The Basics

Take more risk for a bigger retirement payoff

Many boomers will retire with more than $1 million in savings, but believe it or not, it may not be enough. Here's a guide to saving that million (quickly) and having the retirement you want.

By Charles Fishman

There is some delightful news hidden in all the concern these days about the stock market, investing and personal finance: You may still become a millionaire.

Not you in general, but you, the man or woman reading this right now. It doesn't require winning the lottery, or having 10,000 stock options in a soaring IPO that doesn't subsequently crash (although that doesn't hurt). It doesn't even require extraordinary saving and the self-denial of never eating out, of wearing last season's Banana Republic colors or becoming a coupon-clipper.

But here's the disappointing news: Having a million dollars not only isn't going to solve your problems, it isn't even going to solve your financial problems. Having $2 million -- you might well get there, too -- will certainly be better, but even that kind of nest egg won't leave you carefree.

Still, before we start feeling inadequate because we have only $2 million (or because we don't have $2 million), let's pause briefly to explain how you're going to become a millionaire. In fact, for a whole swath of middle- and upper-middle-class Americans, seven-figure savings may soon be routine. They will also be essential.

Indeed, if you had $25,000 15 years ago, had been reasonably diligent about keeping that money invested and adding to it through a 401(k) plan, and then avoided the worst of the recent bear market, turning the $25,000 into $300,000 would have required returns of only about 60% of what the stock market delivered during that time.

So how do you take the leap from $300,000 to $1 million? Or maybe just $30,000 to $100,000? And what should would-be millionaires worry about? Here are six surprising facts:

- To become a millionaire, do nothing.
- Don't diversify.
- You only need 5% to make your money last forever.
- Retirement won't be cheap.
- You can't retire on $1 million, or even $2 million.
- You're never too rich to save.

And what if you're just starting out and your nest egg is only $25,000 rather than $250,000? Most of the following applies to you, too.

1. To become a millionaire, do nothing.

Or, at least, do nothing *differently*.

"There's nothing particularly magic about going from $30,000 to $300,000 over 15 years," says Eleanor Blayney, a financial planner in McLean, Va. "Whatever strategy got you to $300,000, probably that strategy is going to take you to the next level."

Let's say you're 40. You and your spouse have $400,000 in savings through IRAs, 401(k)s, brokerage accounts, college-savings accounts -- everything but the equity in your house. Without adding a penny of additional savings, that $400,000 will become $1.9 million in 15 years, if you earn a 10.5% return (compounded quarterly) -- and 10.5% is what the stock market has averaged each year over the last 70 years.

The numbers are just as persuasive if you're 25 and have $30,000. By the time you're 40, the $30,000 becomes $144,000, if you do nothing but invest it and get an average return. (But no 25-year-old should be ignoring the power of saving. You need to be adding to the $30,000 every year. More about that below.)

2. To get really rich, don't diversify.

At least, don't diversify too much. We know this isn't advice you hear from most financial planners, but it's gaining popularity.

"Great wealth comes from undiversified risk," says Ross Levin, a financial planner with Accredited Investors in Minneapolis. "Bill Gates didn't get rich by selling Microsoft stock and buying other things. If you spread out your investments too thinly, the diversification drags down the return, as opposed to enhancing it."

How powerful are individual stocks?

- If you had put $10,000 into MSN Money publisher Microsoft in 1990, that $5,000 would have been worth about $500,000 at the end of 2004, despite the market's long struggle;
- $10,000 in CNBC parent General Electric's stock in 1990 would have been worth roughly $90,000;
- And if you had put $10,000 into Cisco Systems when it went public in 1990, you'd have had more than $2 million.

It doesn't take too many returns like these to build a retirement portfolio. But stocks go down, too. And you could just as easily have put $10,000 bets on companies such as Enron or Kmart. In those cases, you'd be lucky to have any of your money left.

Peter L. Bermont, a senior vice president at Salomon Smith Barney who with his brother handles more than $1 billion running the Bermont Group in Miami, specializes in making the kind of targeted investments that can pay off big. Despite the size of the assets he manages, Bermont puts all his clients in the same 10 stocks. It's a strategy he thinks individual investors with some tolerance for risk can adapt.

"I'm a concentrated investor," he says. "I will put more money into fewer situations. Whereas many managers with $400,000 in an account would buy 50 stocks, I'll buy 10. My theory is: If you do the research, it's not necessary to spread it out."

This kind of investing isn't for the faint-hearted. In fact, it flies in the face of most conventional investment counsel. But Bermont's point is this: Pick a sector you think is going to do well, do some research and place a couple or three bets on the well-positioned companies in that sector.

With a $400,000 portfolio, you can place bets of $10,000 in 20 stocks. (Remember, we don't have the time or research resources that Bermont does.) If you pick a couple of winners, the performance of the rest almost doesn't matter. And you still have $200,000 for more-cautious mutual fund and index fund investing.

Bermont, mind you, doesn't go for unproven, baby stocks. Five years from now, he says, perhaps "two or three" of his current list of 10 stocks will have changed. "We buy and hold with strong growth stocks."

Moreover, Bermont's entire strategy is easily adapted to mutual funds, which softens the risk considerably.

3. You only need 5% to make your money last forever.

"Do I have enough money to retire now?" The question always makes Eleanor Blayney laugh. "Can you retire?" she asks. "You tell me." The answer depends on you, and how much you need to live on.

Blayney's rule of thumb, shared by other financial planners, is that you can pay yourself 5% of whatever your "personal endowment" is and in the process leave your principal holdings untouched. (The 5% is the same figure many foundations and universities use when calculating how much income from their endowments they can use each year.) That doesn't include money you ultimately might receive from a corporate pension or Social Security.

So if you have $1 million, you can count on taking out $50,000 a year. On average, the million will grow more than 5% -- enough to provide the $50,000, and to throw off enough so the endowment and the payout both keep pace with inflation.

"Is $50,000 a get-out-of-town lifestyle?" asks Blayney. "No, for most people, it's not."

Of course, it's not absolutely necessary to preserve the capital off which you're living. Many people don't feel any particular need to pass a large estate on to their children or grandchildren, and so could pay themselves more in retirement while gradually whittling their nest egg down. This involves tremendous daring, though. You have to guess how long you're going to live. If you miscalculate, you could run out of money.

4. Retirement won't be cheap.

It's an accepted truth with many people that living as a retiree is cheaper than living as a working person.

"That's horse puckey," says Deena Katz. She's a financial planner in Coral Gables, Fla., who is good at bringing a dose of reality to people's fantasies about retirement.

The idea that retirement costs less than "normal" life, for instance, "assumes that when folks retire, they move to Florida and sit in a rocking chair on the porch until they die," says Katz. Few people do that anymore.

Katz is among a growing cadre of planners discovering that people don't want their lifestyles to suffer in retirement. Baby boomers who retire want to travel, get involved in hobbies like gardening (and investing), eat out, keep their homes, and entertain guests and relatives on a regular basis. So why would they spend less money? Indeed, their retirement could be more expensive than their work years.

"To go see their own kids and their grandkids these days, most people have to take an airline flight," says Katz. "Just getting to see the family is more expensive than it used to be."

Then there's the large number of "late starters" on the family front. A number of 40-year-old couples have managed to accumulate $400,000 in part because they've only just started having children.

So at a time -- between ages 55 and 65 -- when their parents were finished paying for college for a couple of children, today's parents will just be starting to pay for college. At that same moment, today's couples may have to start helping their own parents financially, as their retirement stretches into 30 years, or leads to a nursing home.

Perhaps most important of all, people haven't imagined the duration of their own retirement very precisely. These days, most financial planners assume you or your spouse will live to be 100. You may not know how your retirement savings are really holding up until you're 80 or 85 -- a little late to start supplementing it.

In fact, if you retire at 60, you could end up spending more time "retired" than you did working. It would be truly extraordinary to have earned enough in 40 years of work to sustain you through 40 years of retirement.

5. You can't retire on $1 million, or even $2 million.

A nest egg of $2 million, with its ability to reliably throw off $100,000 a year in income (without touching the principal), sure seems like enough money to retire, or at least to declare "financial independence" from your job.

Actually, says Katz, "Retiring at 50 years old with $2 million is very risky, unless your expenses are very low, and you are really penurious."

Katz is overstating the case a bit. Retiring at 50 with $2 million set aside isn't very risky; it just might not be as smart, or as liberating, as it seems.

"If you retire at 50 with $2 million, that means you're not working for the last 15 years before Social Security starts paying," says Katz. Social Security benefits are calculated based on your 35 most productive years, income-wise. That can lead to several years of "0" included in the calculations for your benefits.

Social Security may seem like a minor issue for someone with a $2 million portfolio. "But Social Security can make a big difference," says Katz. "The goal is always to take as little as possible out of your portfolio, so when you're old-old, and really can't earn any additional money, you can live off that money. Whatever you can get outside the income from your savings is better."

Then there's medical insurance. Most people get their insurance through work. If you're through working at 50 or 55 (before Medicare eligibility), you have to buy insurance on your own, for yourself, your spouse and perhaps for children who haven't yet headed off to college. And if you think medical insurance is expensive when you're 40, check out the prices when you're 60. "It's a huge cost," says Katz.

Finally, there are costs that today's baby boomers just haven't thought about because they are so far away. If your children won't be in college until you're 60, they may not be getting married until you're 70, or later. Where will the $30,000 for your daughter's wedding come from?

"The biggest mistakes people make are underestimating their expenses and overestimating their returns," Katz says.

6. You're never too rich to save.

This verdict is unanimous. Even if you've got $500,000 saved (which is a goodly amount, we admit) and you're 40 and you're planning to work another 20 years, you still need to save. It's a matter of math, taxes and opportunity.

Jane King, a financial planner in Wellesley, Mass., says when you're working, "the government says, 'You earned a dollar, but you can tell me you earned 90 cents, or 85 cents. Not only can you pretend you earned 85 cents, but you can take the 15 cents, invest it any way you like, and not have to pay taxes on it until you take it out, at some point way in the future.' "

Tax-deferred savings plans are a miraculous invention, something our parents never had. The tax break provides a 20% to 30% boost to your returns. At many companies, 401(k) contributions are matched at least in part, giving you an instant return on your investment of 25% or 50%.

The power of tax-deferred savings is such, says King, "that if I had a 12-year-old with a paper route, I'd get him into a qualified retirement plan."

And, of course, you never know what might happen. The stock market averaged nearly 20% returns for 10 years, then fell over in 2001 and 2002. "I believe returns regress to the mean," says Katz. "If that's true, with a historic average around 11%, we're in for some low returns in the next few years." She means: 0%. Or less.

Given the size of college costs, it's also smart to calculate what they will be beyond your established savings plans, and save just to cover college. If you don't end up needing the extra savings, it certainly won't hurt to have it.

Saving serves another, more psychological purpose. "Consumption is sticky," says Blayney, the planner from Virginia. What she means is, once you start spending on a certain lifestyle, you rarely scale it back voluntarily. Saving is a way of controlling spending: It gives you a margin to grow into.

It is, of course, absurd to say that $2 million isn't enough to retire on. Many people will reach retirement age with much less than that set aside. They, too, will be able to retire. A longer period of being healthy, energetic and capable means many people will end up semi-retired, with a nest egg that throws off $1,500 a month, Social Security that adds another $2,000 a month, and a part-time job that keeps them engaged and adds $1,000 a month in income. Some of that may end up as savings, to help the nest egg grow.

And here's a little kicker to help keep your life in perspective:

Maybe you should retire now.

Levin, the financial planner from Minneapolis, says people have a view of retirement that's too rigid and limited. "Retirement is forever changed," he says. "People with fulfilling careers will need fulfilling retirements. For most of our clients, the biggest issue isn't financial, it's the emotional implications of retirement."

Levin wants people with reasonable financial resources to think creatively about how to use them. Sometimes, he says, people are frantically saving too much, "without thinking about lifestyle choices."

"If you have a couple, and they're both working now, maybe one of you would like to stay home and raise the family for three or four years. Well, it's OK to say, 'Let's have one of us take three years off now and sacrifice three years of retirement.' "

Or, more precisely, take your retirement in small chunks, a little at a time, when you can really enjoy it.

"Instead of retiring at 60," says Levin, "retire at 63, but take three years off in the middle. Those are choices people need to be more conscious of, and they need to be more intentional about them."

(We should note, however, that taking three years off when you’re young will cut into your retirement nest egg far more than if you merely retired three years earlier than expected.)

Says King, "All money is good for is to buy stuff, or to buy freedom, independence, time." The rush to retire could mean passing up some real opportunities for freedom along the way.

Even the penurious Katz counsels some indulgence. "We tell some of our clients, 'Take a cab. Let your heirs walk.'"

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