

The Decision Decade

Important choices before and after retirement

By Mark L Smith CPA/PFS

A funny thing happens in many households a few years before retirement. Money appears! It's a perfect storm of sorts as one or more of the following happy milestones is reached: The nest is finally empty. The mortgage is paid off. College tuition is done. The last wedding bell has rung.

This harmonic convergence of final payments can result in a seeming jackpot of additional cash flow – the well-deserved payoff for all those years of financial and familial responsibility. With perhaps tens of thousands of extra discretionary dollars in hand, even the most frugal saver may be tempted by big-ticket purchases. And those fifty-somethings who resist the urge for an Audi TT (or a three week summer getaway to Provence or a second home in the mountains, or, or...) may respond to the extra cash in another way: retiring earlier.

Splurge or save? Retire early or go the distance? These are two of several important choices that comprise the Decision Decade – the five years or so before and after officially retiring. While it may not seem so at the time, the financial and lifestyle decisions made through this key period can deeply influence the quality of retirement that follows.

In our two previous articles we examined the basic math of retirement – how much should be in savings and investments to fund a full and satisfying time of financial independence – and the fundamentals of smart investing. In this third piece to the puzzle, we explore the Decision Decade, with an eye on making smart choices at the end of one's career and during the first stages of retirement.

So many choices; so much time

When the typical life expectancy was 65, retirement planning wasn't so tough. But now, with so many people living to 80 and 90 and beyond, the extra time demands extra care. Prudent planning is a must. In particular, a rational view of the financial future means a close look at Decision Decade choices, which include:

- Can we spend extra cash flow freed up by the end of mortgage and college payments?
- Should we retire before 65?
- If we retire early, should we start collecting Social Security immediately?
- What can we spend each year to ensure that our nest egg lasts as long as we do?

Like most decisions, these have no magic answers that perfectly apply in all situations and for all people. However, it's important to recognize that any choice has consequences, and the consequences of these particular decisions can be dramatic and long-lasting. Let's take a look at each.

Spend or save?

After the decades of discipline that yielded clear title to the homestead, a good education for the kids and a joyous wedding or two, surely it's time for a frivolous purchase or two, right? For those individuals fortunate enough to approach retirement debt-free and with considerable investments, a beautiful Bayliner cabin cruiser or his and her Patek Philippe watches seem fair and reasonable rewards.

But is this kind of spending a smart choice? This is a math problem that can only be reliably solved by projecting cash flows needed for retirement and comparing them to projected sources of income once the paychecks end. As we've discussed in previous articles, few people take the time to make these projections, and the few who do are generally surprised by the numbers, and not in a positive way.

Like it or not, maintaining a comfortable lifestyle through a long retirement is expensive. Furthermore, even modest contributions to investment accounts can grow into serious money over several decades.

Let's assume there's \$20,000 of extra discretionary income available each year starting at age 55. While it would not be difficult to exhaust that cash with a few choice purchases, investing it for retirement could generate a windfall when it is needed most, twenty or thirty years down the road. Stashing away the surplus each year until age 60 (\$100,000 total) and achieving an annual return of 5% more than the inflation rate would produce approximately \$290,000 at age 80, when other savings may be running low. Continuing this practice another five years, to age 65, generates more than \$520,000 by age 80, enough to fund another 10-20 years of comfortable retirement.

The power of compounding is, inevitably, too powerful to ignore when pondering the splurge versus save decision.

Retire early?

In our earlier articles we likened the math of retirement to filling a bucket with money over one's working years and then letting the proceeds drain out of a hole in the bucket during retirement. The goal of course, is to fill the bucket sufficiently so that it does not run dry during one's lifetime.

Retiring early works counter to this goal at both ends of the equation – prematurely ending deposits into the top of the bucket and simultaneously starting the relentless drip. Adding five or more years to retirement spending, while cutting off new savings at likely the highest earning stage of one's career is not a decision to be made lightly. To allow this move, many must accelerate savings through the earlier career years, accept a lower standard of living in retirement or supplement income through a new career in retirement.

Social Security starting when?

On top of all the other uncertainties of Social Security, retirees face a tricky bird-in-the-hand/bush dilemma regarding the timing of payments. The earlier one retires, the lower the monthly payments received. But by the same token, starting the payments earlier means more years of Social Security cash flow.

Determining whether to take smaller payments, and more of them, or fewer, larger payments is an optimization problem that can only be solved correctly when one's age at death is known. Of course, few people know this important data point at the time when they must decide whether to take or defer Social Security payments. Life expectancy charts only provide averages – meaning almost all individuals live longer or less long than the number on the chart.

Most of our clients have planned and invested sufficiently that Social Security acts only as a mild supplement to portfolio income. With this in mind, we generally advise clients to start collecting payments as soon after retirement as possible and investing the proceeds rather than gambling on a longer than average life expectancy. We will be pleased to review and explain your choices as they approach.

What can we withdraw?

The decisions do not end at retirement. A critical choice immediately follows the receipt of the gold watch: how much can be withdrawn from investments each year to make sure the bucket does not go prematurely empty?

It's another math exercise that we'd be pleased to review with you. But the short, ballpark answer is no more than four percent per year. Based on typical returns on investment, inflation rates and retirement lengths, withdrawing four percent or less reduces the chance of consuming the entire nest egg to an acceptably low level. Increasing withdrawals to five percent greatly increases the chance of running the bucket dry. Withdrawing seven percent each year essentially guarantees a shortfall.

This four percent figure is a helpful guide in determining how much money must be in one's portfolio at retirement. A couple needing \$40,000 from savings during each year of retirement needs \$1 million at the start of retirement to withstand four percent annual withdrawals to keep up with inflation.

Decisions are cumulative

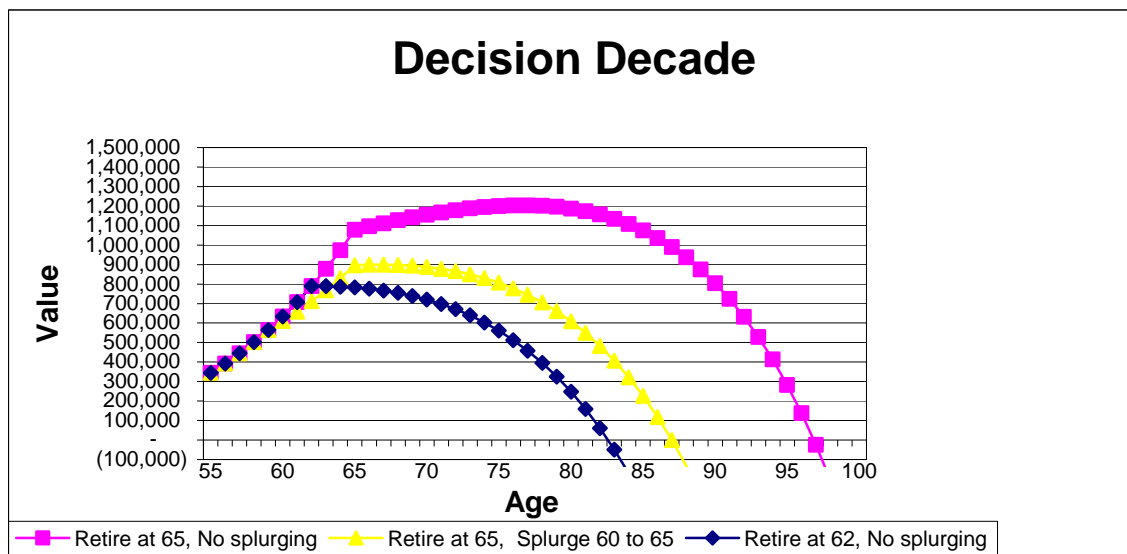
We have discussed each of these Decision Decade choices individually as each should be clearly understood on its own. In reality, of course, the decisions are more than related. For most families, they are completely interdependent. Buying the Porsche now means pushing retirement back a year. Choosing a three-star vacation instead of the five-star extravaganza improves the chance for retiring a little earlier. And so on. Because of the expense of a lengthy retirement, only the lucky few can afford to both spend extra cash and retire early. On the other hand, making the more conservative choice in both respects – saving extra discretionary cash and working to age 65 – greatly enhances the security of retirement cash flows.

Proof in numbers

Consider this example. A couple, both age 55, is looking ahead to retirement. They have a total of \$300,000 in accumulated savings. Their current income yields an "extra" \$20,000 per year beyond expenses. They expect to need \$50,000 (today's dollars) per year to fund their retirement. They wonder whether they can meet their goals while spending the extra money on "splurges" - the high-end vacations they have always dreamed of. They are also considering retiring early.

The following chart shows when the money runs out based on three possible courses of action:

- Pink: Retire at 65 and continue to save the extra \$20,000 per year
- Yellow: Retire at 65, but spend the extra \$20,000 each year from age 60 to 65
- Blue: Retire early at age 62 and continue to save the \$20,000



(assumes 3% inflation and 8% annual return)

As the chart demonstrates, the results vary widely based on the couple's Decision Decade choices:

- Retiring early, even without splurging (blue), leads to a zero balance at 83.
- Working to 65 and avoiding the urge to splurge (pink) yields a comfortable retirement to age 97.
- Working to 65, and spending the extra discretionary income between ages 60 and 65 (yellow) falls in between.

It is interesting to note that spending the extra \$20,000 each year for five years results in a zero balance ten years sooner than the no-splurge option (comparing yellow to pink).

Individual answers

The choices necessary during the Decision Decade are complicated, not just for the math involved, but also for the lifestyle, health and other issues that may come into play. As mentioned earlier, the answers are rarely black and white. In working with clients, we often discuss compromise approaches where, for instance, a portion of surplus cash is allocated to splurges, with the remainder committed to investment. In other cases, one spouse may retire early while the other continues.

Regardless of the specific choices made, knowledge and forethought in this area are invaluable. We look forward to discussing your own Decision Decade at your convenience. These discussions can be particularly valuable for individuals who have considerable time before retirement, as understanding the variables well in advance facilitates positive lifelong saving and investing habits.

Please contact us at any time to discuss this article or to request one of our previous articles:

Understanding the Math of Retirement Planning
Find your "turn around point" and other key measures

Funding a Comfortable Retirement
The fundamentals of retirement investing

© Mark Smith, 2006 –
Mark L. Smith is the Managing Member of
Solutions For Wealth Management, LLC, a
Personal Financial Specialist and a Certified
Public Accountant in Bourbonnais, IL 60914.
marks@w-m-s.com