RETIREMENT PLAN:

eight reasons why yours may be off-track

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We've all seen the TV commercials asking the question, "What's your number?", which in plain terms actually means, "How much money will you need to retire?". For many of our clients, the idea of retirement has evolved. Rather than setting a specific date to end their career, many want to achieve a work-optional scenario, giving them the ability to do what they want and not worry about money.

The problem comes when a financial plan is based on aggressive or unrealistic assumptions that make it appear you will be able to retire comfortably, when in reality, these assumptions may leave you underfunded.

Here are eight assumptions you will need to consider to ensure your retirement plan won't fail.

Inflation

Ere on the conservative side: Over the past 60 years, from 1960 to 2020, the average annual inflation rate in Canada was 3.7% (source: inflationcalculator.ca). On average, a basket of goods and services that cost $100 back then, would set you back $882 today. If that same rate continued, a basket that costs $100 today, will be almost $300 in 30 years. Many financial planners use a whole number of 3% for inflation because it has been low as of late. But using a rate of 3% vs. 4% for an inflation assumption can mean literally hundreds of thousands of dollars difference in your retirement planning projections. The conservative assumption to use should be 4%. If you are using 3%, and we go through a higher inflationary period over the next 50 years, this may leave you with a tremendous shortfall in retirement.

Tax Rate

Understand how taxes play into your plan: There are two ways to look at the tax rate we pay in Canada. There is your marginal rate and your effective rate. As your income goes up, you pay a higher and higher percentage as you enter into higher and higher tax brackets. Your marginal tax rate is the tax rate on the very last dollar of income that comes into your household. The effective tax rate (also known as your average tax rate) is the overall tax rate on your money earned. A less sophisticated financial plan may make use of just one tax rate and apply it to all of your investments and sources of income. If, for example, a financial plan uses an effective tax rate of 20% and your income is higher, you may be underestimating that amount of tax you'll actually be paying.

You also need to make sure your assumptions take into consideration the source of your income. In retirement you may be collecting your Canada Pension Plan (CPP), Old Age Security (OAS) while also withdrawing from your RRIF. All of these would be subject to the same tax rate. However, if you are collecting dividends or generating capital gains in an investment account, these are taxed quite differently and they should be dealt with differently than CPP, OAS and RRIF income.

Finally, it's not uncommon for people to assume they will be in a lower tax rate when they retire because they will make less money but this is not always the case. A properly constructed financial projection can really help to give you a more accurate idea of what your after-tax retirement income will look like.

Rates of Return

Set realistic rates of return: Financial plans must assume a rate of return on your investments from now until you retire, along with the return you will earn after you retire. Here are a few things to keep in mind:

- As much as possible you should create a financial plan that truly matches your risk tolerance. Since it is common for most people to take a more conservative approach as they get older, the rates of return used over time should reflect that.
- If you hold a lot of investments outside of your registered accounts (RRSP, TFSA, RRIF), you need to make sure that you are using after-tax rates of return. That's why it's important to make sure that your financial plan takes into consideration your investment strategy. Most good quality financial planning software will do this.

- Be certain you aren't using double digit returns on your pre-retirement rate of return. This is a very aggressive assumption and may not be realistic.

Your Home

Don't overvalue this asset: For many people, your home is your greatest asset and is included as potential retirement income. If you expect to sell your home and use the equity in your retirement, it's important to be realistic about the rate of return and not overvalue this asset. Keeping the rate of return on your home in-line with the rate of inflation is a prudent way to go about it. And if you expect to live in your house for as long as possible, make sure your income is going to come from investments and not from real property.

Savings & Additional Resources

Follow through and review: You need to be realistic about what financial resources you can commit (lump sum or monthly savings) to your retirement goals. If you build your assumption into your plan, your retirement numbers will look easier to achieve. However, you need to make sure you follow through on increasing those savings, practically every year.

It's also important to consider unexpected situations and plan for them. For example, nobody predicted COVID-19 and the havoc it played for many in terms of job loss or forced early-retirement. Having an emergency fund can play an important role in planning.

A retirement plan isn't an exercise that can be done and forgotten. Together with your advisor, you should review your plan on an annual basis and ensure your strategy continues to be aligned with your goals, risk tolerance, time horizon and personal situation.

Living Expenses

Don't underestimate your future living expenses: What number did you use for living expenses? It's an important question to ask. Did you estimate your expenses increasing with inflation? Did you evaluate what will happen with expenses if you or your partner/spouse has a need for long-term care? These are important questions to review when building a financial plan to ensure that you will be able to live comfortably in retirement.

Life Expectancy

Don't underestimate your life expectancy: Overall, people are living longer and healthier in retirement. Underestimating life expectancy can be a mistake when running retirement projections. For example, the difference of dying at the age of 85 or the age of 90 will have a big impact on the nest egg you will need for retirement. As a rule, we use a life expectancy of 95 when building plans for our clients. While not everyone lives to this age, it allows us to build a conservative projection to ensure clients don't have to worry about running out of money late in life.

Retirement Assets

Use assets earmarked for retirement in your calculations: Far too often, financial advisors will show you a retirement picture based on your assets, without discussing with you which of those assets will be available for retirement. For example, if you have earmarked some of your investments for a different purpose, like starting a new business, or paying a child's education, then a plan that looks like it is on track may actually be off-course. Make sure to have these discussions up-front in order to set realistic goals and expectations for your long-term plan.

Life is a series of planned and unplanned events, and as such it's important to build your financial plan using conservative assumptions that allow for the unknowns that may lead ahead. Although building a plan using best-case scenarios may make you feel good today, it won't do you any good in the long-run. Being realistic about your future will allow you to plan appropriately and deal with any potential shortfalls before it's too late.

For more information or a free consultation, reach out to us at mark.shimkovitz@raymondjames.ca or through our website at www.markshimkovitz.com.