THE Wealth REPORT

RETIREMENT: WHAT'S A SAFE SAVINGS RATE?

Various retirement strategies are based on specific factors, such as accumulating a certain "number" of assets by retirement, achieving a particular average annual return or withdrawing 4 percent or some other appropriate share of savings throughout retirement. However, a study of "safe savings rates" demonstrates a real-world approach that marries the accumulation and distribution approach to retirement planning.[1]

Overview

Previous studies have emphasized the strategy of consistent saving practiced throughout one's career to meet retirement income goals. However, these studies generally assume a consistent savings rate starting at age 25 until retirement.[2] Unfortunately, that's not a common scenario. Because starting salaries are often just enough to pay for a worker's cost of living, many people do not actually start saving on a regular basis until their 30s or 40s.

Furthermore, a consistent savings rate is generally aligned with cost-of-living increases, but there are two problems with this. First, workers typically increase their income during the early portion of their career at a much higher rate than inflation. This is usually accomplished by early promotions or switching jobs to procure a substantial increase in salary. Second, because the personal savings rate at the beginning of a career tends to be quite low, it doesn't account for the ability to increase the percentage of income workers can save as their salaries increase — for example, from a 2 percent salary deferral on up to 10 percent later in their careers.

Saving Early vs. Saving Late

A personal savings rate is just that — personal. Everyone has a different career trajectory, which can even include a reduction in salary now and then. Therefore a "safe savings rate" (SSR) will differ with each person. However, the math that supports the strategy of consistent, long-term savings is interesting, as detailed below. It even illustrates that people who get a late start saving for retirement may not have quite as difficult a time as generally perceived.[3]

If you divide a person's career roughly into thirds, it often looks like this:

1. First 10-15 years — rapid income growth
2. Second 10-15 years — slower income growth (i.e., cost-of-living increases)
3. Third 10-15 years — even slower or no income growth

Analysts report there is typically a decline in earnings, adjusted for inflation, during the last 10 years of one's career. However, there is an interesting savings correlation with this income progression.[4]

1. First 10-15 years — low savings rate
2. Second 10-15 years — slightly higher savings rate, impaired by increased costs (buying a home, raising a family, improving one's standard of living)

3. Third 10-15 years — significantly higher savings rate due to reduced expenses (assuming the standard of living has plateaued)

The advantage of the third phase of work is that the income, although not increasing, may still be at the highest level ever for that particular worker. At the same time, living expenses tend to decrease as children graduate, move out of the family home and become financially independent. At this stage, one or two people live on an income that used to support three or more. Moreover, assuming these workers do not increase their spending habits, they can settle into a household budget that more closely resembles future retirement spending.

The reality is that many people do not start making significant retirement savings efforts until the third stage of their career. The good news is that they may be able to save at a substantially higher rate than during previous work stages.

Market Impact

Another variable that will impact retirement income readiness is investment performance. While past results are no guarantee of future performance, traditionally the markets have demonstrated steady gains for a well-diversified portfolio invested over a 30-year period. Of course, if a saver starts late, he or she may not have the luxury of time to smooth over volatile periods. Therefore, it's worth evaluating market performance just before or just after retirement begins.

As a general rule, a long bull market prior to retirement may increase a portfolio's net worth. However, it also increases the risk that markets have become overvalued and may be due for a correction. Should a decline occur right around the time a person retires, this can dramatically impact how long that portfolio will be able to provide retirement income.

Conversely, if the markets experience a long-running bear market before retirement age, the odds are increased that growth is right around the corner. This is worth noting when considering whether to transition a substantial portion of a retirement portfolio to more conservative holdings upon retirement.

Safe Savings Rate

The research associated with a "safe savings rate" illustrates that saving at a consistent rate from early until late career would likely be adequate to fund a 30-year (plus) retirement, using the following data and assumptions:[5]

- More than 100 years of annual financial asset returns
- Rolling 70-year time periods of safe savings rates to fund retirement (40 years of saving and 30 years in retirement)

- A portfolio of 60% stocks and 40% short-term fixed income, rebalanced annually (taxes and investment fees not included)
- Withdrawal rate to support an inflation-adjusted 100% of pre-retirement spending

Based on these assumptions, the average safe savings rate required to fund retirement successfully is 15.36 percent of earnings (including annual cost of living increases).[6]

The Social Security Factor

It's worth noting that these calculations do not incorporate Social Security benefits, which pay for a significant portion of retirement expenses at every income level. Interestingly, the lower the income earner, the higher the income coverage by Social Security benefits — and thus the less one needs to save. Not only do people in the lower income brackets not need to save 15 percent to support their lower-income retirement lifestyle, but those at the lowest level may not need to save for retirement at all.[7]

At the 70th percentile income level, Social Security benefits generally provide enough income to reduce the cited personal savings rate by half. At the 90th income percentile, the safe savings rate should actually increase to more than 18 percent.[8] This is because higher-earning consumers generally spend more money as their income increases — known as "lifestyle creep." In other words, higher earners must save more for retirement income in order to pay for their more upscale lifestyle.

Higher Income can Lead to Higher Spending ...

"Each individual in this analysis is assumed to save the percentage they need to replace their income given their income growth, but the levels of spending in retirement may be very different based on the actual income growth experienced."[9]

– Derek Tharp
Research associate, Kitces.com

Final Thoughts

It would seem obvious that savings rates should increase as earnings increase. Unfortunately, midcareer expenses that may include a larger family, larger mortgage and increased lifestyle outlays can undermine our ability to save more. These efforts may be further hindered by sums paid for college expenses and elderly parent care.

However, the bigger problem may be lifestyle creep. For those starting late who need to catch up on their retirement savings, this could require a reduction in current household spending. Other factors such as retirement lifestyle goals, asset allocation during retirement and the availability of other income sources directly impact the personal "safe savings rate" required to adequately fund retirement.

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[1] Derek Tharp. Nerd's Eye View. May 24, 2017. "Safe Savings Rates With Real-World Wage Increases Over Time." https://www.kitces.com/blog/safe-savings-rates-real-earnings-growth-curve-cost-of-living-raises/. Accessed Oct. 18, 2017.
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] Ibid.
[8] Ibid.
[9] Ibid.

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