Income Planning? Think Expense Planning First!

Carolyn was an administrator at a local college, and was planning to retire in one year. She was feeling good about the decision. She estimated her retirement expenses to be $4,000 per month, or 20% less than her expenses while working. Her income would be $5,000 per month after taxes, consisting of pension and social security. Carolyn had given herself the green light to retire, as her retirement income was $1,000 per month greater than her expenses.

Unfortunately, Carolyn experienced a stroke during her last year of work, and was home on disability for six months. When she returned to work, she asked for a meeting with me to review the retirement income and expense plan. During the conversation, she suggested that her retirement expenses might be 10% *more* than her expenses while working.

I was naturally curious to know what happened during her time at home. "Over the last few years while working, I have been tracking my expenses. While working, Saturday was the one day of the week that I spent the most money. When I was home on disability leave, everyday seemed like a Saturday. By being home, my expenses increased." The short term disability served as a test drive for her retirement lifestyle. "Even though I didn't have the costs of commuting, my utility bills increased for lights, heat, and air conditioning. I spent more time on the computer which tempted me to make purchases I would not otherwise make. In other words, if you are not making money, you are spending money."

It was now a priority to rework her retirement income and expense plan. Given the income of $5,000 per month and revised expenses of $5,500 per month, there was now a $500 gap between income and expenses.

Retirement Income Gap = Income – Expenses

The $500 gap we identified was for today's lifestyle, at today's cost of living. Carolyn didn't think the $500 gap was anything significant. To cover the gap, we discussed four scenarios. She could delay retirement. A second option is to work part time in retirement and make $500 per month. She could also reduce her expenses, which was not preferred, but she did recognize that this could be an option. The fourth option was to begin income from the investment accounts.

In order to maintain her lifestyle, Carolyn would need to give herself raises in retirement. The pension was fixed, and does not increase over time. And while social security offers a cost of living adjustment (COLA), it never seems like the COLA is enough. (Over the last eight years, the social security COLA was 0.0% three times, and was 0.3% in 2017.[1])

We agreed that for the purposes of planning, we would consider a conservative scenario where social security would not offer any COLAs. We also used a 3.5% annual increase for expense planning, which means her expenses will double every twenty years. The results were eye opening for Carolyn. What seemed like a harmless $500 gap in today's dollars was projected to be $1,500 per month in five years, and $6,000 per month in twenty years.

Monthly Retirement Income Gap

Age	*Expenses*	*Income*	*Gap*
65	$5,500	$5,000	$500
70	$6,500	$5,000	$1,500
75	$7,800	$5,000	$2,800
80	$9,200	$5,000	$4,200
85	$11,000	$5,000	$6,000
90	$13,000	$5,000	$8,000
95	$15,500	$5,000	$10,500

In addition to expense planning to prepare for her lifestyle expenses, Carolyn failed to plan for health care expenses during retirement. While she did budget for Medicare premiums, she didn't realize that Medicare covers only about 62% of expenses associated with health care services.[2,3] Health care is a big-ticket expense for most retirees, especially with rising costs and the likelihood of needing long-term care. If you're not prepared for these expenses, they can put pressure on other aspects of your retirement financial plan and limit the choices you can make later in life.

Carolyn was faced with the retirement income challenge we are all facing, or will face one day. Given fixed income sources of pensions and social security, how can she create an increasing retirement income she cannot outlive?

We went back to review the conversation of possible scenarios to close the gap: delaying retirement, working during retirement, lowering expenses, and income from investments. She could consider delaying her retirement and working longer, which would increase her pension, social security and the value of her retirement accounts. Another consideration would be to work part time in retirement. If she collects social security at age 65, she would need to be aware of the $17,040 per year earned income limit. Social security imposes a penalty if you have earned income in excess of this limit before reaching full retirement age. (In the year you reach full your retirement age**,** the earnings limit is $45,360, and Social Security only counts earnings before the month you reach your full retirement age.[4]) If Carolyn earned $17,040 in retirement, it would be about $1,200 per month, after taxes. The earned income, combined with her pension plus social security would provide her with a monthly income of $6,200 per month – more than she was making during her full time job. She was fortunate to have this scenario available, which means she could continue with her savings plan into retirement.

For the purposes of prudent planning, we also needed to consider a scenario where Carolyn was not able to work. If earned income in retirement was not available, this would create a dependence on the retirement assets to provide income to fill the gaps. As expenses increase and gaps widen over time, it puts more pressure on the investment accounts to provide income.

So, the million dollar question is, how much would she need in these accounts to cover the retirement income gap?

The answer: $1,000,000. (*This assumes a 5% return on investments. Actual returns will be variable, and may be higher or lower than 5%. A 20% effective federal and state tax rate on retirement account withdrawals.)*

I'm happy to report that after a few years of careful planning, Carolyn is happily retired. She enjoys working at a local museum and volunteering for the senior center and library. She is living a lifestyle where she is in control of the finances, and the finances are not in control of her. Looking back, our conversation started with expense planning. By having a better understanding of the future expenses, it created a better awareness of the income needs. The comprehensive financial planning and investment advisory conversation offered a peace of mind and confidence to Carolyn, knowing that she will have access to an increasing income in retirement.

Sources:

1) History of Automatic Cost-Of-Living Adjustments (COLA) https://www.ssa.gov/news/cola/
2) "How Much Does Medicare Cover?" EBRI Fast Facts. #251. Oct. 17, 2013
3) Nationwide Retirement Institute, Health Care Planning and Costs In Retirement, October 13, 2017
4) Getting Benefits While Working, Social Security Administration, https://www.ssa.gov/planners/retire/whileworking.html

Jim Werner, CFP® is a Vice President with Halliday Financial, a full service financial planning and investment advisory firm in Glen Head, NY. Jim and his specializes in helping union members, educators, and administrators make smart decisions with their finances.

http://www.hallidayfinancial.com/staff/werner-cfp/

James Werner, MBA

CERTIFIED FINANCIAL PLANNER™

Vice President

Halliday Financial

725 Glen Cove Avenue

Glen Head, NY 11545

Phone: 516-671-1099 x245

Phone: 800-786-1598 x 245

Fax: 516-676-3528

www.hallidayfinancial.com

www.retire804.com