RETIREMENT EARLY RETIREMENT

Why Retiring Early May Be More Affordable Than You Think

Jonathan Guyton | June 5, 2015

You don't need a whopping pile of cash.

How soon can I retire?

For some, this question is as tantalizing as it can be vexing. After many years of saving and planning for a secure, fulfilling, and comfortable retirement, it's natural to wonder, "How much is enough?" From my experience helping people answer this question over 25 years as an adviser, researcher, and writer, the answer is quite often, "Less than you may think." Obviously, it depends on many factors. But a key takeaway is that what you believe and how you think about the financial resources already available to you is likely what matters most of all.

Consider the situation of one typical client; let's call her Sally. She recently turned 59 and earns $114,000 as a corporate manager with 27 years' experience. She loves her work and assumed she'd do it for another five to seven years. Her career has been rewarding, but there have also been challenges along the way, including becoming a single mom to her two children. But the kids are now launched (more or less), and since becoming an empty-nester Sally has pursued outside interests that have added new balance and meaning to her life.

One of these is photography. Turns out Sally has a real talent; in fact, she's already been paid for some of her work. All this has helped her realize she'd much prefer trading her job for a part-time career in commercial photography. "But there's no way," she tells herself. "I'm only 59; people can't retire that early these days. And my mortgage won't be paid off until I'm 65."

Lately, though, Sally has begun to get impatient. She looks forward to more time for herself and photography much sooner than seven years from now. She could use accumulated vacation time to take much of the summer off, but she'd still have to return to work full-time come fall. Or does she? Let's look more closely.

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Sally lives comfortably on her $5,700 monthly take-home pay after deducting taxes, benefits, and her 15% 401(k) contribution. She makes a $1,500 payment (principal plus interest) against her remaining $110,000 mortgage and saves another $500 for travel. Her retirement savings include $575,000 in her 401(k) and $150,000 in an after-tax brokerage account. Her company pension would pay $1,500 monthly, and Social Security credits will provide a $2,500 monthly benefit if she works into 2022 ($2,250 if she goes part-time now).

Though Sally clearly has an exciting vision for her life's next chapter, several key questions remain. At the age of only 59, how much sustainable after-tax income is available? How should she bridge the gap to Social Security? How can she afford discretionary extras that are sure to arise, especially in the next 10 to 15 years? And what about future health care costs?

The key to letting Sally consider retiring to this new life is understanding that not all her expenses must be sustained for her entire future. She won't have that mortgage payment forever, nor will she likely travel as much beyond her mid-70s; cutting out the mortgage payment and the $500 saved monthly for travel will knock $2,000 off her monthly expenses. Some research convinces her to add back $550 for health insurance (later Medicare and a supplement) plus out-of-pocket needs, and another $250 for long-term care insurance. So in today's terms, she'll have to sustain only a $4,500 monthly income for life, not her current $5,700.

So how can Sally get rid of her mortgage? One option is to pay it off with a lump sum from her brokerage account. The problem with draining that account so quickly, however, is that most of her remaining money would be in her taxable 401(k)—money that, upon withdrawal, would be subject to ordinary income taxes likely higher than the capital gains rate on money pulled from her brokerage account. A better option, which Sally will explore, is to refinance into a new 30-year mortgage. Based on a back-of-the-envelope calculation, she'd pay $550 monthly. That would bring her core monthly lifetime expenses to $5,050.

Sally could also stop treating travel as a monthly expense. Instead, she could cover it by carving out a $100,000 'travel fund' from her brokerage assets, supplementing it with photography earnings in good years. Together, this could provide $6,000 to $8,000 of yearly travel (or other discretionary expenses) for at least 12 to 15 years when she's in her 70s.

So in retirement, Sally will need to cover $60,600 in annual expenses—$5,500 per month.

What she'll really need, though, is $70,000 total income, since she'll also have to cover federal and state income taxes.

How can she do that? Start with her pension, which will cover $18,000. Seven years from now, when she reaches her full retirement age of 66, she plans to start taking Social Security, which would give her another $27,000 in annual income. Between now and then, she plans to come up with $27,000 annually by tapping $125,000 of her retirement savings (invested conservatively) at the rate of $18,000 a year and netting $9,000 a year from her photography business.

For the final $25,000 a year she needs in lifetime income, she'll draw upon her remaining $500,000 in retirement savings. That means pulling out 5% of the initial amount annually ($25,000 divided by $500,000). If Sally is willing to cut back on expenses during tough economic times, this withdrawal rate will work over a 40-year period, as shown by research here and here.

Financially, Sally is ready for early retirement—and so are many who dream about it. Although diligent saving is a prerequisite, you don't necessarily need a whopping pile of cash. What you do need is some planning, some creativity, some flexibility, and an understanding that you may have to draw upon multiple financial resources.

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