



Guidelines for Saving

We spend a lot of time talking to our clients about risk tolerance, asset allocation, and investment performance, but there is another investment topic that is of equal importance, especially to our younger clients and our clients' children -- personal savings rates. What makes this subject critical for younger investors is that the availability of traditional employer-funded pensions (defined benefit plans) have been on the decline for decades; these plans are being replaced with savings plans controlled by and largely funded by employees (defined contribution plans). This shift has transferred the responsibility of accumulating retirement savings, and investing those funds, from the employer to the employee.

While Social Security exists to provide some base level of support for most individuals in retirement, the reality is that this safety net is under stress. With more and more baby boomers heading for retirement and fewer and fewer workers available to pay into the system, it's only a matter of time before some type of Social Security reform will be needed. Even if we assume that Social Security retains its current benefit levels, this safety net is just that - a safety net. Social Security will provide significant income replacement only for the lowest-paid workers; everyone else will need to accumulate substantial personal savings. This challenge comes at a time when the U.S. average savings rate has dropped to an alarmingly low percentage -- it's time for a wake-up call for younger Americans.

I recently read an excellent article in the April issue of the *Journal of Financial Planning*, titled "National Savings Rate Guidelines for Individuals" by Roger Ibbotson, Ph.D; James Xiong, Ph.D, CFA; Robert Kreitler, CFP®; Charles Kreitler; and Pen Chen, Ph.D, CFA. While there are a large number of variables to consider when developing a retirement plan, I think this article did a very good job of developing generic guidelines that young people could use as a rule of thumb to get started.

The authors developed various savings rate guidelines for individuals. In one scenario, they assumed no prior savings, and included estimated Social Security benefits. They developed savings targets at two different income replacement levels: 60% and 80%. The income being replaced is equal to the saver's current gross income, less their current annual contributions to retirement savings accounts.

While the article goes into much greater detail on what variables were included and how these calculations were made, below is a quick summary for ages 25 and 35 at various incomes:

Age	Annual Gross Income	Savings Rate for 60% Income Replacement	Savings Rate for 80% Income Replacement
25	\$20,000	1.4%	6.8%
25	\$40,000	4.6%	10.0%
25	\$60,000	6.4%	12.0%
25	\$80,000	8.0%	13.8%
35	\$20,000	2.4%	11.4%
35	\$40,000	7.4%	16.4%
35	\$60,000	10.6%	19.6%
35	\$80,000	13.2%	22.0%

The point of course is that delaying savings for retirement can be very costly. For example, a 25 year old making \$60,000 per year, targeting 80% net replacement income in retirement, should be saving 12% per year (employee and employer contributions combined). If that same individual waits until age 35 to start saving, he or she needs to save at a rate of 19.6% per year. As you can imagine, the required savings rate continues to escalate as you age -- dramatically.

The old rule of thumb of 10% a year just isn't going to cut it for most people, especially those who delayed saving for retirement. Financial challenges are numerous for young people: accumulating enough to buy a house, pay off college loans, and save for retirement is not easy. However, this chart illustrates the alternative, and it's eye-opening. If you'd like the full chart to share with your children or grandchildren, just let us know.

-- Joe Hebert. Posted 05/16/07.