Can you afford to retire?

When deciding whether you can afford to retire, a rule of thumb comes in handy. Even if you are already retired, with a little creativity the rule is flexible enough to determine if you will outlive your assets. Like any rule of thumb, it only puts you in the ballpark. It is not designed to give you a precise conclusion.

One final comment: The rule has been rigorously explored in the academic literature for many years. While its acceptance is not universal (academics argue over everything!), most finance professionals see merit in its practical use.

The rule says the current value of your retirement account will generate an income of 4 percent the first year and 4 percent plus the rate of inflation in each subsequent year for the rest of your life. If that amount of income is sufficient to replace your lost income, you can retire without sacrificing current lifestyle.

As you read further, a question may arise in your mind as to what the proper asset allocation should be in order to generate the requisite income. Without going into detail at this time, I can assure you that this issue is not a problem. A more developed response will have to wait for another time.

Example 1

Let's say your retirement account has a value of $800,000, your bring-home wages equal $70,000, and you can now draw Social Security benefits of $25,000 per year. In this case, you need to replace lost income of $45,000. Can you afford to retire?

$70,000 wages
- 25,000 SS benefits
$45,000 income to replace

Rule: 4% x $800,000 = $32,000

Since $32,000 is less than $45,000 by $13,000, you are not able to retire and enjoy the standard of living to which you have become accustomed. So, the question is, how much should your retirement account equal to allow you to retire now?

Example 2

Using the above data above to replace income of $45,000, the rule says the value your retirement account should equal $1,125,000 to allow for that level of replacement income:

$1,125,000 = $45,000/.04

Because your retirement account currently equals $800,000, you need to increase it by $325,000 (= $1,125,000 -$800,000) if you want to retire now. Since coming up with that amount of money out of thin air is highly unlikely unless you hit the lottery jackpot or receive a lucky inheritance, you have a few options:

1. Don't retire but keep working. This option allows you to continue contributing to your retirement account until you decide to hang it up. A longer work-life means a shorter period you would need funds in retirement. Continuing to work would also allow you to postpone drawing SS benefits that increase by 8 percent per year until you retire, but no later than age 70.5 when you have to begin drawing benefits.

2. Reduce your living expenses to the point you don't need the full $45,000. This would be difficult for most people. One way to reduce living expenses is to downsize, but that strategy could trigger emotional problems.

3. Retire and take a part-time job to fill the gap of $13,000. In the gig economy, many people are taking this option although finding a good part-time job is easier said than done. Besides, why give up a good paying full-time job to take a lesser paying part-time one?

I'll mention a fourth option but do so hesitantly. Be careful here because this strategy could backfire and cause you serious financial problems. Given that word of caution, here it is: increase the risk of your retirement account. Taking on more risk does not mean you will necessarily earn a higher return. Like I say, be careful here!

Another word or caution: This 4 percent rule does not consider the cost associated with long-term care. Another rule says you may need approximately $80,000 per year for 3 years of nursing care on top of normal living expenses. Putting $240,000 (= $80,000 x 3) on top of a retirement account of $1,125,000 means you would need a total of $1,365,000 (= $1,125,000+$240,000) in order to retire now.

Please call or email if you would like to discuss your retirement plan. A key point of this article is to save as much as you can during your working years without overly penalizing your life style. Better too have much down the road, as opposed to not enough.

All the best,

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