ThinkAdvisor

How Long Will $1 Million Last in Retirement?

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How much is enough? When can your clients retire?

Millions of baby boomers, and even members of later generations who have visions of an early retirement, are all asking these same questions.

The longing for an answer, a definitive finish line, has prompted many large financial institutions to market a “number.” *Reach this number and you’ll be set*. Anyone wise and patient enough to run a stochastic analysis will quickly realize there is no perfect “number”. A financially successful retirement depends upon hundreds of variables, some within our clients’ control and others beyond their management. Nevertheless, a frame of reference can at least offer a starting point.

Here are four major topics I encourage clients to consider.

1. Spenddown

Here’s the easiest solution to offer consumers who ask, “How long will $1 million last in retirement?”

Help them take their nest egg and divide it by the retirement time horizon. In other words, $1 million over a 20-year retirement will offer $50,000 of annual income, assuming a linear paydown with no other influencing factors.

Your clients can probably assume that they will invest the funds, not just store cash under the mattress.

This leads to another common solution: using only the interest distributions, to preserve principle.

Assuming Mr. and Mrs. Retiree receive a net return of 4% every year in retirement and peel this off as income, they get $40,000 of annual income.

But why not combine some interest with the original linear paydown strategy? If Mr. and Mrs. Retiree were to do so, they'd now enjoy $70,752 annually. They could die right on time, after year 20, with zero dollars remaining.

2. Inflation

The number "1 million" has long held an aura about it.

To some of your clients, $1 million may still sound like a sexy fortune that can cure all worries.

Others may recognize that $1 million just isn't what it used to be.

This awareness can help you start the conversation about a major wealth-eroding factor: inflation.

In 1913, when the federal income tax was permanently enacted, $1 million would be equivalent to $25.8 million in 2019 dollars.

In 1945, when World War II ended, the spending power of $1 million amounted to $14.2 million in 2019 dollars.

By 1981, when the first millennial was born, the spending power of $1 million had fallen to $2.8 million 2019 dollars.

If your clients retire with $1 million this year, at the age of 65, and inflation averages 3%, that $1 million will feel like just $744,000 in 2039, when your clients are 85.

3. Uncle Sam

Of course, another important wealth-eroding factor for your clients to consider is income taxes.

Your clients may understand that they can take $1 million out of a Roth IRA, once they're over the age of 59.5, without federal income tax consequences.

If Mr. and Mrs. Retiree had the $1 million in their non-qualified joint brokerage account, and they tried to live only off of the account interest, taxes could reduce their annual take-home income from the account to $28,000.

4. The Markets

Still another wealth-eroding factor for your clients to think about is, of course, the markets.

When John Pierpont Morgan was asked what he expected the stock market to do, he famously answered, "It will fluctuate." These fluctuations can wreak havoc on your clients' nest egg, or help modest funds grow to support a golden retirement.

You can use the discussion about this to introduce a concept known as the sequence of returns.

If Mr. Retiree and Mrs. Retiree were to average the same rate of return on their portfolio's during retirement, but Mr. Retiree experiences bear markets in the early years of distribution, whereas Mrs. Retiree experiences bull markets during the same years, his money risks depletion far earlier than hers.

This is where averages can be somewhat misleading. Note the classic example of an investor with $1 million losing 50% in year 1 and gaining 50% in year 2. In that scenario, the portfolio average annual return is 0%, but there is $250,000 missing. This is where distributions can make an investment more fragile.

So how long will $1 million (or, at least, $1 million held outside an annuity with a lifetime benefit period) last in retirement?

I don't know, you don't know, nor does anyone else.

I've explored three major wealth-eroding factors here in isolation. Some of the other many issues that affect the longevity of $1 million include housing costs, food, insurance, transportation, vacation, legacy goals, dependents, location, additional income or financial resources, long-term care, and the ultimate risk/reward multiplier: life expectancy.

Here you should explain to your clients that proactive financial planning can mitigate risks and potentially make $1 million last longer.