



Points of Interest – Replacement Ratio

Best Route



Use the replacement ratio calculation as a guideline when retirement is five or more years away.

Once you're nearing retirement (or if you've already retired), begin detailed tracking and analysis of your expenses and your projected retirement income.

Work with a financial advisor to develop strategies to help you meet your retirement income needs, including ways to reduce expenses or increase income once you retire. Your financial advisor can also help you identify financial challenges you may face in retirement and develop approaches for addressing them.

With a sound strategy, your advisor can help you prepare for retirement income for the long run.

Replacement ratio: Doing the retirement income math

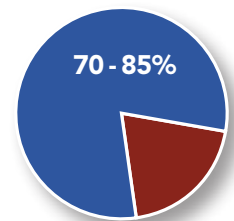
Some retirees approach retirement planning with precision. They know exactly how much income they will need. For the rest of us, using a "replacement ratio" is a good approach to estimating retirement income. **This simple calculation allows you to quickly estimate the percentage of your working income you'll need once you retire.** It assumes that your post retirement lifestyle will mirror the lifestyle supported by your current income.

What the replacement ratio assumes

The replacement ratio helps you figure out how much income you'll need to maintain your pre-retirement lifestyle. The ratio most commonly cited is **70 to 85 percent of pre-retirement income**. Those percentages are based on the *assumption* that you'll need less income at retirement because:

- You won't have work-related expenses.
- Your taxes will decrease because some of your income (Social Security, for example) may not be taxed or will be taxed at a lower rate.
- You'll no longer need to save for retirement.
- You won't have dependents to support.
- You won't have debt to pay off.

Retirement
Income



Pluses and minuses

Keep a few things in mind when using the replacement ratio.

Advantages

- It's easy to calculate and understand.
- It adjusts to changing incomes and lifestyles. If your income increases over time, your replacement ratio will reflect that change.
- For someone whose retirement is years away, the formula helps make something distant and fuzzy more tangible and easier to grasp.
- It gives you a goal you can work toward.

Explore more ►

Drawbacks

- It's a "one size fits all" calculation that doesn't reflect individual differences.
- Some assumptions about lower expenses and the absence of debt may not be valid. Recent studies show that some retirees owe as much as they've saved, and will continue to have to pay down debt. Also, many members of the baby boom generation are providing financial and personal support to parents and/or children. And future tax policy is unpredictable at best.
- The calculation is too general to be of use to someone planning to retire in the next three to five years. If retirement is approaching, you need a more detailed, rigorous analysis of what you're spending now, what you're likely to spend after you retire and how you'll cover those expenses.
- Recent trends point to several potential sources of higher costs for retirees, including increases in medical costs, rising health plan premiums and the possibility future tax rates could go up. With the Social Security system under financial stress, future benefits could be reduced, cutting income for retirees.

How to make the replacement ratio work for you

Calculating your replacement ratio can be a good place to start thinking about how you'll pay for retirement. If you're earning \$80,000 annually, replacing 75 to 80 percent of your income means you'll need to come up with somewhere in the neighborhood of \$60,000 - \$65,000 annually.

The next, most important, step is identifying how you'll produce that income. Social Security, pensions and personal savings are the most common retirement income sources. By calculating what you expect to generate from those sources, you'll have a general idea of whether you're on or off track. You'll want to calculate your ratio annually to identify whether you need to make adjustments. Job changes, investment market performance and life events can have a big impact on personal savings and retirement plans.

The replacement ratio is one of those "rules of thumb" that sometimes takes on more authority than merited. If you [view it more as a ballpark estimate](#) than an ironclad formula, it can be a useful tool.

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