We do a lot of financial planning with fancy software for clients at RIA Advisors. We think a financial plan is the basis for someone having a successful financial life. But sometimes you don?t need a fancy computer program with a lot of bells and whistles to get started. There are only a few things you have to know about planning for retirement. And if you do your own back-of-the-envelop calculations, that may spur you to see an advisor and get a more detailed plan in place.

Work Backwards From Income Needed

Strangely enough, it helps to start backwards. So the first thing someone planning for retirement should think of is how much of an annual income they?ll need. There are rules of thumb including one that says 80% of your income in your last working years is adequate. Nobody really knows for sure though, so you should spend some time thinking about that. Keep in mind that an amount of income you think is adequate today will likely be more in the future because of inflation. We'll address that below.

Nest Egg Required To Generate Income

Once you come up with that required income number -- and, by all means, it can be a range instead of a precise number -- you can use it to figure out how big of a nest egg you?ll need to generate income on top of Social Security and any other pensions you anticipate receiving. The old rule of thumb in financial planning is the 4% rule, which states you can take 4% from your assets the first year in retirement and then increase that by 4% of the initial withdrawal amount each successive year. (So if you take out $10,000 the first year of retirement, you can take out $10,400 the second year, $10,816 the third year, and so on.) If you?re very close to retirement (a year or two away), it might be better to cut that withdrawal rate to 3.5% now. If you?re very conservative, you can even cut it to 3%. Remember the 10-year U.S. Treasury is yielding around 2.7% currently. Also, stocks are trading at high prices relative to past earnings, and that usually means future returns will be muted. So a balanced portfolio (roughly half stocks half bonds) is unlikely to deliver more than 4% annualized, and may deliver less over the next decade. It probably won?t deliver the 7% annualized that it has in the past and that many financial planners cavalierly tell their clients.

So let?s say $10,000 isn't enough, and you want more like $35,000 per year to supplement Social Security and any other pensions you might have, when you retire at 65. In that case, you?ll need to have a nest egg of $1 million. The formula for figuring that out using our 3.5% rule is $35,000 = .035*nest egg. In other words, take the annual income you need and state mathematically that it equals 3.5% or .035 times the nest egg or pile of money you?ll need to have.

If you need your assets to generate $70,000 per year in the first year of retirement ? double the amount of annual income in our first example -- you?ll need a $2 million nest egg ? double the nest egg in our first example. If you need $17,000 or $18,000 of annual income ? half the amount of income in our first example, you?ll need a $500,000 nest egg ? half the amount of the nest egg in our first example.

If you?re far from retirement, and you think you need a certain amount of money, given what it can buy today, you should compound that ?nominal? amount by something for inflation. So if you?re, say, 20 years from retirement, and you think you?ll need $35,000 of income from your assets in retirement, it might be reasonable to compound that $35,000 by 3% per year to come up with the number of dollars you?ll need 20 years from now. Nobody knows how much inflation will run over the next two decades, but 3% has been a decent rule of thumb. It turns out that $35,000 compounded by 3% every year for 20 years amounts to around $63,000. That means it will take $63,000 in 20 years to buy what $35,000 buys now. It also means you?ll need a nest egg of $1.8 million in 20 years to generate that $63,000 of income using the 4% rule adjusted down to 3.5%.

Savings Required To Produce Nest Egg

Finally, now that you have a handle on how big your nest egg needs to be, you can figure out how much to save to get there. Any online financial calculator, such as this one, will let you put in a number of dollars already saved, future annual savings, and an estimated rate of return to get a future value estimate of your nest egg.

If you're within a decade of retirement, you should count on modest returns. Check out a recent article by Morningstar's Christine Benz on how some well-respected investors are saying financial markets won't deliver robust returns for the next decade or so. If you're two decades or more from retirement, go ahead and plug in 6% returns from a global balanced portfolio.

To recap, if you want a back-of-the-envelop financial plan, start backwards with how much annual income you?ll need from your assets. You're really trying to solve for an income number in retirement. Then figure out how much capital is required to generate that amount of income safely. Then figure out how much money you need to save to build that nest egg or pile of assets.

It?s true there are other things involved in retirement planning, including questions about when someone should take Social Security, whether and how to buy supplemental healthcare coverage, how to leave a legacy to heirs, etc? And a good financial advisor can help you with these things. But, if you want to get a head start, train yourself to start thinking about the first three parts of financial planning ? income needed, nest egg needed to generate the income, and amount of savings needed to build the nest egg.

Please feel free to contact us with your financial planning needs.