

When You Haven't Saved Enough for Retirement

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Article Highlights

- A shortcut for calculating how much money you will have to spend in first year of retirement is 4% of your retirement savings plus potential Social Security benefits and (if eligible) pension benefits.
- Maximizing contributions to retirement accounts (or at least maximizing any employer matching contribution), working longer, delaying claiming Social Security benefits and tapping home equity could help fund retirement.
- Even when starting at age 50, significant retirement wealth can be accumulated if saving is done consistently and a long-term allocation is adhered to.

If you've come to the realization that you haven't saved enough for retirement, then this article is for you.

It details various strategies for increasing your odds of being able to afford retirement. The strategies fall under three primary categories: saving, investment and additional options for retirement income.

Before delving into them, there is a fourth category to discuss: psychology. Funding retirement is first and foremost a math problem. Either you have enough in savings, Social Security benefits, pension benefits and other sources of income, or you don't. No amount of anger or self-loathing is going to change this. Harping on past poor decisions and bad luck won't change reality. The situation you are in today is the situation you are in today. Constantly focusing on the past won't help you now.

This isn't to say you should ignore the past. Quite the contrary, to the extent that the lack of adequate savings is due to past mistakes, it can be helpful to review them. For example, perhaps you panicked during the last bear market and waited too long to get back into stocks. Maybe you made bad investment decisions that caused you to underperform. There could have been a lack of a concerted effort to save more. Whatever the cause, think about what you can change now and in the future to prevent the same mistake from recurring.

How Much Do You Have?

Before addressing the problem of not being able to af-



ford retirement, it's important to know the scope of your potential shortfall.

The very first step is to assess your financial situation. Simply put, how much do you have saved? How much is in your retirement accounts? How much is in your savings accounts? Once you have done this, take a look at your liabilities. How much do you owe? What is your current ability to make

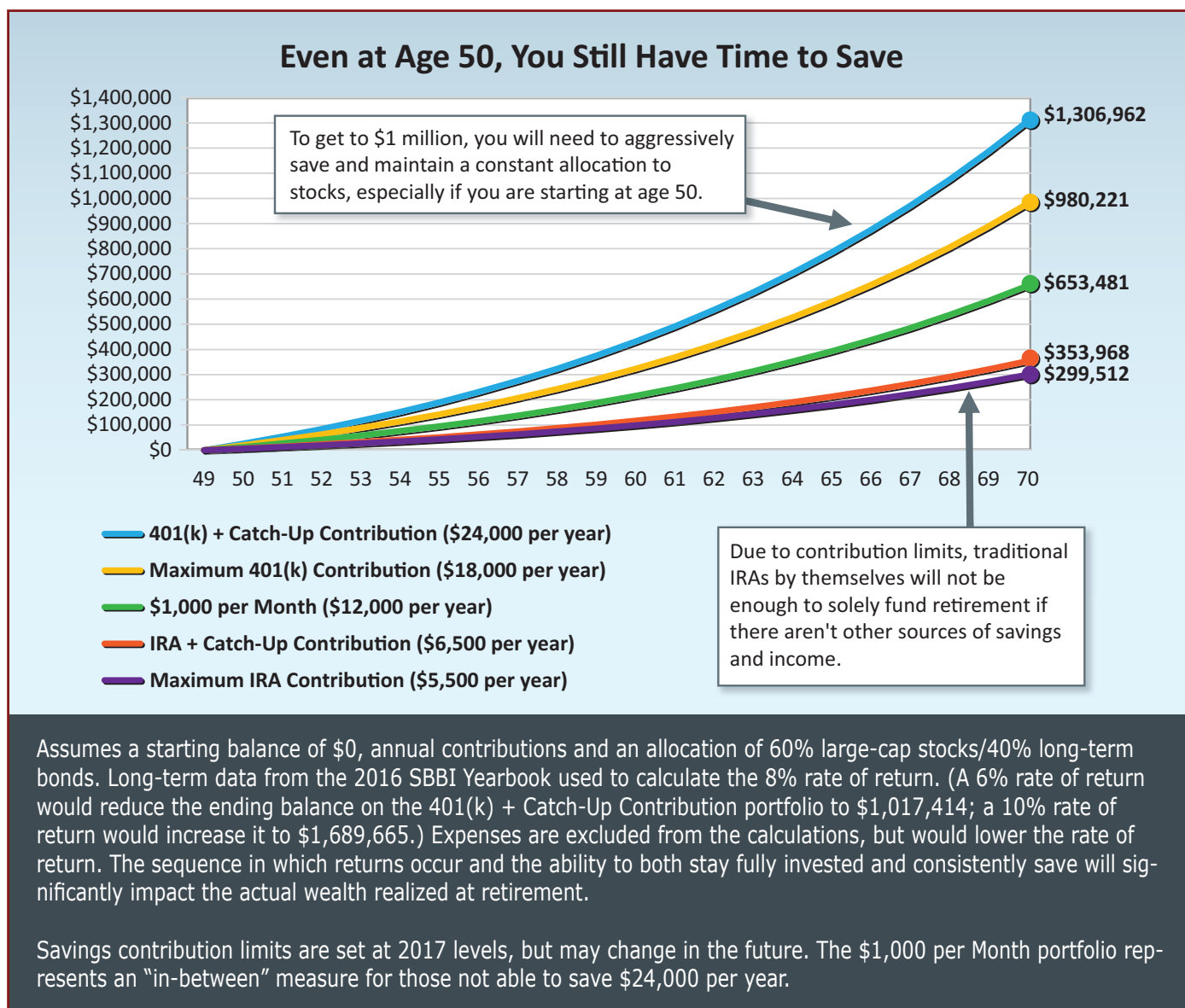
your mortgage, your car loan and credit card payments? Finally, look at your necessary and discretionary spending. Doing so will tell you how much flexibility you have to boost savings.

This information will help you establish a budget. In creating the budget, be realistic. If you enjoy meeting your friends every Saturday for golf or you're hooked on HBO, then you're going to have hard time stopping either. You might, however, find it easier to drink the office coffee instead of stopping at Starbucks every day or hold onto your cars for longer periods than replacing them every two to five years.

Budgeting is like diets: Both are easier to stick to if they are not too strict. With both dieting and saving, it's often easier to start with small changes and evolve from there. Perhaps you can figure out how to free up an additional 1% of your salary to contribute to retirement (and opt for grilled instead of fried food). From there, you can make further changes allowing you to move closer to your long-term goal.

Next, look to see how much in Social Security benefits you can expect given your present income and work history. You can find this out by going to the Social Security Administration's website at www.ssa.gov. Be sure to look at your full earnings record to ensure there are no errors. If you're married, have your spouse do the same. Keep in mind that

Figure 1. What Can Be Accumulated by Starting to Save at Age 50



higher future earnings years will help to offset lower earning past years. Plus, Social Security benefits are adjusted for inflation, which means they will increase over time.

If you've worked or are working at a job with a pension, speak to human resources about what your benefit is. Also ask when you will qualify to receive it. If you are married, ask if a survivor benefit is available and what effect registering for it has. (The survivor benefit makes your spouse eligible to receive the pension, though not necessarily the full benefit, should you die first.)

Once you have this information, you

can get an idea of how much retirement income you will have. A simplified equation for determining how much you will be able to spend during your first year in retirement is Social Security benefit(s) + pension benefit(s) + 4% of retirement savings. The 4% figure is the percentage of retirement savings that can be initially withdrawn without incurring a high risk of outliving your savings. (The initial amount withdrawn is adjusted upward each subsequent year for inflation.) This formula works best for those near or at retirement age. (It mostly gives you a pretax figure. Retirement savings in a Roth IRA or Roth 401(k) account will

generally not be taxed if withdrawn past the age of 59½.) Those who are younger will need to make assumptions about how much they will have saved. The various retirement calculators available online can help, though their estimates may vary.

You can then compare your projected retirement income against your likely expenses. While work-related expenses such as commuting and dry cleaning will go away, you will have much more free time to fill up once retired. As such, your actual spending may not go down as much as you think. Still, you can start by estimating your fixed expenses and

likely discretionary expenses to get an idea of what you will need. Any deficit between your projected income and your projected expenses is the hole you need to fill.

Basic Strategies for Catching Up

Beyond establishing a budget, the first goal for any person saving for retirement is to take full advantage of the matching contribution offered by their employer. Even in a 401(k) or similar type of defined-contribution plan with less-than-ideal expenses and investment options, taking full advantage of the employer match can be highly beneficial. It is free money that usually exceeds the plan costs. [Roll the account over to a brokerage account, mutual fund family or a more attractive 401(k) plan when you leave the employer if the plan has high cost, poor investment options or you want more control and flexibility.]

Similarly, those with pensions should be sure to understand all the rules regarding receiving the maximum benefits as well as the rules regarding survivor benefits.

Beyond saving more, a very beneficial step you can take is to work longer. Working longer both increases the number of years savings can be contributed and reduces the number of years withdrawals will be taken from retirement accounts. If someone has a life expectancy of 85, (the approximate actuarial average for a person turning 65 at the time this article is being written, according to the Social Security Administration), retiring at 65 requires savings to last 20 years. Postponing retirement to age 70 both allows for five more years of savings and shortens the withdrawal period to 15 years. Assuming a person is able to set aside the 2017 maximum 401(k) contribution limit of \$24,000 (\$18,000 maximum plus \$6,000 catch-up for those aged 50 and older), delaying retirement by five years and continuing to save equates to an additional \$120,000 of retirement savings before any employer match, additional savings (e.g., Roth IRA contributions) or positive investment returns are accounted for.

Figure 1 shows how much in savings can be accumulated if a person starts at age 50 and realizes a rate of return equal to the historical average for a 60% stock/40% bond allocation. Its biggest lesson is the importance of saving and investing continuously over a long period of time.

Obviously, the actual amount of retirement savings will depend on an individual's circumstances, but there are other advantages to postponing retirement. Every year no money is withdrawn from retirement savings is an extra year those savings can benefit from compounded returns. A growing body of research is finding that postponing retirement is also beneficial to a person's health.

Then there is Social Security. Social Security benefits increase by approximately 7% every year claiming is delayed. Postponing claiming from age 62 to age 70 will boost the monthly benefit by 76%. The size of benefits will also be increased if a higher earning year replaces a lower earning year. (Social Security benefits are based on the 35 years of highest earnings.) Should your spouse claim benefits on your record, her or his benefit will also increase—as will the survivor benefit. [Working married couples may find it beneficial to consult with a financial professional well versed in claiming Social Security benefits or use a tool such as Social Security Solutions (www.socialsecuritysolutions.com) to determine the most optimal strategy.]

Once these steps have been taken, seek to use the tax code to your advantage. Traditional individual retirement account (IRA) contributions can be made by those not covered by a workplace savings plan. The deductibility is phased out for taxpayers whose adjusted gross earnings exceed a threshold (partially above \$99,000 and fully at/above \$119,000 for married filing jointly in 2017). Contributions are capped at \$5,500 plus a \$1,000 contribution limit for those age 50 or older in 2017 subject to minimum income requirements. (This limit is subject to annual inflation adjustments.) Contributions are tax-deductible, but future withdrawals

will be taxed at ordinary income rates. Once a person turns age 70½, required minimum withdrawals (RMDs) must be taken from traditional IRAs, as well as from 401(k)s, SEP IRAs, Roth 401(k)s and similar accounts.

Contributions to Roth IRA accounts are also limited to \$5,500/\$6,500, subject to income minimum requirements. A phaseout starts for married couples filing joint returns with modified adjusted income (MAGI) of more than \$186,000; couples with MAGI above \$196,000 are not allowed to contribute to a Roth IRA. (No income limits exist on Roth IRA conversions, however.) Contributions to Roth IRAs are not tax-deductible, but withdrawals are not taxed (assuming a person is at least 59½ and contributions were made at least five years prior). More importantly, withdrawals are not required. Roth 401(k)s can be rolled over into Roth IRA accounts without incurring taxes. The lack of RMDs for Roth IRAs makes doing this conversion a prudent move; RMDs are required from Roth 401(k) accounts.

Traditional IRAs can also be converted into Roth IRAs, but the conversion is taxable. For a person who has not saved enough, the potential tax savings must be weighed against the ability to save more for retirement.

The argument for Roth IRAs largely rests on taxes. Though Roth IRA withdrawals are not taxed, a person's or couple's tax rate may be lower in retirement. This would occur if taxable income in retirement is lower than income earned during working years. The difference in tax rates will depend on where a person or couple falls in the tax brackets. Future tax rates, which are harder to predict, will also play a role.

Health savings accounts (HSAs) can also be used to boost retirement savings. Contributions not made by your employer are deductible; withdrawals are tax-free as long as they are used to pay for qualified medical expenses, which include Medicare premiums. No contributions are allowed to an HSA once a person enrolls in Medicare.

Your non-retirement savings accounts matter too. Money you have

Ways You Can Fund Retirement

Even if you are behind on your retirement savings, there are various ways you can save for and fund retirement. These include, but are not limited, to:



Social Security: Benefits are based on the highest 35 years of earnings. Every year a person delays claiming, benefits increase by approximately 7% (delaying from age 62 to age 70 results in a cumulative 76% increase). Couples would be wise to explore claiming strategies.



Pension: If eligible to receive a pension, speak to human resources about potential benefits, including if there is an option for a survivor benefit.



401(k) Plans (and similar workplace retirement plans): Up to \$18,000 per year plus an additional \$6,000 catch-up contribution for those age 50 or older can be contributed annually (based on 2017 limits). If an employer match is available, try to contribute enough to maximize it if unable to save the maximum \$18,000/\$24,000.



IRAs: Dollars contributed to a traditional individual retirement account are tax-deductible. Mandatory withdrawals (RMDs) start at age 70½, and all withdrawals are taxed at ordinary income rates.



Roth IRAs: Contributions are made with aftertax dollars, but withdrawals are not taxed. Plus, no withdrawals are required for the account owner.



Health Savings Accounts: Contributions not made by your employer are tax-deductible and there is no time limit for when you must spend the HSA balance. Withdrawals are tax-free if used to pay for qualified medical expenses.



Housing: Downsizing your house and/or moving to a less expensive area frees up cash and reduces expenses. The first \$500,000 in capital gains on the sale of a married couple's home is not taxed as long as basic requirements are met. If you plan to stay in your existing house throughout retirement (or least most of it), a reverse mortgage can provide a stream of income.



Work Longer: Postponing retirement gives you more years to save, creates more time for your savings to grow and reduces the amount of time your savings have to last. Once in retirement, working part-time can provide supplemental income even if it means that more of your Social Security benefits are taxed.



Taxable Accounts: Money saved in bank accounts and traditional brokerage accounts counts as part of your cumulative wealth. Even if you have it mentally budgeted to pay for other things, these savings should not be ignored when it comes to funding retirement expenses.

saved in bank accounts and traditional brokerage accounts can be used to pay for retirement expenses. Even if you have money in such accounts mentally budgeted for other expenses (emergencies, cars, vacations, etc.), all of your accounts determine how much you can spend.

Investing to Catch Up

The temptation when not having enough saved up is to try to realize the highest possible return on investing. This is also the riskiest strategy and could cause you to fall further behind. If this sounds counterintuitive, allow me to explain why it isn't.

Risk, in the world of investment theory, is defined as the variance in returns. Greater variance is viewed as the price for seeking higher returns, all else being equal. Put another way, investments with higher long-term rates of return also tend to be those that experience the biggest short-term swings (both up and down) in price. If you want high returns, you must be willing to tolerate painful short-term losses.

It's easy to accept downside volatility when only the possible upside returns are focused on or when the markets are performing well. Large-cap stocks have rewarded investors with annualized returns of approximately 10.0% per year since 1926. However, these same stocks have fallen in price the equivalent of slightly more than once every four calendar years. Put another way, over the course of a 20-year period (e.g., age 50 to age 70), large-cap stocks can be expected to decline in value on an annual basis five times. (The actual number of declines may be higher or lower, with varying timing and degrees of severity.)

This matters, because your ability to seek higher returns in order to boost your savings is directly dependent on your ability to cope with market corrections and bear markets. A good exercise is to review what you did during the last bear market (or last two bear markets, if possible). Find out if you stayed allocated to stocks, bought more stocks to take advantage of the cheaper prices or

got out of stocks to limit the losses. If possible, go back and look at the actual brokerage statements from that time. Doing so will reveal your psychological ability to tolerate downward moves in the stock market.

Once you have assessed your pain threshold for holding onto stocks, you'll be better able to determine the allocation you should have now. Your goal is to have an equity allocation slightly above the threshold where you feel uncomfortable about holding onto stocks—a large enough allocation to give you extra return, but not so much that you cannot resist giving into your emotions and selling in reaction to market volatility.

There isn't a magical amount for how much you should allocate to stocks. Allocation is a personal decision. AAI's moderate portfolio allocation model calls for 70% stocks/30% bonds. The conservative allocation model calls for 50% stocks/50% bonds. A well-established benchmark is 60% stocks/40% bonds. All of these can serve as starting points, with adjustments made based on what you do (or don't do) during the next bear market. A good rule of thumb is to increase the allocation to stocks the further out retirement is. (Once in retirement, maintaining an allocation to stocks can help preserve your ability to buy goods and services on an inflation-adjusted basis.)

A bucket strategy may help you maintain a larger allocation to stocks. A bucket strategy segments your portfolio by when you will need the money. A basic example would be to allocate money needed within one to five years to a cash bucket. Allocate money needed in three to seven years to a bucket with high-quality bonds and high-quality dividend-paying stocks. Money needed beyond the next four to seven years should be allocated solely to stocks. Each year, the equivalent of one year's expenditures is moved from the all-stock bucket to the bond/dividend bucket and from the bond/dividend bucket to the cash bucket.

There are variations on this approach. One approach suggested by AAI founder and chairman James

Cloonan in his book, "Investing at Level3" (AAII, 2016), is to put four years' worth of expenditures into cash and invest the rest in stocks. Regardless of how you set up your buckets, the big advantage of the strategy is the cash bucket. This provides a safety net against short-term market moves, giving you the confidence to stick with a long-term investment strategy.

The big role the cash bucket plays is protecting against downward market volatility. Though large-cap (and small-cap) stocks have realized gains during more than 86% of all rolling five-year periods since 1926, they are also susceptible to large short-term drops. Having a plan in place to cope with the inevitable corrections and bear markets will go a long way toward helping you live a better retirement.

Beyond allocation, follow a low-cost strategy proven to work over the long term. Such strategies are usually quantitatively based, with clear buy and sell rules. None are get-rich-quick schemes seeking out the best stock to own right now. While realizing as big as possible returns right now may seem like the best way to catch up on retirement savings, you are more likely to strike out than hit a home run.

There are investment characteristics known to boost returns. Stocks with smaller capitalizations (size), trading at lower valuations (value), and having greater relative six-to-12 month returns (momentum) have tended to perform better over the long term. Quality helps to boost relative returns too: stable (as opposed to volatile) earnings, manageable levels of debt and less aggressive accounting. Many of these stocks won't be the ones you hear talked about or featured in the media, but they will help your portfolio. Investing is about taking smart, calculated risks. Fundamentally sound companies trading at discounted valuations can grow wealth, while so-called lottery stocks with lots of perceived potential but high valuations and questionable fundamentals/business models can cause unnecessary harm.

The alternative approach is to simply buy a fund instead of buying stocks.

Mutual funds and exchange-traded funds (ETFs) remove the need to analyze individual stocks. The big key here is costs. Every dollar you pay in expenses is a dollar you'll never see again. The math is every 0.10% in fees costs \$1 dollar every year for each \$1,000 invested. Again, the fees are annual; they don't go away. This is why many experts tout index funds. Their low cost makes them a competitive option. There are exceptions when paying a little more gets you more: For example, the Guggenheim S&P 500 Equal Weight ETF (RSP) has topped its traditional index competitors over the past 10 years despite its comparatively higher expense ratio. (RSP is held in AAI's Level3 Passive Portfolio.)

Withdrawing From a Retirement Portfolio

Once a person reaches age 70½, the Internal Revenue Service requires withdrawals to be made from traditional individual retirement accounts (IRAs), SEP IRAs, 401(k) accounts, Roth 401(k) accounts, 403(b) accounts and similar retirement accounts. The notable exception is Roth IRAs, which are exempt from the required minimum distribution rules.

To preserve savings throughout retirement, it's critical not to withdraw too much during any given year. A well-tested strategy is the 4% rule. As mentioned, this strategy calls for withdrawing 4% of the portfolio's value as of the start of retirement. The initial amount is then adjusted upward each year by the rate of inflation. For instance, if the starting balance is \$100,000, then \$4,000 could be withdrawn the first year. If inflation runs at 3%, then \$4,120 can be withdrawn in the second year ($\$4,000 \times 1.03$).

A big key to this strategy is the percentage amount withdrawn. Portfolios have been shown to last 30 years when the 4% rule is followed. Lowering the withdrawal amount to 3% adds safety, while boosting the rate to 5% provides more current income albeit with a greater risk of outliving your savings. An initial withdrawal rate greater than 5% incurs

a much high rate of failure—meaning running out of money.

Some advisers suggest using bands instead of a fixed percentage. A smaller withdrawal rate is used during years with bad investment returns and a larger withdrawal rate is used during years with good investment returns. A Vanguard study found that the ability to reduce spending during bad market environments has such a beneficial impact on long-term retirement success that it more than offsets increasing the withdrawal rate during good market environments. For those who are behind in savings, this study highlights the importance of controlling expenditures where possible. (See “Vanguard’s Dynamic Spending Strategy for Retirees” in the January 2017 *AAL Journal* for more information.)

Seek Out Other Sources of Income

Saving more and making smart investment decisions are not the only levers you can pull to fund retirement. There are other strategies.

As mentioned previously, work

longer and delay claiming Social Security. Postponing retirement until age 70, instead of age 65, provides five more years of salary to fund savings with. It also gives your existing savings five more years to grow and five less years they have to cover. Social Security benefits will increase in size as well.

It can also be beneficial to work once in retirement. Though a larger amount of Social Security benefits will be taxed, the wages will provide extra cash to cover expenses—potentially allowing for smaller withdrawals from savings. Working can also have social and cognitive benefits, which in turn can positively impact your health. Keep in mind that working does not mean staying at the same job—you can consult, change careers and/or work part-time.

Your house can be good source of equity to tap. Downsizing to a smaller, less-expensive house will both free up cash and reduce expenses (e.g., lower utility bills) going forward. The first \$500,000 of capital gains on the sale of a house for married couples filing jointly is not taxed as long as certain requirements are met. Those with the flexibility to move to a different

geographic area may want to take state and local taxes into consideration as well, since the long-term savings may more than offset the short-term costs of selling and moving.

If you’d rather stay in your house, consider a reverse mortgage. The extra income can help to cover expenses, thereby reducing the amount that needs to be withdrawn from savings. You will need to be able to stay in your home for many years as well as cover its expenses to make a reverse mortgage feasible, however. Be sure to shop around and make sure you understand all the details and caveats.

Final Suggestions

Funding retirement is first and foremost a math problem. Assessing your current situation, saving more, making smarter investing decisions, working longer and tapping the equity in your house can all help.

If you believe you are behind on where you should in terms of building a retirement nest egg, the sooner you start addressing the problem, the better your odds of solving it will be. ▲

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