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Wealthy need to watch spending

Michael Nairne, Serious Money

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Rather than saving for retirement, some wealthy couples actually increase their spending as they get older, writes Michael Nairne.

There's an old financial planning adage that states "your rate of saving is just as important as your rate of return." Savings, particularly in the early years of wealth building, creates the seed capital that unleashes the magic of compounding. Today, with the Baby Boomers heading into retirement, a more apt adage is "your rate of spending is just as important as your rate of return."

This maxim is critical for the affluent. A family earning $70,000 a year, about the median Canadian family income, will find that CPP and OAS payments on retirement replace a healthy portion of their employment income. Affluent families, on the other hand, who are used to several hundred thousand dollars a year of income, will find that these payments are a drop in their expenditure bucket. Many will have their OAS payments clawed back.

Also, one of the biggest expense reductions for the typical family on retirement comes from paying off their mortgage. Most high net worth families will have paid off their mortgages long before retirement. Their ongoing expenditures are related to lifestyle – expensive homes and vacation properties, luxury autos, first class travel and hefty charitable giving. Some couples even increase their spending as they get older.

The key challenge for the affluent is scaling their cost of living to their portfolio's capacity to support their retirement lifestyle. This is easier said than done. The lifestyle expenditures of many well-compensated corporate executives and professionals often increase over time. The urge to splurge is everywhere - stretching for that bigger house, buying a fancy vacation condo or leasing the newest luxury import is common behaviour when times are good.

Retirement, however can hit these folks like a pail of cold water. Their fixed costs – property taxes, utilities, maintenance – often from multiple properties in combination with expensive auto leases are now a burden on their much reduced cash inflows. Also, in my experience, many will have been generous, both with charities and less fortunate family members, and are reluctant to cut back in this realm.

Even business owners who sell their companies can find retirement funding challenging. They often don't appreciate the quantum of investment capital needed to replace the stream of employment income and dividends that their business previously generated.

Unfortunately, in planning their retirement expenditures, many investors suffer from what behaviour finance experts call the money illusion. They think in nominal terms instead of real (i.e. net of inflation) and hence, underestimate the impact of inflation on the amount of capital they will require.

According to the Credit Suisse Research Institute, since 1900 the annual nominal return on Canadian stocks and bonds has been 9.1% and 5.2% respectively. On the surface, then, one might assume a balanced portfolio will generate returns in the 7% range and that to fund $250,000 in expenses (including taxes), about $3.5 million in capital is needed.

Unfortunately, this back-of-the-envelope math ignores inflation. Net of inflation, the real annual return on stocks and bonds has been only 5.9% and 2.1%. Depending on how conservatively the portfolio is positioned, a family might require anywhere from $5 million to $7.5 million to fund a $250,000 lifestyle. For many, cutting spending is a more realistic option than amassing that extra several million of capital.

In actuality, the amount of capital needed to fund a retirement is a complex assessment that also includes risk tolerance, taxes, pensions, bequest goals and capital depletion preferences. When it is all said and done, however, most families will find that their rate of spending is just as important as their rate of return. After all, a penny saved is a penny earned.

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