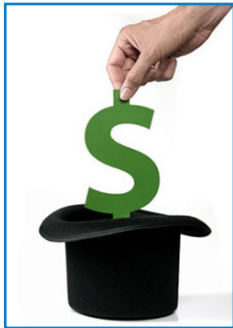


SECOND OPINION



## An Urban Legend: The Retirement Income Replacement Rate

Urban legends are seldom-examined stories that circulate as fact. In reality, they are untrue. The sewers of New York are not filled with baby alligators. A frog will jump out of a pot of water that is put on a stove.

The most common urban legend in personal finance is a rule of thumb: the retirement income replacement rate. It says that most people will need 70% to 85% of the income they earn immediately before retirement when they retire. So if you are earning \$50,000 at age 65, you'll need, say, \$40,000 in your first year of retirement.

What if you have less? The rule says your standard of living will decline. Prepare to buy a copy of the "Cat Food Diet Cookbook," large-print edition.

This is nonsense. In fact, if you are married, had and educated children, financed the purchase of a home or paid off student loans, odds are the 70% to 85% rule doesn't apply to you.

That's a lot of people.

One immediate consequence of having a lower replacement rate is that the amount of money we need to add to Social Security benefits to sustain our standard of living in retirement is smaller. That, in turn, means that our nest egg can be smaller. That's fortunate, because most people have smaller nest eggs than they are told they should have.

The fundamental problem with the retirement income replacement rate idea is that it uses income immediately before retirement to measure our retirement needs.

*It ignores our standard of living during the 40 or 45 preceding years. Basically, it ignores our entire adult lives.*

It ignores all the decisions we make that reduce our standard of living when younger. It ignores getting married, buying a house, having children and educating them. It ignores mortgages that have been paid off, tuition checks that have been cashed and special help to ailing parents. It ignores the major realities of daily living.

I think you'll agree that's a pretty major omission.

Indeed, I can think of only one person in all of literature for whom the retirement income replacement rate might be a meaningful figure - John Marcher, the central character in Henry James' exquisite short novel, "The Beast in the Jungle." John Marcher's singular distinction as a human being is that *nothing at all happened in his entire life* - so his spending would have been quite regular.

Here are five reasons the conventionally used replacement rate is misleading and generally wrong:

- Debt service. We carry different amounts of debt at different times. When young, the amount can be quite large. Every dollar spent on debt service is a dollar not available to spend on consumption. A young couple may

spend 20 % of their gross income on a home mortgage and another 10 % on car payments. That's 30 % of income that won't need to be replaced when the mortgage is paid off and buying new cars is no longer a thrill.

- Raising and educating children. We adore our children but, with any luck, they are off the payroll by the time we retire. Some cut it closer than others, of course, but all those expenses - from disposable diapers to college tuition - are dollars that we've never had to sustain our personal standard of living. But our adult standard of living - the money we spend on ourselves - is what we need to sustain in retirement.
- New spending in retirement. Both of those adult standard of living reducers could be followed by increases in retirement. One that comes to mind is rapidly escalating Medicare Part B premiums. It could also be the expense of living so long that nursing home care is needed, etc.
- Eventual widowhood. Short of perishing together in a romantic accident, we can be virtually certain that one partner will outlive the other. In typical marriages, women will survive their husbands by about six years. As a consequence, part of future spending will reflect the lower expenses of a single person household.

## SECOND OPINION

- Spending principal. The replacement rate assumes that we never, ever spend principal. In fact, most people do. Some do this out of necessity. Some do it by choice. Either way, spending principal works to sustain consumption.

If you're thinking, "Wow, I'm off the hook for saving," forget about it. You'll still need to save - but it may not be a "Mission Impossible."

(Questions about personal finance and investments may be sent by e-mail to [scott@scottburns.com](mailto:scott@scottburns.com) or by fax to

505-424-0938. Check the Web site: [www.scottburns.com](http://www.scottburns.com). Questions of general interest will be answered in future columns.)

COPYRIGHT 2007 UNIVERSAL PRESS SYNDICATE

This feature may not be reproduced or distributed electronically, in print or otherwise without the written permission of uclick and Universal Press Syndicate.

### On The Web

"Your Retirement May Be Better Than You Think" (8/27/06):  
<http://assetbuilder.com/?p=12>

Urban legends: alligators:  
[www.snopes.com/critters/lurkers/gator.htm](http://www.snopes.com/critters/lurkers/gator.htm)

EmploymentCrossing is the largest collection of active jobs in the world.

We continuously monitor the hiring needs of more than 750,000 employers, including virtually every corporation and organization in the United States. We do not charge employers to post their jobs, and we aggressively contact and investigate thousands of employers each day to learn of new positions. No one works harder than EmploymentCrossing.

Let EmploymentCrossing go to work for you.