3 Critical Retirement Questions

1. "How much will I need for retirement?"

The basic rule of thumb used by many financial planners is that a person will need about 60-90 percent of their final income before retirement to maintain their lifestyle during the non-working years. Of course, this rule will vary with everyone's situation. But the best way to address this issue of expenses during retirement is to sit down and plan a budget.

To identify future expenses there are some key questions to consider. How much traveling do you want to do in retirement? Will your medical expenses and insurance costs increase once you leave your company? Will your mortgage expense change because you plan to sell your house and relocate?

After considering the kind of retirement expenses you will be faced with, consider next the income needed to cover these expenses. In doing so, be sure to consider inflation as a factor in your retirement planning. Living expenses are likely to be greater in the future because inflation increases the cost of goods and services. It will require more dollars in the future to enjoy the comparable lifestyle you have today.

2. "How can I account for inflation in my planning?"

To address the issue of inflation, the easiest approach is to look at everything in today's dollars and then adjust income and return with an inflation factor. For example, if you want to assume an average return on hypothetical investments of 7 percent and an average inflation factor over the years of 4 percent, then in your calculations, you would use a net 3 percent return (7 percent minus 4 percent). This approximates the inflation factor by placing all numbers in current dollars.

Do you know what a gallon of milk will cost in twenty years? How about a loaf of bread? The answer of course, we cannot know, but we do know that it will in fact cost more than today. Because of inflation, a dollar today will not be worth as much in the future.

Don't worry too much about inflation, because incomes generally keep up, more or less, with prices. The key is to plan for a retirement income which will keep you up with, or better still, ahead of inflation. If your after-tax return on savings and investments exceeds the inflation rate over the long run, you'll come out ahead and retain your purchasing power.

A simple formula for determining the investment return needed just to break even after taxes and inflation is to divide the current inflation rate by 100 minus your marginal tax bracket. You must exceed the result in order for your retirement savings to grow. Let's say for example that inflation jumps to 5 percent and that you remain in the 15 percent tax bracket. Given this scenario the rate of return needed for you to breakeven is 5.9 percent. Should you be in the 28 percent tax bracket, your breakeven rate is 6.9 percent. When it comes to investing, a realistic after-tax/after-inflation goal is around 1-4 percent above the breakeven rate. In the previous scenario, the 28 percent bracket investor should seek a taxable investment product yielding 8-11 percent.

Estimating income begins with the basics of most retirement savings plans. These basics include both Social Security, 401(k)'s and IRA's. Social Security provides only a base level of income. You can affect the amount of your Social Security benefit by the age at which you decide to collect. Age 62 is the earliest you can collect. But if you begin collecting before age 65, your benefits will be reduced. And, if you delay until after age 65, benefits are increased. Your Social Security benefit can also be reduced if your retirement earnings exceed a certain level of income while drawing Social Security.

3. "How will my retirement be funded?"

For many people, their own 401k's or IRA's will provide a major portion of retirement income. If you are fortunate enough to have a company pension plan, then all the better. A lot of pensions are provided in the form of an annuity (equal periodic payments over a lifetime), although some will give you the option to take a lump sum distribution at retirement. To identify your pension benefits, you should request an estimate of your expected annual pension from your Employee Benefits department.

Pension payouts during retirement depend on various factors, such as the length of time you stay at a company, whether or not a pension has an inflation adjustment, and your salary. Many people do not realize the impact frequent job changes may have on future retirement benefits.