A Readiness Strategy for Retirement

Try this experiment to see how you would fare.

BY JON A. HULTMAN, DPM, MBA

According to a survey conducted by Transamerica Center for Retirement Studies, the number one fear for baby boomers is running out of money in their retirement years. In fact, outliving their money was actually more frightening to them than death. According to Stephen Rischall, co-founder of the *1980 Financial Group,* this fear is further compounded by the fact that boomers have "higher expectations than their parents in regards to the retirement lifestyle they wish to live." While financial "experts" have circulated no shortage of books, articles, or advice pertaining to retirement planning, none of this "expertise" is ideal because it all relies on unpredictable information regarding the future.

Many experts recommend an exercise whereby one constructs a detailed budget to ascertain how his/her spending habits will change in retirement. A basic flaw with this strategy is that budgets and other financial projection tools are dependent on making assumptions—guesses, really—about the spending choices a person will make when faced with a situation s/he has never before faced. Spending involves making trade-offs among a host of options, and a person often has little idea what tradeoffs s/he will be willing to make when actually faced with spending decisions in retirement. The options that present themselves in an imagined future budget are difficult to fully grasp while one is still fully employed.

What makes sense is to consider a real-world situation—such as that a person faces who unexpectedly loses his/her job, or is otherwise unable to work. With no prior financial planning or budgeting in place for this event, someone faced with such a dilemma is required to instantly manage his/her money very differently going forward. S/he will need to make spending tradeoffs that are based on real information—not on assumptions or guesses. For example, this person may have always planned on staying in his/her current home and previously may not have been open to the possibility of moving. That former intention might change quickly if it becomes clear that selling and moving to a smaller home would be the best financial option in this new situation. As bills arrive, each one will be looked at through a new lens. Someone faced with this dilemma is likely to consider changes in spending or life-style that s/he had either never previously considered or had ruled out entirely. The most relevant measure of one's differential cash flow—spending versus savings—can ultimately be determined by the amount of money that is left over each month after paying all the bills. It is this idea that suggests a different type of experiment for evaluating how one might fare in retirement.

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If you are still working and planning retirement, or are within a few years of considering retirement, a more realistic "experiment" to try in order to see what your cash flow and spending habits might need to be following retirement is to assume a real-world simulation of a scenario similar to that mentioned above—in which you lose your job. This exercise will be based on actual data and real-life living circumstance rather than on guesses. What is required is to set up a new bank account into which you deposit all *earned* income from your practice or employment. Then, you pay all bills from a separate account into which you are depositing all *unearned* income—such as that from interest, dividends, capital gains, rental payments, required minimum distributions from IRAs, Social Security, etc.

Any time throughout the year that you have insufficient income in this *unearned* income account to pay all the bills or make discretionary purchases, the shortage will have to be paid from your *earned* income account. This will let you know how "short" you were in your *unearned* account. At the conclusion of this experiment, you will have real world information for making decisions—decisions which will be based on how much you needed to

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subsidize the shortfall from your *earned* income account*. If, for example, you were short $40,000 over the course of a year—and needed $40,000 in withdrawals from your *earned* income account to subsidize your lifestyle—you will have determined that in retirement you will need to either 1) work part-time to produce, at least, this $40,000 a year amount, 2) consider life-style changes you would be willing to make in order to reduce your spending by this $40,000 a year, 3) work longer to build investment assets that will produce an additional $40,000 a year in *unearned* income, or 4) consider a combination of these three options.

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Conducting this experiment will provide you with critical information that would be difficult to gather in any other way. The most significant findings from this exercise would be the tradeoffs in lifestyle that you would actually be willing to make if your expenses were to turn out to be higher than your income. Every time you need to write a check from your *earned* income account—an option that will no longer be available upon full retirement—you will gain greater insight into the trade-offs you may need to make. Utilizing this simulation experiment, you will be able to make a more accurate assessment of your financial needs prior to retirement and structure your post-retirement financial and lifestyle options more reliably.

*Note: At the end of this experiment, ask your CPA to calculate the amount of the taxes that you paid on your *earned* income throughout this experimental period, and adjust any "shortfall" during the experimental period by this amount. This will take into account the fact that, in retirement, you will only have taxes based on your *unearned* income. **PM**

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