Your Secret Weapon

You have a secret weapon that you may not even know about. It can be extraordinarily powerful although is the classic "simple, but not easy" to use. What is the secret weapon? Spending less money. Let me explain.

Your Secret Weapon and Financial Independence

Financial independence is the new retirement. Retirement just isn't hip enough any more. Now the goal is to be financially independent. Financial independence is a number, not a date. There is some debate about how to calculate the number, but the most widely used formula is this:

Financial Independence = (Annual spending – guaranteed annual income) x 25

There's not a lot you can do about your guaranteed annual income. This is usually a pension or Social Security. You can buy a pension (i.e. a Single Premium Immediate Annuity) but that does reduce your nest egg. You can also call real estate income "guaranteed," although of course it isn't and tends to become non-guaranteed at the worst possible times.

A not-so-secret weapon, despite the camouflage

There also isn’t a lot you can do about the “25” portion of the equation. Some people argue it should be 30 or even 33. Lunatics (just kidding, I mean hyper-conservative pessimists) argue it should be 40. Optimists might argue it could be as low as 20, but 25 is in the general ballpark.

But what can you do a lot about? You can do an awful lot about how much you spend. That’s your secret weapon. We’re technically not financially independent yet unless you count the value of our most illiquid asset (this website.) That’s because we spend a lot more than the equivalent of 1/25th of our assets each year. However, if we chose to implement our “secret weapon,” we could be financially independent today. Let me explain.

As I write this (months ago it should be noted), our retirement nest egg (i.e. that portion of our net worth dedicated to retirement) is about $1.5 Million. Our net worth is about twice that when you consider the value of our house, our business, and resources dedicated toward other goals, like an emergency fund, paying off our mortgage, and college. *[Update just prior to publication: Our net worth is highly* *dependent on the value of this business, which was revalued dramatically upward between the time this post was written and the time it ran.]*

That $1.5M nest egg could support an income of something like $60K a year. So if we only spent $60K a year, we would be financially independent right now. Could we get by on only $60K a year? You betcha. We've spent a significant portion of our married life (all but the last 7 years) spending less than that. Would I rather work at this point than live on $60K a year? Absolutely. In fact, I'd probably work even if we had a nest egg 5 times that size because I'm trying to only do work I like. But the option to cut back and spend less and be financially independent right now is a secret weapon we could employ at any time.

Your Secret Weapon and Sequence of Returns Risk

Let's talk about another time when the secret weapon could be profitably employed. I was having a discussion on a forum recently with one of those fanatics advocating for a 40X nest egg. You know the arguments- expected future returns are low, longevity is going up, I'm retiring early, the world is going to hell in a hand basket etc. The problem is that people don't apply the "real world" factor. In the real world, people don't lock themselves into some bizarre withdrawal plan on the eve of their retirement. They make adjustments as they go. The type of person who can save up 25X of their expenses to retire is precisely the person who can actually adjust what he spends in retirement to make sure he doesn't run out of money.

Sequence of returns risk is that risk that you run out of money in retirement because despite having adequate average returns, you get the bad returns early on and the good returns late. So how do you employ the secret weapon? If bad returns show up early in retirement, you start spending less money. Crazy, right? But if you have the ability to do that, you can probably enjoy a much higher withdrawal rate than someone without that secret weapon.

What does that look like? Well, let's say you like to send your 20 grandkids $200 each for their birthdays and Christmas. If you employ the secret weapon, you only send them $50 a piece. Maybe you would like to go on three cruises a year. With the secret weapon, you go on one. Maybe you want to get a new car every 8 years. If those lousy early returns show up, maybe you wait 10-12. Cheaper booze. Less eating out. Watch the old TV for another year instead of upgrading. Voila! You got your portfolio through the bad return years with minimal damage and can now get on with the rest of your retirement.

Spending less is a secret weapon that can have a dramatic effect both on getting to financial independence and dealing with sequence of returns risk.

What do you think? If you employed your secret weapon could you be financially independent today? Could you cut back on your spending in retirement if you had to? Why or why not? Comment below!