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Perspectives

Is It Time to Fire Up Your Retirement?

What if you could retire early? We're talking really early—not just a few years, but a few decades? Imagining yourself enjoying a life of leisure, no longer a slave to the working world is enticing. This idea, though not new, has gained popularity recently. In its latest incarnation, it has been dubbed Financial Independence, Retire Early, or FIRE. The framework is based on aggressive saving and penny pinching for as long as it takes to save "enough" to retire. Once in retirement, FIRE adherents aim to maintain a very frugal lifestyle, often relocating to low cost cities, trading cars for bicycles, and shopping at thrift stores. Because some adherents retire in their mid-30s or 40s, looking out at five-plus decades of not working, frugality is the key.

A few months back, financial guru Suze Orman came out swinging against FIRE, noting that future health care needs, and other unexpected life events could easily derail an early retiree, leaving them low on cash with many more years to live. She also lamented the early retirees' missing out on years of compounding returns. While some dismissed the criticism as self-serving, Orman is absolutely correct about the benefits of compounding returns.

The Magic of Compounding

Sometimes called the eighth wonder of the world, compounding often seems magical—turning a small amount of money today into much more in 20, 30, or 40 years. Compounding simply means that investors earn "interest on interest." For example, an investor saves $1,000 today in an account that earns 10% per year. After one year the account will be worth $1,100 (the initial $1,000 and $100 in interest). In the second year, the account earns 10% on both the initial investment and the interest, for a total of $1,210. This continues for as long the money remains in the account.

To make the most of compounding, investors must not only save early and often, but keep their money invested for the very long term. Living off the income generated from a principle balance (as many early retirees do), does not allow investors to gain that "interest on interest" described above.

Let's assume someone saved $1 million at age 40 and decided to retire early. To preserve principal, a must when one is planning to live off the portfolio's income for decades, the retiree will likely invest somewhat conservatively. Over the last twenty years, a 60/40 combination of the S&P 500 and the Bloomberg Barclay's Aggregate Bond indexes, rebalanced quarterly, returned an average of about 6.3%, annually. Over the same time, the average annual inflation rate was about 2%, according to the Bureau of Labor Statistics. This means the early retiree could plan a withdrawal rate of about 4% each year (pretax) to preserve principal and purchasing power. If one year she has additional expenses and digs into principal—say for an unplanned medical expense—her annual withdrawals must decrease if she wants to maintain the asset base on which to generate income for years to come.

Without getting too technical, this idea of a flat rate of withdrawal is also problematic. Last year, the 60/40 portfolio returned -2.6%, for example. If our early retiree took out 4% during the year, she likely would have depleted the principal balance, though the timing of withdrawals would make a difference. Pulling money out of a portfolio during a downturn isn't a good idea, but if the only source of income is from investments, options are severely limited—either stop spending money, or dig into the principal balance which will lower the future income generating power.

Alternatively, if that $1 million could grow, compounding at 6.3% each year for 20 years, our retiree would have a nest egg of $3.4 million at age 60. Even putting off retirement for just 10 years would nearly double the amount to $1.8 million. That does not include any additional money that would likely be saved if our early retiree continued to work and contribute to retirement accounts.

Choosing when to retire is a very personal decision, but it's important to remember that three decades from now will not look like today. Unforeseen expenses will arise, and inflation and taxes will take a bite out of investment returns. Compounding is a mathematical wonder, turning a little money into a lot more, just by waiting. Early retirees are missing out on decades of compounding returns.

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