

# Your retirement funding formula



By Prabath Ekanayake

**PORTFOLIO POINT:** How much do you need in retirement? A simple formula helps calculate 'Freedom of Choice Capital'.

Perhaps the most frequently asked question of all financial planners is: "How much do I need to retire?"

There is no simple answer, but we can arrive at an approximation by assessing your desired lifestyle and calculating the income required to satisfy it.

On face value this may seem obvious but it is surprising how many investors grapple with this issue when asked how much income they would need in their retirement.

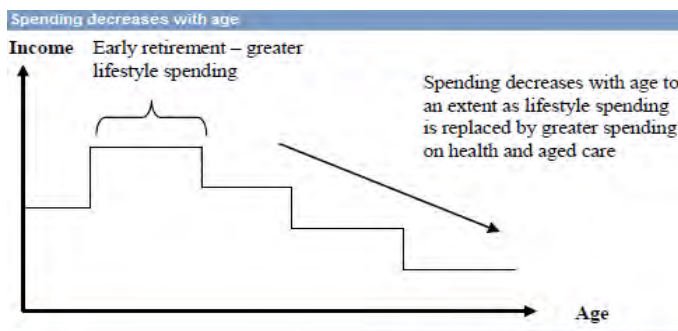
The larger the required income, the larger the capital base required to generate that income. I call this capital amount the Freedom of Choice Capital (FOCC) because once accumulated, it offers retirees the freedom to choose the way they live. And in the end, is it not everybody's ultimate goal to be financially independent?

## So how to determine likely living expenses in retirement?

A good starting point is to look at your interests. Retirees often nominate overseas travel, home renovations and assisting with grandchildren's education expenses.

According to the Westpac ASFA retirement standard, a "comfortable" cost of living for a couple in retirement is about \$54,000 a year after tax; a "modest" cost of living requires about \$30,000. This is assuming you are debt-free empty nesters.

Many people get accustomed to a particular lifestyle during their working lives and they wish to continue this in retirement. However, the level of retirement income is never static. Anecdotal evidence suggests retirees follow a spending pattern similar to the chart below.



This highlights a couple of important factors that should be considered in planning for retirement. First, the extra spending for holidays, renovations, etc, needs to be funded from investment income as well as capital.

This means the liquidity of your investments becomes critical.

Second, the large capital expenses in retirement need to be planned for when determining how much capital is required to retire.

## How do you determine the Freedom of Choice Capital?

We help individuals determine their retirement cost of living by identifying their current expenditure and exploring capital expenditure requirements in retirement. Once this is established then we apply this to our FOCC model to determine the required level of retirement capital. This is best demonstrated with an example:

Janice (56) and Graham (59) are approaching retirement. They wish to be self-funded retirees at age 65 with a retirement income of \$65,000 p.a. Their current super balance is \$950,000. During the initial meeting they advised of the following requirements in retirement:

- Spend \$75,000 on a nine-month overseas holiday immediately after retirement.
- An upgrade to their kitchen and bathroom costing \$50,000, expected to be incurred two years after retirement.
- They wish to leave a \$100,000 inheritance for their children.

The above figures are in today's dollars. Armed with this information, we can use our FOCC model to determine the level of retirement capital the couple will need at age 65. In our modelling we account for inflation in the calculation and use the ABS life expectancy figures (plus five years) as the forecast period.

Erring on the side of conservatism, we calculate two FOCC figures: one using a conservative 4% figure and another using a more aggressive 7%. This can be thought of as the upper and lower limits of the FOCC range, depending on how much investment risk you are willing to take. An average of the two figures is taken to then determine the FOCC target.

This allows a buffer to be built into the figure to ensure that even if the investments reduce in value as you approach retirement, you may still be within your FOCC range.

Assuming an inflation rate of 3%, Janice and Graham would have an upper FOCC limit of \$1.78 million and a lower limit of \$1.31 million. Therefore, they would require approximately \$1.55 million of retirement capital by age 65.

This amount allows the couple to draw an ongoing income of \$65,000 in today's dollars adjusted for inflation while satisfying the required capital expenses. At age 87 some \$228,793 (\$100,000 adjusted for inflation over 28 years) will remain as an inheritance.

Therefore, their FOCC target is \$1.55 million. Given their current super balance is \$950,000, they need to accumulate a further \$600,000 in six years. Now that they have a target we can implement strategies to assist them reach it. This might be achieved through a transition to retirement strategy (click [here](#)).

As shown above the FOCC is a very individual figure that is dependent on numerous factors. As a guide, if a couple is looking to retire at age 65 and wish to afford a comfortable living standard of \$54,000 a year, they will require a capital sum of \$776,737 at age 65. There is a significant disparity between this figure and the average superannuation balance of \$78,000 for a 65 year old.

The concept of FOCC is fundamental to the financial planning process as it provides a long-term target based on your individual requirements. Popular psychology suggests individuals are far more likely to stay the course with a given strategy if they have an end target to aim for.

Determining your personal FOCC and implementing strategies as early as possible will give you the best chance of achieving financial independence, and good financial planning is a critical element in this process. ♦

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