Secret Money Business for mums

LESSON 3 - WORKSHEET

Am I on track for retirement?

WHAT KIND OF INCOME YOU'LL NEED TO RETIRE

Step 1 - What does it cost you to live??

Use your current cost of living as a starting point, a reference point if you like for what it costs you to live.

So look at your budget and work out what your annual cost of living is.

WRITE IT DOWN =

Step 2 - Discount this by those expenses you will no longer have in retirement.

Have you successfully paid off your home by retirement? Yes - then there will be no housing costs.

The kids are all grown up? So there will be no daycare or private school fees - so you can take these expenses out.

Go through your budget and work out those expenses that will no longer apply. Write down your new cost of living.

WRITE IT DOWN =

Step 3 - Add in an estimate for the additional expenses you are likely to have in retirement

That trip around Europe you've been dreaming of? OR that holiday to Hawaii once a year in retirement - this is where you factor that cost in.

If you have any solid plans to take up a particular hobby or activity in retirement - you'll want to add in the additional expenses associated with it here.

And you'll be a little older at this stage and likely have a few more medical expenses - so it's a good idea to build in a little additional annual revenue to fund these extra medical expenses.

Unless you have existing medical conditions that you can anticipate the cost of - a rough estimate is fine.

Have a think about it, add them up and add them to your cost of living number from Step 2.

WRITE IT DOWN =

This is a rough estimate of what annual income you're likely to need in retirement.

CALCULATE THE SUPER BALANCE NEEDED

Now that you've got the annual income, you can start to calculate the lump sum account balance you'll need to generate that income. Here's a few popular methods for calculating this number.

Method 1 - The rule of 25

With this method you multiply the annual income goal by 25. So if you want $50,000 of income in retirement - you'll multiply 50 x 25 = $1.25 million.

This assumes that if you have a lump sum of $1.25 million in assets outside the family home returning 4% - then you can generate $50,000 per annum in income off that balance.

This is a "back of the envelope" type method which helps give you some indication of the lump sum needed if you are:

- not going to touch any of the balance,
- live only off the income generated on that amount and
- there is no aged pension entitlement.

Method 2 - Target investment return

With this approach, to work out your retirement lump sum, you would divide the annual target income figure by the annual target investment return.

So if you want $60,000 income in retirement and your target investment return is 6% you would need a lump sum of $1 million [60,000 / 6 % = 1,000,000]

Generally, the lower the investment return on your savings during retirement, the bigger the lump sum you will need for retirement.

On the other hand, the higher the investment return you earn on your savings in retirement, the smaller the lump sum you will need when you retire.

However - If your return target is a higher investment return, then you generally have to take more risk with your investments to deliver that higher return. So you need to be aware of the risk / return relationship here.

Method 3 - Investment Return & Aged Pension

The only difference between this method and Method 2 is that this method factors in your aged pension eligibility and includes that annual income towards your total target annual income.

This has the effect of reducing the lump sum required as with the aged pension there is an additional income stream other than investment returns.

To use this Method you would need to use the MoneySmart 'Retirement Planner' Calculator.

CLICK HERE TO USE THE MONEYSMART CALCULATOR

When using the calculator with your own details keep in mind the following:

(1) Pay close attention to the "Investment Before Retirement" under "Advanced Settings" section. This is where you can play with different target rates of return. As a point of interest; plug in 3%, 5% and 7% to see the difference these rates of return make to your estimated income and balance. This is the importance of investing in line with your risk profile. To ensure that you are not missing out on potential returns.

(2) Pay close attention to the "Include the Aged Pension" check box under "Advanced Settings - Other". This is where you can turn this additional income source on and off to see the impact this has on your estimated income and balance.