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RETIREMENT PLANNING

Hold Fire on retirement until you have the funds

If you plan to stop working in your 40s you will need a large sum of money to live off

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Many people hope to retire ahead of state pension age, maybe in their early 60s or even 50s. But advocates of the Financial Independence, Retire Early (Fire) movement try to retire even earlier, maybe in their 40s, and finance it via extreme saving and investing.

The Fire movement has been attributed to a book published in 1992 called *Your Money or Your Life* by Vicki Robin and Joe Dominguez. There are a number of US Fire proponents and UK advocates include Maynard Paton, who left nine-to-five work at age 43. He has written about how he did this on his blog at *maynard-paton.com/my-story-to-becoming-mortgage-free-and-retiring-early*.

US advocates include Tanja Hester, who writes about how she has stepped back from conventional work on her *Our Next Life* blog at *https://ournextlife.com/*.

Although the movement's name includes the term 'retire' many of its advocates work part-time – a much more realistic option if you are in your 40s.

"I know very few early retirees who earn $0 a year from work in one form or another," comments Ms Hester. "If you end up making a little side hustle money in retirement, that very well might provide the perfect buffer against higher-than-expected spending on the fun things that you enjoy. Just make sure you've done the math on how much you might realistically net from part-time work before you start planning on that income."

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Mr Paton says: "Working part time is a more realistic ambition. I write part-time – although this was not in my original plan. So if my dividends fall I've got this to fall back on."

However, getting to a strong enough financial position to retire or step back from work early is probably not possible for most people. Given average life expectancies, it could mean having to fund a retirement of 40 to 50 years, or longer. And it could mean living very frugally before that in order to build up the large amount of money you would need, and living a modest lifestyle when you stop full-time work.

It is very important to have a plan. "This should include details of when you want to stop working and how much income you are targeting to live off," says Michael Lapham, director of planning at accountants Mercer & Hole. "It should also include a cash-flow model with reasonable expectations. Ask yourself, where am I now? Where do I want to get to? How am I going to get there? Plan around how you plan to extract [income]. Budget and forecast. Look at your existing expenditure and consider how much you can afford to commit to saving. Also think about where you are putting these savings and how much they are likely to grow, not forgetting the impact of inflation."

How much will I need?

The 70 per cent rule states that most people will need 70 per cent of their working income to maintain their lifestyle in retirement. So, for example, if you retire on a salary of £50,000 you might want an income in retirement of around £35,000.

Sarah Coles, personal finance analyst at Hargreaves Lansdown, says if you want an income of £25,000 a year when you are no longer working you will need a pot of around £625,000, assuming a 4 per cent withdrawal rate. "If you assume you have 20 years to build this pot, and your investments grow at 5 per cent a year, you'd need to put aside over £1,500 a month," she says.

Kay Ingram, chartered financial planner at LEBC Group, says that a rough rule of thumb is that every £1,000 of annual income in retirement requires a fund of £50,000 to support it.

And Jon Greer, head of retirement policy at wealth manager Quilter, highlights the Pensions and Lifetime Savings Association's guide. This suggests a minimum of £15,000 per year for a couple to live a relatively frugal retirement, around £30,000 to provide more comfort and some recreational spend, and closer to £50,000 for a more lavish retirement.

"Getting a good handle on how much income will be needed in retirement is key to being able to achieve it," says Ms Ingram.

"This needs to be considered in terms of essential and discretionary spending. One way is to look at current outgoings – a budgeting app can be a good way to monitor this – and divide spending between essential and discretionary elements."

How to build up the necessary sum

A key consideration is how much you are willing to contribute to build up your desired sum. "The more you give up now, the faster you'll reach your retirement date," says Mr Greer. "It may feel like a big sacrifice, but getting as close as you can to [saving] 20 per cent of your salary is a good aim if you're serious about retiring early."

But for an extremely early retirement this rate might need to be more. Mr Paton says at one stage he was saving 30 per cent of his aggregate gross salary.

"The key thing is your expenses and if you can control them," says Mr Paton. "Having a mindset of keeping your costs down is very important. Start saving before you have kids because then you have to forget it – at least in the early years [of their lives]."

A problem with retiring in your 40s is that you cannot access your pensions until you are age 55 or 57 from 2028.

The state pension, meanwhile, does not start to pay out until age 66, and this rises to 67 in 2028. And if you retire in your 40s you may not qualify for the full state pension.

This means that you will need to build up funds in other accounts such as individual savings accounts (Isas) to bridge the gap. However, you do not get any tax relief on money that you put into them. If you use a Lifetime Isa, there are restrictions on access.

If you own buy-to-let properties these could be a source of income. Letting a room in your house to a lodger or downsizing your home to realise funds are also ways to raise money, as are proceeds from the sale of a business.

But pensions remain a very important way to build up savings to fund the later years of your retirement, especially if you are a higher earner. You earn tax relief on pension contributions at your marginal income tax rate, so 20, 40 or 45 per cent. And if you are in a workplace scheme it is likely that your employer will put in a contribution, boosting your pot further.

Most people can contribute up to £40,000 or the amount of their taxable income – whichever is lower – per year to a pension. And, in some cases, it is possible to use unused pension allowances from the previous three years.

If you use up your annual pensions and Isa allowances, you can apply other tax reliefs to unwrapped investments. You can receive dividends worth up to £2,000 a year tax-free.

'Build a cash cushion into your plan. Give yourself the flexibility [not to] have to sell shares when the markets are tanking'

You must also factor in a realistic growth rate. Financial professionals often assume average annual growth of 5 per cent a year over the long term on equity investments, but this does not take into account the costs of investment and tax.

Having an appropriate asset allocation and good diversification is important to ensure that you get a decent level of growth without taking the risk that the value of your assets will fall to nothing. Mr Paton invests directly in UK-listed shares, but points out that dividend cuts and reductions are a risk – as this year has demonstrated. Being diversified across different geographies within your equity allocation, and having assets other than equities, is a good way to mitigate this problem.

Debt

Clearing any debts before you step back from full-time work is a good idea. "Be mortgage-free then think about whether you can retire," says Mr Paton.

But Ms Ingram argues: "While interest rates remain low, there is little advantage in reducing mortgage debt, especially if this means that other savings are not made. If pension savings, which attract tax relief at a minimum of 20 per cent, are foregone to achieve this it would be a false economy."

Withdrawals

You need to consider what level of income you can sustainably take from your savings when you stop working. "Much of this depends on whether you will have other sources of guaranteed income in later years so that withdrawals from savings can be reduced [when they start to pay out]," says Ms Ingram.

The 4 per cent rule, devised by US financial adviser Bill Bengen in the 1990s, has been used to estimate how much someone in retirement can withdraw from their assets each year while maintaining a balance to generate income throughout retirement.

But Ms Ingram warns: "If the income is to be guaranteed for an average life expectation, then a 4 per cent withdrawal rate may be too high. Maybe no more than 2 per cent to 2.5 per cent should be considered, as the investment fund will also need to keep pace with inflation."

The order in which you draw from your various accounts is also very important. "With pensions, Isas and general investment accounts, it is usually the case that you fill them in that order [of priority] and withdraw from them in reverse," says Mr Lapham. "With a general investment account you could take out gains up to your capital gains tax exemption. You could take your pensions tax-free cash [when that is possible] and use your personal allowance for income tax [£12,500 for the 2020-21 tax year] to make [further] withdrawals from your pension if it has not been used up elsewhere."

Mr Paton suggests just drawing the natural income from your investments so that you do not deplete the capital value of your assets early on. He adds: "Leave room for margin of error at the start [of your retirement], for example, unexpected expenses or income fluctuating."

For this reason it is important to have a contingency plan. This should include a cash reserve in case, for example, your investment income falls or unexpected expenses occur. "I have three years of expenditure alongside [my investment] pot," says Mr Paton.

And Ms Hester advises: "Build a cash cushion into your plan. Give yourself the flexibility [not to] have to sell shares when the markets are tanking. Most retirement experts recommend having two to three years of expenses in cash when you retire. We started with slightly more than three years' [of expenses in] cash."

In your 40s you may have responsibilities to parents or children, which can be expensive and create unexpected expenses. "You're also likely to need to do some repairs and maintenance to your property over the next 40 years, which you will need to factor into your plans," adds Ms Coles.

If you change your mind or run out of money it could be difficult to get a new full-time job – or certainly with a salary at the same level as you used to have – especially if unemployment is high.