How Much Is Enough?

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Financial Independence
How Close Are You?

Financial independence means having the necessary economic stability to support yourself for the remainder of your life, following your retirement from an income-earning career. It means being financially secure for the future, with a relative degree of certainty that you will not become economically dependent on your family, your friends or the government to take care of you in the later years of your life. I use the term "a relative degree of certainty" because this process of defining your financial future is in large part placing guesses as to future economic conditions.

There are four (4) specific future economic conditions that you can define today that will provide you with a path to follow in building your financial independence program. What follows is a discussion of each of these four conditions, along with steps to guide you in building your financial independence picture. To the degree that you have done this work in the past, hopefully these steps will provide you with a fresh perspective to a very important part of your financial plan—namely your security in retirement.

In the event that you have not begun this process of looking at your needs for the future, my hope is that these four simple steps will help you tackle the not-so-simple question of how to provide for your financial needs, after retirement.
Let's begin with a brief look at each of the four steps in the financial independence formula and then expand on each step by creating a life-like example of how the process works.

First, let me put the goal of financial independence in the form of a future desired state: "I want to create a 'nest egg' that will provide for my income needs for life." Given this simple statement, let's look at the four steps to filling in the pieces of this formula for financial independence.

Step 1: Define your "nest egg"
Step 2: Define your income needs
Step 3: Define your life expectancy
Step 4: Define key assumptions

My work in addressing this process over the past decade has convinced me that it is possible to define your future needs, with a fair degree of certainty, when you take it a step at a time and define these four key elements in your financial independence work, to the best of your ability today. So let's look at this process a step at a time.

Step 1: Define Your "Nest Egg"
The term "nest egg" is a casual term that represents the sum total of all resources you may have at your disposal to take care of you financially for the remainder of your lifetime, once you leave the workplace and no longer can count on your paycheck to support your needs. We can create a short list of the three most likely elements that will make up your "nest egg," including the following:

- Savings and investments

- Assets (business/real estate)
- Social Security

When combined together for their best use (which is the key to making your plan work) these three pieces of your "nest egg" should provide your income needs for life. Let's leave it at that for now, and we'll return to this step when we develop the full scenario.

Step 2: Define Your Income Needs

As much as I try to avoid certain words in my work, sometimes you just can't beat around the bush. Yes, the step two process means taking a look at that "B" word—your personal <u>budget</u>. As much as people do not like to sit down and go through the process of looking at where their money goes each month, the process of knowing your personal budget is critical in forming your financial independence program. It is critical to know where you stand today in your income needs—so that you can forecast your needs out into the future, to the point of retirement, and well into your retirement years.

As you may realize, your income needs do shift as time passes. In the early income years, when you may have high debts, lower wages, and small children, to the middle income years when your family is growing and hopefully your debt is shrinking, onto the college years, and finally to the "empty nest" years leading into retirement. With each passing stage of your life, your income needs shift according to the demands on your pocketbook. Your goal is to position yourself at the time of your retirement, such that your income demands have begun to shrink from where they were in your peak income years. This generally occurs as a result of needing less income to support your debts, your college payments for children and the higher lifestyle cost when the children are still under your care.

A rule of thumb in financial planning is that you will need 75% of your pre-retirement income to meet your needs into retirement. Although this number may work out by chance, I believe there is more chance than I care to leave in the equation. The only way you will know how much you will need in retirement is to estimate how each area of your budget will change once you stop working. This involves asking yourself the following questions:

A. What debts am I currently paying in the budget that will be paid off at retirement (such as the home mortgage, loans, etc.)?

B. What costs in my personal budget, particularly in the areas of home, children, autos and insurance, will be reduced or gone at retirement (such as disability insurance, kids' allowance, autos, savings plans, etc.)?

C. What costs am I not currently paying in the personal budget that may need to be added at retirement (such as health insur-ance or auto costs being paid for by the business)?

As you begin to understand how your income needs will shift from now until retirement and beyond, it will become clearer to you what your income requirements will be from your "nest egg." Keep in mind that as you grow older, your needs will change simply based on the realities of age. In the early years of retirement, costs seem to go up for travel and leisure, as you do the things you've always dreamed. As time passes, the travel and leisure shifts to time with the children and grandchildren. And as you get older, the need for income to support travel, auto use and a more active life also winds down. The tradeoff (which is the big unknown, and not easily definable at this point) is how your medical and health care costs will shift as you age.

Taking a look at your personal budget and your current and future income needs (or you might say spending needs) may be the most important of all of the four steps in this process of defining your financial independence program.

Step 3: Define Your Life Expectancy
This is a very difficult step for many people to come to terms with as it involves asking yourself the question, "When do I believe I will die?" My work in the financial planning business has proven to me that addressing the issues surrounding death, life expectancy and mortality (if you want to call it that) are the toughest for most people to address—and usually the last. It is why people typically put off taking care of their life insurance and estate planning needs until it is absolutely necessary. Sometimes they never get the chance!

For this discussion, defining your life expectancy is a matter of giving your best "guesstimate" as to how long you will need to provide an income stream to meet your needs as well as your spouse's needs. I always ask people to define for me how long they think they will live. I do so because some people have some very clearly defined answers based on their own personal life experience, their family history or other reasons. For my work in this area and in order to be safe and to plan *not* to run out of money, I begin by defining the end of one's life as being at age 100. If we begin there, we will be more than safe for 90% of society. This may cause the plan to be overly conservative, but it also protects from the plan running out of money too soon, which is the number one concern for most people when addressing this issue of financial freedom.

I would suggest that to plan for an income need for you and a spouse to an age less than 70 or 80 may be setting yourself up for a thin retirement in terms of income and the increased chance of outliving your means. Somewhere between the ages of 80 and 100 will likely be the normal range of death for the generation now closest to retirement age (in the next 10 years).

Step 4: Define Key Assumptions
This is a very important part of this work. You must make a "best guess" as to three assumptions for the future—namely the inflation rate, your savings growth rate and your income tax rate.

A. Inflation rate: Historically, the cost of inflation has been around 3% to 3.5% annually. This is important because over 20 years your cost of living will double, whereas you may still be living on the same fixed income stream from your "nest egg."

B. Savings growth rate: Historically, the growth rate for bonds has been around 6% and for stocks around 10%, with each of those figures up by 2% the past 15 years. If you have a balanced investment plan and expect a long-term savings growth rate in excess of 10% to 12%, you would likely be setting yourself up for failure. Many of my financial independence plans call for a 9% growth rate in the years after retirement and a 7% rate of distribution (meaning the amount you actually take out of the plan).

C. Income tax rate: Although you may have less income in retirement, you may likely have lower deductions. Thus, your total tax rate may not fall as much as you think. To use a range of 25% to 33% for your income tax rate in retirement would be reasonable.

Now having addressed the four steps of the financial independence process, let's put together a life-like example to bring it all together. What follows is a typical profile of a pre-retirement couple looking to see how close they are to achieving the goal of financial independence.

Financial Independence Example:
Let's assume we have a couple whose ages are around 55. They have grown their savings to $550,000 through a pension plan and some IRAs. The dentist plans to sell his practice at age 60 for $300,000. They each have submitted a request of benefits form to Social Security and have received a report suggesting that at the age of 67 they will receive a combined income of $1,950 monthly from Social Security. (Note to readers: If you have not submitted this request form to Social Security, you can call our office, and we'll send you a form.) For the next five years, this couple plans on contributing $20,000 annually to their retirement savings plan. They do not plan on selling their home and will have a remaining mortgage of $67,000 at age 60. They estimate that the dental building which they own will be worth $210,000 at age 60 and would likely be leased to the buyer for three years, then sold. At age 60, the building will be paid for in full.

The couple is currently finishing their years of supporting educational expenses for their children. With their estimated budget changes between now and age 60, they believe their income needs at age 60 will be $6,600 monthly after-taxes. They foresee this cost of living growing 3.25% each year due to inflation. And, they see their post-retirement income tax rate in the neighborhood of 30% for combined federal and state income taxes.

Based on their risk tolerance and their goal for savings growth, they have set a target for savings growth at 10% annually to age 60 then 9% annually thereafter in their retirement years. They plan on taking out no more than 7% of their total savings balance in any year, in order to allow for some cushion in a down market year. Based on their family history and their current health, the couple believe they will likely live to the age of 95.

So…if you were their advisor, what would you tell them when they ask, "Do we have enough to make it for the rest of our lives, based on this plan?" What would you guess? It needs to be more than a guess.

Next month, we'll answer for this couple, "How close are you?" In the mean time, I'd ask you to contemplate this very same important question, "Do you have enough to make it for the rest of your life?"