The magic number

Early retirement:

The magic number With no company match or pension, this reader wants to know how much more she should save to retire in 5 years. By Walter Updegrave, Money Magazine senior editor

December 19 2006: 12:41 PM EST NEW YORK (Money) -- Question: I'd like your view on what percentage of pay I should be putting in my 401(k) for retirement. I'm currently saving 15 percent of my annual salary of $74,000 a year, and have accumulated $392,000 so far.

There is no company match in my company plan, nor any pension beyond the 401(k). I have another $46,000 in mutual funds and own a home that's worth about $320,000, although I owe about $95,000 on a home equity loan. I'm 55 and would really like to retire by 60, if not sooner. How much do I have to contribute to my 401(k) to make that possible? - Joanne

Answer: Before I get to your question, let me first say that I think you're a wonderful model for others who are reading this column and trying to plan successfully for their own retirement. You've obviously socked away some serious bucks over the course of your career and you're continuing to save, which is terrific.

Even better, your question shows that you're also thinking ahead to the crucial transition from building your nest egg to drawing on it in retirement. It's smart to begin tackling that task well before you retire so you still have a chance to make some adjustments, if necessary, to better your prospects.

But enough lavish praise. Let's get to the nitty gritty of your situation. If we assume that you earn 8 percent a year on your investments, you're on track to accumulate a bit over $700,000 at the end of five years. (That includes the growth in your current 401(k) balance, plus what you'll add over the next five years and the growth of your mutual fund investments.) Applying a rule of thumb that you should withdraw no more than 4 percent of your retirement savings the first year of retirement and then increase that dollar amount each year for inflation, we're talking inflation-adjusted annual income from your portfolio of about $28,000 a year. Figure another $21,000 or so annually from Social Security - you can get a more exact figure by revving up one of the Social Security administration's benefit calculators - and you can reasonably expect annual retirement income of just under $50,000 or so.

That's pretty good, although that represents only about two-thirds of your current annual income. Most advisers recommend shooting for replacement income of at least 70 percent of your pre-retirement salary, and many suggest a target of 85 percent or more if you want greater assurance of being able to maintain your pre-retirement standard of living. All in all, though, it seems fairly likely that if you continue to save at your current rate, you'll be in pretty decent shape to retire in five years.

The real nest-egg calculation Ah, but do qualifiers like "fairly likely" and "pretty decent shape" give you the feeling of confidence you would like to have before leaving your job and actually retiring? I suspect the answer is no. At least I know I would want a higher level of certainty of whether I need to save more-and possibly make other adjustments as well. So how do you get greater assurance of where you stand and how you might improve your retirement prospects? Well, to do that you've got to do a more rigorous analysis of your prospects than it's possible for me to do within the space of a column.

There are two ways to do that. One is to go to one of the more sophisticated online retirement calculators, such as our Retirement Planner, Fidelity's myPlan Retirement Quick Check, and the Plan For Retirement tool on the Investment Calculators page of the American Century site. For example, I assumed you would earn an 8 percent annual return on your investments. That's reasonable, but it may not reflect the way you actually invest. And even if it did, it assumes you'll earn 8 percent year in and year out. In reality your return will likely fluctuate considerably from year to year, which can have a sizeable effect on the value of your portfolio.

The better online calculators factor such variability into their projections. Similarly, while I did include an estimate for your Social Security income, there's a timing issue I didn't address - namely, you can't start collecting benefits until you're 62. That means there will be a couple of years where you'll need to draw more from your portfolio to get that annual income of $50,000 or so. A good calculator will not only include that lag in its projections; it will also allow you to test whether you're better off postponing Social Security benefits until you're older when the payments will be larger. 37 years. $5 million. What could go wrong? Ideally, you would also want a calculator that will help you determine how much income you'll actually need to meet your retirement expenses instead of relying on rules of thumb like 70 percent of pre-retirement income as your target.

Even more important, by running several scenarios with different assumptions, you can see how, say, increasing the percentage of salary you contribute to your 401(k) or postponing retirement or holding off on Social Security until you're older or changing your investment strategy will affect the amount of income you can reasonably expect in the future. This will allow you to make adjustments now that will enhance your retirement security.

Of course, if you're not comfortable doing this sort of number crunching on your own even with the help of an online calculator, there's another way to get this sort of real-world analysis - go to a financial adviser. Most large investment firms, including ones like T. Rowe Price, Fidelity,Vanguard and Schwab, offer a variety of retirement planning services.

And, of course, you can always hire an independent financial planner. No matter how you decide to do it, however, the important thing is that you run the sort of analysis I've described. Otherwise, you can't really know whether you're on track toward your goal of retiring at 60 or, for that matter, whether you might be able to reach that goal in much better shape by making some changes. So fire up one of the calculators I've mentioned or get thee to an adviser while you've still got time to maneuver. You've done a terrific job planning for retirement so far. Keep up the good work down the final stretch.