# Sound Financial Bites 042 - Paul Adams

*Episode Transcription*

> *"At least become a world class saver of setting aside 20% of your gross income."*

Hello, Paul Adams here. Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life.

Hello, and welcome to Sound Financial Bites. My name is Paul Adams, your host of today's episode, as well as the president of Sound Financial Group. It's great to have everyone with us today. Today we're going to learn something unique that people don't talk about or only periodically talk about, and that is three numbers that every person doing any degree of planning must memorize. These are numbers that you need to know, there's only three of them, but these are things you really need to know because they hinge-- they are the hinge, the fulcrum behind so many of your financial decisions and incorrect assumptions around these three numbers, that are really financial mechanics could really potentially lead to enormous disaster. What disaster often looks like for people financially is the slow and eroding situation in their lifestyle, or the slow and eroding financial security that they have, sometimes it happens all at once. But many times it's just like the slow bleeding that happens and people don't notice it over time. That's going to be the main subject of our conversation today is you will know by now we have our financial philosophy conversations like the one today. We'll have those analytical conversations periodically, we'll have somebody come in, it's just a good life conversation about being more healthy, it could be a biohacker, marriage counselor, and we're also going to have these conversations that are the career or business owner type talks that you seen us strip in our past episodes. But today is financial philosophy, and as many of you know, all we want to do by bringing this podcast is serve our existing clients to do our best, to give them a source of well-grounded financial knowledge. Things that are grounded in in the disputable math and independent scholarships so that they can continue to grow in their knowledge. We believe it's our job to educate clients throughout our relationship with them so that they get the greatest potential possibility of making the best financial decisions for themselves and for their family.

So if you're not a client of ours right now, feel free, you can email us at info@sfgwa.com, that's info@sfgwa.com and just say "initial conversation" in the subject line and we'll be sure to take of you. Any of you investing in yourself by being on this podcast, I will be happy to invest time with you in a one-on-one conversation with me. And even if I'm not the right fit for you, but one of our advisors is, we'll be sure to make that introduction if that's appropriate. So welcome.

Let's get to the topic today. Now I'm going to give you the three numbers, they're not going to be hard to memorize, they're not long numbers but they are critical numbers for what's important to you in your future. Those three numbers are: 4, 65, and 95. I'm going to say it again: 4, 65, and 95. Now, 4 is 4%, 65 is age 65, and 95 is age 95. Now, this talk that we're going to put on the podcast today is really the preview of a conversation I'm going to have with a group of ambitious business professionals that are part of a two different conferences I'm going to be speaking at soon. These are all people that are-- for the most part, a quarter million dollars and up in annual income who have paid in some cases tens of thousands of dollars to be in these rooms to learn from surreal leaders in the business community about how to build better careers, how to build better businesses. But as they build better careers and better businesses, what are they doing with the new income and cash flow that they have. So these conversations are all financial mechanics. One of the fundamental underlying things that should really be behind every decisions.

So as your income goes up over time, believe it or not, you're more than likely-- and certainly these programs I'm going to be speaking to are also people really paying great attention with their health. They're doing their best to make sure that their weight is where they want it, that they're fit, that they're eating a non-inflammatory diet. So for those people, and maybe for many of you, you plan and not only having financial success over time, but you also plan on being more healthy. And yet, having more financial success over time and having better health over time can actually be the biggest breakdowns to your current financial practices. Let me explain.

*"If we take out more than 4% a year, we increase our risk of running out over a 30-year period."*

If you retired and you're relatively unhealthy, hardened arteries, enormous heart disease, maybe even a family history of some problems but not doing anything that care for those things, and then you die at like age 70, it doesn't take that much money to retire. You see every year we go through retirement, it takes less money to retire if we're closer to our mortality. It's very easy to say to somebody if they say, "Well, I want $100,000 a year of income or $200,000, or $400,000 a year of income in my retirement," but I'm only going to live three years. Well, that's not that hard to build. But for many people how long they're going to live is basically forever. What I mean by forever is there's no real statistical deviation between living a very very long time in retirement and basically having-- have enough money to live forever. So we really have to have a lot of money built up and in savings because if we're going to be healthy when we get there, we're going to live a much longer period of time.

Now, the second part is, our increased income. You see as our income increases, it's actually going to be harder to build a level of wealth that we want to build in retirement. The higher your income is, the more likely you're going to be surrounded in a network, or an ecology of people that are also high income earners, who are also more likely to be big spenders. Now even-- let's not even go big spender like they're doing crazy stuff, I just mean somebody puts a couple of Altis in the driveway, or they put a couple of Lexus in the driveway, they're buying new cars every four to five years. They are posting their amazing vacations to Facebook, none of that stuff is bad necessarily but we're more likely to have people around us who are putting us in the position where their spending is going to draw us into more spending. The higher our lifestyle is, the more it's going to take to be able to have enough income to one day and retire. You see, if what you want to do is at least which is what we would recommend, at least become a world-class saver of setting aside 20% of your gross income. Then in an another podcast, I will ground that for you about why 20% of your gross income is really the minimum that we should be at, money going to the wealth coronation account which will be in our next podcast. We're going to do a wealth coronation account part two, that you need to be able to set that money aside consistently, 20% for building assets. If we're now setting aside 20%, then we're not going to have the ability to have a likely amount of capital at work to replace the other 80% that was being spent or consumed in some way.

So as you make more money, it becomes more tempting to not set aside the 20 and you now need a larger pile of money to get the job done, which is pay all your expenses that you want to have when you get to age 65 and beyond. Now, many people say well, living expenses drop in retirement. Well, they might. I guess that's possible. But do you want that to have to be the case? You see so many people are talking about along in the future, "I'm going to be okay because the mortgage will be paid off," or "The kids will be moved out of the house," and yet, that is probably going to happen well before the day you decided to punch out and reach financial independence, which for the sake of our conversation today on this podcast we're going to use 65, but for many of you, especially our clients who maybe in the strategy to stop having to work for money much earlier.

So you make more money, it takes more money on the pile of capital at work that you have in old age, to produce the income that you want. Well, how much is that pile have to be? That brings us

*"You might have to have your income for longer than you worked in your entire career."*

to our first number, 4, 4%. When we're taking money from our assets for the sake of consumption, okay, so we can do all kinds of great things in our financial lives with money. We can keep it moving around on our balance sheet, we can build velocity with our money, we can do something like put it down payment on a rental property, or pay for a rental property cash, that rent could then go to a mutual fund or a portfolio of investments, how we were prefer to have people do it was a portfolio of passive structured investments, academically allocated, globally diversified portfolio, the rents could go right into that portfolio. Then a certain amount of the portfolio every year could actually be getting dripped off every single year to build the asset class of whole life insurance on somebody's balance sheet. Like $1 that we paid for a rental property in cash or even a down-payment on rental property enough for it to be a positive cash flow, might potentially be able to get three things done in our life. That money is moving around in our life and we're doing our best to keep that money flowing, and yet, when we put money in just one place and it needs to get something done like pay for our groceries, then the velocity of that money sort of stops in our lives. We don't get any additional uses on that dollar. So this is key. The 4% distribution in retirement is really crafted around the idea that we're going to take money out and that money is going to go off our balance sheet. We're not going to have anymore uses of the capital.

So if you have a portfolio of residential real estate, if you have a portfolio of commercial real estate, if you have a basket of mutual funds or as we would recommend a passive structured portfolio, whatever the assets are that you have, the most that we should be taking off of that portfolio every year for the sake of consumption is 4% a year. Now why, why is that? It's because when we take money out in retirement, the portfolio itself is going to rise and fall. As the portfolio itself rises and falls, if we take out the average rate of return, then we're going to be accelerating the erosion of our capital in those down years. So how does it work in a regular investment portfolio, and then I'm going to tie it back for those of you that are serious real estate investors et cetera. If we look at it, in just a simple portfolio, in this case I'm going to use purely the Standard & Poor's 500 okay? There's two brothers-- the two brothers are just five years apart in age, and they're both getting near retirement. One of them has a million dollars and he retires at age 95. They held almost exactly the same career path, just five years difference in them and he retires in age 95 and he says, "I don't want an advisor, I don't want any help. I'm going to put all my money in the S&P 500 which has averaged 11 in some change since the beginning of time, or whatever the statistic is that people threw out. I'm going to take out 8% a year from this portfolio because I think it's going to do better than that. He begins taking out $80,000 a year.

Now the rates of return in the S&P 500 for its total return, in 95 was 37, in 96 it was 22, in 97 it was 33. In 1998 it was 28% and in 1999 was a 21% rate of return. So he gets to the end of five years, he's taken out $80,000 every year in income, and there's still $2.6 million of investments. He went from 1 million to 2.6 million, despite taking out $80,000 a year. So his younger brother getting ready to retire comes to him and says, "Hey I notice you stayed in the same neighborhood when you retired and you seem to take some vacations, and life is good. What should I do?" Older brother says, "It's so easy. All you have to do is put all your money in the Standard & Poor's 500 and you'd take out $80,000 a year, and it just works. Look at me I've got $2.6 million now." A small side note, this is why when somebody else says, "My experience is, or my opinion is we need to back-out including your advisors, we need to back-out of that conversation long enough to go check the math and the scholarship.

So here's what happens to the younger brother when he retires at age 65. He takes out $80,000 the first year, except the market that year, the S&P 500, his million dollars dropped because it went down 9.1% that year. In 2001, it went down 11.9%. In 2002 it went down 22%, he's now down to 456,000, well man. Good news in 2003, it's up to 28%. The problem with being up 28% in 2003 is that it's 28% positive return on 456,000. So the portfolio barely rebounds by less than $30,000 that year, once the withdrawal has taken into account. In 2004, that portfolio did 11.01% at S&P 500. So a hypothetical story, this person now has 448,000 and still wanted to take $80,000 a year. That's just doesn't work. You see when we're taking out money, we need to take out a small enough amount of money that when those downturns happen, they're not accelerating the erosion of our capital. Now incidentally, it's also not super wise to be 100% equities as a retiree. One of the things that we want to be able to do when we are doing our distribution planning is not only have buckets of money for the different horizons of time that we're looking at, we also want to make sure that we have a portfolio that's the appropriate amount of volatility for our distributions. So that's why 4% a year.

If we take out more than 4, we increase our risk of running out. Now 4% does not guarantee that we won't run out, but it's massively increases the statistical likelihood that we won't run out over a 30 year period of time, according to things like the trinity study and running Monte Carlos scenarios which is common financial software that the advisors have.

So let's cut over to commercial real estate. Commercial real estate, residential real estate, you might be able to buy a piece of real estate that is going to say as an 8% cap rate, and the 8% cap rate is suppose to take into account. The vacancies, repairs, everything else and you have 8% cash flow after all that stuff, and the answer is, maybe you do. But that 8% cap rate might be dividing the repair of the roof over 20 years. It's probably dividing the vacancy rate possibility over 10 or 20 years over time, and then giving you a component of it like you'll be empty for two weeks or four weeks every year, and it's giving you a part of that, but that doesn't change your personal experience if that property is vacant for a year. I think enough of us have driven by areas where people obviously own these commercial buildings, and they've stayed vacant for quite some time. It's that individual that if they're using for income, they can't take that money. So it might be cash flowing it, but some of that money needs to go in the reserves and then the other 4% consumed so that we increase the safety and sustainability of that portfolio, whether it is the portfolio of investments, whether it's real estate or other, what I would call book value or promise-based assets. Things like safe vehicle CDs or life insurance cash values, or certain types, I'm not a fan of all annuities but certain types of guaranteed annuities.

Now that's the background to why is 4% is so important. 4% is so important because that's the number that gives you the ability to do the math of how much capital it's going to take for you to have enough money to sustain distributions to fund your lifestyle. So the simple math would be if you're making $400,000 a year right now, taxable, and that's kind of your consumption rate, for instance let's say you're making $600, you're saving maybe $80 after taxes. So in one way or another, you're spending $400,000 a year. Then you need to have in all likelihood $10 million in some set of assets that can spend off income on a consistent basis which if you're a business owner, you can't count the value that business yet. Not intel it converts to your balance sheet. You can never retire on the business' balance sheet.

So 4% a year coming off means that you have to have 25 times the amount in assets that you had in income that you were spending on lifestyle to be able to replace it. That's why the 4% is so important. Similarly, you can look at your actual amount of income that you make and be real straight with yourself what your worth in the marketplace. Many of you if you're making $200,000 a year, that means the capital equivalent of you would require $5 million. Now many people I've met or making $200,000 a year, perhaps one of our advisors first meets them, and they've got half a million dollars for their life insurance. Well that's nowhere near capital replacement for that person in terms of their human capital and how it's valued in the marketplace. So that's why 4%, you kind of get a sense of all the different decisions it makes, if you want to "retire early" which I would prefer to call. Just being financially independent which there's no reason in the world why that would mean you would stop working. Something I think that is really true and reflect on it is how much more fun, almost any kind of work becomes if you don't have to do it for money. So it's just crossing the barrier of having enough capital at work somewhere that you don't have to do what you're doing for money, 4%. Let's get to 65.

Now because many of you listening to this podcast or you're listening to other podcasts, you're reading books, you're those people that are investing in yourself and almost anybody who is investing in themselves is highly highly likely to also be paying attention to their health. So if you're paying attention to your health-- I've picture all of you listening to the podcast a huge room with me, and I say in the room, "Who would like to be really really unhealthy at age 65? Like anybody that's in your goals," and just picture the crickets in the audience. There's just going to be crickets. Nobody is going to be raising their hands, and I'm really hoping that I am knocking on heaven's door at age 65. As a result, almost all of us would desire to be very healthy at age 65. But here's the problem, we're fooled about how long we're going to live. We're fooled about how long we're going to live. So 65 is a start point if we're healthy at age 65, like we're taught that-- and you can open up USA Today or some other journal out there and you're going to see how long the average baby boomer is going to live, or the average millennial is going to live.

The problem with those statistics is it's counting everybody. Those people that have assets in their old age, those that don't, those who are healthy, those that are sick, and even many of those mortality stage also include those people that are already dead. Well, we would hope that you're not any of those groups. You would be the people that are wealthy, those that are healthy, and if you're in that group of the higher socio-economic status plus you're also healthy when you arrive at age 65, you're mortality goes out much much longer. It really, there's a couple of different ways to look at it, but for the most part, if man and woman are both healthy. I'm not talking the best health, just healthy at age 65. What's called their joint mortality stretches out to age 95. Let me explain joint mortality.

Joint mortality is how long the second of two people is going to live, the second death. So the second death for that couple is going to stretch out to be about age 95. Okay. The second person is about 50 to 54% likely to be dead by age 95, and a huge set of people going back to age 65. Now why is this different in these mortality studies that are out there? This is actually coming from the mortality tables of actual insurance companies. So now you see why there's 65 and 95 are important. If we're taking care of our health to age 65, then we need the plan to be in a position that we will have income for as long as 30 years. Maybe as long as our career and maybe longer, because here's the thing, anytime you see a mortality statistic, there's something a little bit deceptive there, that is-- that's the halfway point not the endpoint. That means half of the couples have passed, where both in the couple have passed by age 95. This is with current medical technology and the current assessment of insurance companies ensuring people. So it maybe longer. You might have to have your income for longer than you worked in your entire career, especially for those of you that are building strategies with us that produce financial independence much earlier where you can take on that dream career or dream job because you've got enough assets now to provide income.

So we have to have that 4% distribution last for a very very very long time. It's no longer I'm going to just be okay. Now here's the other thing that I want to blow up as a myth. Many people say, "Well, I just have to keep working." Now two things I want to have you hear in that, how quickly people are willing to have to do something later, like they don't look at as I absolutely have to put money in my wealth coronation account and acquire assets and learn about money so that I don't have to work in my old age, but people are perfectly happy to not take care any of their financial concerns today, and then wait and have to work in their old age, age 65 and beyond. What I would like is I'd like people who are enormously valuable. People that have incredible skills, life experience, the ability to mentor, the ability to be unflappable when it comes to certain business and economic environments, I don't want those people out of the workforce. I don't know about you, and for many of you, you're going to be your most valuable in that 60 plus age range because of all the knowledge that you bring. And yet, how much more valuable would you be if you don't have to work for money? Or you can show up and probably make as much or more money than you were making when you had to do it for money, and yet not have to. How much better of a mentor could you be? How much better of a leader could you be? How much better if you're a business owner and you're transitioning your success to the next generation, how much more beneficial could you be to your successor if you can come alongside them and mentor them in being more effective with their money?

But we're going to have to live a long time. I'm not asking anybody to check out in that period of time, but what I don't want is for people to think that what they're going to do is just get to work in their old age. I remember sitting side by side with a friend of mine on a plane and we're sitting next to a gentleman who was a COO of a large regional manufacturing type firm. As I was sitting next to him, we're talking and sharing to him a little bit about what we do and he just start peppering me with questions. Oh what should I do with this? What should I've done? And he's-- I don't have really have much. I'm in my mid-50s and I've got $1,800 a month, what should I do with it? I gave him polite advice, just as well you might want to consider this kind of thing or that kind of thing, and we got up, then we got off the aircraft. We kind of look to each other, it's like wow, I don't know, go get an awesome car maybe. This is our private conversation, maybe you should just go get a really cool car which would be the worst possible advice but it's just that he's starting so late. He said, "Wow, I'll probably just have to work until I'm 80," but this is somebody that was making top 1% income in his role. He said, "I'm just going to work until I'm 80."

There aren't very many people who have to work for money. There's still making top 1% income age 65 and beyond. There's some that make that kind of income, age 65 and beyond, absolutely. But most of them are in a position where they're not having to do it for money. That's what I like you guys to be, that's why we got to memorize that 4, 65, 95, that 4% distribution is a sustainable distribution rate from all statistical standards. It's possible to run out but at least it would happen slow enough that you could see it coming. Age 65 that if you're healthy at that age, then you've got a high probability that you and your spouse are going to make it, one of you to age 95. That's like 50% probability, 54% probability one of you makes it to 95.

So I just want to encourage everybody listening to hold these numbers, think about it, scrutinize what your advisors have said. I have seen financial plans done by advisors that are counting on taking out the average rate of return of the portfolio and retirement just doesn't work. You know, where we think this kind of portfolio is going to do 7% and now as you retire, you're just going to take out 7% per year. There's zero academic evidence that that would be accurate or possible, it might work for some in fact, I guess statistically it is possible that you could be part of the 5% to that works out for. But those high level of distributions, if we run it though a Monte Carlo scenario that runs 3,000 different iterations and it runs out 95% of the time, you could be in the 5%, and it works out fine. That's not what I want to plan in my future on or have a conversation to our clients would be depending on that.

So 4%, age 65 healthy, it means likely you and your spouse are going to live to age 95. What I want to encourage all of you to do is to scrutinize what you're doing, to see if you're on track to have the capital at work necessary, to arrive there with confidence so that you can build the financial independence you want and work because you love to.

So glad you could be with us today. Stay with us for the next episode next week and really learn again about what that wealth coronation account is, and how you can use it as the centerpiece for your financial strategies.

Hi, Paul Adams here. I want to acknowledge you for taking the time to invest in yourself by listening to our podcast. Not everybody does that, and out of my commitment to you, I will take just a few of our podcast listeners between each of our episodes and spend time with them one-on-one. And if you think you'd like some of that one-on-one time to learn more about our process, our philosophy, or whether or not we'd be a fit to work together, just email info@sfgwa.com - that's info@sfgwa.com - and I'll be more than honored to take that time with you. You can also go to our website, www.sfgwa.com, download the first three chapters of my book, see upcoming in-person events that we have, or listen to past episodes. You can also go to our Facebook page and engage us there, our LinkedIn, and send us questions for upcoming podcasts. You might hear one of your comments or questions on a future podcast. For our full disclosure, you can check the description on this podcast, or on the podcast series, or go to our website. Have a great day.