Pre-retirement Savings Rates for Renters -- with and without investment cost improvements

Category : Financial Planning When You Rent

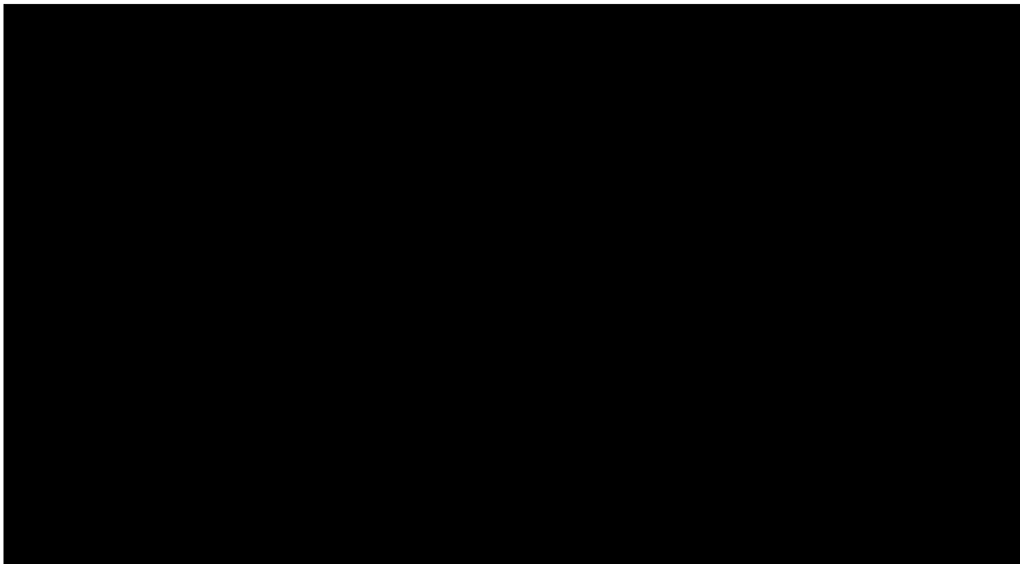
Published by The Skilled Investor on Jul/6/2007

Pre-retirement Savings Rates for Renters
-- with and without investment cost improvements

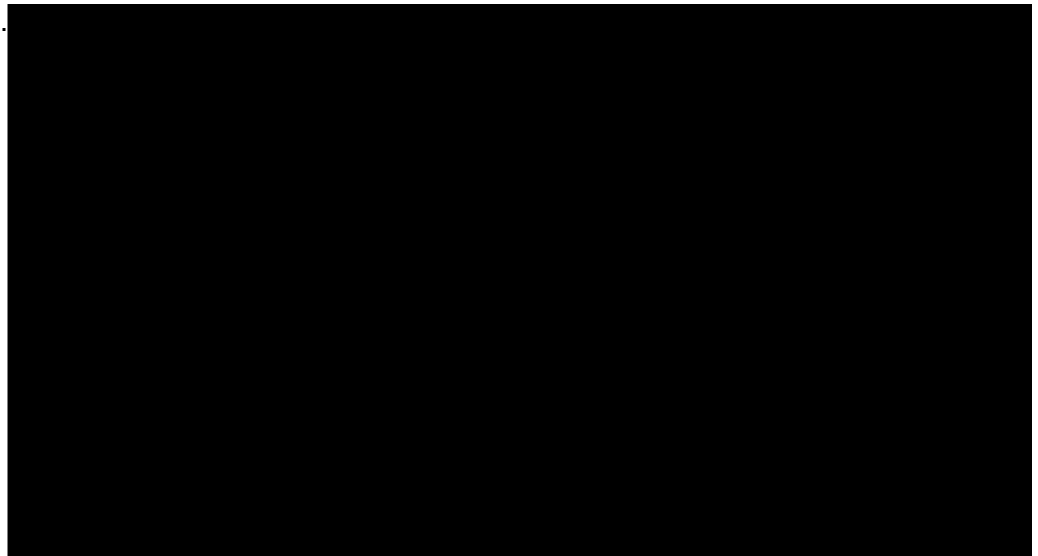
Improving on Fran and Fred's lifetime financial plan through lower investment costs Fran and Fred Frugal, both age 30, are a married working couple with $100,000 in combined annual earned income. They want to understand how valuable different personal finance strategies could be to their lifetime finances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

Obviously, in this baseline scenario Fran and Fran have NOT adopted many of the lifetime financial planning practices that would make it easier to achieve financial success in life. See the "Fran and Fred's Baseline Lifetime Planning 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 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 Saving Calculator How much should Fran and Fred save to have enough financial assets until age 95, when they adopt a very low lifetime investment costs strategy?** At age 30, Fran and Fred have begun to reevaluate their financial practices. 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. In an investment cost improvement scenario over their baseline financial planning case, Fran and Fred decided to commit to a significant reduction in their lifetime investment costs. Instead of paying average investment costs during their lifetimes, they decided to pay much lower investment costs. They intend to pay investment costs that would be typical of a passive, broad market, index investment strategy that is also managed to have very low costs. Fran and Fred realize that reducing investment costs will take a some effort on their part. Instead of waiting to have costly brokers or advisors sell them expensive investments, they will seek out lower cost investments by themselves. Despite the additional effort on their part, their investment cost improvement scenario showed them that keeping their investment costs down could be worth far more than a million dollars over their lifetimes. Fran and Fred now understand that even average investment costs are simply outrageous and that their lifetime investment costs could make the difference between the success and failure of their lifetime financial plan.

For more information on investment costs, see these 15 articles in the "Controlling Investment Costs" section of *The Skilled Investor's* main website. For more information on lower cost investments, see these 18 articles in the "Selecting Investment Funds" section of *The Skilled Investor's* main website. In the graphic below, Fran and Fred have generated a revised lifetime financial planning scenario, which assumes that they will: a) pay low investment costs over their lifetimes, and b) save at rates that might allow their financial assets to last just until they are 95. This graphic shows their projected annual pre-retirement savings rates for this scenario.



Note that their savings rates are lower in the first six years of their projection due to required debt payments. Also, their annual savings rates decline over the years due to increasing taxes related to their growing taxable assets. For an explanation of either of these situations, see this article about required savings in Fran and Fred's baseline financial plan: Retirement savings needs of renters — prior to any financial planning improvements. **How do these annual savings rates compare to Fran and Fred's baseline plan with average investment costs?** When Fran and Fred had projected to pay "average" investment costs in their baseline lifetime financial plan, their required annual pre-retirement savings rates were much higher. The following graphic shows these higher required savings rates.



The two savings rate charts above have the same characteristic shapes due to required debt repayments in the first six years and increasing asset taxes on their exclusively taxable asset accounts thereafter. However, in each projection year there is roughly a 6 percentage point difference in the required savings rate between the "average" investment cost scenario and the low investment cost scenario. In effect, by reducing their investment costs they greatly reduce their savings requirements. Even so, they could end up at the same goal, which is to have adequate financial assets through age 95. **Conclusion: Reducing investment costs can dramatically lower required savings rates.** If they adopt the savings pattern in the second graphic above (the average investment cost scenario), Fran and Fred would have $53,050 in "real" constant purchasing power dollars to spend every year during their lives. However, if they adopt the savings pattern in the first graphic above while choosing investments with much lower costs, they would have about $59,630 to

spend each year. This means that Fran and Fred would have almost $6,600 more to spend every year out of their total gross income of $100,000! What they do not waste on unproductive investment costs flows back to them in terms of higher returns on their investment assets. Higher net returns reduce their savings requirements dramatically. In effect, it is much easier for Fran and Fred to find their own low cost investments while adopting a passive, broad market index investment strategy. While it might seem easier to follow the recommendations of brokers and investment advisors, unfortunately their advice tends to be very expensive. Brokers and investment advisers may seem to make investing easier, but their direct costs and their tendency to lead you into excessively expensive investments tend to reduce your long-term net investment returns very significantly. As a result, you have to save far more over your working lifetime to make up the difference. (For more on the subject of excessive advisory costs, see this article: "Pay Less to Get More")

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 or collectively. In the next article, we will project what would happen, if Fran and Fred were to adopt low investment costs and keep their baseline savings rate high. Instead, they will determine how much earlier than age 65 that they might ~~be able to retire, while still planning for their assets to last until a~~ge 95.

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 the best Retirement Savings 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 various 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 with 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. (IN THIS SCENARIO, THEY COMPARE LOW COST AND AVERAGE COST INVESTMENT STRATEGIES.) 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 versus TAX-DEFERRED ACCOUNTS:** They expect to use only taxable investment vehicles and do not plan to use any tax-advantaged retirement accounts. **TELL US THE PROJECTION YOU WOULD LIKE TO SEE FOR FRAN & FRED.** .