

Smoothing Your Retirement Plan

by

ANDREA COOMBES

November 11, 2007

Nobody ever said figuring out how much you need to set aside for retirement is easy.

Among the many variables: your income for the next decade (or two or three), future inflation and investment returns, and the magnitude of expenses such as medical care once you retire. The real kicker: You have to guess how long you'll live.

If you can't afford a financial adviser to answer the complex question of how much to stash away, there is a slew of free calculators online to help.

But how good are they? One economist argues that most retirement-savings calculators get it wrong.

Typical calculators focus on income, figuring that in retirement you'll need some percentage of your current income, say 85%. When you plug in your information -- such as how much you earn, how much you've saved and when you expect to retire -- they calculate how much you'll need to save to reach that goal. But they essentially ignore how your expenses change dramatically both before and in retirement.

Laurence Kotlikoff, an economist at Boston University, says targeting a specific dollar amount for the future is the wrong way to approach the question.

Level Living Standard

Mr. Kotlikoff and his colleagues have developed and market a tool called ESPlanner (www.ESPlanner.com) based on economists' theory of "consumption smoothing" -- the idea of maintaining a relatively level living standard over your lifetime.

A consumption-smoothing model focuses on your likely spending and saving needs over time, accounting for temporary big outlays and a changing household structure (for instance, once the

kids leave home, your expenses change). It aims to make sure your living standard remains steady, rather than suffering jolts as you try to sock away, say, 20% of your income every year no matter what comes up.

Such a model plots your saving rate for each and every year, while typical tools don't account for those years when that rate might have to drop as you put your kids through college.

For example, consider a 45-year-old who plans to retire at 67, has \$60,000 saved, currently earns \$65,000 annually and saves 15% of income. A typical online calculator might tell her to bump up her savings rate to 20% of gross income to enjoy 85% of preretirement income in retirement.

By using a consumption smoothing program, however, that same person would receive a detailed spending plan for each and every year until death -- a plan that is automatically updated when you feed in new or different information.

"You don't want to be splurging now and starving later" or vice versa, Mr. Kotlikoff says. ESPlanner, which costs \$150, "can calculate that smooth living standard and figure out how much to spend every year based on it."

ESPlanner tackles some complex calculations. You input a lot of information about your current finances -- much more than the typical free calculator -- and the tool figures out how to maintain a smooth standard of living from now through retirement.

"The Kotlikoff tool [does] a very, very careful calculation of how your consumption ought to vary with variations in family size, with college expenses and all the rest of it," says Tony Webb, a research economist at Boston College's Center for Retirement Research.

But Mr. Webb and others have reservations. For one, savers must be comfortable making major assumptions about the future. Simpler retirement calculators tend to ignore many variables, but that does make them easier to use. The other problem: ESPlanner takes a fair amount of time to use.

Consumption smoothing "is a good procedure to use," says Annamaria Lusardi, an economics professor at Dartmouth College, but "there is the drawback that the more complex it is, the more discouraging it is to use."

If you're not ready to spend more than a small amount of time, start with the free online tools, some of which take just five minutes. They at least offer an estimate to get you going on retirement savings.

Online Options

Consider Fidelity's MyPlan (www.fidelity.com/myplan), the RetirAbility Check on Nationwide.com, various tools under Vanguard.com's planning and education tab, or the estimator at ChooseToSave.org of the nonprofit Employee Benefit Research Institute.

Still, for those willing to take the time, ESPlanner provides some meaty information.

FinancialEngines.com also sells an in-depth economist-developed product, starting at \$150. It focuses mainly on investments and is not based on a consumption smoothing model.

"Nothing is perfect," says Brian Berberet, a chartered financial analyst and adviser at Carrick Bend Advisors, in San Mateo, Calif., who uses ESPlanner in his practice.

"You're obviously making quite a few assumptions with any tools that you use," says Mr. Berberet. What's smart about ESPlanner, he adds, is that it answers the question, "How much can I spend over the rest of my life?"