



The Secret to Retire in Style

by Robert Mecca CFP, MBA, RIA

Countless surveys are conducted asking Americans about our financial goals. Year after year, the overwhelming response as the top financial goal is to retire as early as possible and live comfortably.

We've met clients of all ages and varied professions fed up with work and stressed-out to the max. They are desperately searching for a way to get out of the "rat race" as many call it looking forward to the day they can tell their boss to take the job and...you know the rest.

Retirement is their single most precious dream. But what causes many Americans to fall short of their dream? The absence of maximizing cash flow during retirement is a major reason people miss the mark.

There are two components of retirement cash flow...cash inflow and cash outflow.

Retirement cash inflow can include

- social security (reduced for early age distributions)
- pension, if applicable
- net rental income, if applicable
- cash interest or cash dividends

Retirement cash outflow can include

- living costs adjusted for inflation
- federal income taxes
- state income taxes
- insurance premiums (continually rising)
- interest paid on debt outstanding

We Americans tend to live up to our income. The more we earn, the more we spend on our lifestyle. According to the US Commerce Department, personal savings as a percentage of after tax income dropped to nearly -1% in 2005. That is the lowest level of savings since the height of the Great Depression.

If cash outflow exceeds inflow, the result may mean either the investment portfolio is not maximized or investment principal is consumed increasing the risk outliving assets prior to death. As a consequence, a reduced estate would be left to family members. In contrast, most retirees of any size wealth yearn to leave a sizeable inheritance to beneficiaries.

Maximizing cash flow involves financial planning techniques which increase inflow and minimize outflow to the extent possible without sacrificing the desired retirement lifestyle. He who controls cash flow usually wins the game of retiring comfortably and worry-free.



The Secret to Retire in Style
(Page 2 of 5)

Of major interest in our analysis is what constitutes living costs. Americans entering retirement are of different breed than that of prior generations. Retirees are younger, more active, and eager to enjoy life, all of which requires money. Add to this the rising cost of healthcare including doctor and hospital costs and prescription drug costs. To make matters worse, the federal government continues to reduce insurance coverage via medicare thus leaving retirees to pay more. And lately corporations are modifying or completely eliminating retiree health plans resulting in higher costs borne by retirees who have relied on this benefit. All this adds up to retirement disaster.

Through the astounding advancements of medical technology, people are living longer. It not uncommon to see people alive in their mid nineties. Living longer means invested assets must be properly invested without taking unnecessary risks in order to make the money last as long as possible. During wealth producing years, investors are more apt to take risks. Striving to attain 12% or so average return may be practical.

But, as a retiree, wealth accumulation strategies change to wealth preservation strategies. High risk investment strategies aren't as appropriate so investment returns tend to be lower in retirement based on more conservative strategies. Earning a respectable net real return during retirement is warranted. Net real return is defined as the following...

	Gross return on investment
Less:	Fees associated with the investment
Less:	Federal and state taxes
Less:	Inflation

	Net Real Return on Investments

The one major component of the equation is inflation. Retirement related expenses continue to rise primarily since retirees are more active than ever. Traveling, enjoying hobbies, entertaining, and participating in varied social activities can be very expensive. Consequently, living costs to enjoy retirement are significant. Add an inflation rate rising every year to the cost of living during retirement and the numbers add quickly.

The consumer price index, a measure of inflation, is about 3%. During the 70's and 80's, the CPI was in double digits. But let's assume an average 4%.

A 50 year old striving to semi retire at age 60 living on \$100,000 in today's dollars would require \$148,000 the first year of retirement given a 4% average inflation rate. And each year thereafter during retirement living costs increase. By the time this person reaches age 80, the future value annual living cost is \$324,000.

Clearly, Americans are not prepared for retirement. They spend weeks, years, or months planning a vacation that may last a couple weeks. But they spend little effort planning retirement, an extended vacation lasting numerous years. A recent article in Financial Advisor entitles an article "The Big Train Wreck Coming, Boomer retirement plans are on a collision course with reality." Indeed Americans are



The Secret to Retire in Style

(Page 3 of 5)

not realistic when it comes to retirement goals. There are positive steps to take to help prepare for retirement. Specific strategies can be implemented to help avoid retirement meltdown.

We know that cash outflow includes many variables. No doubt the major living expense item during retirement is your mortgage. During this last prolonged bull market in the housing industry, the value of houses increased double digits. Depending on location, housing values increased 12% per year; far above the 5% to 6% historical norms. To buy or build a house during these past several years meant digging more deeply into your pocket for a larger deposit. Even so, many Americans faced a relatively large mortgage.

Buying a \$900,000 house and depositing \$400,000 equates to a \$500,000 mortgage. A fixed rate, thirty year mortgage at 6.50% interest means \$3,160 per month principal and interest. Real estate tax, home insurance, and association fees are extra.

Many positive strategies exist to retire in style. But the best way to accomplish this mission is to have no mortgage.

Most people think this strategy doesn't make sense. They believe or have been told that having the mortgage interest tax deduction is valuable. I contend the opposite.

Going into retirement, one of the largest, if not the largest living expense (cash outflow) is your mortgage. Let's go back to my example to drive home some major points.

A person age 50 financing \$500,000 at 6.5% pays \$3,160 per month principal and interest or nearly \$38,000 per year. In the first year of the mortgage, about \$2,700 of the monthly mortgage payment applies to interest. So, over \$32,000 is paid in interest for a year. While earning income, it can be presumed the tax bracket is relatively high. One in the 36% tax bracket can deduct about \$11,500 interest from taxes or less if full deductions are not allowed.

Two-thirds into the thirty year mortgage, less than half the monthly payment is attributed towards interest. According to projections, about \$18,000 will be paid toward interest. A retiree in a lower tax bracket, say 20% may deduct \$3,600 interest from taxes. By default, through time there is less interest qualifying for an income tax deduction.

Retirees are commonly in a lower income tax bracket so the mortgage interest income tax deduction is not as valuable for retirees. For every dollar of interest paid to the mortgage company, only 20 cents is applied versus 36 cents while working. The lower the tax bracket, the less valuable an income tax deduction.

In wage-earning years, the more income tax deductions the better all things equal. Maximizing deductions to offset wages and other sources of income is prudent. Certainly, what you keep is what really counts.

But during retirement, with substantial mortgage balance outstanding the cash out of pocket remains \$3,600. Add to this 4% per year inflation to other living expenses equates to higher cash outflow.



The Secret to Retire in Style

(Page 4 of 5)

Sometimes people have a hard time understanding this. "Isn't all the interest tax deductible?" they ask. Think of it this way. Your taxable income is \$200,000. Is \$200,000 tax due? No. If so, this would mean you are in the 100% tax bracket. No one is in this bracket. Taxable income is bracketed. Mortgage interest deductions are less valuable when in a lower tax bracket.

Federal tax law provides for a taxpayer to itemize deductions or take a standard flat amount for deductions. Some retirees may not qualify for significant tax deductions thus file for the standard flat deduction. A married couple over age 65 filing jointly is eligible for \$12,000 standard deduction from federal taxes.

Simultaneously, if adjusted gross income exceeds \$145,950, Schedule A federal deductions are reduced. Adjusted gross income, or AGI includes:

- ▣ taxable wages
- ▣ interest income
- ▣ dividend income
- ▣ capital gains
- ▣ net rental income
- ▣ net self employed income
- ▣ social security and pension
- ▣ other miscellaneous income such as jury duty, etc.

It is easy to see that a taxpayer can exceed the threshold when all components are added together. Hence, itemized deductions such as mortgage interest are not fully deducted, but rather reduced. As a consequence, federal tax deductions are not as attractive compared to the standard deduction for most retirees. There is no income tax break for mortgage interest even if retirees continue to make monthly payments.

Paying off the mortgage prior to retirement is a sound financial strategy because cash flow, not an income tax deduction, is priority for retirees. In our example, not paying \$38,000 per year is a very substantial savings to most anyone's retirement budget.

Without a mortgage, retirees are less inclined to have life insurance covering the outstanding mortgage liability. Beneficiaries of the estate can receive the asset value without a cumbersome debt obligation. There would be no immediate rush to sell the house and with real estate values cooling, flexibility helps.

So how do you accomplish this? Proper financial planning in anticipation of that special retirement date is important. The sooner you plan, the better. First determine how much you need to live comfortably in today's dollars for retirement. Ascertain how many more years prior to fully or semi retirement. Develop a program for prepaying the mortgage during the working years. As a general rule, I don't subscribe to paying the financial institution a fee which allows the mortgage holder to make extra mortgage payments. The key is to determine how much extra principal is needed in order to enter retirement mortgage-free. Models can be run.



The Secret to Retire in Style (Page 5 of 5)

For more aggressive investors, instead of paying down the mortgage until retirement, invest the extra money in an attempt to earn higher net returns above the mortgage rate. Establishing a proper asset allocation is the key to success. Here is one example:

- 10% of invested assets as an emergency fund
- 20% of invested assets in fixed income
- 60% of invested assets in capital appreciation securities
- 10% of invested in sector securities (gold, energy, etc. depending on the market)

Going into retirement, pull down these invested assets and pay off the mortgage after paying minimal capital gains tax.

Taking retirement seriously and implementing strategies today can make the difference between financial failure and financial success. The latter can result in comfortable retirement for you and your family. The secret to retire in style lies within your house. Use it as an asset, not a cash flow liability.

Robert A. Mecca & Associates, LLC is a comprehensive life planning consulting firm located in Mt. Prospect, Illinois helping people for over 20 years reach their financial goals. Robert Mecca CFP, MBA, RIA is a fee-only certified financial planner listed in The Guide to America's Best Financial Planners. Bob can be reached at 847-359-2900 or bob@MeccaOnMoney.com. His website is www.MeccaOnMoney.com.



[About Us](#) | [News](#) | [Alerts](#) | [Articles](#) | [Newsletter](#) | [Research](#) | [Calendar](#) | [Contact](#) | [Register](#) | [Free Opinion](#)

Sponsored by James J. Eccleston, an attorney representing stockbrokers, financial planners and investors nationwide in arbitration, litigation and regulatory matters, and an equity partner with the law firm Shaheen, Novoselsky, Staat, Filipowski & Eccleston (www.snsfe-law.com). This Web site contains material of general interest. It is neither intended to nor constitutes either legal advice or investment advice. Always consult an attorney and/or investment advisor when building and protecting your wealth.

All content Copyright © 2003 FinancialCounsel.com, Inc. except where noted. All rights reserved.
20 North Wacker Drive, Suite 2900, Chicago, Illinois 60606
Telephone: 312-621-4400 | Fax: 312-621-0268

