

The Squirrel's Savings Plan

Looking back on my own retirement savings history, I found that I retired in one of the best of stock market times. In the decade prior to my retirement, my largest investment was the S&P 500, and it earned nearly 12% over those ten years. When I retired near the end of 1989, the S&P 500 was \$353. Ten years later it closed at \$1,469. That's over 15% return or 18% with dividends included. The next ten years weren't so good and the market closed down at \$1,115 which about broke even after dividends. It's really good to have a good start in retirement and really bad to have a bad one. If the decades were reversed so that I earned 0% in the first 10 years and 18% in the second ten years, my ending investment balance would have been considerably less than half of my actual ending balance if I had the same withdrawals. I was extremely lucky.

My father retired in 1965, one of the very worst times to retire. His first ten years were terrible. Those who retired in 1999 have started off badly and now face one of the worst financial outlooks our country has seen. A bad start will require a spectacular next decade to approach long-term historical averages.

I know that virtually the whole financial community (or at least those dependent on selling stocks) will disagree with the approach below, and even I would like to think that it's too conservative. Still, if one is going to err, it's better to err on the conservative side in my view.

Consider the life of a squirrel. A squirrel has to collect enough nuts in the summer to provide for the winter. The squirrel hides them in safe places to keep them secure until needed. Hopefully, they have good memories. If the squirrel needs 200 nuts a month for 4 months of winter, he must store 800 [4 x 200] nuts when working the other 8 months. That means he must save 100 [8 x 100] nuts a month for each of 8 months. But he also needs 200 nuts a month to live on while working, so he has to collect 300 [200 to consume now + 100 saved] nuts each month. Thus he has to save one-third of his income.

If we didn't have a retirement pension or Social Security, and our returns equaled inflation as with the squirrel, and if our retired years were going to be one half of our working years, as with the squirrel above, then we too would need to "squirrel away" about one-third of our income.

But we do have Social Security and a few of us have pensions. Yet few retirees get a much better return than inflation. Returns for retirees get hurt by reverse-dollar-cost-averaging as well as fees, taxes and chasing investments that were already near highs or selling when investments were near their lows. More importantly, the return's purchasing power gets hurt by inflation. Our current struggling economy exacerbates all of the factors that affect returns. It's time to consider more realistic future returns than the default values of most Web retirement programs and those "success probabilities" often quoted by professional planners doing personal projections. We are not living in the past when past statistics had some meaning. We are facing a new, less generous, economy.

It's possible to invest in Savings I Bonds and Treasury Inflation-Protected Securities (TIPS) to come close to getting returns equal to inflation. I still think people need some stocks and REITS to boost returns, but performance will be but a faint image of their past. So let's look at some practical squirrel theory.

For example, consider a woman who works for 40 years and makes \$60,000 a year that always increases with inflation. Suppose also that she expects to live for 20 years in retirement and get \$20,000 a year in Social Security. She believes that she will be able to retire on 80% of her working wage, that is, \$48,000 [80% x \$60,000] a year. After subtracting her Social Security, she finds that she must save enough to provide, \$28,000 [\$48,000 - \$20,000] from savings for 20 years. That will total to \$560,000 [20 x \$28,000] savings needed when she starts retirement.

To save \$560,000 over 40 years of work, she will have to save \$14,000 [\$560,000 / 40] each year. That's 23% of her working wage.

But everything she reads says she should save between 10% and 15% of her income to get a retirement income that's 80% of her working wage. The 15% applies to someone who has no pension, so let's see what kind of return would be needed so that she would still save \$560,000 over 40 years. Our handy financial calculator says that would require 2.1% return. At first this sounds reasonable, but that's the return after inflation, and if in a taxable account, the return after taxes. With 3% inflation, that would require over 5% [2.1% + 3%] actual return in a qualified account like a 401(k) or IRA. This will take an improved stock market, low cost investing, and disciplines quite different from those used by people who chase the markets. If in a taxable account at a 20% tax rate, it would require a 6.4% [5% / (1 - 20%)] return. This is a bigger challenge yet unless this economy really picks up.

My thoughts for most people are to plan to work till their late sixties and save more than 15% if no pension and more than 10% with a significant pension. If people have not already been saving such sums, then they must save more if possible. If you think that is impossible, you may be living beyond your means and need some serious financial planning. Now is the time to first do a squirrel theory analysis to ballpark your readiness followed by some sharp pencil analysis and/or face up to a significantly different lifestyle in retirement. I highly recommend using the scenario for a 1965 retirement in one of the retirement planners from www.analyzenow.com because that scenario embodies most of the things we are likely to experience in my view.

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