

Research Comments

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The Cost of Waiting

As Tom Petty is known to say, "the waiting is the hardest part." To paraphrase this in the context of retirement planning, "waiting will absolutely destroy your chances for a comfortable retirement."

Many individuals delay far too long in beginning to accumulate assets for retirement or other far-away financial goals. Procrastination, however, can be costly both in terms of how financially secure you are when you reach retirement and also in terms of how much incremental savings you must generate to meet your goals as you near retirement.

Let's take the situation of John Doe, Sr. (JDS), who is currently 30 years old and makes \$40,000 a year. He plans to retire when he reaches age 60 (in 30 years) and his friendly insurance agent has told him he should expect to live until 85. JDS has hired an investment advisor whom he expects will earn 10% on his investments. JDS believes that the inflationary spirals of the 1970's are a thing of the past and that future inflation will average around 3% per year. He further believes he will need about 60% of his current income (adjusted for inflation) annually throughout retirement. To date JDS has saved nothing toward retirement and given his youthful age, he is highly skeptical that Social Security will be around when he retires, therefore he is not counting on anything from that source.

Using basic, and given the above scenario, JDS will need to amass a retirement portfolio of about \$670,000 to reach his goal. He has several options. He could found an internet company and do an IPO. He could inherit his fortune from Aunt Jane. Or, he could save almost \$4,100 (over 20% of his pre tax income) per year on his own or invest a lump sum of \$38,500 right now.

By the time he reaches retirement age his annual income will be over \$97,000 based on 3% inflation per year. He will need 60% of this or about \$58,000 per year to maintain his current standard of living. Keep in mind a few things. This scenario assumes he conducts all his investment activity in a tax free account such as a 401(k). For simplicity's sake it also assumes he receives no company match. It also assumes he earns 10% on his investments, about the historical rate of return on common stocks. Bonds have been in the neighborhood of 6% and cash has returned around 3%. The after tax numbers required to reach his goal are astonishing. In the 28% tax bracket he needs a portfolio of over \$876,000, which would require \$8,950 annually, \$109,000 in a lump sum, or a much richer aunt.

This is where it really gets interesting. What if he waits 10 years to begin saving? He wakes up on his 40th birthday and is happy that he is now earning almost \$54,000 a year and has only 20 years remaining until retirement. He had a particularly good day at work. When he arrived home, however, things took a turn for the worse. Included in the day's mail was a letter from his investment advisor stating that he now needed to save almost \$12,000 per year or over \$900 per month to meet his retirement goals versus 10 years ago when he only needed to save \$4,100 annually or \$307 per month. Wow, what a cost of waiting! The lump sum ante is now up to almost \$100,000. Unfortunately he may no longer be able to rely solely on Aunt Jane. She's had her

money in CD's during this great bull market.

The morals of this story are fairly straightforward. 1) Start saving NOW! 2) Save about 20% of your income (read the book, The Millionaire Next Door). 3) Invest in stocks for retirement.

There's another lesson lurking deep out of sight here. Conventional wisdom says that as you near retirement age, reduce your exposure to equity. Forget it - raise some cash and stay in equities. In our example, JDS is expected to live another 25 years WHILE HE IS RETIRED AND LIVING OFF HIS PORTFOLIO! In his first year of retirement he will withdraw about \$58,000 from his account or slightly less than 9% of his portfolio. If his investments are earning 10% (which we assume they are) he will die with exactly \$0 in his portfolio. No legacy for his children. No endowed chair in finance at the local university. If his investments earn 6% (bonds), he is withdrawing 9% and inflation is 3%, he runs out of money very quickly. If he's in cash, the game is over before it starts. Stay in stocks. The greatest risk about retirement may be outliving your money, not the risk in the market itself.

For those of you interested in pursuing this further, you can download our Retirement Planning Worksheet from this site. You will need Excel 97 or higher. Enjoy.