

Does Not Work

Retirement Savings Needs of Renters -- prior to any financial planning improvements

Category : Financial Planning When You Rent

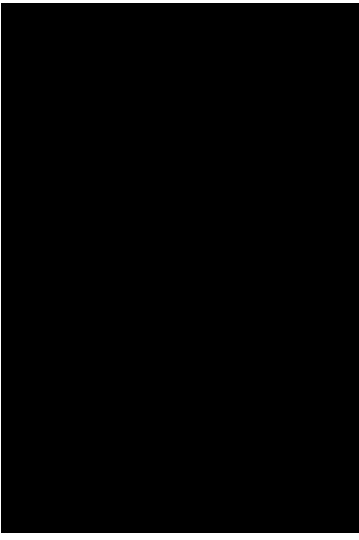
Published by [The Skilled Investor](#) on Jul/5/2007

Retirement Savings Needs of Renters -- prior to any financial planning improvements

Starting to plan with a non-optimal baseline projection Fran and Fred Frugal, both age 30, are a married working couple with \$100,000 in combined annual earned income. They want to understand how valuable different personal finance strategies could be to their lifetime finances and retirement security. In this baseline projection scenario, they plan always to rent, will not have children, will retire at age 65, will not use any tax-deferred investments, and will pay average investment costs.

See the "BASELINE PROJECTION ASSUMPTIONS" section at the bottom of this article for more information about Fran and Fred's current personal finances and their other lifetime financial planning assumptions. In this "baseline" case, Fran and Fran have NOT adopted many of the lifetime financial planning practices that make it easier to achieve financial success in life. In a series of articles, *The Skilled Investor* will compare different lifetime financial planning projections for Fran and Fred to illustrate the relative value of adopting different financial planning strategies. **Click here to learn more about the best -- >> [Retirement Plan Calculator](#) A hard financial road for Fran and Fred to travel in life**

At age 30, Fran and Fred have begun to reevaluate their financial practices. They still have \$20,000 in educational debts and \$15,000 in credit card debt. They have accumulated \$30,000 in financial assets. They want to know how much they "need to save" or "could spend" this year and in the years ahead and still have enough over their lives until age 95. How much should they be saving each year over their working years? This "Pre-retirement Savings Rate" graphic tells the tale. In summary, they should be saving a lot and at higher percentages than most people think are necessary.



As renters in this baseline case, who will not take advantage of tax-deferred investment accounts during their lives, their nearer term savings percentage requirements are very high -- exceeding 20% in the early years. Several things should be noted about this Pre-retirement Savings Rate graphic. First, during the initial six years of their forecast, Fran and Fred are inhibited from saving more by their outstanding debts. From ages 30 to 36, they plan to repay both their remaining educational loans and their current credit card debt. Then, they intend to remain debt free thereafter.

From ages 30 to 36, the green line in the graphic above shows how much their projected savings rate is depressed by required debt payments. The good news is that they took out educational loans to improve their joint ability to earn money, so their educational loan payments are classified in the graphic as investment oriented debts. Illustrated by the blue line, the payoff of their educational debts can be considered a form of savings. (The return on this debt is reflected in the \$100,000 of combined annual gross income that they earn now.) The dotted line reflects the total of their actual savings from earned income and their payoff of their investment-oriented educational debt. The gap above the dotted line reflects the payoff of their credit card debt. These payments are not classified as any form of savings, because these debts represent excess past consumption. In effect, Fran and Fred have lived a bit beyond their means since college -- even though they have saved \$30,000 in taxable cash, bond, and stock investment funds. They realize that they have not fully lived up to their last name of Frugal, as much as they intend to so in the future. While they could pay down their credit card debt with some of these financial assets, Fran and Fred have decided to model a six year payoff of their credit card debt, while holding their financial assets for both asset growth and emergency finance purposes. Second, it may seem odd that Fran and Fred's planned percentage savings rate would decline over their working years rather than increase, as is recommended practice for workers who get closer to retirement. The presumption is that household formation expenses are behind older workers and savings is easier. Whatever the truth of this, higher savings rates earlier in life provide an appealing opportunity of long-term capital appreciation.

In Fran and Fred's baseline financial plan, they assume that both their current income and current expenses will increase at the rate of inflation over their working lifetimes -- holding constant every year in "real dollar" or constant purchasing power terms. Even though their real dollar income and expenses are held constant, Fran and Fred's savings rate declines in their baseline plan, because of increasing tax payments on their growing financial assets. As they will be building up cash, bond, and stock financial assets in taxable accounts, they will pay increasingly more in taxes every year. In fact, without tax avoidance through tax-deferred accounts or itemized income tax deductions, which they will tend to lack as lifelong renters, their average overall tax rate is about 25% now and would steadily increase to about 30% just prior to retirement. In total during the coming year of their lifetime projection, Fran and Fred would earn \$100,000. Federal and state income taxes plus FICA (Social Security taxes) and Medicare taxes would take away about \$25,500 or 25.5%. Debt payments would take another \$7,200 or 7.2%. Required current savings for their lifetime financial planning would take an additional \$14,250 or 14.25%. What remains for Fran and Fred to live on and pay the rent is about \$53,050 or 53%. Unfortunately, over their working careers, increasing taxes on their growing assets will push their average tax rate up to about 30%. To hold their real dollar living expense budget constant over time, these increasing asset taxes must erode their savings rate. Otherwise, they must liquidate assets to pay their increasing tax bill. In setting their initial lifetime assumptions for their "non-optimized" baseline, Fran and Fred have come to realize that they need to make some changes. They worry about whether rents will grow faster than inflation. While they do not plan to have children, their thoughts on this subject might change. They want to explore how to make improvements to this baseline plan. Subsequent articles in this series, will illustrate the value to Fran and Fred of making long-term financial planning strategy improvements, taken one at a time and then collectively.

DO YOUR OWN LIFETIME FINANCIAL PLANNING -- easily in your own home! VeriPlan lets you

focus on your own particular financial needs, circumstances, and goals. VeriPlan is the most powerful and sophisticated do-it-yourself financial planning software available to you. As a fully integrated lifetime personal financial planner, VeriPlan automatically and instantly projects annual values over your lifetime for your family's income, living expenses, debts, taxes, taxable and tax-deferred assets, and property. Every VeriPlan lifetime projection presents your personalized financial information net of your federal, state, and local taxes and your investment costs. **Click here to learn more about VeriPlan -- >> [Saving for Retirement Calculator](#)**

Fran and Fred's Baseline Lifetime Planning Assumptions: Fran and Fred Frugal, now age 30, are a married working couple with \$100,000 in total annual earned income. Their major lifetime financial planning goals are to have enough financial assets until at least age 95, in case both live that long. These are Fran and Fred's major baseline projection assumptions.

NOTE: Of course, some of Fran and Fred's assumptions are not optimal. In future scenarios, we will change these assumptions to illustrate the relative value of improvements. **Fran and Fred expect the following:**

WORKING INCOME: Both intend to work full-time, until retirement at age 65. They expect their earned income to grow with the rate of inflation. **RETIREMENT INCOME:** They expect to collect 60% of currently quoted Social Security retirement benefits. They do not expect to have any pensions. **LIVING EXPENSES:** They expect that their living expenses, before and after retirement, will grow with the rate of inflation. They plan always to rent and never to buy their residence. They do not plan to have any children. They expect that their retirement living expenses will be the same as their living expenses, when they were working. **DEBTS:** They plan to pay off their current \$20,000 in educational debts and \$15,000 in credit card debt, as required by these debt contracts. Then, they plan to remain debt free throughout their lives. **TAXES:** They plan to file income taxes using standard tax deductions. They expect always to live in Massachusetts, a state with a 5.3% flat income tax rate. **INVESTMENT STRATEGY:** They now have \$10,000 in money market funds, \$10,000 in bond funds, and \$10,000 in stock funds. They expect to use an average investment strategy with an average asset allocation throughout their lives. They intend to hold only money market fund, bond fund, and stock fund investments. They hope to earn very long-term historical asset class investment rates of return. They plan to pay average investment costs. They intend to buy-and-hold very broad market index funds, to withdraw assets only to meet expenses, and to pay long-term capital gains tax rates, as much as possible. **TAXABLE vs TAX-DEFERRED ACCOUNTS:** They expect to use only taxable investment vehicles and do not plan to use any tax-advantaged retirement accounts.