# Brent Sheather's RESEARCH

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## RETIREMENT: HOW MUCH DO YOU NEED? (AGAIN) – Part 1: It Depends Who You Ask

As NBR readers will know saving for retirement and the subsequent decumulation stage are, for some reason, special interests of mine. Due to a previous life as a financial analyst writing financial models and sitting back while the computer does all the calculations feels more like fun than work. Additionally, the whole "how much should you save for retirement?" topic is often dominated by fund managers and financial advisors who are conflicted because they either receive commission from KiwiSaver providers based on FUM or are executives of the firms that provide KiwiSaver products. Given these conflicts it's no surprise that most investment people warn that NZ Super won't be around for much longer and everyone should live frugally whilst saving as much as possible. One of the advantages of having some rudimentary financial modeling skills is that you can "fact check" statements made by fund managers and other retirement savings experts including, as we will see in part 4 of this series, investigating the relative importance of key variables like "how much should you save" versus "how much it costs" in terms of their impact on investment outcomes.

A recent highlight for local "saving for retirement" junkies was the publication by the Retirement Income Interest Group (RIIG) of a paper entitled "Retirement Saving: A Framework for Adequacy". The RIIG membership is drawn from the NZ Society of Actuaries.

The RIIG summarises it's paper as follows:

**"This Retirement Income Interest Group (RIIG) report considers how much saving is needed for retirement in New Zealand**.

- **We use a method of assessing adequacy based on replacement rate**, defined as net income immediately after retirement divided by net income immediately before retirement. Net income is after income tax and KiwiSaver contribution.
- **We assess retirement income as adequate if it implies a replacement rate of 80%-100% after tax with income lasting to at least age 90**.
- **Our modelling suggests a matched 5% contribution would be a suitable default KiwiSaver contribution rate** to meet this objective**."**

So to summarise the summary, the RIIG reckon to have a comfortable retirement, defined as earning between 80% and 100% of your earnings as at the last year of your employment, the default KiwiSaver (KS) contribution should be set at 5% from you and 5% from your employer. The RIIG calculation of "earnings in retirement" includes NZ Super. For non-actuaries that's 10% of your wages redirected towards KiwiSaver providers. So that is obviously the latter's retirements sorted but does increasing the default contribution from the current 6% to 10% really make sense for the majority of New Zealanders who aren't fortunate enough to be on the KiwiSaver gravy train? Sure KiwiSaver balances will be higher but, for an individual earning the average wage with a mortgage and a couple of kids, an increase in KS contributions of this level could mean a sharply lower level of discretionary spending. The Australian experience highlights some of the downsides of a high level of compulsory saving. That is the topic for the next column.

At the risk of stating the obvious the reason most people contribute to KS is to help ensure that they have enough money in retirement, and conversely, the reason many don't contribute to KiwiSaver is because they haven't got enough money when they are working. The big question is "how much do you need for a comfortable retirement"? The actuaries' view is that it's much, much more than what an unconflicted local expert thinks is appropriate: the RIIG's determination of a suitable income in retirement, using its replacement rate methodology, is much higher than that derived by Massey University's Retirement Expenditure Guidelines. For example the RIIG's determination of the terminal sum required for a median wage earner is, at $388,000 in 2025 dollars, more than six times the amount estimated by Massey University to enable a "no frills" retirement for an individual living in an NZ city.

The various estimates of the extra income required for an individual, over and above NZ super, together with the sum required to achieve those incomes (using a decumulation strategy) are detailed in the table below.

The RIIG argue that their "replacement rate method" is likely to be a better estimate of the actual income required in retirement than the "hypothetical spend method" used by Massey as their method uses an individual's own earnings as an input. The actuaries criticism of the Massey analysis is that the "no frills" and "choices" levels of spending don't reflect reality: "Because spending tends to decrease in real terms through retirement it is likely that the lower level is indicative of what older retirees are spending, and the higher level is disproportionately younger retirees spend. The two levels are not representative of all retirees".

For what it is worth my view is that the default level of KS distributions need to be realistic for individuals on the average wage, given the opportunity cost of investing, otherwise the risk is that many people in their 30s and 40s with high living expenses will ask themselves if they are happy to be effectively borrowing money to buy shares. In down markets these individuals are likely to suspend contributions entirely and move to paying off the mortgage. High leverage and high KiwiSaver balances are the perfect scenario for the financial sector but make very little sense for consumers. The RIIG are recommending that KiwiSaver contributions move from the current 6% to 10% which would, for many individuals on the average wage, mean a substantial decrease in their discretionary spending. A cynical person might venture that, although actuaries probably aren't as conflicted as your average fund manager or financial advisor, because they earn at least twice the

| | RIIG | Massey University | |
|---|---|---|---|
| | | No frills[1] metropolitan | Choices[2] metropolitan |
| Retirement income required pa (in addition to NZ Super of $21,534) | $44,807-$21,534<br>= $23,273 | (109 x 52) / 2<br>= $2,834 | (952 x 52) / 2<br>= $24,752 |
| Terminal sum required | $388,000 | $59,000 | $516,000 |

1 *The **No Frills** guidelines reflect a basic standard of living that includes few, if any, luxuries.*
2 *The **Choices** guidelines represent a more comfortable standard of living, which includes some luxuries or treats.*

average wage and spend much of their lives worrying about retirement and risk, they are not particularly well equipped to assess the wider population's perception of the trade-offs involved between fun times today versus (the actuarial probability of) fun times after retirement. Indeed, such are the earnings expectations of those in the rarified world of investment and private wealth, most participants are likely to also be of the view that the average wage would not be adequate before retirement either.

I sent a draft of this report to the RIIG and by email Helen Mexted, Chief Executive of the New Zealand Society of Actuaries, asked to include the following statement: "While our report recommended a default contribution rate of 5% plus 5%, we explicitly stated that 3% plus 3% remains appropriate as a minimum, reflecting concerns that some low-income earners could otherwise over-save. We also noted that NZ Superannuation alone may provide an adequate replacement ratio for those on very low incomes.