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IN MEMORIAM

Everything You Need to Know About Retirement Spending

By Michael S. Falk, CFA®, CRC

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Let's begin with a few immutable truths:

1. What happens with our investments or in investment markets is beyond anyone's control.
2. Your spending is within your control but for debt repayments and essential or fixed costs to an extent (e.g., your electric and grocery bills).
3. None of us knows when we will leave this world, even those of us who are terminal (like me).

Retirement spending that acknowledges those three truths can become easy to execute well. Yes, I know that may seem counterintuitive, but the title of this article includes the word "everything." What does it mean to execute well? This is meant to imply that retirees can overcome most of their real or perceived risks—running out of money before they run out of life—and realize some of their aspirational expenses for as long as they live. And I am distinguishing retirement spending from an overall retirement plan. Note that I am not using any terms like "best" or "most" because an optimal plan is fantasy and often not very flexible. Because the future is uncertain, all spending plans need to remain flexible. In this brief, I will help you understand how to succeed with the following:

- Knowing your essential and aspirational spending
- Understanding your financial levers
- Aligning your spending with your savings to maximize your life

Perfect is the enemy of good, so we will not need or be using any fancy math. This may even be an article that many in the profession don't like. I don't mean to imply that certain sophisticated calculations and strategies can't be helpful but rather that, at the core of a successful retirement spending plan, a clarity and simplicity exists. The balance of this article is to share an elegant retirement-spending approach that can benefit even the most complex household situation.

UNDERSTAND YOUR SPENDING (LIABILITIES)

Take your current household spending plan and label every item as either essential, aspirational, a combination, or gone by retirement.

Essential expenses are recurring and required parts of your spending such as a mortgage payment or a car payment. Aspirational expenses are neither required nor recurring but typically are enjoyable, such as a vacation. Combination expenses are a bit of both, like food; for example, your spending on protein could be for pork, chicken, hamburger, steak, or even lobster. Combination expenses should be split by the proportions included in the fixed and aspirational amounts. The types of spending that may be gone by retirement are child-related expenses (or is that aspirational?) or a mortgage (because retirees should avoid debt).

Of course, you should consider adding one additional fixed expense, an estimate of your monthly out-of-pocket healthcare costs.[1] There are surveys that estimate what retirees could expect, and although it is just an estimate for any individual, a monthly fixed-cost addition is sensible due to the size of the estimates.

Now you should be able to understand a quality estimate of your fixed and aspirational expenses. Missing will be uh-oh expenses, for example, a major car repair (see table 1).

Table 1

UNDERSTAND YOUR SPENDING (LIABILITIES)

Liabilities	• "Fixed" needs-based expenses (lower = more control and flexibility)
	• "Variable" aspirational expenses
	• Uh-oh's • Cash reserves, insurances • If "seemingly chronic," add to fixed

KNOW YOUR FINANCIAL LEVERS (ASSETS)

Social Security is a significant lever in that it is both inflation-adjusted and will last as long as you do. Social Security offers a guaranteed monthly income to help offset your fixed expenses.

Do you have a pension due from an employer? If you have a pension, the monthly amount can be added to your Social Security benefits to help offset your fixed expenses.

Sum all your other personal savings such as a 401(k) plan, an individual retirement account, a brokerage account, a bank account, etc. These savings, which can rise and fall in value, can be used to cover aspirational expenses or to purchase additional monthly income types of investments, e.g., annuities or a bond ladder, to help ensure your fixed expenses are 100-percent covered. For any savings that will be taxed before they are spent, you may wish to count only the after-tax equivalent amounts.

Do you own your own home? If so, then your equity could be tapped to provide a fixed monthly income, e.g., a reverse mortgage,[2] or you could sell the home, buy something smaller, and add the balance to your personal savings. A reverse mortgage would be considered an offset to your fixed expenses, and your savings would grow by the amount of the proceeds from downsizing your home.

Do you have the capability and desire to work part-time? Retirement does not have to mean stop working. In fact, for many people, part-time work brings all sorts of benefits. There is the obvious benefit of income, but there are many other real benefits such as socialization and connection. Imagine part-time work where you regularly spend money and now receive a discount on some of your expenditures. Take that one step further, work where you have a hobby, and you can gain another benefit.

These levers are all parts of what I call your "immunization potential." Immunization in a spending plan is the act of matching income or assets to liabilities or expenses. When there is a match, you are immunized from the cost of the liability, the same way a certain vaccine protects you against a certain virus.

Table 2

KNOW YOUR FINANCIAL LEVERS (ASSETS)

Assets	• Social Security • Pensions • Annuities or laddered bonds • Reverse mortgage • In aggregate, this is your immunization potential*
	• Growth-oriented investments
	• Insurances • Cash reserves (from growth)

** The pieces of the immunization potential are among the most complex and can benefit from professional assistance. Immunization is the act of matching income or assets to liabilities; when there is a match, you are immunized from the costs of your liabilities. This is analogous to a vaccine against a virus.*

Table 3

ALIGN SPENDING WITH SAVINGS

• When immunized, investment markets can't hurt you
• Growth—profit or loss volatility can't affect your immunized fixed spending • In good, profitable years, pursue "wants" • In bad years, wait until next year

The levers discussed above—Social Security, pension, a reverse mortgage, part-time work—may immunize your spending plan against some or all of your fixed expenses. To extend your immunization potential to possibly cover all your fixed expenses and to include aspirational and uh-oh expenses, you need some additional levers—cash reserves, insurances, and growth-oriented investments.

All these levers together make up the immunization potential of your spending plan. Getting the immunization potential right is among the most complex parts of planning for a successful retirement, and most people can benefit from professional assistance with this part of their plans (see table 2).

ALIGN SPENDING WITH SAVINGS TO MAXIMIZE YOUR LIFE (THE SIMPLE SAUCE)

Meet your needs and cover your fixed expenses. Do this first, the best you can through your immunization potential, and take the worry and stress out of your retirement to the greatest extent possible. The biggest possible wrinkle in this approach is a health-related uh-oh expense.

Reach for your wants. Allow your excess savings, i.e., the savings not needed to increase your immunization potential, to enable the pursuit of your aspirational spending. What surprises most people is that this excess can be invested mostly in stocks,[3] for example, because you don't need to spend the profits or losses every year. If history is any guide, stocks offer the greatest opportunity over time to achieve some aspirational goals and overcome any inflation risks from your fixed expenses.

Cover your uh-oh expenses. This is where the benefits of insurances can be realized, not that anyone really should ever want to need their insurance policies to pay off. Apart from insurance, building up a cash reserve also makes sense (see table 3).

And here is the math that makes it all work:

Within the growth investments,[4] reference the previous year's profits or losses as your aspirational spending guide:

- If the profits meet or exceed inflation plus 4 percent, then you can aspirationally spend up to 80 percent of that success and use the balance to build up cash reserves, pay for any uh-oh expenses, or reinvest.
- If the gains are less than inflation plus 4 percent, yet still positive, you should spend no more than half of that gain.
- If your performance was negative, there should be no aspirational spending.

When your cash reserves are equal to at least 25 percent of your annual fixed expenses, you should consider no longer adding to these reserves. I use the term "consider"

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without knowing the specific amount or type of fixed expenses.

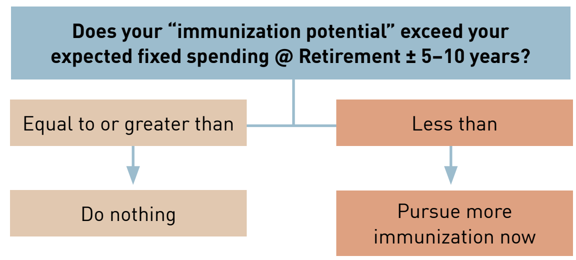
The final step does not need to be enumerated, but it needs some numbers because of what has been dubbed "the retirement risk zone," or the 5–10 years both before and after your retirement date. Failure during this 10–20-year aggregate period has a significant impact on the entirety of one's retirement success. Please use figure 1 to help you prepare to navigate the zone appropriately.

To conclude, happy and peaceful spending to you during your retirement.

This article was written by Michael S. Falk (1967–2021), CFA®, CRC, who was a partner at the Focus Consulting Group and practiced what he described above for the benefit of his family after his passing. Questions can be directed to the mailbox at www.focusCgroup.com.

Figure 1

IMMUNIZATION POTENTIAL



ENDNOTES

1. Retiree healthcare costs and coverages are an impactful and important topic for retirees that entail more complexity and can benefit from professional assistance.
2. Reverse mortgages and home equity lines of credit can be valuable planning tools for retirees.
3. Mostly, in my opinion, is up to 85 percent.
4. This is imagined as a diversified portfolio of equity-oriented investments.

INVESTMENTS & WEALTH INSTITUTE®

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org