

## Understanding Your Retirement Income Replacement Ratio

Although the term retirement income replacement ratio sounds formidable, it's actually a simple, understandable concept that doesn't require any fancy math. The ratio helps you zero in on your retirement savings goal and periodically measure your progress as you move toward your target.

Will you need 60%, 75%, 90% or even 100% of the income you have in your last year of work to maintain a desirable standard of living after you retire? The answer to this question is your income replacement ratio--the percentage of your pre-retirement earnings that will provide you with the same standard of living in retirement. For example, if your pre-retirement income is \$50,000 but your income after retirement is \$35,000, you have a replacement ratio of 70% (\$35,000 divided by \$50,000).

### Setting the Foundation of Your Plan

Widely used by financial planners, replacement ratios are common elements of worksheets, online calculators and computer software programs created to help individuals plan how they will finance their retirement years.

With the ratio, you can estimate how much income you may need for a comfortable retirement and how much money you need to save to supplement your expected sources of income--which may be some combination of Social Security, pension benefits, personal investments and postretirement employment. If these income sources fall short of your goal, you can increase your rate of saving or take other actions to close the projected deficit, such as planning to reduce living expenses or moving to a lower-cost locale in retirement.

### What Research Tells Us

Opinions vary on the question of how much replacement income retirees need. However, one recent study from the Employee Benefit Research Institute (EBRI) found that if current Social Security benefits are not reduced, between 83% and 86% of workers with at least 30 years of eligibility in a 401(k) retirement plan could have enough funds to replace at least 60% of their age-64 wages on an inflation-adjusted basis.<sup>1</sup>

When the ante is upped to 70% of age-64 pay, the EBRI study found that three-quarters of workers would still have adequate income, relying solely on 401(k) savings and Social Security benefits. At an 80% replacement rate, 67% of the lowest income group studied would still meet the threshold if they had 30 years of eligibility in a 401(k) plan.<sup>1</sup>

The bottom line: Many people may need between 60% and 80% of their final working years' income to maintain their lifestyle after retiring--and long-term commitment to an employer-sponsored retirement plan is key to meeting that goal.

Why don't retirees need 100% of their working income? Lower taxes may be one reason. When a person is no longer employed, there are no Social Security payroll taxes to pay. Federal income taxes are usually lower because Social Security benefits are either partially or fully tax free for many retirees, and extra deductions are available for people over age 65. In addition, many people no longer need to save for retirement, and those who have paid off debts before retiring or eliminated work-related expenses, such as commuting costs, also have a greater share of their income available for spending.

However, one increasingly important “unknown” is the rising cost of medical care. Already, medical care has been taking a bigger bite out of retiree budgets as health care expenses have risen; some employers have reduced or eliminated medical coverage for retired employees; and life expectancy has lengthened. In addition, retirees have faced higher contributions for Medicare benefits and increased premiums for Medicare supplemental insurance policies.

## The Outlook for Future Retirees

While recent retirees and those nearing retirement may have adequate replacement income, the situation may not be so favorable in the future. For instance, the increasing financial strains on Social Security caused by the nation’s aging population may lead Congress to alter the system at some point in the future, perhaps reducing Social Security benefits or increasing the age of eligibility. As a result of these trends, future retirees may have to rely more on income from personal savings and investments than today’s retirees.

## What You Can Do

Putting yourself on track to a secure retirement requires a few calculations, which can be accomplished relatively easily by using a retirement planning worksheet or calculator available on the Internet, or from financial advisors and retirement plan providers.

Calculators and worksheets typically factor in a replacement income ratio, along with assumptions about future inflation rates, longevity and the growth rate of retirement savings. (As you complete these calculations, bear in mind that such assumptions can’t be guaranteed.) Calculators and worksheets also usually take into account information about your current retirement account balances, rate of savings and anticipated benefits from outside sources, including Social Security and pensions.

While ballpark estimates may be adequate when retirement is a long way off, more accurate planning is advisable as your actual retirement date approaches. If you don’t feel up to the task of refining the numbers, consult a financial advisor. He or she can help you develop detailed income and expense projections, review your assumptions about inflation and future returns from savings and investments and determine a prudent level of withdrawals from your assets.

<sup>1</sup>Source: Employee Benefit Research Institute, [“Can Social Security and 401\(k\) Savings Be “Enough?”](#) January 22, 2014.

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