Retirement Planning – Beyond the basics

"Once you have established the goals you want and the price you're willing to pay, you can ignore the minor hurts, the opponent's pressure and the temporary failures."

Vince Lombardi

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Source: Getty Images

There must be over 1000 posts or articles per year on common mistakes investors make before retirement. A good retirement checklist is about a dime a dozen and, unfortunately, often falls on deaf ears. Though most contain great information, we want to share with you a few of the best practices and common mistakes we have seen over the course of our years in practice. We believe knowledge is power, so read on, and you'll be in much better shape that most retirees.

Have a Detailed Plan

To use a football analogy, no team can win without a playbook or a game plan.

This seems incredibly basic, but it's a mistake that millions of people make. According to the 2017 Retirement Confidence Survey, 41% of respondents said that they knew how much money they needed in retirement. That means that the other 59% have no idea and absolutely no plan to get there.

So, for those of you who used to play touch football in the front yard of your parents' house, that's like being in the huddle and telling your team to "get open." Investors need to be far more detailed in their planning than just knowing how much money they will need in retirement.

Source: OWL Football Kids

Start with your *Honest* Spending

To estimate how much money investors need to comfortably retire, you have to start with spending. This is the single most impactful variable in a retirement plan, not investment returns as most people think. Investments are merely a means to achieve spending goals, but you have to first honestly identify those goals.

It may be easiest to think about it in terms of buckets. You should start by calculating your monthly fixed expense bucket (utilities, insurance, groceries, gas, debt payments, etc) and then add the discretionary bucket (eating out, entertainment, regular travel, clothing, etc.). Now you can move on to regular annual expenses such as property taxes, home maintenance, insurance premiums, etc. Finally, you should identify some of the semi-regular or onetime items like car purchases, large trips, weddings, home improvements, etc.

Remember that Advisors aren't here to judge your spending. Most of the time we don't want to get into itemizing it unless you want to!

Calculate your Expected Distribution Rate

Don't run away……We promise it is simple math. The Distribution Rate, or burn rate, is the best method to do a quick "health check" on your retirement plan. Simply take your total annual net spending needs in retirement (i.e. after income such as Social Security or Pension) and divide that sum by your total financial assets. For example, let's say I want to spend $10,000/month in Retirement and will have $2,500 coming in from Social Security. That leaves $7,500/month that will need to be sourced, or distributed, from my savings which amounts to $90,000/year. If I have $1,500,000 in a joint investment account and $1,500,000 in an IRA, then I divide $90,000 by $3,000,000 to find my expected distribution rate which would be 3%.

Let's discuss a few best practices. A healthy and sustainable distribution rate is about 5%. Another way to think about it is you would hope to earn, on average, about 5% net of taxes and fees on your investment accounts that would then be used to pay your way through retirement (live on earnings) and maintain your principal.

You also can't forget to think about taxes. You should include estimated federal and state tax liabilities in your spending when calculating your distribution rate. A fun fact about our home state, Georgia, is that we have a $64,000 per person retirement income exclusion, so no need to make that move to Florida!

You can also use the Distribution Rate to calculate how much you need to retire by flipping the equation around. Let's use the same retirement income and spending assumption as above, so I would need to distribute $90,000/year to maintain my lifestyle in retirement. If I divide that by 5%, the healthy distribution rate, I find that I should plan to have at least $1,800,000 in savings to fund my retirement.

Lastly, remember that real estate does not count towards "financial assets" because it is illiquid. So unless you have plans to sell it upon retirement (in which case you should use a conservative sales estimate net of real estate commissions), you should not use it when calculating your distribution rate.

Approaching Retirement with Outsized Home Cost

Once you understand your spending, retirees should look at the consumption of the real estate on their balance sheet.

Entering retirement with a large, expensive home or mortgage (or debt) isn't necessarily a bad thing. Entering retirement with a home you can't afford, however, is a potential disaster. Remember, a primary residence is a consumptive asset and takes away from your ability to spend your money in other places, like travel.

Even the best plan can be disrupted by too much cash flow going towards real estate. With the passing of the Tax Cuts and Jobs Act of 2017, there were many unfavorable changes to the deductibility of mortgage interest and property taxes eliminating some of the benefits of owning a home. Also, remember you must itemize deductions on your tax return to see these benefits as those who take the Standard Deduction do not see a reduction in taxable income for these items.

For that reason, as part of a detailed plan, we recommend you look "under the hood" into how much of your distribution rate goes towards home ownership, and make sure you understand the after-tax benefit (or cost!) of carrying the home.

Source: Businesslive.com

Choosing the Wrong Tax Strategy

While saving for retirement, it is important to remember that at some point you will have to pay taxes. It is very tempting to maximize pre-tax savings while working and kick the tax liability down to the road to a time when you "will be in a lower tax bracket." Generally, that has held true.

Now, we do not have a crystal ball here at Lakeview, but with a 22 Trillion-Dollar deficit and both political parties spending with very little fiscal restraint, it would seem likely that tax rates will be higher in the future than they are today.

We do believe that one of the keys to a healthy retirement plan is to actually have a balance between pre-tax (401k, IRA) and after-tax (individual/joint, Real Estate) savings. You want to be able to dip into the after-tax bucket to pay for large expense and the pre-tax bucket if you have a year of high income tax deductions, for example. Also, Roth IRA's and Roth 401k's are tax-free vehicles that are underutilized in a lot of retirement plans. You can expect to pay ordinary income tax for every dollar you take out of a pre-tax bucket, pay more favorable capital gains tax on the earnings inside of the after tax bucket, and you never pay tax on withdrawals from a Roth if you follow a few simple rules.

Secondly, and possibly more importantly, a retirement plan really gains steam when investors locate the right investments in the correct (pre-tax, after tax, and tax free) accounts. You want to put your tax inefficient assets like corporate bonds in your 401k/IRA, your US large equity exposure in your individual/joint accounts and your higher risk/return assets like emerging markets or innovative technology in your Roth.

If you don't know what investments work best in your case, or not sure if you can get money into a Roth, talk to a Lakeview advisor for more details.

Ignoring Inflation

Warren Buffett has said, "The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislature." Now that's easy for him to say as a multi-billionaire, but the truth of the matter is that the US taxes income and earnings, but inflation is applied (or taxed) to everything. So, while you might earn 4% interest on a fixed income annuity, if inflation is 4%, it will wipe out that gain on a "real return" basis.

Even though inflation has been low (under 2%) for some time now, historically inflation has averaged 2.5-3% per year (note: in any given period, it can be higher or lower). In 2015, for example, it averaged just above 0%, while it was 6% in 1982, 9% in 1975 and more than 13% in 1980. Even at 3%, it can really shrink the purchasing power of retirees' future dollars, as something that cost $1000 today may cost about $1800 in 20 years.

Imagine you want to retire on $875,000 in 20 years' time, figuring that will be enough money to support retirement. Well, if annual inflation averages 3%, that $875,000 will end up having the purchasing power of just $484,000 in today's dollars, not quite as much as expected.

The point we are trying to make is that asset allocation based on risk/return and inflation is a key component of retirement success and is vital as part of retirement planning. And, the good news is that the best way to protect yourself against inflation is to invest in the stock markets or real estate.

Being Early

It has been said many times that "Early is on-time and on-time is late." This may be true when it comes to a meeting, but this doesn't work when it comes to retirement.

Retiring too early commonly means taking a pension or starting social security too soon. But these are some of the largest mistakes made by retirees, even if they have been removed from their job by their employer. We understand it may be painful to rejoin the workforce, but it is far better to do so than take your retirement benefits and cap the retirement accumulation.

As an example, let's look at social security. For each month that a retiree takes benefits before their Normal Retirement Age (NRA as defined to Social Security), that benefit amount will be reduced by 5/9 of 1%, for up to 36 months. If they start benefits more than 36 months before their full retirement age, they will be further reduced by 5/12 of 1% per month. That means if their full retirement age is 66 and they begin benefits at 62, they will see a 25% reduction in benefits.

Conversely, benefits can grow substantially if you delay filing past full retirement age. Retirees that are able to delay taking benefits to age 70, allow their benefits grow at 8% per year, not a bad rate of return. There are some life expectancy considerations, so this isn't the right strategy for everyone, but overall, we think it can be wise to greater utilize your investment accounts up to age 70 and realize that 8% annual increase in benefits.

Not Planning for Long Term Care

Long term care is very often overlooked by retirees. If you have ever cared for an aging parent or loved one, you understand the emotional and financial toll it takes. According to the US Department of Health, over 70% of people over 65 will require long term care at some point in their lives. That's right…… 7 in 10 people. Long term care costs are rising and can rapidly deplete a retirement portfolio, so it's very important to incorporate these potential expenses into your retirement plan.

Drop the Insurance

We can think of no other time in your life that more consistently calls for a full insurance coverage review than Retirement. Not only should you be dropping those disability policies, but perhaps you no longer have a true need for life insurance if the original purpose was income replacement. As you get older, insurance becomes more expensive, all the more reason for a full insurance review to validate your needs.

Also, and commonly overlooked, you should ensure your "nest egg" is protected should you be found liable for an accident with your car or at home. Personal Liability Umbrella Policies are one of the cheapest types of insurance to hold, and they are also one of the most impactful. A good rule of thumb is to hold a policy that matches your net worth.

Have a team

As coach of the Green Bay Packers, Vince Lombardi was one of the all-time greatest motivators of individual achievement. But, he always stressed that everyone was only as good as the team around them. In retirement planning, the same holds true.

It's important to spend a little time educating yourself on how to approach retirement and to make smart moves. In order to do this, you need to work with a great team to plan for and protect your retirement savings. By having great information and great advice, investors can end up with thousands, tens of thousands or even hundreds of thousands of dollars more than expected.

For more information, contact your local Lakeview Capital Advisor.