Moving to action: Twelve numbers to change your life
excerpted from "Financial Fitness Forever"
(courtesy of McGraw-Hill Education), Chapter 10

"The beginning is the most important part of the work."
-- Plato

By this point you may understand what you can and should do to improve your financial future. But understanding, if it's not followed by action, can be the booby prize. You deserve better than that.

What I care about most is changing people's lives. And in this chapter, I'll show you how that happens. Until now this book has dealt in generalities without looking at exactly how they might affect you. Here, your circumstances and your financial fitness is the focus.

If I could have a personal conversation with you, I would cover the topics you will find here. We would go over the most important numbers that every investor who's preparing for retirement should know. If you're already retired, some of these won't apply to you, and that will be obvious. But you may still find this discussion helpful.

If you do your homework and nail down these numbers, you will get a good general picture of your financial fitness. You'll know whether or not you are on track to retire when you want to. If you need to make changes, you'll have the background to figure out what they are.

Over the years I have worked with thousands of people. When they uncover these fundamental facts in an organized way, their circumstances can suddenly become much clearer and less mysterious. I think the same will happen to you.

The following exercise is one of discovery. There are no right answers or wrong answers. The best answers are the accurate ones. Some are easy, and some are more difficult. I recommend that you do your best the first time through, then revisit this topic from time to time as you get closer to retirement.

Let's begin.

Number One: Your current cost of living. This is the bedrock on which the rest of these exercises are built, so you should later seek an answer that's as accurate as possible. You can start with a quick-and-dirty approach. Identify your current gross income, then subtract whatever you are saving for the future. (If you have credit card debts that you can't pay off every month, you may be overspending your income, but for this chapter I'll assume that's not the case.)

To show you how these 12 numbers come together, I will construct a hypothetical example. I start by assuming that your two-income household takes in $146,000 a year in gross salaries and that together you and your spouse are aggressive savers and adding $24,000 a year to your retirement nest egg. In this quick-and-dirty calculation, that means your cost of living is about **$122,000** a year. This figure includes the income taxes you pay plus Medicare and Social Security payroll taxes.

If you need to get more control over the spending part of your life, or if you want more detail about where your money is going, you can set up an account online at mint.com and let it have access to your bank and credit card accounts. The site will then do its best to categorize your spending into categories that you can track over time.

Monitoring your spending doesn't sound like an investment topic, but in fact it is essential to planning for retirement. If spending is an issue, this is a very worthwhile place to focus your attention.

Number Two: The rate of inflation you assume for the future. This is a wild card, but whatever number you choose will have a big effect on your financial future. When I talk to investors, I am most comfortable assuming inflation will be **3.5 percent**. That may not seem like much. But over the years it can do more damage than you might think.

Number Three: Number of years before you will retire. This isn't always a simple calculation. You may not be in control of when you retire, for health or other reasons. You may have no intention of ever retiring, just cutting back to part-time work. Or you may want to ease into retirement gradually by reducing your hours in one or more steps before you leave the workforce entirely.

However, in order to keep things relatively simple in this example, I'll assume you are both 55 and you both plan to retire "cold turkey" in **12 years**.

Number Four: Your inflation-adjusted cost of living after you retire. This can be a complicated number to pin down, because you have to try to anticipate things that will change. Some of them won't be under your control, some will. Some changes will be major, others will have less impact on your finances.

Some people plan to move closer to their kids. Others plan to move to a better climate or to an area with lower housing prices. (If this describes you, don't forget the one-time cost of the move itself.)

After you retire you may find yourself with much more time to pursue hobbies and travel; you may find that you are spending more money than you are accustomed to. You'll probably pay less for commuting and clothes, and you won't need to keep contributing to your retirement plans.

Your taxes will change, too. After you retire you won't have to pay Social Security and Medicare taxes any more. I'm going to assume that the bulk of your retirement savings are in Rollover IRA and 401(k) retirement accounts. That means that withdrawals from them will be fully taxable. I also assume that your Social Security and that pension will be taxable as well.

For our example, I'll fill in the blanks with some more made-up numbers in order to show how this series of calculations works.

To your current $122,000 cost of living, I am going to add $5,000 to cover what I assume will be higher health care costs plus another $3,000 for travel in addition to whatever you are spending now. The latter is an optional expense that you can reduce if necessary, and that makes it a bit of a cushion. That brings your total to $130,000.

On the other hand, I estimate that you can subtract $6,000 that you will no longer have to pay for commuting and various other business costs. I also subtract $10,000 in Social Security and Medicare taxes. You have nine years to go on your mortgage, which will be paid off three years before you retire. That will save you about $32,000 a year in retirement. In addition, as I complete another step in this process I will assume you will add that $32,000 to your retirement savings for the last three years.

The net of all these changes is a first-year retirement cost of living of $82,000 in your first year of retirement.

That number is stated in current dollars, before adjusting for inflation. If you have access to a financial calculator or know your way around a computer spreadsheet, it's easy to adjust this for a decade of 3.5 percent inflation. The result is an inflation-adjusted cost of living that's about $124,000. (Remember, these are future dollars, and that's why the number seems so big.)

By necessity, this number is built on many assumptions, guesses, and estimates. Accordingly, I don't totally trust it. But you have 12 years to refine this, and for now that number is good enough to give you an idea of where you stand. Therefore, we'll assume you will need **$124,000** in your first year of retirement.

Now we want to know where that $124,000 will come from.

Item	Your number
Present cost of living	**$122,000**
Assumed future inflation	**3.5 percent**
Years until retirement	**12 years**
Cost of living 1st year of retirement	**$124,000**

Number Five: Retirement income you can count on. For most people, this category will include Social Security. It might also include a pension, rental income or notes receivable. For this calculation, don't include investment income such as interest, dividends or expected capital gains.

I'll assume that you and your spouse will collect a total of $36,000 in Social Security and that you will have a pension of $13,000 a year from a previous job. If we assume that these figures don't have to be adjusted for future inflation and we add them together, you will have **$49,000** you can count on.

Number Six: Retirement income you'll need every year from your portfolio. This requires nothing more than elementary-school math: You need $124,000 when you retire. You can count on $49,000. That leaves **$75,000** that must come from somewhere else.

Number Seven: Portfolio you'll need at retirement. If your investments are properly balanced between well-diversified stock funds and bond funds, you can get a quick and dirty answer in this step by multiplying $75,000 by 25. This assumes you will withdraw 4 percent of your portfolio's value the first year you're retired, then adjust the number every subsequent year to cover inflation.

(Please note that a withdrawal rate of 4 percent may or may not be appropriate for you. Your circumstances may dictate something different. I highly recommend that you study Appendix H, an article that goes into this topic in detail.)

Four percent is a conservative withdrawal rate that will minimize your risk of running out of money. To support that, you have to have a big portfolio. In your case, that means you will need **$1,875,000** worth of investments when you retire.

This is not an exact number by any means. We tossed precision out the window when we put together all our assumptions and estimates and then multiplied the result by 25.

The $1,875,000 target is the bad news. The good news is that you still have 12 years before you retire. That's a decade in which to refine your objectives, find ways to invest better, and to save more.

Item	Your number
Present cost of living	$122,000
Assumed future inflation	3.5 percent
Years until retirement	12 years
Cost of living 1st year of retirement	$124,000
Fixed retirement income	$49,000
Income needed from investments	$75,000
Portfolio size at retirement	$1,875,000

Number Eight: The current size of your investment portfolio. This number should include only your investments, excluding real estate and other non-liquid assets. In addition to stocks, bonds, mutual funds, IRAs, 401(k) and similar accounts, your portfolio may include cash, certificates of deposit, Treasury bills or notes as well as loans payable to you that you reasonably expect to be paid by the time you retire.

To continue our calculations, I'm going to assume that you have been aggressive savers and your portfolio is worth **$510,000** right now. In the next few steps, we'll find out what's necessary for it to grow to $1,875,000 in 12 years.

Number Nine: Your annual retirement savings. Actually, we already know this number from our very first calculation. You and your spouse are saving **$24,000** a year. If you keep that up, you will add $288,000 to your portfolio over the 12 years plus $96,000 in the last three years when your mortgage is paid off. If your investments didn't make any money or lose any money in the meantime, you would have $894,000, leaving you far short of your target. That's why you need growth in your portfolio.

Number Ten: The annual return you need from now until you retire. To figure this out, you'll need a financial calculator or a computer spreadsheet.

Based on the numbers that we just outlined and your goal of having $1,875,000 in 12 years, my calculator tells me that you can get there if your money grows at an annualized rate of **8.1 percent**. That's in the ballpark of historical returns for well-diversified portfolios with very moderate levels of risk.

Item	Your number
Present cost of living	$122,000
Assumed future inflation	3.5 percent
Years until retirement	12 years
Cost of living 1st year of retirement	$124,000
Fixed retirement income	$49,000
Income needed from investments	$75,000
Portfolio size at retirement	$1,875,000
Portfolio size now	$510,000
Annual savings	$24,000
Investment return needed	8.1 percent
Current allocation to stocks	84 percent
Current risk exposure (12-month loss)	45 percent

It has taken a lot of work to get to that number. But now we can see that you have a shot at meeting your goal if you invest prudently and keep your expenses under control.

Nobody can tell you what investment returns will be over the next 10 years, so there is no guarantee of anything. You'll find a table of long-term returns in Appendix B, part of an article that looks at levels of risk and return going back to 1970 for portfolios with various combinations of stocks and bonds. Though this table is only a very approximate guide to the future, I think it encouraging in your situation.

From 1970 through 2010, a relatively low-risk portfolio with 60 percent in properly diversified stock funds and 40 percent in bond funds achieved an annualized return of 10.6 percent – definitely higher than the 8.1 percent you need.

Even if we assume that over the next 12 years such a portfolio would achieve two full percentage points less than that, or 8.6 percent, that would still be above what you need.

Having 60 percent of your portfolio in stock funds unquestionably subjects you to some risk, and you should carefully consider this. In the 41 years we just examined, that 60 percent equity portfolio had a worst-12-months loss of 33.5 percent. That would be a significant setback for you, and if it occurred just before or just after you retired, you would have to modify your expectations.

Because in this chapter "you" are purely a hypothetical creature of my imagination, I'm in charge of you. Therefore I can say on good authority that you and your spouse are sensible enough and resilient enough that you would be willing and able to work longer or scale back your retirement spending plans – or perhaps both – until you recovered.

I started this chapter with the promise of 12 numbers that can change your financial future. Two more remain that will help you improve your financial fitness and have the future you want.

Number Eleven: The overall stock allocation of your portfolio now. If you have most or all of your investments in one place, you may already know this figure. But many investors have to dig a bit to figure this one out. A financial software program such as Quicken can help, if you use it to keep track of your holdings. If your portfolio consists of stocks, ETFs and mutual funds, you can use the Portfolio X-Ray tool at Morningstar.com to determine your overall exposure to stocks and bonds.

For purposes of this example, I'm going to assume we have discovered that your current allocation is **84 percent stocks** and 16 percent bonds. This is a bit aggressive for somebody within 12 years of retirement, and it suggests you are subjecting yourself and your family to more risk than is necessary. Fortunately, we can make a pretty good estimate of this.

Number Twelve: The amount of risk in your portfolio now. If you have 84 percent of your portfolio in stock funds, the full version of the table in Appendix B leads me to conclude that you're exposed to the risk of losing **45 percent** of your portfolio in some 12-month period. This assumes your stock holdings are well diversified. If that's not the case, your risk exposure is probably higher.

Even exceptionally good investors and sensible people like you and your spouse would have a hard time recovering from a loss of 45 or more percent. Fortunately, you don't need to take that much risk.

Where do you go from here?

Now we are ready to discuss what you can do to maximize your chances of meeting your retirement goals. If I were meeting with you and your spouse, based on what I know of your circumstances I would probably tell you the most important thing you can do is reduce the amount of risk that you are taking.

Over the last four decades, if you had invested 40 percent of your money in a well-diversified group of stock funds and the other 60 percent in bond funds, your greatest 12-month loss would have been 23.1 percent. A 40 percent equity portfolio represents a much more conservative approach than you are now taking. And the good news is that, over that same period, your annualized return in such a portfolio would have been 9.4 percent – higher than you need.

However, I don't know how likely it is that this conservative allocation will earn that level of return over the next 12 years, and I think a higher equity allocation is more likely to be successful for you.

Your action plan

The very final step in this process is to think about what changes you need or want to make. You have achieved a good platform on which to build the rest of your nest egg. Now you need to keep building and defend your position at the same time.

Faced with the facts in the hypothetical scenario I have constructed here, I would have three recommendations:

1. Rebalance your portfolio in order to scale your stock exposure to no more than 60 percent; in your case, 50 percent might be sufficient to meet your goals, and I prefer that slightly more conservative allocation. But since you and your spouse are good savers as well as reasonable and resilient, I would not try to talk you out of a 60 percent equity portfolio if you want a slightly higher expected return.
2. Have a conversation in which you go over these numbers and projections with your spouse. Include your grown children if that is appropriate. Do your best to obtain their support for continuing your savings and keeping your expenses under control.
3. Keep your calculations, either on paper or in a computer file, where you can find them easily. Every year, update the numbers to keep abreast of your changing portfolio value, your living expenses and inflation. The changes may be very minor in any one year, but things will change, and you should keep fine-tuning your calculations to make sure you're still on track. Once you've done this a few times, it will become easy and you'll recognize the records you should be keeping for this exercise.

Perhaps the best investment you can make

I do live in the real world, and I know that most people won't do all these things, even though we've seen how valuable this exercise can be. Rounding up the numbers can be daunting, and there are multiple places where you may feel like throwing up your hands because of information you simply don't have – or information that you don't want to face up to.

However, I believe this exercise is absolutely necessary if you want to maximize your financial fitness in preparation for retiring.

Here’s my final recommendation: Get a professional to help you with these things.

- If you are using a financial advisor or you’re thinking of hiring one, he or she should be able to help you with all these numbers and then figure out the appropriate action plan. This is a huge benefit of having an advisor.
- If you aren’t interested in taking that route, find somebody to help you with this on an hourly basis. A Certified Public Accountant with training in personal finance could certainly help you arrive at the numbers you need. I know that CPAs often have time available after their busy tax season, January through April. A Certified Financial Planner can also do this for you. If all you want is expert help with the exercises in this chapter, make sure you choose somebody who’s willing to work for an hourly fee and who does not sell financial products.

For more on choosing a good advisor, see Appendix I.

If you do your homework well and do a good job of calculating these 12 numbers, I’m very confident that it will be well worth your efforts.

I can’t guarantee that you’ll like the results of such a “financial fitness checkup.” But when you’re done, you will have the facts. Once you know the facts, you can figure out a plan to achieve the retirement you want.

In the second paragraph of this chapter, I told you that what I care about most is changing people’s lives. Now you have seen exactly how that happens.