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Why This Works Better Than the 4 Percent Rule

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Figuring out how much you need to save for retirement is a moving target. Save too little, you run out of money in old age. Save too much, you end up with a fancy funeral and wealthy heirs.

BlackRock, the world's largest asset manager, created a series of indexes to track how much it would cost for investors to generate income in retirement.

"If you don't know the fair value today of your anticipated retirement needs, it's kind of like buying a house and not knowing what the mortgage is," said Chip Castille, BlackRock's chief retirement strategist.

A Federal Reserve rate hike in December and a Donald Trump stock market rally have made it easier for investors to meet their retirement needs, according to BlackRock's cost of retirement income, or CoRI, indexes. (See chart below.)

The cost of retirement income and interest rates move in opposite directions. As rates rise, the cost of retirement income falls, like the relationship between bond prices and yields.

Fed officials expect to raise interest rates three times this year, which could further lower the cost of retirement income.

The CoRI index value shows how much it would cost to buy $1 of retirement income. For example, the index for investors retiring in 2025 currently indicates that it costs $16.10 today for $1 of income eight years for now.

So if you're an investor who wants $100,000 in annual retirement income in 2025, you would need a $1.61 million nest egg, or $16.10 multiplied by $100,000. That would be enough for that investor to buy a fixed annuity to generate $100,000 in lifetime annual income.

"The CoRI indexes takes into account how retirement income can fluctuate because of interest rates and inflation," said Wade Pfau, a professor of retirement income at the American College of Financial Services who has his own retirement savings benchmarks.

The 4 percent rule

Most investors ditch precise measures of what they need for retirement in favor of simple rules of thumb, such as the 4 percent rule.

Under the rule, you withdraw 4 percent per year from a diversified portfolio of stocks and bonds, adjust annually for inflation, and you will have enough to last for 30 years in retirement based on historical returns of the U.S. stock market.

The problem is that the 4 percent rule was developed in the 1990s when interest rates were significantly higher than they are today.

"The success of the 4 percent rule may be a historical anomaly," Pfau said. He also found in his research that portfolio losses in the early years of retirement would make use of the rule unsafe for many retirees.

The magic number

If you use the 4 percent rule or some other withdrawal rubric, it implies a target, or magic number, for how much you should save for retirement.

For example, if you needed $100,000 in annual income, you could simply divide that sum by 4 percent to get a target. In this case, $2.5 million. (Keep in mind that crude figure does not include what benefits you may receive from Social Security or pensions.)

A $2.5 million target may seem daunting for someone making $100,000 annually.

Fidelity Investments, a large provider of retirement accounts, has an easier metric to follow. It recommends people save at least 10 times their ending salary by age 67, which is the age at which most workers qualify for full retirement benefits from Social Security. Under this rule, someone making $100,000 would only need to save $1 million in their retirement accounts.

"A wealth target is problematic because it doesn't take into consideration current interest rates and inflation," Pfau said.

Even if your magic number changes with interest rates and inflation, everyone has a different definition of retirement and spending.

"It is so customized to the individual. Spending can change dramatically depending on what stage of retirement you are in," said Paul Palazzo, a certified financial planner and managing director at Altfest Personal Wealth Management in New York.

Palazzo characterizes the three stages of retirement as go-go (think of early retirees traveling the world), slow-go (hanging out with the grandkids) and no-go (dealing with long-term care).

A magic number may get you in the right territory for retirement, but what you do with your savings will differ from everyone else.