Planning for Your Financial Planning

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As President Dwight D. Eisenhower said, “In preparing for battle, I’ve always found that plans are useless, but planning is indispensable.” With all the uncertainties in the financial markets, the emotional impact that money has on one’s psychic and relationships, he could have easily been talking about personal financial planning. A plan that one develops may only last a few months or it may last a lifetime. It may be based on assumptions that soon have little connection to reality or they provide reliable numbers for an effective plan. However, the process of financial planning and understanding where you are financially as you head into the life stage often known as “retirement,” are critical to finding peace of mind.

The goal is to understand where you are and what you need to do to live within your means. The reason is very simple. If you lead a lifestyle that is not sustainable by your financial assets (and assuming you do not have someone you can rely on for your financial wellbeing), the time when you “run out of gas” will be at that point in your life when you will be least able to handle it. So, it is important to understand your current conditions, forecast these out till you reach age 100, and then see where you are. Working with a financial planner who both understands you, your wants and wishes, and is truly a professional that puts your interests first, will turn out to be one of your most important investments. I am not a financial planner, I am not certified to be one, and I know some wonderful people who are. I trust and rely on their counsel, and I encourage you to find one as well. But, be cautious, the world is full of people who seek to separate you from your money. Choose wisely.

Therefore, the purpose of this paper is to offer a process for preparing for your personal financial planning. This should give you guidance on what you need to do to prepare for working with a financial planner. Remember, they are advisors at best and the more work you can do to prepare for these meetings, the more productive (and less costly) will be your engagement. Also, you are responsible for your financial conditions and investments not your advisors. Working with a strong financial planner does not absolve you from doing your homework, providing this person with full and robust information on your current conditions and making your own informed decisions. Hopefully, this paper will offer some important guidance on what you can do to make this plan a meaningful and profitable experience.

When you start analyzing your financial conditions, some people will look from the bottom up – your projected expenses and then what income is needed to support them. Others will look top down – what income are you likely to have, and then adjust your expenses so you can live within your means. There is no right or wrong way of looking at this, you need to examine both. We'll start with the Top-Down and understand your income sources approach.

Know Where Your Money Will Be Coming From

As you move to a time when your income is not based on what you earn, but on your investments, your well-being will be very dependent on understanding your sources of income. Let us highlight some of the things to think about and perhaps enable you to identify your potential sources of income and then compare this to your expenses.

There are many sources of income, and here are the most common.

1. **Earned income** – This in income you may receive from your employer or your business activities. This may include your working part time (including a gradual reduction), joining another company who is paying for your services, or starting a new business. This could also include consulting fees, fees paid if you participate on a Board of Directors for a company, or income from previous work such as royalties, licensing rights, etc. This could also be rental income from property you have that can be rented. Finding sources for earning income after you have left the official workforce may be challenging and will require you to adjust your lifestyle. Or, this will be income that will diminish over time.

2. **Social Security Income** – If you have paid into Social Security system, contact them to determine the specific amount you will be eligible to receive and when you will be eligible to receive this. You may have already received statements from them with this amount. This income may increase modestly based on the cost-of-living adjustments made to Social Security. If you can delay this income till you reach age 70, do so. The income you will receive will increase by an average of 6% - 8% per year or potentially

30% from age 62 to age 70. There are those who are concerned about whether this program will remain fully funded; examining this issue is beyond the scope of this paper and something that I personally don't worry much about. There are more things in my control or ability to impact.

3. **Pension Income** – A few employers still have pension plans. If you are one of the lucky ones who currently has a pension program, your only risk is the solvency of the organization that funds this program. Check to see if you are eligible to receive this income from your current or past employers. Also, determine how secure the sources of funding of this program are and whether there are options to better secure this income if you have concerns. If you are eligible but have not started this program, examine the potential income for spouse and survivor benefits or whether you can receive lump sum distribution, and see what will work best for you. Again, your financial planner or advisor may help you make the best decision.

4. **Investment Income** – This is income you generate off the financial assets you have received through an inheritance or generated during your working career. This is perhaps the most important source for the income you will have for your lifestyle. The question here is whether you intend to gradually spend this down over the rest of your life and leave only what is remaining to your children and desired charities, or you will seek to preserve these assets for your children and next generations. There is more information about the income you can expect in the next section of this paper. You may also consider using cash value or loans from your life insurance program if you have had one for a long time. This can be an additional source for tax efficient income.

5. **Receipts from Selling Major Assets** – This is income you receive when you sell a major asset, like a house or property. While one's home is often a major equity asset, you will need someplace to live so the sale of your home may mean you will need to add rent to your expense budget or just live on the difference between your previous home and your new home assuming you downsized. There may come a time when you will want to consider a reverse mortgage or similar financing techniques on your home. These programs use the equity (i.e., the appraised value less any mortgage) as a source for supplemental income. This can enable you to stay in your home and use the equity as a source for income. However, this can be very costly and risky, so again, work with your financial advisor before taking such action.

Once you have identified these sources of income, it is important to forecast what income you will likely receive from these sources over time, perhaps till age 100. While this may sound like a long time and unrealistic life expectancy, the number of people reaching 100 is growing by over 1000%. This may be you. So, it is important for you to identify the risks, expected levels of income and the liquidity (i.e., how easy it is to acquire these funds) associated with these sources of funds to determine this part of your financial future.

What You Can Expect from Investment Income

While many Americans have very little stashed away in savings, others have been saving through a 401k, 403b or similar programs throughout their working career. Hopefully, this is a sizable nest egg on which to supplement your other income sources. The conventional wisdom is that if you withdraw 4% of these funds after you reach the age of 65 or 70, then you should have sufficient assets to last your lifetime. However, you cannot do this if your assets are in fixed income, savings accounts or certificates of deposits. They don't generate enough income to fund this cash flow to you. This conventional wisdom was developed and then reviewed by many economists. (Pfau, Wade and David Blanchett, "Can Retirees Still Use a 4% Withdrawal Rate?, Advisor Perspectives, September 2, 2014.) and has been well established as a guiding principle for managing retirement assets. Your financial planner may use other financial models.

Consider if you invest your assets and generate an average of 6.8% per year. For the last 50 years, 1971 – 2020, the equities market has grown an average annual rate of 10.9% (or 6.8% when adjusted for inflation). If you withdraw 4%, your assets will continue to grow by about 3% per year. To achieve this most investment advisors base this 7% growth on invested assets that are 60% in equities and 40% in fixed income or bonds. If your assets are in cash or bonds, then you will not be able to generate the 7% needed to support a 4% withdrawal rate. If significantly more is invested in equities (80% - 90%), you may be forced to sell some of your invested assets to meet living expenses when the market is in a serous decline or recession stage. Also, this extra 3% will enable you to weather most inflationary pressure.

Finally, if you have put money into a 401(k) or 403(b) qualified savings account, the IRS requires you to start withdrawing a certain amount of these assets after you are 72 (or born after 1949). To find out what you need to withdraw, visit the IRS website: (www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds.

In forecasting your income, remember that income received from your 401(k) or 403(b) accounts will be taxed as ordinary income. So, when you withdraw 4% of this to live on, the income will be taxed at your marginal tax rate. You can check current tax tables to determine the tax rate that will apply to this income, and this needs to be incorporate into your total income projections on which you will live.

The task now is to total your sources and determine your after-tax forecast of your income over the next 10 to 40 years, or more. Perhaps the worst-case scenario is to not know where you are financially as you enter this next stage of life. Viewing this income over time enables you to see where you might be most vulnerable or understand that your income sources are secure and will provide an sufficient amount.

Know Where Your Money Will Be Going

One of the most stressing elements of moving from a life focused on work to life focused on self (some call this retirement, Next Stage, Reinventing Stage, etc.) is understanding how your expenses will change over time. There is conventional wisdom that your expenses may decrease by 20% or 30% because you no longer have to dress for work, face the costs of commuting, and you won't be putting money into a retirement saving account. In most cases, however, research is showing that expenses will likely only drop by 10% to 15% depending on how and where you work. You will also have more free time and may likely increase your spending on travel, improvements to your home, or luxury items that you postponed in during your working and raising children life stage. You may also have continuing costs associated with your children – college, living, job searching, health related, etc. or support aging parents.

Looking at your current and projected living expenses is a major factor in determining whether you will have enough money. Start with looking at your past 3-years expenses. Then, prepare a model budget for your post working years. You may want to focus on your initial years (1 – 3 years) or focus on the next 5 to 10 years. Some expenses will change, but many won't. Start with a model year for your "Next Stage" budget and set this up on a spreadsheet.

Once you have identified sources and amounts for your expenses, put them into categories. The following is a very useful framework for understanding your expenses.

1. **Fixed expenses** – These are expenses that you must pay every month, quarter or year. They include mortgage, property taxes, income taxes, insurance premiums, utilities and out-of-pocket medical expenses.

2. **Semi-fixed expenses** – These are expenses that may vary by your actions but are necessary part of living. These include groceries, auto maintenance and gas, gifts for birthdays and holidays, possibly club memberships or other elements of life that bring great enjoyment. You may be able to modify them, but you cannot eliminate them.

3. **Variable expenses** – These are expenses that are discretionary, and you may choose to do or not do them depending on your income. These include vacations, clothing, contributions to charities, most dinners out and most entertainment. For some people, these expenses may fall into semi-fixed, but ultimately, they are a choice you make based on how you want to live.

4. **Special expenses** -- These are expenses that are usually for something very important and specific. They may include a wedding for your child, helping your child buy a house or payoff student loans, your purchase of a vacation home, boat, or trailer home. These are one-time expenses that may be necessary or discretionary. Note the amount and timing for them in your projection budget.

After you have identified these expenses and determined the total, forecast how they are likely to change over the next 10 to 30 years. Which ones are impacted by inflation? Inflation historically (the last 20 years) has been 2.5% (as measured by the Consumer Price Index), but not everything is susceptible to this price escalation rate. Also note if there are any times when your expenses are likely to increase because of planned actions (e.g., education for grandchildren) or unplanned (e.g., major health expenses), or decrease due to changes in lifestyle and living arrangements (e.g., you are no longer able to travel). If you know the amount and the general time frame, modify your budget worksheet. For example, at age 85 or 90, your expenses are likely to decrease by 20% to 30% because you will no longer be able to travel and entertain as you did earlier. More of your expenses are likely to be going to health care costs or in-home care. You may also plan for when and where you may join a retirement or assisted living community. While this may be emotionally difficult to consider now, this analysis will help you understand your financial future. The simple challenge is to develop a forecast of your planned expenses and use this to compare to your projected income.

Determine Your Financial Situation

Once you have collected and projected your income and your expenses and made some reasonable adjustments to give you confidence that each set of numbers is accurate as possible, sit back and look at where you are. What is the difference between your income and expenses? How does this change over time? If there a point where you “run out” of assets? How do you feel about this? Where and when do you feel the most “at risk”? Where and when do you feel the most confident?

A helpful conclusion is to identify where you are on the following 1 to 5 scale:

Level 1: **Significant deficit** – This means you have a major problem. Your expenses are too high for your anticipated income. While it may not be impacting you now, because you are still earning income, it will when this source of income stops. Look for where you can reduce your expenses because it may be that some of the expenses are really no longer important. Look for ways to continue earning income in work that you enjoy and find meaningful. You are the most challenged, but you can find solutions to these risks. Seriously simplify your life, be careful and appreciate what you have.

Level 2: **Moderate deficit** – This means that your expenses exceed your projected income by 10% or 20%. While drastic changes may not be necessary, this condition is not sustainable. Examine what expenses can be reduced now so that your future expenses can realize more balance to your anticipated income. Don't increase your projected income to make up for excessive expenses but look for ways to increase your income or assets where possible without taking undue risks. Be creative and resourceful. Take action now, while you can.

Level 3: Relative balance – This means that your income and expenses are relatively in balance. This may mean that your income or expenses are within + or – 5% (to 10%) of the other. If expenses are slightly higher than projected income, you may need to make some important changes to your activities, or make certain adjustments regarding your sources of income. All in all, things are in balance, but be careful.

Level 4: **Moderate surplus** – This means that your projected income is higher than anticipated expenses by perhaps 10% to 20%. While it appears that you can afford your plans, care must be taken to monitor and assure these assets or expenses remain in positive territory. Enjoy, and appreciate what you have and have created.

Level 5: Significant surplus – This means that your projected income exceeds your anticipated expenses by 20% or 30%. You do not anticipate the need to worry about whether or not you will be able to afford the lifestyle you seek. You can plan how your financial legacy will be left to others. Enjoy life. You are one of the fortunate ones.

Some financial planners will take this information on your income and expenses and perform sophisticated modeling and analysis to give you a "probability" of sustaining your lifestyle. This may be through using a Monte Carlo analysis or other statistical methods. The conclusion should indicate to you where you are on a similar scale. Your actions now will determine your future financial health.

Your Next Steps

Where did you come out? As you look at your financial resources over your extended life, you can now have a clearer idea of where you are and what adjustments you may need to make now or in the near future. As I said in the beginning of this paper, the purpose here is to increase your sense of peace of mind regarding your financial conditions. You want to focus on your life, your passions and interests, your friends and relationships, your health and well being and not be dragged down by financial worries. Wouldn't it be a wonderful experience the time in your life feeling confident in your financial conditions, and though you may need to make necessary adjustments, your issues with money are in the background? They are not driving your behavior or view of the world. This is freedom, flexibility and being responsible. Remember that the word responsible is actually rooted in two concepts: **Response** – you adapt to changing conditions, and **Able** – you have the capabilities to do so. That is being responsible with your financial conditions for yourself and your family. **Responsibility!**

Now, go meet with your financial planner and help them understand where you are and identify your primary needs, wants and wishes. This will enable you to go and enjoy your life. You deserve this.

Author's Note: *This information and this narrative is contained in my book Next Stage: In Your Retirement, Create the Life You Want. It can be found in the chapter 5, titled: "Will You Have Enough Money." The book addresses the five (5) core issues that my research has shown are the most perplexing to people planning or entering the retirement stage of life. I hope this paper has offered some helpful insights and encourages you to learn more from my book and with your financial planner. Feel free to reach out to me at tom@mynextstage.org, and visit my website: www.MyNextStage.org. "Enjoy, Dream, Discover." (Mark Twain)*