BUSINESS

Road to Retirement: Be aware of five big challenges to retiring early

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With the stock market and real estate values hitting record highs, some folks are thinking of early retirement. But retiring early comes with challenges. Consider that if a couple retires at 55, there are fairly good odds that one of them will need their retirement nest egg to last close to 40 years.

Here are five big challenges that come with an early retirement:

Health care. If you work for someone else, you may not know just how much your health care costs. But if you retire early, you'll need to obtain health care for you and your family until you are eligible for Medicare at age 65. For a couple in their mid-50s, a good health care policy can easily cost between $24,000 and $30,000 a year. Moreover, you should figure these costs will rise between 5% and 8% a year. The earlier you retire, the bigger this number is. Consider that if you retire at 55, 10 years of health care coverage at $25,000 a year and 5% inflation will cost over $300,000. Make sure you've got that squirreled away.

Photograph by Ellen Jaskol

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Real estate taxes. While it's nice that our houses are going up in value, your taxes will as well. In years past, Colorado was in better shape than other parts of the country, but our low tax structure is changing. Last year voters repealed the Gallagher amendment, and this has set the stage for higher residential real estate taxes.

In other parts of the country (the East Coast in particular), real estate taxes for a retiree are often more than the retiree's original mortgage. Colorado will look more like this in the years to come. If you retire at say 55, it's prudent to anticipate that real estate taxes will consume more of your living expenses as those taxes compound over a potential 40-year retirement cycle. Based on tax rates in other parts of the country, a rough estimate is 1% to 1.5% of the value of your home. Once retired, you'll dread getting those Zillow emails telling you how much your house is worth.

Inflation. If inflation runs at just 2% a year, over 40 years, you'll need 220% more money to maintain your standard of living. That means if you retire on $100,000 a year, eventually your income needs will climb to over $220,000.

With interest rates at all-time lows, to generate returns sufficient to support a doubling of your retirement income, you'll need to be more aggressive with your investments. Yet, many investors want to get more conservative when they retire, and "preserve what they have." If you retire early, it's unlikely that your money will last if you don't invest more aggressively. That means you'll need to get used to a large part of your lifestyle being driven by stock market returns; for better or worse. Gone are the days of buying some CDs and comfortably living off the interest payments.

4% rule. If you've done any research on retirement income, you've probably come across a figure called the 4% rule. What that rule generally says is that if you distribute 4% of your money each year, you are unlikely to run out of money in retirement. Most retirement planning programs use this distribution rate when calculating your potential retirement income. That means for every $100,000 in savings, you could plan to distribute $4,000 a year for living expenses.

That rate, however, is based on historical studies of 30-year market cycles. But if you retire at 55, you are looking at close to 40 years of retirement, or a 33% longer time horizon. The financial services industry doesn't have good data on the risks of living on your money for that long.

It is practically impossible to plan for a time horizon that stretches four decades. That means you should create a margin of safety around the 4% rule. If you retire early at age 60, you should plan on a distribution rate in the 3.5% zone. If you retire at 55, use 3%. More than that and you are rolling the dice on whether your money will last.

Unknowns. If you are trying to plan for 40 years, you should be prepared for risks you can't even think of today. Just consider the four-decade cycle from 1980 to 2020 and how much has changed in the financial markets. I can guarantee there was not one market forecaster in 1980 who even came close to predicting the range of things we've seen over the last 40 years.

If you are going to retire early, you'll need a big financial cushion to manage these unknown risks. To create that cushion, you'll want your living expenses as low as possible. That means no mortgage, no auto loans, no credit card debt or other sizeable, fixed obligations that you can't escape. This gives you a fighting chance to get through the multiple financial crises you'll likely experience that no one has thought of yet.

Retiring early is a great goal, but it comes with big financial risks and responsibilities. Don't venture into it unless you are fully prepared.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.

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