The Flip Side of Spending Too Much: The Risks of Spending Too Little

Comedian Will Ferrell was interviewed in the Fall of 2006 for an article in *The New York Times Magazine*. Unlike many comedians, Ferrell did not have a tragic childhood that caused him to retreat into the world of comedy as an escape. To the contrary, he says he was always a "half-full" person. This attitude can be seen in his handling of his parent's divorce. At only eight years old, he had the wisdom to console a sibling – "think of it this way – we'll have two Christmases now!" This article will take a page out of Will Ferrell's book and explore the "half-full" side of a topic that is almost invariably dealt with in a "half-empty" way.

Much has been written about the importance of limiting annual spending to a certain percentage of your investment assets. The frequently cited number is 4% per year. That's $40,000 per million of investment assets! That will not buy a "millionaire's" lifestyle, so where does that "safe" percentage come from?

Common stocks of large US companies returned 10.4% from 1926 through 2005 based on the Standard and Poors' 500 stock index. Moderating this return to reflect a growth-oriented, yet balanced portfolio of 70% stocks and 30% bonds would have decreased the return to about 8.7% per year. To bring this into real-world possibilities, let's reduce it by 1.2% per year to reflect management costs.

So now we're down to 7.5%, but we're not finished yet. Don't forget Uncle Sam – he'll demand his share of your return sooner or later. (For sake of simplicity, we're ignoring any benefit of tax-deferral, although that is a major component of our approach to portfolio management.) Even at modest income tax rates, there goes another 1.5% per year.

Finally, we must consider the impact of inflation to allow our withdrawals to keep up with the increasing cost of living. Here, history tells us that the long-term annual rate of inflation has averaged 3.1%; we'll use 3%. Let's recap:

Gross annual return from balanced portfolio	8.7%
Less:	
Management fees	(1.2)
Income taxes	(1.5)
Inflation	(3.0)
After-tax, inflation-adjusted annual net return	3.0%

This means that our "conservative" 4% withdrawal rate is not even going to keep up with inflation! Pretty sobering, eh?

So how can there be risks of spending too little? The main risk is not living your life consistent with your core values. Most people, when asked later in life about their major regrets, speak about the things they did not do rather than "mistakes" they made. Would being paralyzed by a 4% withdrawal rate prevent you from fulfilling a life-long dream or passion? Would you regret not taking that year-long sabbatical to immerse yourself in your avocation? Would you regret not taking your children or grandchildren on that once-in-a-lifetime trip? Would you regret not helping out your children or grandchildren now when they have greater financial needs instead of leaving them money when they are in their 60's? What would be your regret?

©RCG; All rights reserved

How else can we poke holes in the 4% mantra? The over-simplified math above assumes that your annual spending stays the same, and even keeps up with inflation. However, this is usually not what happens in the real world. We have worked with many clients who have followed a very different road. Spending after a life-transition event (such as retirement, sale of a business, inheritance) typically **increases** as a result of long-postponed enjoyment of travel and family-related spending. This increased spending eventually settles down, however, under the "been there, done that" principle. As our clients have reached their 80's, we have seen a DRAMATIC decline in spending. So a "linear" rate of spending is just not how most people live their lives.

Now, let's delve further into the investment rate of return assumption. While some commentators have cautioned that the return on stocks in the future may be lower than the actual return experienced since 1926, let us play the part of the devil's advocate. It is also possible to make an argument that the historical rate of return on large US common stocks as an assumption is too low for a broadly diversified portfolio!

The oft-cited starting point of 10.4% per year since 1926 represents the return of U.S. large capitalization stocks. A globally diversified portfolio that has been strategically tilted toward documented long-term sources of additional return such as small capitalization stocks, value stocks and emerging market stocks may indeed have measurably greater horsepower than the plain vanilla portfolio used in most illustrations. And we hasten to point out that the low payout rate recommendation usually comes from investment advisors who have a vested interest in the outcome – the less you withdraw, the more assets they manage, and therefore the higher their management fees.

Resource Consulting Group clients also pay lower management fees than most individual investors. After all, the <u>only</u> investing strategy GUARANTEED to increase your investment return is reducing costs. Other strategies are designed to produce hoped-for return enhancements, but cost reduction is the only one guaranteed. Because of economies of scale, the larger the portfolio, the lower the investment management fee on a percentage basis, and clients of Resource Consulting Group tend to have portfolios that result in these lower fees.

Combining the above factors could increase returns by as much as two or three percent per year. Is that significant? You bet it is! Over a period of only twenty years, a starting portfolio value of $1 million would grow to $3.9 million at 7% and $5.6 million at 9%. Would having an "extra" $1.7 million at age 80 cause you any regrets?

We would be the last to advocate a reckless approach to managing your finances by spending without regard to the long-term consequences of that spending. By the same token, we are not advocating a fear-based approach to your finances that may result in regret for the road not taken.

What, then, is the answer? How do you balance the competing objectives of maintaining your financial independence while living a fulfilling and meaningful life and creating opportunities for loved ones? We'll explore that in our next article – ***The Crucial Decision Maker℠ – How Scenario Planning Can Bring Balance To Your Financial Life***.

©RCG; All rights reserved