EARLY EXIT

ACADEMY

INVESTMENT PLANNER

Disclaimer: Dr. Brenda is not a financial planner or advisor and cannot provide individualized advice. The following information is a compilation of advice and recommendations from personal finance bloggers who are leaders in the financial independence and FIRE movements.

This investment planner is based on the following philosophy.

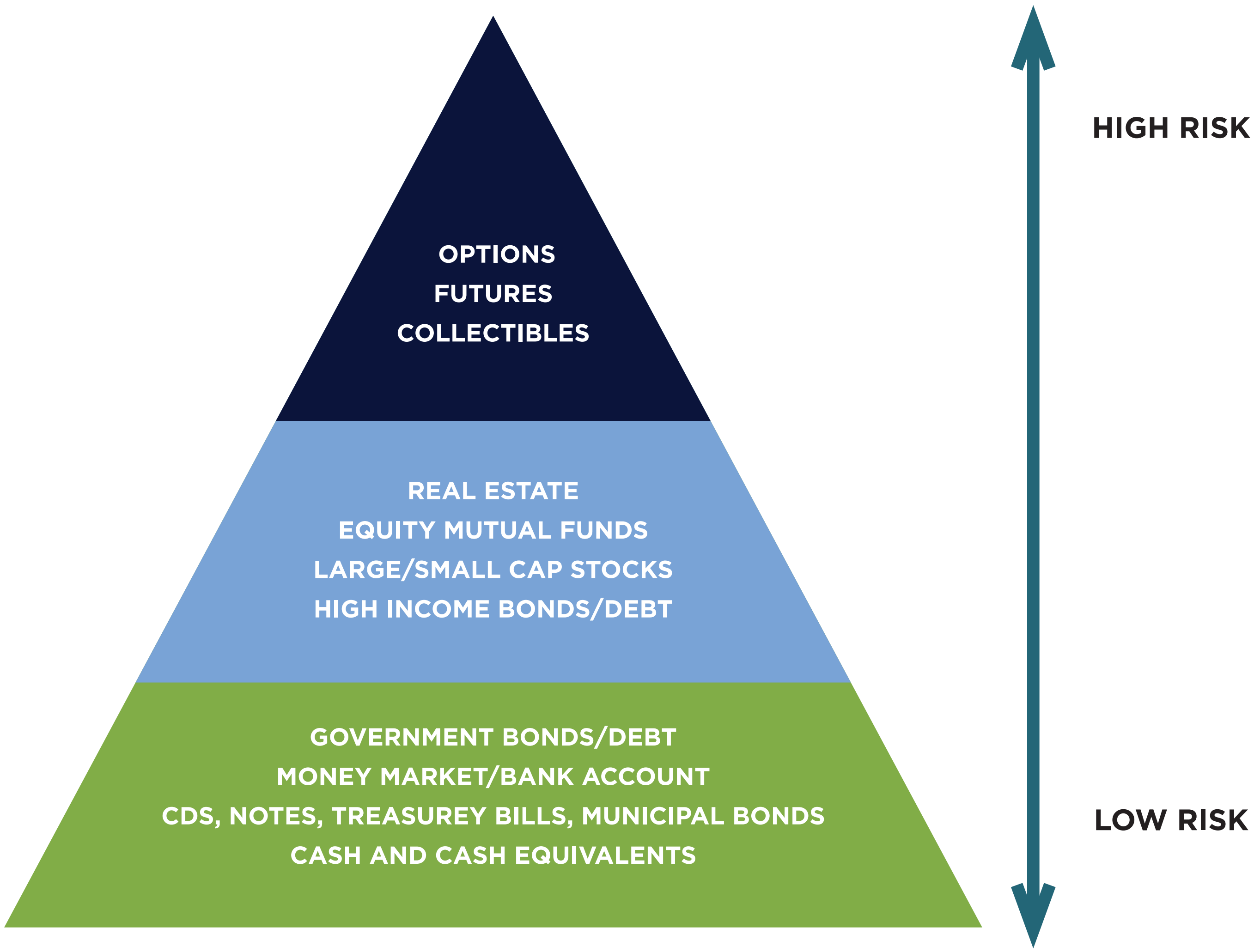
1. Keep it simple. Understand what you are investing in and keep your investments in a small number of funds.
2. Invest in low-fee index funds that track the market. Over time, index funds outperform funds that are managed by an "expert" and the lower fees result in higher profits.
3. Automate your contributions. Rebalance periodically to maintain a healthy balance of stocks, bonds, and real estate funds.
4. Do not take a loan from your retirement funds. It's not a bank.
5. If you want to purchase individual company stocks, understand that you may lose your entire investment. Limit such purchases to no more than 10% of your portfolio.
6. Keep your investing boring. Don't gamble your money on "get rich quick" schemes and "hot" tips.

THE PROBLEM WITH RISK

If you use the services of a professional financial advisor, quite likely you will be asked to take a risk assessment quiz. Score low and you'll be steered toward a more conservative portfolio. Score high and enter the high-risk game. But here's the problem – the assessments are notoriously inaccurate! Why? Because risk is a multi-dimensional concept that is highly influenced by your most recent experience. If the stock market just plummeted, you'll be more likely to score as being risk-averse – hey, you just lost money. If the stock market is booming, more people are likely to say they are open to aggressive investments. Essentially, your score has nothing to do with your behavior.

The investment pyramid below is a general guide on risk levels by the type of investment. If you put all your money in a savings account, inflation will eventually eat up the value of your investment. If you invest

in high risk things like stock futures and derivatives, you could lose your entire investment in one fell swoop. What's the answer? Diversify across assets and pay attention to your timeframe. And know your weaknesses. It's been well-documented that we feel the pain of losing money much more than we feel the joy of gaining money. If you have a tendency to freak out and pull funds out when the market hits a snag, then you'll need to halt that behavior or lessen your risk level. Each investor has different priorities and tendencies.



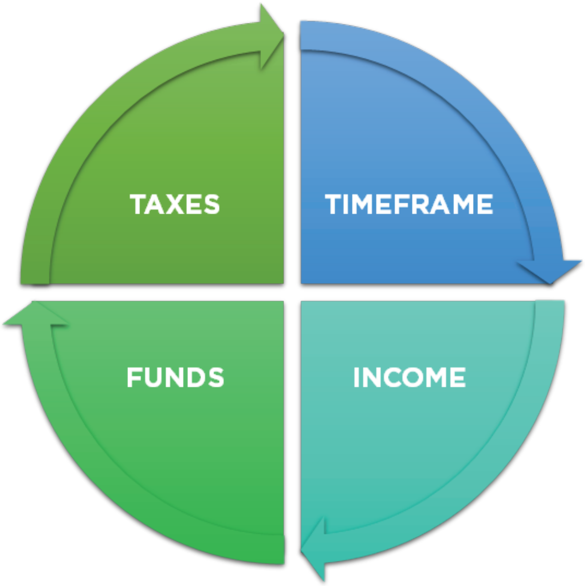
FACTORS TO CONSIDER FOR EARLY EXIT OVERACHIEVERS

Most people think of two phases to later life – full-time work followed by retirement. They don't plan for any lengthy absences from the workforce, even unplanned absences due to health or the loss of a job. Despite this two-phased approach, most Americans workers are terribly unprepared financially to retire in their 60s or even 70s. Too many senior citizens remain on the job because they don't have a choice.

But here you are in the Early Exit Academy. Not only are you planning on a fun-filled retirement, you're chasing the financial independence dream. And maybe you'd like to leave the workforce well before you hit Social Security age. So you need to create an investment plan that includes coverage of gap years – the years between full-time employment and the traditional retirement age.

Investing is a complicated topic with thousands of moving parts. It can be overwhelming. My goal is to keep this a simple as possible by focusing on four key questions:

1. What's your timeframe?
2. What do you plan to do for income during your gap years?
3. What is the tax status of the funds you plan to tap into to cover your expenses?
4. What is your preference in terms of investment funds?



WHAT'S YOUR TIMEFRAME?

Generally, investment strategies should be based on when you need the money. If you need money next week, you want to hold it in a safe place. If you need money 20 years from now, you want to invest in riskier but higher return funds. In terms of what is considered short-term to long-term, there isn't a whole lot of agreement, but the following guide works well for our purposes.

Instructions: Fill in the amount of money you think you will need for each timeframe. For example, if you think you will need to replace a vehicle in three years, add the extra expense into the one-time purchase cell for short-term timeframe.

Emergency Fund Up to 1 year	$	$	Savings, checking account, money market
Short-Term 1 to 3 years	$	$	CDs, bond funds, balanced index funds (some stock exposure)
Medium-Term 4 to 9 years	$	$	Bonds, balanced index funds, municipal bonds, REITs
Long-Term 10 or more years	$	$	Individual stocks, real estate, stock market index funds

Essentially, your decisions about where and how to invest depends on your comfort level with the stock market. And that comfort level can change over time. You may prefer to have three years of expenses stored in a boring savings account. Or maybe some of your long-term investments are held in riskier options, like commodities. Those decisions are personal and only you can decide. However, if you prefer to put the majority of your funds in low risk investments, understand that you will have to save up a whole lot more money to account for the low interest rates your money will earn.

WHAT WILL YOU DO FOR INCOME IN YOUR GAP YEARS?

Look at the timeframe you sketched out in the Early Exit Action Plan. Even though your timeframe is a draft, use it to answer the following questions:

How many more years do you plan to work full-time and accumulate money?

How many gap years do you expect between full-time work and retirement?

What will be your source of money during the gap years? Check all that apply.

- ☐ Investment income
- ☐ Part-time work
- ☐ Real estate
- ☐ Other side hustles

How much money, on average, will you need annually, during your gap years? $

Sketch out your game plan. Be as specific as you can. For instance, I will need $40,000 per year, on average, to cover living expenses during my gap year. Half ($20,000) will come from rental properties, $10,000 from a side hustle on coaching people on how to invest in real estate, and $10,000 will be drawn from investments.

My Plan:

TIP: Create a separate "basket" for one-time expenses. Most online banking accounts and some investment companies allow you to create and name multiple sub-accounts. For instance, you might have a sub-account called "New Car" and another for "Remodeling Projects." Then set up automatic deposits into the appropriate accounts until you reach your target goal.

Don't be afraid to be creative. Write down your ideal plan, even if it seems out of reach at the moment. For example, you may just be forming an idea for a side hustle and you have no idea whether it will be successful and how much income it will produce. This is YOUR document and you'll edit, revise, and delete as you figure things out. Don't be afraid to write down a plan!

WHAT IS THE TAX STATUS OF THE FUNDS YOU PLAN TO TAP INTO TO COVER YOUR EXPENSES?

Do you want a single phase of retirement or a two-phase retirement? What's the difference? In a single phase, you move from traditional work to living off of your retirement funds. In two phases, you move from working full-time to a transition/gap period in which you find other sources of income, and then you tap into your retirement funds when you are 60 or older. What's your preference?

○ Single phase – I'd like to tap into my retirement funds early.

◉ Two phases – I plan to use taxable funds and other sources of income to cover my gap years. I'll save my retirement funds for later in life.

One of the best investments you can make is in your retirement funds. The traditional employer-sponsored plan often comes with an employer match and a tax break on your contributions. And the Roth version – employer sponsored or Roth IRA – saves you from taxes when you withdraw funds. However, most plans include tax penalties if you withdraw funds early. For IRAs, the magic number is 59-1/2.

IRS Rule: A plan distribution before you turn 65 (or the plan's normal retirement age, if earlier) may result in an additional income tax of 10% of the amount of the withdrawal. IRA withdrawals are considered early before you reach age 59½, unless you qualify for another exception to the tax.

Most early retirees prefer to use taxable investments and other sources of income to pay for expenses during the gap years – a strategy that lets retirement funds continue to grow tax-free. But that means you'll have to save up a lot of money outside of your retirement funds and you'll need to consider how your investments will be taxed. If that doesn't appeal to you, there are two ways to withdraw your retirement funds without being penalized.

TIP: Most employer-based plans do not allow you to withdraw funds from your retirement account while you are still employed there. Depending on your fund choices, fees, and your selected withdrawal method, you should consider moving your retirement funds into a personal IRA after you leave your employer.

Strategy #1: Substantially Equal Periodic Payments (SEPP)
The IRS allows you to take annual payments out of your tax-advantaged funds at any age as long as you continue to take those annual payments until you turn 59-1/2 – a rule known as SEPP 72(t). They provide three ways in which you can calculate the amount of payments you can withdraw, each based on your life expectancy.

For example, let's say you begin taking SEPP payments at age 50. The IRS predicts you will live to 85, so you'll need those funds to last for 35 years. Therefore, you'll withdraw 1/35th of your fund per year (or 2.9% each year). This approach is the Required Minimum Distribution method. The two other approaches—amortization method and annuitization computation method—are far more complex. If you are planning on taking SEPPs, this is one case where it will be helpful to discuss the pros and cons of each method with a tax attorney.

The SEPP rule can be applied to some or all of your accounts. For instance, you can apply it to just the amount held in your 401(k) or 403(b), leaving the amount in your personal IRA untouched. However, there are some downsides to the SEPP approach:

1. You can't discontinue payments or alter the amount of the payments once you begin taking distributions. You will be locked in to the amount.
2. You cannot change the computation method for at least five years, and only then if you have reached the age of 59-1/2. The IRS allows you to change the computation just once.
3. If you change anything, the 10% early distribution penalty will be applied retroactively to every year of payments you've already received.

Strategy #2: Roth Conversion Ladder
The IRS treats Roth IRAs differently because you paid taxes when you contributed to your Roth fund. Since the taxes are already paid, there isn't a 10% penalty and you won't be taxed for withdrawing funds before you turn 59-1/2. BUT this is only true for the contributions you made (not the earnings). For example, if you contribute $20,000 to an IRA and it's now worth $30,000, you can withdraw the $20,000 without penalty. You'll have to leave the remaining $10,000 of earnings in your account.

Most early retirees contribute most of their assets into a traditional employer-sponsored plan or personal IRA to get the upfront tax break. But there's a way to convert your traditional retirement funds into a Roth, which will allow you to access funds early without penalty. It's called a Roth conversion ladder and it looks something like this.

CONTRIBUTIONS	WITHDRAWS
Year 1 Roth Conversion	No Roth Withdrawal
Year 2 Roth Conversion	No Roth Withdrawal
Year 3 Roth Conversion	No Roth Withdrawal
Year 4 Roth Conversion	No Roth Withdrawal
Year 5 Roth Conversion	No Roth Withdrawal
Year 6 Roth Conversion	Year 1 Roth Conversion Available
Year 7 Roth Conversion	Year 2 Roth Conversion Available

In a Roth conversion ladder, you convert funds from a pretax retirement account, like a 401(k) or an IRA to a Roth IRA, and then pay the income tax you owe on the amount you converted in that tax year. As long as you don't use any part of the converted amount to pay the income tax you owe for the conversion, you won't have to pay a 10% penalty IF the funds you withdraw have been in your Roth account for at least 5 years. This method requires a fair amount of planning as you want to make sure that you don't convert so much into a Roth that it pushes you into a higher tax bracket.

The Roth conversion ladder offers considerable flexibility once you hit the five-year mark. If things are going well and you don't need to withdraw from your Roth funds, you don't. You can convert any amount at any time. If your side hustle income picks up and you feel good about covering the gap years with that income, you can skip or stop your Roth conversions altogether.

The Roth has another big advantage over the traditional IRA – you do not have to take required minimum distributions. In a traditional account, you are required to take required minimum distributions (RMDs) when you turn 70-1/2. So Roth funds are great for even longer-term investing.

My Approach: My preference is to leave my retirement funds untouched for as long as possible. I treat my retirement account as two separate funds – the traditional IRA, which I will tap into to cover the early part of my retirement (about ages 60 to 71) and my Roth RIA, which is for my later years of retirement (70s and beyond). This approach lets my Roth funds grow an extra decade while ensuring tax-free withdrawals.

WHAT IS YOUR PREFERENCE IN TERMS OF INVESTMENT FUNDS?

Now you have a good understanding of your timeframe, your income during the gap years, and whether you'll tap into your retirement account. But what about actual investments? While I can't steer you to particular investments, I can share the primary investing strategies for those who reached financial independence and left the workforce early.

Here are a couple of questions to get you to think about your investments.

1. Do you plan to use the services of a professional financial planner?

   ◉ Yes ○ No ○ Not sure

2. Do you pay attention to the fees associated with your funds?

   ◉ Yes ○ No ○ Not sure

3. Do you ever make investments in things you don't understand?

   ○ Yes ◉ No

CREATING A BASIC PORTFOLIO

Most financial professionals insist that you need their services to build wealth. But here's the typical investment philosophy of early retirees:

Invest in low-fee index funds and do it yourself.

That's it! They keep their investments simple and manage it themselves. And they don't invest in high-risk things that they don't understand. It's really quite basic.

Your biggest investment over time is likely to be your employer-sponsored retirement investment. If you have haven't carefully looked at your current investments, this is the time to do it. Do one thing – look at fees. The amount you are paying in fees can have a tremendous impact on the bottom line (see this article). Funds that are actively managed have higher fees, while index funds that automatically track the market tend to have low fees. While an actively managed fund might beat out an index fund in a given year, over the long term, they underperform the market. Not only will you pay more in fees for an actively managed fund, you'll have lower returns over time.

Let's make this extra simple. You can make all your investments using a handful of different funds.

- Emergency and short-term funds: Go to Bankrate.com and find rates for savings accounts, money markets, and CDs.
- All other funds: Invest in index funds. The two most popular companies used by early retirees are Vanguard and Fidelity. Also, if you'd like to purchase individual stock funds, you can do that within Vanguard and Fidelity investor accounts.

SAMPLE VANGUARD PORTFOLIO	
Short-term assets (taxable & low risk)	Prime money market, Long-term Treasury index
Medium-term assets (taxable & moderate risk)	Tax-exempt bond index, Tax-managed balanced fund, Real Estate Index Fund
Long-term assets (retirement & high risk)	500 index, Mid-cap growth index, Small-cap index, Developed markets index, Real Estate index fund

Notes:

- For funds in taxable accounts, you can also invest in Exchange-Traded Funds/ETFs, which act like index funds but can be traded any time the stock market is open.

- In 2018, Real Estate Investment Trusts (REITs) received some tax breaks that make them suitable for taxable accounts.

HOW TO CONQUER TAXES IN YOUR TAXABLE ACCOUNTS

One way to assess a fund's exposure to taxes is to look at something called the Tax Cost Ratio, which measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Typically, the tax cost ratio varies from a low of 0% to a high of 5% - the lower the better. For example, if a fund had a 2% tax cost ratio for a three-year period, it means that on average each year, investors in that fund lost 2% of their assets to taxes. Increasingly, people are turning to computer-assisted investing tools (robo-advisors) to manage their taxable accounts.

> A robo-advisor is an online, automated portfolio management service. Because these companies use computer algorithms, they offer much lower fees than managed funds. Lower costs, combined with automatic portfolio rebalancing and tax-loss harvesting, can translate into higher net returns for investors.

Robo-advisors often produce better results by cutting down on fees and selling funds based on their minimal impact on taxes. Some of the more popular robo-advisors include:

- Betterment (my referral link)
- Wealthfront
- Ellevest

See this review of the top Robo-Advisor companies.

NOTES ON HIRING A FINANCIAL ADVISOR

If you feel totally overwhelmed or you have a complicated set of circumstances, like an inheritance, you might consider hiring a financial advisor. If you decide to go that route, be prepared. Many financial advisors still base their calculations of how much money you need in retirement on your income. As you learned, that's an erroneous assumption that doesn't work with the FI community who have large gaps between income and expenses. Worse, advisors may try to steer you toward funds that give them a hefty commission. Here are some tips to consider:

- Seek someone with the professional credential of a Certified Financial Planner (CFP)
- Use fee-only financial planners – they won't be influenced by commissions
- Check out advisors' compliance records at FINRA.org
- Interview financial planners before making your choice (ask these questions).

My Approach: All of my retirement investments are held in Vanguard funds. My traditional IRA is held in more conservative index funds, while my Roth IRA is comprised of stock index funds and some individual stocks. I have some short-term and medium-term funds in Betterment and a DRiP (dividend reinvestment plan) stock fund managed by Computershare.

BONUS: STRATEGIES TO MANAGE LONG-TERM RISK

There is very little written on risk management. Sure, we are told not to pull out when the market drops and that 10% "corrections" are not unusual. The conventional advice is to ride out the storm and wait (hope) for the recovery. Or to go easy on the risk level and contribute a whole lot more to make up for the lower returns. I've ridden out several stock market tumbles and a recession. But I could make up for lost time when I was young. Now I'm older and have to play defense with my portfolio. My timeframe is a lot shorter. The example below is my personal method for managing risk in my retirement portfolio. It sets a brake on losses, based on my comfort level and read on the economy.

Here's how I manage risk in my retirement portfolio:
From January 2008 to January 2009, my retirement account declined by a frightening 35%. In one year, over $85,000 evaporated. I continued to invest and a year later, I was back to my pre-recession level. But it's an experience that I cannot afford to repeat - especially as I crawl toward that retirement line. So how do I continue investing somewhat aggressively while protecting my assets? I set a brake.

I love spreadsheets. Every Friday I update my spreadsheet with the latest value of my retirement account. After the 2008-2009 recession, I added some calcuations to my spreadsheet. Here's an example of how it works.

- When my retirement account hits a new high balance, I record the dollar amount and the date. In this example, we use a high balance of $800,579 reached on April 22, 2019.
- I use a formula to automatically calculate the value of a 10% and 5% loss. In this example, a 10% loss will bring my account down to $720,521; a loss of $80,058.
- My current balance is then recorded. Let's say my retirement account as of today is $787,398. While that's a $13,181 decline, it's not even close to the 5% mark.
- If my balance begins to approach the 10% loss mark, I look at the larger economy for signs of a long-term decline or recession and I consider how I will feel if the value of my portfolio declines more than 10%. If I'm uncomfortable, I will trade the stocks for something safer, like US Treasury bills or a bond fund.
- Should I decide to sell stocks and move funds into conservative investments, I record the value of the S&P 500 (SNP), which is a good indicator of the stock market and a number that can be easily found online. Why record the S&P 500 on the day I sell? I then have a set point that will help me detect where the economy stands in relation to my selling point.
    - The S&P 500 set point gives me a gauge that I use to help me decide if I should purchase stocks "on sale" if the market further plummets.

When the S&P 500 returns to the set point, it signals a rebound and I may feel more comfortable increasing my stock investments.	*Date of High Balance: April 22, 2019*	
		Dollar Difference
Highest Balance	$800,579	-$13,181
Current Balance	$787,398	-$80,058
10% loss	$720,521	-$40,029
5% loss	$760,550	
S&P 500 at point sold:		

Have I used this approach yet? No. I've moved to a more conservative portfolio, and fortunately, have not experienced any major declines. However, this table allows me to quickly "eyeball" where things stand and it helps me assess my comfort level. Would I be okay with a 10% drop? I'm not sure. I know that I would definitely be researching additional signs that the economy may be headed into a recession or lengthy downturn.

The method isn't bulletproof. But it gives me peace of mind that I can take steps to prevent a catastrophic loss of my biggest asset – my retirement funds.