commercial websites. Be sure to investigate several sites, and evaluate the assumptions upon which each site bases its calculations. No endorsement of a commercial site is intended, nor is criticism implied of those not mentioned.

- **U.S. Securities and Exchange Commission—** *www.sec.gov/investor/tools.shtml* Offers several tools and calculators to use in making investment decisions
- **American Savings Education Council's Ballpark Estimate—***www.choosetosave.org/ballpark/*
- **The Motley Fool Retirement Calculator—***www.fool.com/calcs/calculators.htm*
- **AARP Retirement Calculator—***www.aarp.org/work/retirement-planning/retirement_calculator.html*
- **MSN Money: Plan Your Retirement—***money.msn.com/retirement/retirement-calculator.aspx*
- **Market Watch Retirement Planner—***www.marketwatch.com/retirement/tools/retirement-planning-calculator*

Endnote

[1] Lusardi (2006) found median retirement assets doubled or more for those who did even a small amount of retirement planning in "Baby Boomer Retirement Security" *http://www.nber.org/papers/w12585.pdf?new_window=1*

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http://store.extension.iastate.edu

Written by Barb Wollan and Tim Griesdorn, family finance specialists. Reviewed by a team of ISU Extension and Outreach family finance specialists. Designed by Hobbs Designs, LLC.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Cathann A. Kress, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.