Opinion

The importance of the 5-15-75 rule for your retirement funds

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To mathematicians the numbers 5, 15 and 75 may have no fascinating correlation or geometric relationship. They are not the Golden Ratio, nor did they help solve Fermat's Last Theorem. But to retirement specialists, they provide the starting point for calculating how much you really need in your retirement.

The "5" relates to the generally accepted "safe" percentage SA retirees can draw down from their retirement capital on an annual basis to receive a sustainable, inflation-adjusted retirement income for life. The "15" refers to the percentage of salary it is recommended you should save for retirement each month. It is also the number by which your current annual income is multiplied to give the required amount of capital needed at retirement. Lastly, "75" is the percentage of your salary that should be received in retirement to maintain your standard of living.

No-one really knew how much you needed for retirement until 1994 when American financial planner William Bengen crunched the numbers and came up with 4% as the "safe withdrawal rate". That meant, by US standards you could withdraw 4% from your retirement portfolio every year over an estimated 30-year period, without seeing a decline in living standards late in retirement.

In SA the number is higher, at 5%, mostly because of an historically higher interest rate environment and the positive effects higher interest rates have on retirement portfolios. But even the 5% withdrawal rate should be used as a guideline.

Bengen acknowledged in his study that volatility in asset returns during retirement would cause the safe withdrawal rate to fall. So it is advisable to be somewhat flexible. This is especially relevant for recent retirees, given how disappointing returns have been in the recent past. Older retirees have shorter time horizons and can therefore justify higher withdrawal rates.

The replacement ratio (the percentage of your final salary required at retirement) is generally considered to be around 75% in SA. This ratio is based on the actuarially calculated amount that defined benefit pension funds paid out when they were still applicable to most people's pension funds.

Unless you are a government employee, you are much more likely to be invested in a defined contribution pension fund today, where the retiree needs to take responsibility for having adequate retirement capital to fund their future income needs. The rationale for replacing only 75% of your final salary is that retirees will need less than 100% of their annual salary in retirement.

As a start, you will no longer be saving 15% of your salary for retirement. Other costs (such as debt servicing, transport, children's education and housing) may reduce too. Predictably, the highest cost, particularly in the latter years of retirement, is medical costs, making continued membership of a quality medical aid very important.

Based on a withdrawal rate of 5% and the replacement ratio of 75% of annual salary, the amount that is required at retirement is 15 times your final annual salary.

However, if the numbers were fail-safe and the process was risk-free, retirement would not be the complicated process it has become. Like an obstacle course, numerous hazards lie in your way:

- Even if retirees do all the right things, they may still fall victim to retiring at the wrong time. The sequence of returns is a risk that affects retirees, depending on the order in which returns on their retirement investment occur. If a higher proportion of negative returns takes place at the beginning of retirement it will have a lasting negative effect and reduce the amount of income you can withdraw over your lifetime. To avoid crystallising big losses, you need a portfolio that limits large losses.
- Most people in their early 60s can expect to live another 20 to 30 years. But of course, no-one can predict when they will die. It is therefore considered prudent to plan for a longer lifespan of at least 30 years. Even this is not always fail-safe, but you can manage this risk through insurance by using some of your capital to buy a guaranteed income for life.
- And there is always inflation. If the rate of inflation exceeds returns, capital and therefore retirement income will be eroded, so the aim of all retirement funding portfolios should be to achieve real returns of at least 3% to 4% over time. Growth assets such as equities and property provide the best protection against inflation over time; moderate growth exposure is therefore an essential element in the fight against inflation.

Most people in SA do not plan sufficiently for retirement and leave saving for it too late. However, the numbers, 5, 15 and 75 may provide some guidance on how to plan as efficiently as possible and not be caught unawares. It is always advisable to know how much is enough.

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