The New Math, Part II

Planning to celebrate Independence Day on the Olympic Peninsula requires one to acknowledge two certainties: 1) every year this holiday occurs on July 4th and 2) the weather is totally unpredictable.

Over the years I remember thinking as a child many times how nice it would have been to celebrate "the 4th" on the 5th or the 3rd because the weather was so much nicer on those days! My Dad would remind me not to worry about the weather because you can't control it. However, he did say that I could control my attitude and how I chose to celebrate. Today, rain or shine, I enjoy the 4th.

The "new math" discussed in my last column acknowledged the fact that we cannot control the sequence of investment returns (any more than we can control the weather on the 4th). However, we can control how we plan for this uncertainty so that the rain from investments won't dampen our financial independence day(s).

Here is a five-step approach for retirement income planning that works, whether you are already retired or still years away:

1. Inventory Expenses. Estimate monthly or annual expenses. Divide them into "essential" (food, clothing, housing, health care, etc.) and "discretionary" (travel, entertainment, etc.). Estimate any amount you wish to leave as a legacy.

2. Inventory Income. Identify current and future sources of income. Start with what might be considered as predictable long-term income flows such as social security, pensions and lifetime annuities. Then consider all financial and real assets (stocks, bonds, funds, CDs, real estate, rentals, etc.) that could be used to fund retirement and discretionary expenses.

3. Compare Essential Expenses with Predictable Income. Do you have enough pension, social security or other similar sources to cover necessities?

4. Allocate Assets to Cover Essentials and to Fund Discretionary Expenses. If predictable income is not enough, then financial and real assets will be needed to close the gap. You can do this by segregating a pool of assets to draw on systematically over time and/or by using an amount to purchase a guaranteed income product.
   Once essential expenses are covered, the remaining funds may be used for discretionary expenses, perhaps through a separate systematic withdrawal plan.

5. Protect and Update Your Plan. Be sure you have the right amount and right type of insurance to protect your lifetime income plan. This includes health insurance, property and casualty insurance, life insurance and long-term care insurance.

Review your plan, at least annually, and be prepared to adjust all elements, including expenses, asset allocation and withdrawal rates. This will empower you to meet life's changes.

Will these steps completely protect you from longevity risk, inflation risk, asset allocation risk, withdrawal risk and health care expense risk? Of course not. But, just as sure as Independence Day comes every July 4th, by taking these steps you'll be ready to celebrate your financial independence every year come rain or shine.

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