The Retirement Equation

By Paul Kluskowski

I was sitting in my 8th grade Algebra class and my head was swimming. The teacher was going through the motions of solving equations and it just didn't make sense. There was something oddly powerful about the equal sign and I needed to unlock it. In a flash of insight, it came to me: to maintain the balance, whatever was done to one side of the equation had to be likewise done to the other. This flash would serve me well in the years to come including all the math that would follow.

In my career as a financial professional, this principle of equality can be applied to retirement planning. While many consider retirement planning to center on finding the lump sum needed to retire, I view it as an equation: The Retirement Equation. It simply states that at a minimum, retirement income must equal monthly expenses. While this may seem basic, it contains some powerful principles and insights, no different than that moment in 8th grade Algebra.

Surprisingly, I find few people who really have a grasp on their actual monthly expenses and spending. Lacking this key piece of information makes solving the retirement equation impossible, or at best, a guess. My approach, and the one I recommend to others, is to break monthly expenditures into three main categories:

1. **Normal/Recurring.** This includes housing, utilities, food, automotive, etc. These are expenses that are difficult to reduce.
2. **Discretionary.** This includes entertainment, dining out, vacations, luxury purchases. These are expenses that can be reduced if needed.
3. **Unexpected.** This includes home repairs, appliance replacements, auto repairs, unreimbursed health care costs. These are difficult to reduce but can sometimes be insured.

On a daily basis, track all of your spending and categorize each accordingly. Then, on a monthly basis, run your totals. Over the course of 3-6 months, you will get a good sense for your baseline spending. Many people are surprised at this number. From here, it is possible to identify possible reductions, but it is the first half of the retirement equation. With a clear and accurate measure of monthly income needs, it is time to consider the other side of the equal sign, retirement income.

Retirement income generation generally falls into one of the following six categories:

1. Withdrawals from stock, bond, mutual fund accounts, either regular or IRA
2. Insurance products, especially immediate annuities
3. Cash flow from tangible assets
4. Social Security
5. Small/Micro business (aka, Side Gig)
6. Pensions

By far, the stock/bond/mutual fund account category gets the most attention. People are encouraged to save and plan based on historical data from various stock and bond measures. In today's ultralow interest rate environment, I would offer a word of caution here. This is truly a time when past performance is no guarantee of future results. Much of the gains in both stocks and bonds have been driven by declining interest rates and unprecedented action by central banks. For the next 3-5 years at least, I would recommend a far more conservative estimate in one's planning assumptions. To be on the safe side, I would assume no more than 1-3% annual growth. If it turns out higher, then it is to your benefit so no harm. The downside to low returns is that it necessitates more significant savings, or other income streams.

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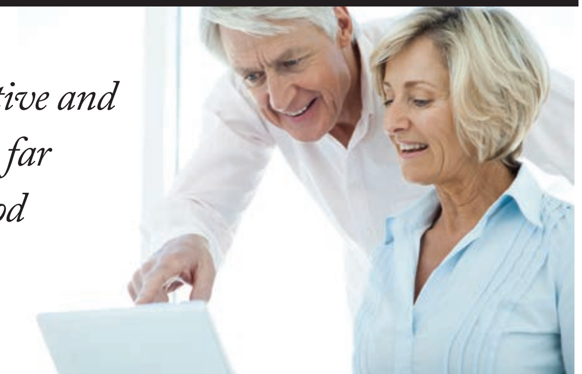

Insurance products are another avenue utilized to generate retirement income. These take the form of immediate annuities, in particular. Quite simply, a lump sum of money is given to the insurance company in exchange for a monthly check, usually for life. The monthly payouts for a given lump sum are based on a number of factors including: prevailing interest rates, age of annuitant at start of benefit, gender, stipulations such as joint life or sum certain, and any other special terms or conditions. All other things being equal, prevailing interest rates are a significant variable in the payout. Insurance companies back future obligations with high quality bonds, among other assets. When making comparisons amongst providers, ensure that the products are sufficiently similar so that a sound choice can be made.

Tangible assets are an often overlooked source of retirement income. A reverse mortgage is a simple example. If you are 62 years or older and have at least 50% equity in your home, then you may be eligible for a reverse mortgage. One option is a monthly check, among others. To learn more about this, find a licensed reverse mortgage broker to guide you through the process. Other tangible assets include rental properties, storage units, and farm land to name a few. Not only can many tangible assets provide some income, but they may also have tax benefits as well. Consult your CPA for more insights into this area. In short, there are countless manners in which one can generate income from property and other capital assets.

Social security is a major component of retirement income for many. While it is a complicated program, a simple approach is to consider whether you anticipate living beyond 80 years of age or not. If you do, then delay collecting benefits as long as possible, 70 years old ideally. This will maximize your potential lifetime cumulative benefit. Otherwise, begin collecting at a younger age so that funds are available sooner, albeit at a lower lifetime cumulative benefit should you live beyond 80. Be certain to monitor your projected benefits by going to www.ssa.gov to access your social security records. Your report will show your year-by-year earnings credit along with projected future benefits. Lastly, if you have a complicated situation such as divorce, etc, then consult with someone equipped to help you navigate the Social Security rules and regulations. There are tools available to help financial professionals address Social Security questions that clients often have. Remember, Social Security personnel are not allowed to give individualized advice.

Small/Micro businesses (sometimes called a "side gig") are another interesting opportunity for retirement income. There is nothing worse than rusting away in one's later years. People who are active and engaged tend to be far happier and in good health longer. Consider starting a small business for yourself. (See my list of 89 money-making ideas for retirement to get some ideas).

Lastly, if you are covered by a pension, then feel fortunate. And, know that you may not be out of the woods, either. Pay particular attention to the pension fund's annual report. You will want to monitor the level of funding. This will be shown in two manners. One uses the actual, current interest rate and the other uses a historical average which is typically higher. If these values are 85-90% or higher, then your plan is reasonably well-funded and should be ok. If the funding values are below perhaps 65-70%, then your plan may have difficulty meeting its future obligations. Should this be the situation, call the plan administrator for more information and prepare for a possible reduction in your anticipated benefit.

As I stated at the onset, the premise of the Retirement Equation seems basic. Yet, we have drawn many insights along the way. With a right-minded, fact-based approach to retirement planning, it is not only possible but even likely to balance the retirement equation of income versus expenses. In doing so, you will have much greater peace of mind as well as confidence in your retirement timing decision.