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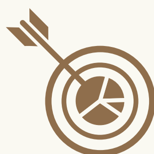
How Much Income Will I Need in Retirement?



The goal for many retirees is to maintain a standard of living similar to the one they enjoyed when they were working. The dollar amount will vary per person, but many investment professionals suggest a replacement ratio of around 70 percent to 90 percent of preretirement income. For example, if an individual had a gross income of $100,000 before retirement, this gauge suggests between $70,000 and $90,000 would be needed for the first year of retirement.

Many retirees fail to account for the possibility that the spare time available in retirement often leads to additional spending. As a result, we recommend investors nearing or in retirement employ a more thorough budgeting and expense-planning process. A good way to do this is to list all your preretirement expenses and then estimate how much you believe each of them will be in retirement. Transportation and clothing expenses, for example, may decrease, while the amount you spend on leisure activities and health care may increase.

How Do I Generate Income to Fund Retirement?

Key Takeaways

- Investors should estimate what their spending and income needs will be before they retire and adjust their portfolios to address those needs.
- A variety of income sources can be used to fund retirement. These include Social Security, pensions, investments, and savings, for example.
- Investors should determine the impact various investment strategies may have on the performance of their investment portfolios. In our opinion, they should consider focusing on a total-return approach and understand the difference between portfolio yield and income. In addition, we believe determining the withdrawal rate of an investment portfolio is key to mitigating market and longevity risks.

Addressing the Retirement Income Challenge

Retirement can be an exciting time. Yet, the months leading up to it and the beginning of retirement can be filled with uncertainty for many individuals. Today, Baby Boomers are retiring at an accelerating rate, and many are faced with questions about how to manage finances when they are no longer working. Having a retirement income plan can help ease this transition.

Both current and future retirees need to plan for life beyond a steady income. Income in retirement may come from a combination of sources, including Social Security, pensions, investments (including employer-sponsored plans and individual retirement accounts,) savings, or even a part-time job. Investors approaching retirement need to prepare their portfolios for the transition and, once in retirement, understand how they can potentially generate income to support their needs. This requires developing, and then sticking to, a plan to help ensure income needs are met throughout retirement.

Putting the Pieces Together

We like to think of retirement as a puzzle that has several moving pieces. In this report, we address *one key piece* of the puzzle: **generating income during retirement.**

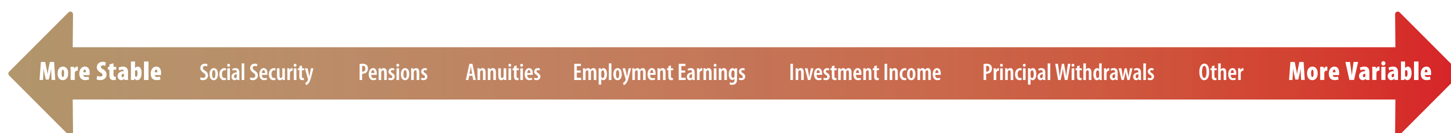
A few of your other pieces may include:

- Risk management
- Maximizing Social Security
- Expense planning and budgeting
- Estate and legacy planning
- Contingency planning

Investment and Insurance Products:
NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

What Income Sources Can I Use to Fund My Retirement?

The income sources to support retirement will vary for each individual and often include a combination of Social Security, pensions, savings, investments, annuities, and part-time employment. Ideally, fixed-income sources, such as Social Security, should cover essential expenses to avoid forced selling of assets at an inopportune time, such as during a bear market, to meet these expenses.



Should I Work During Retirement?

Retirement does not mean the end of working for many people. Some envision working in retirement as an opportunity to explore areas of interest they may not have had time for while they were working full time and raising a family. For others, it simply may be necessary to meet day-to-day expenses. Whatever the case, a job in retirement can help with income needs and offer a way to spend time in a social setting. If you choose to work, make sure to understand the implications this may have on your Social Security income if you retired before reaching your *full retirement age*, which will vary depending on your birth year.

What Are the Risks Involved With Achieving My Retirement Income Needs?

Retirees face a variety of risks while attempting to achieve their income needs, including market volatility, spending needs, health care costs, inflation, longevity and outliving one's savings, and solvency of pension plans and Social Security, to name a few. We believe it is imperative to plan for these risks well ahead of your official retirement day. The table below shows some of the most common risks retirees face along with the potential effect of different strategies for managing them.

	Market Volatility Risk	Inflation Risk	Withdrawal Rate	Health Care Costs	Longevity Risk
Strategies to Help Manage These Risks					
Comprehensive initial planning	●	●	●	✦	✦
Expense budgeting	●	●	✦	✦	●
Effective withdrawal planning	●	●	●	○	●
Diversified income sources	●	✦	✦	○	●
Inflation-adjusted income sources	○	●	✦	✦	●
Asset and product allocations	●	●	✦	○	●
Cash reserve and liquidity management	●	✦	✦	●	✦
Continuous monitoring and adaptive planning	●	✦	●	●	●

Source: Wells Fargo Advisors, March 2019

Risk Management Potential: Significant = ● Moderate = ✦ No/Low = ○

How Should I Diversify to Generate an Income Stream?

Diversification offers several potential benefits. A diversified portfolio can help smooth out returns over time. Adjusting an asset allocation to increase an income stream is an option for some investors. This may include increasing exposure to bonds and dividend-paying stocks, adding a fixed annuity to your holdings, or using a combination of these potential income-generating strategies.

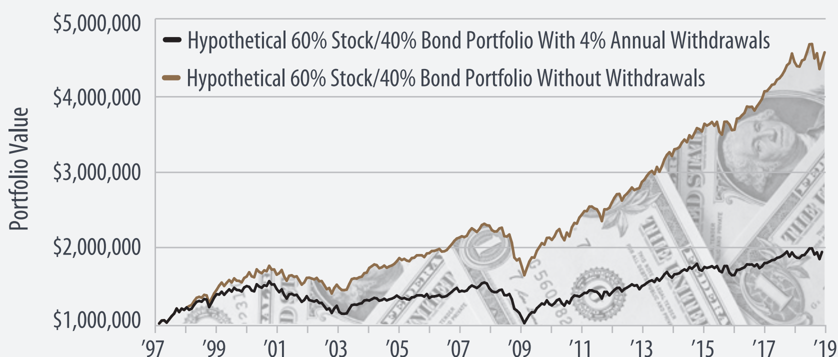
How Much Can I Withdraw From My Portfolio Each Year?

The answer to this question depends on an investor's unique circumstances, so there is no single correct answer. However, we can say overall withdrawal levels are influenced by expenses, inflation, and portfolio performance. For retirees concerned about how much they can withdraw from their portfolio annually and not outlive their assets, we believe it is better for investors to manage a retirement portfolio using a total-return approach (see sidebar for definition).

Because income from your portfolio can fluctuate, we recommend monitoring your spending and combining your withdrawal strategy with some adaptive measures when possible. Retirees should particularly strive to reduce the amount they withdraw from their portfolios in the midst of or following difficult periods in the market. Using this strategy lets them keep more in the market so that if markets recover, they can return their spending and withdrawals to the previous levels. As a result, they should have increased the probability of having more resources for the future.

The chart below shows a hypothetical example of what could have happened to an investor who retired at the end of 1996 with $1 million invested in a portfolio of 60 percent large-capitalization stocks and 40 percent Treasury bonds. Each year after that, the investor withdrew a constant 4 percent of the portfolio's value and rebalanced quarterly to maintain the 60 percent/40 percent allocation.

Impact of 4 Percent Annual Withdrawals Over 20 Years



Results will vary based on time period chosen and over time as assumptions change.

The hypothetical portfolio assumes a constant withdrawal of 4% of the balance at the beginning of each year, so the withdrawals will fluctuate over time. The hypothetical portfolio also assumes no tax law changes, as well as no deduction for fees, expenses, and taxes applicable to an investment portfolio.

Yield and Income: They Are Not the Same

Measures of yield and measures of income are not the same. Yield specifically relates an asset's current price to how much in dividends or interest the investor should expect to receive. For example, an investment selling for $100 that pays $10 in dividends or interest has a 10 percent yield. On the other hand, income is what investors live on during retirement, regardless of an asset's price.

We believe it is better for investors to manage a retirement portfolio using a total-return approach, taking into consideration the potential price appreciation (growth) of assets coupled with the interest or dividends received (income) from those assets.

Chasing yield by, for example, purchasing longer-term or lower-rated bonds may stem from the idea that it is better to spend interest and dividends without tapping into the original principal. During higher-interest-rate periods (think of the 1980s, for example), this approach seemed reasonable and may have worked for many investors; however, it is generally less realistic in today's low-interest-rate environment.

No investment should be purchased on the basis of yield alone. Dividends are not guaranteed and are subject to change, deferral, or elimination depending on the dividend policies of the company.

Source: Wells Fargo Investment Institute; Morningstar Direct, as of Dec. 31, 2018. Monthly returns from Jan. 1, 1997, to Dec. 31, 2018. Hypothetical portfolio is composed of 60 percent IA SBBI U.S. Large Stock TR Index and 40 percent IA SBBI U.S. Intermediate Government Bond TR Index. Information is for illustrative and educational purposes only. It does not represent an actual investment portfolio nor does it reflect any fees, expenses, or taxes applicable to such an investment. **Hypothetical and past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. See page 4 for the risks associated with investment in these asset classes and index definitions.

What Concerns Should I Consider Before I Retire?

If you are nearing or already in retirement and are concerned about generating adequate income to support your lifestyle needs, we encourage you to talk with your investment professional about:

- Lifestyle expenses
- Income sources
- Portfolio withdrawals and sustainability
- Inflation
- Taxes
- Social Security claiming strategies
- Medical expenses and long-term care insurance
- Diversification
- Portfolio rebalancing

Index Definitions

Ibbotson Associates Stocks, Bonds, Bills, and Inflation Series (IA SBBI) U.S. Large Stock TR Index: The large-cap stock total return index is based on the S&P Composite Index. This index is a readily available, carefully constructed, market-value-weighted benchmark of large-cap stock performance. The large-capitalization stock total return is provided by S&P Dow Jones Indices, which calculates the total return based on the daily reinvestment of dividends on the ex-dividend date.

Ibbotson Associates Stocks, Bonds, Bills, and Inflation Series (IA SBBI) U.S. Intermediate-Term Government Bonds TR Index: The Ibbotson Associates SBBI U.S. Intermediate-Term Government Bond Index is an unweighted index that measures the performance of 5-year maturity U.S. Treasury bonds.

Risk Considerations

All investing involves risk, including the possible loss of principal.

There is no guarantee that any income-producing strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Each asset class has its own risk and return characteristics, which should be evaluated carefully before making any investment decision. Stocks are subject to market risk, which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. There is no guarantee that dividend-paying stocks will return more than the overall market. Bonds are subject to interest-rate, credit/default, liquidity, inflation, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower-rated bonds. If sold prior to maturity, fixed-income securities are subject to market risk. All fixed-income investments may be worth less than their original cost upon redemption or maturity.

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