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Reverse Engineering Retirement: An Easy " How-To" Guide

The stock market shattered the dreams of many people planning to retire soon. Over the past three years, those who had hoped to retire are still working because they did not have their portfolios aligned with their retirement needs. Some people are concerned with creating wealth, others with preserving wealth, and some with passing wealth on to the next generation. Whether you are retiring soon or have many years until retirement, there are simple steps to make sure that you can retire on your terms:

1. Establish your retirement income needs.
2. Determine the total amount you will need to fund your retirement.
3. Calculate the investment return necessary to reach your total amount.
4. Achieve that investment return in a diversified, prudent, tax efficient way.

This is called "Reverse Engineering Retirement" -- the process of figuring out how much money you will need during retirement and working your way back to what you need to do *now* to obtain it.

There are three phases to investing for retirement. The first is **wealth creation**, the period where you invest more aggressively in order to allow your portfolio to achieve critical mass. The next phase is **transition**, where within five years of planned retirement you start a slow transition from aggressive investments to a more conservative mix that will fund your retirement income needs. The last phase is **wealth preservation**, the idea of keeping your portfolio at critical mass while drawing a living income from it. Regardless of which phase you are in, the process of determining whether you are on-track to retire on your terms remains the same.

Step One is establishing your annual retirement income in today's dollars. Start with 75% of your current income in today's dollars and then adjust up or down for specific situations.

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Such as, Will your house be paid off? Will you have children in college that aren't there now? Do you plan on a lot of extra travel? Only you can decide how much you will need to meet your retirement income needs. Once you determine the income necessary for retirement, subtract any source of income that cannot be altered from your retirement income, such as social security, pensions, real estate income, life insurance annuities, etc. The amount you have left is the income you need to generate from your investment portfolio.

Step Two is determining the lump sum of all your current investments that give you control of the investment choices - this is your nest egg! This includes 401k's, IRA's, stocks, bonds, mutual funds, inheritances, cash, real estate that could be sold, etc. Once you have today's lump sum, **Step Three is calculating the investment return.** You need to determine how much your current lump sum needs to grow to provide the retirement income you calculated earlier. If, for example, your retirement income needs are $50,000 annually it is a reasonable assumption that you could draw 6% from your portfolio without jeopardizing the principal. This leads to a target lump-sum portfolio of $50,000/.06 = $833,000. Continuing the example, let's say you have a current portfolio of $500,000. Using a little math, you can determine the investment return necessary to get your portfolio from $500,000 to the $833,000. If you have 10 years until retirement, this works out to a little over a 5% required return.

Once you calculate the required investment return to get you from your current portfolio to your target portfolio, take a hard look at your current investments. If your required return is 10% but your retirement portfolio is earning 2% in fixed income investments, you are kidding yourself about reaching your retirement goals. Conversely, if your required return is only 3% but you are fully invested in stocks, you may be taking on more risk than necessary.

Most people have no idea if they are on the right track to retire on their own terms. By going through this process of Reverse Engineering your retirement, you can retire in comfort. Your investments can provide financial security, and you can pass as much as possible to your heirs or beneficiaries. Fine-tuning your retirement portfolio now is like steering an ocean going vessel -- a very minor adjustment makes a huge difference in where you end up.

Reverse engineering your retirement can give your current portfolio a reality check and determine whether you are on course or need a course adjustment. Following through to **Step Four, achieving the investment return in a diversified, prudent, tax-efficient way,** may mean making minor adjustments now rather than ending up in the wrong port at the end of your journey.

Sharp Investments, Inc. is an independent Registered Investment Advisory firm that provides personalized portfolio management to individuals and businesses.

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