THOUGHTS ON THINGS FINANCIAL

YOUR GUIDE TO A CHAOTIC MONEY WORLD

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TABLE OF CONTENTS

Chapter 1

PLANNING IS IMPORTANT... THAT IS, IF YOU EVER REALLY WANT TO GET ANYWHERE 1

Chapter 2

THE GREATEST STORY EVER TOLD (ABOUT MONEY) 9

Chapter 3

DON'T BLAME YOUR DEBT, MANAGE YOUR CASH 23

Chapter 4

CASH MONEY. BLING. BUCKETS. 37

Chapter 5

WHO'S WHO IN THE ZOO? A PLAIN ENGLISH EXPLANATION OF THE PLAYERS IN THE MONEY WORLD 57

Chapter 6

FUNERALS AND FIASCOS: PLANNING FOR WHAT CAN GO WRONG 71

Chapter 7

THE HARDEST EASY 91

Chapter 8

WHEN ENOUGH IS ENOUGH 111

Chapter 9

KIDS AND MONEY, BUT NOT JUST COLLEGE MONEY 123

Chapter 10

LIFE'S FINAL CHAPTER 137

IN CONCLUSION 153

Chapter 8

WHEN ENOUGH IS ENOUGH

"I think we're going to be able to call it," Austin says as we review our clients financial plan and assets on the big screen in my office. We've been running and rerunning the scenarios, carefully reviewing possible future expenses and expected returns. We adjust for different inflation scenarios, stress test against market crashes, model untimely deaths, and add in rising healthcare costs.

Our software hums along, churning out thousands of simulations based upon past market conditions and fluctuations. "There's an 83% probability of success," I say as the Monte Carlo simulation completes its analysis. "Not bad, I think we have it." We're excited. Tomorrow, when our clients come in, we'll call it.

For us, calling it is the culmination and ultimate result of years of work with a client. The day we call it is the day our client could, if they wanted to, quit their paying gig and live comfortably on their accumulated assets. Calling it spells freedom. True financial independence is the ultimate payoff from years of planning and implementation.

The funny thing is, most of the time when we call it for a client, they continue to work and achieve, sometimes for many years after their personal financial success has been cemented. But they work differently, with a different attitude, perspective, and a clear-

er sense of calling that may not have been there before. For many, the culmination of their life's work and accomplishments will occur *after* this moment. I think it's the freedom that personal financial success provides that becomes the impetus.

It's a privilege to be an active participant in such an amazing, life-changing process and event. But it's certainly different than it used to be. Retirement has changed over the years. The retirement of our parents, our grandparents or even our great-grandparents is probably completely different than what we will experience. Back in the day, as the Industrial Revolution took shape, people's bodies would just wear out over time in the factories and mills, and therefore they weren't worth much anymore in the workforce. Social Security and defined benefit pension plans were created to ease workers out to pasture in a humane fashion, so younger, healthier, and cheaper laborers could fill their slots.

The system worked, mainly because most people didn't live very long after retirement. I remember my grandad talking about his dad, my great-grandfather, who died in his easy chair two weeks after retiring from the factory in Houston where had worked his entire adult life. It also worked because our workforce was not very portable, meaning people worked for the same employer for many years, so an old-fashioned pension based upon years of service held value.

Fast forward to today, and we have very different dynamics in play. People live longer and need more money for a longer retirement. We also change jobs a lot more often than our parents or grandparents did, so defined contribution plans, such as 401(k)s, are more popular due to their portability. But most importantly, people often don't want to retire. And because of their knowledge and experience, many are still very much valued in the workplace.

These changing and shifting dynamics make retirement much more difficult to define and plan for. But they also make planning

much, much more important. One of the greatest risks we face in retirement is running out of money before we die, so the longer we're expected to live, the more important it becomes to get our retirement assets squared away. The portable defined contribution retirement plans, or 401(k)s, most of us have now are our responsibility, not our employer's. In most cases, if there is going to be money available for us at retirement, it's up to us to individually make it happen.

Where is Social Security in all of this? It's there, and it's a relevant amount of money. But to get the best bang for your buck, you want to wait all the way to age 70 before you start drawing. But even then, for most of us, it's not enough money to live on comfortably. Many of my clients want to work as long as they can. They love their jobs. They are valued for their skills and are usually making more money than they ever have previously. They don't want to stop, but planning to work until you can't anymore is not a good way to go about it. You never know when that might be.

That's why I encourage anybody and everybody to work toward financial independence. Don't call it retirement if you don't want to, but financial independence is kind of the same thing. When we work toward financial independence, we are simply trying to accumulate enough money to where, if we didn't want to work or couldn't work, we would still be able to live the lifestyle we desire for ourselves.

I always loved the ING commercial where people are walking around with numbers over their heads. "What's your number?" the commercial would ask. It's true. Everybody has a number, and for everybody it's different. Your number depends on what your future expenses look like, your tolerance for risk with your investments, your health, and how adequate your health insurance and long-term care insurance may be. I've spent most of my adult life calculating this number for people and helping them achieve it.

Trying to sum up everything I know on this topic in one chapter is impossible. But hopefully I can provide some insight and guidance to help you along your path.

The Earlier the Better

Hopefully, you can achieve financial independence at a young enough age, so you aren't just going off to pasture to die, like the old days. Rather, this independence should be an opportunity to maybe go do some things that you weren't able to do while you were working. Financial independence is something we should be excited about.

Many times, financial independence can be achieved in phases. Maybe you transition from 40 hours a week to 20 or work more as a consultant and less as an employee. Or maybe you sell a business to devote all of your time to your favorite charity. If you are healthy and enjoy what you do, why not keep doing it? Retirement does not have to be the end of your contributions to the economy or society. Far from it. Many of the people I know who are "retiring" these days see it more as the culmination of their life's experiences, where they feel more valued for who they are and what they do than ever before.

The Right Attitude

Retirement should be fun. It should be something we're looking forward to and not something we're forced into due to circumstances beyond our control. That means we have to be purposeful about it and control what we can; that's retirement planning. If you enjoy your career, then find a way to continue doing what you love. If there are hobbies you enjoy, financial independence will allow you to enjoy them even more. Most of my retired clients travel like crazy. They have been so many places and had so much fun. Retirement allows you to travel during the off season to avoid the crowds.

Looooong

Many times, we joke in the office about what the perfect, most efficient retirement scenario looks like. On a graph, it's downward sloping, where your assets go from something to zero on the day that you die. Home run.

Of course, it's impossible to execute because we generally don't know what day we're going to die ahead of time. Mortality experts predict that many of those in the younger generations today could live to age 120 or beyond. That's crazy to think about, but scary too if you're a financial planner. This makes any kind of spend-down strategy a nonstarter. What I mean is, if people are going to live that long, once they achieve financial independence, they can't afford to spend their basis, or principal, at all.

Expensive

There are a lot of expenses that go away in retirement. Many of my clients pay off their house, so there's no mortgage to deal with. Taxes can go way down, since you're probably not pulling a paycheck anymore. Your kids are hopefully grown, out of the house, and financially independent from you.

But wait, what are you going to do with all of that free time you have? You're probably going to want to travel, entertain, and spend money on all sorts of fun things that you didn't have time for previously. This all usually happens in the first stage of retirement, which I call the honeymoon. It's fun, blissful, and invigorating. It's a carefree existence that makes you feel as if you are newly married, without a care in the world. It looks like fun to me, but you have to make sure you plan for these expenses.

Once the honeymoon is over, a second retirement stage emerges. I call it mature actualization. In this stage, the honeymoon is over, and you come back down out of the clouds. At this point, you become very aware of your mortality, your legacy, and what's truly

important. Bonds with your closest friends and family become stronger than they have ever been before. You travel less and usually spend less money. If you have been blessed with significant, excess assets, many times this is when retirees become very comfortable with gifting to their family and favorite charitable causes.

Health

The third and final phase of retirement is usually not nearly as fun and can be by far the most expensive phase of your entire life. No matter how careful we are with our bodies, eventually they wear out. In the third phase of retirement, we start to lose capabilities either physically, mentally, or both. This phase can be costly and stressful.

I've been through this phase with clients and, of course, parents and grandparents. It's tough on everybody. The key here is to make sure we planned on the expenses somehow, either through long-term care insurance or sufficient funds that have been set aside. Our lifeboat drills start to become the real thing. So it's good that we have talked through stuff, and everybody knows what they are supposed to do.

Finding Your Number and Understanding What It Means

Now you should have a clearer understanding of what retirement may or may not look like and a general picture of what your expenses might be during the different phases of retirement. Your retirement and associated expenses will be unique to you. There are no general rules of thumb that hold up very well in this regard. Initially, you can shoot for 80% replacement of current income, but that's a shot in the dark. What income? Current income? How old are you, and what does that represent in future income dollars? Is your house paid off in retirement? What about health insurance? If you try to retire before age 65, then you are not Medicare eligible yet. What are you going to do about health insurance, and how much is it going to cost?

See what I mean? Modern financial planning software is designed to take all of these considerations into account, and modern financial planners know how to read and interpret what the software is saying, in order to make sound recommendations. But to give you a general idea, let's do some easy math and make some broad assumptions.

The Rule of 72 and the 4% Rule

The rule of 72 is a great way to calculate the growth of investments over time and the erosion of purchasing power by inflation. Unfortunately, it does not provide any insight into cash flow streams, like steady periodic investing or distributions, but the 4% rule helps out on safe distribution amounts. Let's say you crunched some numbers and, in today's dollars, you think you could live off of $9,000 per month in retirement. Social Security is projected to provide $3,000 per month in income in today's dollars. That means you need to figure out how to generate $6,000 per month, or $72,000 for the first year of retirement. Since Social Security is indexed to inflation, you can assume that you will only have to account for inflation on your additional income need. This means that for the next year, you'll need, let's say, 3% more to keep up with inflation.

The mistake a lot of people make here is that they take an assumed return and call it income. For example, let's say you have decided you will invest 60% of your money in stocks and 40% in income. Taking into account historical data, you think you can make, on average, 6% per year. If you divide $72,000 by 6%, you get $1.2 million. This means that $1.2 million could potentially provide $72,000 per year of income for the rest of your life as long as you don't touch the principal. But let's say you are estimating that you'll live 24 years in retirement. This calculation does not properly take into account inflation.

So, assume 3% inflation. The rule of 72 says that if we divide 72 by a factor, it will give the number of years it will take for that

factor to double with compounding. This is super handy. 3 goes into 72 a total of 24 times. This means that in 24 years, you'll need $144,000 per year in income to match the purchasing power of $72,000 in income today, all due to inflation.

Financial planning software takes all of this into account and then some, but there is another handy rule of thumb called the 4% rule that we can use for quick and dirty estimates of what your initial retirement balance needs to be in order to keep up with inflation. Planning geeks like me argue the validity of the 4% rule with each other constantly, and most of us have shifted to more dynamic withdrawal guidelines. But more on that later. The 4% rule says that if you divide a moderately invested portfolio (like the one in this example) by 4%, you should be able to withdraw that amount safely and increase it each year to keep up with inflation during retirement. And $72,000 divided by 4% gives us $1.8 million as our target number, not $1.2 million.

So, is that your number? Nope. Remember, that's your number if you retired today. Let's say you are still 24 years out. If that's the case, we have to adjust your number for inflation. Using our rule of 72 calculation, that's one doubling period for inflation again. If we double the present value calculation, we get $2.4 million. Now *that's* finally your number.

Now that we know the future account balance value needed to retire comfortably, we can use a financial calculator to calculate what it's going to take to get there. Assuming a 6% return, if your current 401(k) balance is $250,000, you'll need to contribute a little over $2,100 per month for the next 24 years to achieve your goal. This is an illustration only, and the numbers will change drastically based upon your circumstances.

I hope all of that makes sense. There are lots of steps to calculating retirement income needs and so many factors to consider. There are a number of good retirement calculation tools on the internet

that can get you pointed in the right direction, but at some point, it will probably make sense to have a financial planner run all of it for you.

Retirement Income Is a Long-Term Goal These Days

You may have noticed that I used a moderate mix of stocks and bonds, both for the portfolio assumption during accumulation *and* during retirement. However, you may have read elsewhere that we are supposed to reduce our reliance on stocks and shift to a safer portfolio as we get older and retire. I don't subscribe to that theory, and here's why. First of all, with longer life expectancies, retirement income becomes just as much of a fight against inflation as it is while saving for retirement. Granted, inflation has been low in recent years, but so have interest rates. If we convert our portfolio to mostly or entirely bonds, we won't generate nearly enough money to maintain a good income stream.

Our best weapon against inflation is a diversified portfolio that includes a good amount of stocks or stock funds. So, keeping stocks in our retirement portfolio after retiring will increase the probability of our money lasting to the end. But more stocks in our portfolio also increases volatility.

This means that, some years, our retirement portfolio will do phenomenally well and in other years it will lose money. How do we deal with this? I think one way we deal with it is by adjusting some of the assumptions we made when coming up with our withdrawal rate. Instead of just calculating 4% of $2.4 million in our example and blindly increasing that income amount by inflation every year, we have to insert some common sense. We can choose to forgo the annual inflation increase, and only increase your income withdrawal every few years, when you feel things are getting tight. We can also recalculate our withdrawal rate against the ending balance annually.

So, for example, if after the first year of retirement you end up with fantastic returns and the balance increases by $100,000, even after your withdrawals, then take 4% of that number and give yourself a raise. If, in the next year, your portfolio loses money and the balance goes down, adjust your income down accordingly. Heck, isn't this what we do our whole lives? When times are good, we go to Disneyland; when they're not, we pack it up and drive to Galveston for summer vacation instead. Why should retirement be any different? Don't think of your retirement income as fixed income, that concept does not hold up under modern market conditions.

In Closing

In closing out this important chapter, I want to get away from the math of retirement and back into the attitude and mindset we should all be striving for if we want to retire successfully. Here are my five most important tips:

1. If you are miserable now, retirement will probably not make you happy. Retirement is not the solution if you don't enjoy your job. Too often we set ourselves up for unrealistic expectations when we are not happy with our current lives. Focus on doing the things you enjoy in your job to get your attitude in shape. Looking to retirement as a solution to all of your problems is dangerous and unrealistic.

2. Practice your retirement today while you are still working. Take time off and do the things you see yourself doing in retirement. Whether it is volunteering, travelling, or consulting you should not wait to try these things on for size. Like with anything, if you practice it makes you better. Heck, you might discover you *hate* travelling. Better to know now.

3. Talk it out with your spouse and your planner. By far the best meetings that happen in my office are the ones where the husband, wife, and I walk through the retirement process. Everybody needs to be onboard, communicating, and engaged early on in order for everything to work out successfully.
4. Plan on being busy, maybe busier than you are today. Know your priorities and values, so you can make good decisions with your time. Just like any other stage of your life, your time will be a valuable commodity, so use it wisely toward the things that really matter.
5. Make your health a top priority. I am seeing more and more studies that demonstrate good health as the top predictor of a successful retirement. Unfortunately, our bodies eventually wear out and things (long-term care, hospitalization, medications) get expensive. Take care of your body so you can maximize the fun part of retirement and minimize healthcare costs.