3 Ways to Make Up For a Retirement Savings Shortfall

The growing disparity between the haves and the have-nots in this country means that while the top wealth-holders have more than enough money to do what they would like in retirement, a majority of Americans are massively underprepared for their non-working years.

It may seem bleak for the large group of people who have little in the way of retirement savings but all is not lost. There are three main ways to ensure a better outcome in your non-working years if you're approaching retirement with a savings shortfall:

Save more money. Approaching retirement with little in savings could cause some people to take more risk in the hopes of hitting it big to dig themselves out of a hole. The odds of that working out are slim since the markets don't provide high returns simply because you need them.

Most investors would be better off increasing their savings rate before it's too late. And with fewer years available to allow compounding to do the heavy lifting, a higher savings rates can have a larger impact than higher investment returns for those in the Twilight of their working life.

Let's assume John and Jane Smith are 55, with a household income of $100,000 and a woefully underfunded retirement account. If they would like to retire by age 65 they have 10 years to play catch-up. If John and Jane were to save 10% of their income and earn 8% on their investments, they would accumulate roughly $165,000 by the time they retire. Earning 8% per year would be helpful but may be difficult to pull off in the current environment of higher valuations and lower interest rates.

Now let's assume they instead save 20% of their income but only earn 4% on their investments. Under this scenario, they would end up with almost $275,000.[1] So over shorter time frames like this, a doubling of your savings rate leads to a far better outcome than a doubling of your investment returns. And the best part is people have control over how much they save, but no control over the performance of the markets.

It's far easier to save a steady percentage of your income from a young age to allow compound interest to do the heavy lifting for you but for many this idea is much easier in theory than practice. Young people often make less money, need to save for a down payment on a house, and spend a high percentage of disposable income raising their children.

The good news is once you reach your 50s, hopefully the kids are out of college, earnings are higher, and you can play catch-up with your savings to make up for any shortfall.

Work longer. With expanding lifespans, the old idea of retiring in your 60s and moving somewhere sunny may be a thing of the past. Some will choose to work longer to stay sharp or simply because they have a hard time letting go of responsibilities. Others will be forced to work longer because they don't have the financial resources to stop working.

Researchers have found there can be huge financial benefits from extending your time in the workforce. A study performed by Gila Bronshtein, Jason Scott, John Shoven, and Sita Slavov found that delaying retirement by 3-6 months has the same impact on your standard of living in retirement as an extra one percent of earnings over 30 years.[2]

The reason working longer can have such a lasting impact on your finances in retirement is threefold: (1) it allows you to take Social Security at a later age, thus increasing your benefits, (2) it allows you to make further retirement contributions, and (3) it allows the power of compounding to continue in your current savings because you're delaying distributions.

Reduce your expectations. Municipal pension plans have wildly optimistic return assumptions and massive future liabilities in the form of payments to their beneficiaries to deal with in the future. In many ways, these pension plans have a lot in common with individuals who have little in the way of retirement savings. Both groups are eventually going to have to adjust their expectations for what the future will hold.

Many pensions will be forced to reduce return expectations, reduce benefit payments, or force municipalities to cut other government services. Underprepared retirees will be forced to save more money, work longer, or reduce their expectations for their standard of living in retirement.

There is no one-size-fits-all solution for those who are underprepared for retirement. The best approach likely includes some combination of the three strategies outlined here. It's not too late to salvage your retirement if you got a late start to saving, but each choice requires sacrifice now to make things easier later.

[1]Both of these examples assumes a 3% increase in wages per year but a static savings rate as a percentage of income.

[2]It is worth noting that these researchers use very conservative estimates for growth in investment accounts to come to this conclusion.