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A new \$20 rule for retirement savings

Rayann Huang / June 03, 2009



Russell Investments has a new way of teaching Canadian couples how to determine how much to save for retirement. The company calls it the "retirement rule of \$20."

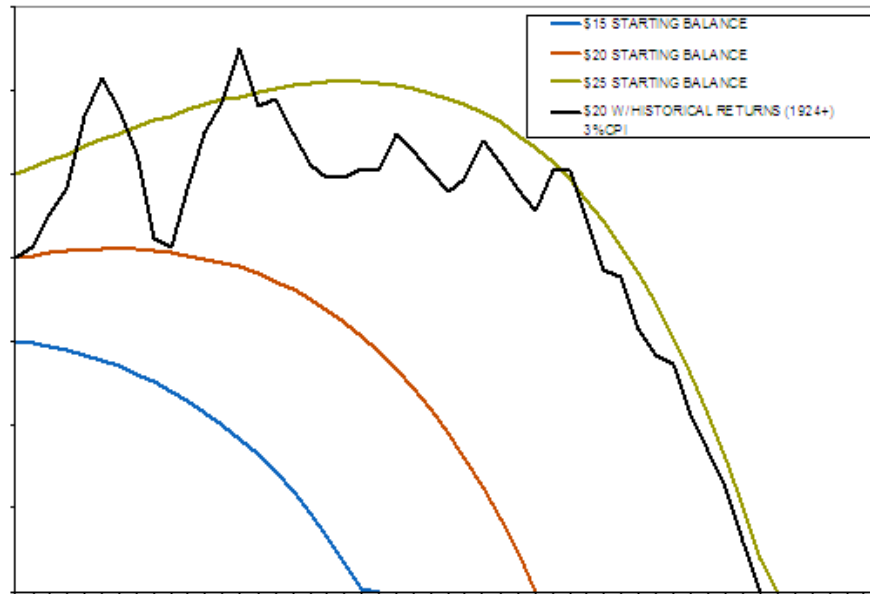
The rule is meant to help retirees combat market volatility and longevity risk. Put simply, the rule says that for every \$1 of income require at retirement, a couple should have \$20 saved at the day of retirement (with inflation index).

"If you are close to retirement or already there, this rule of thumb gives you an estimate of the amount of investment income you can expect to earn annually over the rest of your lifetime. Remember that your investment income may be supplemented by other sources such as pension plans and government programs," explains Irshaad Ahmad, president and managing director of Russell Investments Canada.

The rule is based on a retirement cash flow of 30 years and the long-term rate of return of a conservative portfolio consisting of 35% equities and 65% bonds. The return assumptions for the asset classes are 9% for equities and 6% for fixed income.

To demonstrate the strength of the rule, it was tested in previous historical periods of high market volatility and challenging returns, using a starting point of the mid 1920s. The results of the test show that despite the market volatility, the long-term probabilities of the capital markets helped to maintain the portfolio's payout potential. Overall, the portfolio was sufficient to support retirement cash flow expectations for a little over 30 years.

Using different savings amounts rendered different results. According to the test, saving \$25 for every \$1 desired income would extend payouts slightly beyond age 100. Conversely, lowering savings to \$15 for every \$1 of retirement income led to the possibility of depleting the portfolio by age 80.



Some of the ways couples can make up for the shortfall is to reduce the payout ratio to less than \$1. For example, if a couple was only able to save \$15, reducing the payout to 76 cents will extend the payout period by nine years. Alternatively, the couple can take on part-time employment or curtail spending.

The \$20 rule is similar to findings in the Trinity Study. Written by three business professors (Phillip Cooley, Car Hubbard, and Daniel Walz) from Trinity University in San Antonio, Texas, the study concludes an inflation-adjusted withdrawal rate of 4% (investment income plus principal) is a sustainable withdrawal rate, and would require approximately the same amount of savings as recommended by the rule.

Frank Wiginton, senior financial planner at Tridelta Financial Partners, notes there is "no magic number" and finds the \$20 rule of thumb irresponsible. According to Wiginton, the rule does not consider tax planning and it does not specify if the retirement income is a before- or after-tax amount. Furthermore, he added, everyone's situation is unique. Individuals will have different retirement income sources and be eligible for different government programs. Also through the course of retirement, income needs will change to support lifestyle changes and healthcare expenses. Instead of using the \$20 rule, Wiginton encourages proper planning.

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