The Economics Approach to Financial Planning
*a Five-Part Presentation to Dimensional Fund Advisors*

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Outline of Talks

1. Consumption Smoothing
2. MaxiFi Planner – Illustrating the Economics Approach
3. Pricing Lifestyle Decisions – An Example: When Can I Retire?
4. Secrets to Maximizing Lifetime Social Security Benefits
5. Finding Alpha – Raising Households' Living Standards at No Risk
Finding Alpha

- Alpha references a higher sure component to your investment return
- In efficient financial markets, Alpha is zero, i.e., "You can't beat the market."
- However, there are entirely safe ways to raise your living standard
- Economics-based planning, with its living standard focus, can find these ways
Finding Alpha - Examples

1. Don’t borrow for college
2. Find a higher paying career/job
3. Optimize retirement account contributions (Roth versus non-Roth)
4. Collect the employer 401(k) match
5. Marry or otherwise share housing
6. Own rather than rent and garner the home-ownership tax break
7. Invest in paying off high interest debts
8. Marry for money, divorce only if it pays, and divorce like an economist
Finding Alpha - More Examples

9. Delay retirement
10. Optimize retirement account withdrawals, e.g., Roth conversion
11. Move within state for cheaper housing
12. Relocate states to lower taxes
13. Maximize lifetime Social Security benefits
14. Downsize your home
15. Free trapped home equity
16. Annuitize some of your assets
Using MaxiFi to Find Alpha

Two examples:

1. A retirement makeover for an early retiree who saved far too little

2. An 18-year-old decides whether to become a doctor or a plumber
Example 1: A Retirement Makeover
John Adams is 62, Retired, Single, North Carolinian, With

1. $200K in his checking account

2. $500K in his traditional IRA, which he'll begin tapping at 72

3. $2,500 in monthly Social Security benefits, which he just started

4. A $700K house with a 4% 200K, 10-year mortgage and $15K in annual expenses
John's Lifetime Discretionary Spending: $661,875

### Lifetime Balance Sheet

<table>
<thead>
<tr>
<th>Lifetime Income</th>
<th>Lifetime Spending</th>
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</thead>
<tbody>
<tr>
<td>Labor Earnings</td>
<td>Housing Expenses</td>
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<tr>
<td>Social Security Benefits</td>
<td>Other Expenses</td>
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<tr>
<td>Pensions and Annuities</td>
<td>Federal and State Taxes</td>
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<td>Retirement Account</td>
<td>Retirement Account</td>
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<tr>
<td>Withdrawals</td>
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<td>529 Account Withdrawals</td>
<td>529 Contributions and</td>
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<td>Reserve Fund Assets</td>
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<td>Special Receipts</td>
<td>Life Insurance Premiums</td>
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<tr>
<td>Regular Assets</td>
<td>Discretionary Spending</td>
</tr>
<tr>
<td></td>
<td>TOTAL</td>
</tr>
</tbody>
</table>

TOTAL: $1,744,152
John's Annual Discretionary Spending Is... Low

Annual Income and Spending

Total Income  Fixed Spending  Discretionary Spending

Chart View  Table View

2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034 2035 2036 2037 2038 2039 2040 2041 2042 2043 2044 2045 2046 2047 2048 2049 2050 2051 2052 2053 2054 2055 2056 2057 2058 2059 2060
John Has Two Big Problems

● First, he's broke. His annual discretionary spending starts at $5,091.

● Second, he's severely cash constrained. His annual discretionary spending rises to $18,679 at 72 when
  ○ He begins his IRA withdrawals
  ○ His mortgage ends.
Let's Have John Take His IRA Starting Now

- Raises John's lifetime discretionary spending by $31,203
- Eliminates cash constraint
Next, Let's Have John Move to Texas

- This raises John's lifetime discretionary spending by $2,907
Next, We'll Have John Downsize His House by Half, but Keep His $200K Mortgage

- This raises John's lifetime discretionary spending by $593,748.
- John's annual discretionary spending leaps from $16,234 to $30,083!
Next, Let's Have John Pay Off His Mortgage

- This raises John's lifetime discretionary spending by $27,272.
- John's annual discretionary spending rises from $30,083 to $30,719.
Now, Have John Start Social Security at 70

- This raises John's lifetime discretionary spending by $425,618.
- John's annual discretionary spending rises from $30,719 to $39,138 before age 70 and $40,001 after age 70!
If John Annuitizes His IRA Withdrawals...

- His lifetime discretionary spending rises by $88,638.
- John's annual discretionary spending rises from $30,719 to $39,138 before age 70 and $42,715 after age 70!
Six Moves Yield a Lot of Alpha!

The moves:
- Begin IRA withdrawals at 62
- Move to Texas
- Downsize by half
- Pay off his mortgage
- Begin Social Security at 70
- Annuitize IRA withdrawals

The gains:
- John's lifetime discretionary spending rises from $661,875 to $1,831,261 – a factor of 2.76
- John's annual discretionary spending rises
  - From $5,091 to $39,138 before age 70 (7.7x)
  - From $18,679 to $39,138 after age 70 (2.1x)
Any Other Magic Tricks for Safely Raising John's Living Standard?

- John can marry/partner and enjoy the marvelous economies of shared living.
- If John marries/partners his financial clone, his living standard will rise by over 40 percent given that two can live more cheaply than one.
Example 2: Doctor or Plumber?
If California Jane Becomes a Doctor...

1. Four years of college at $50K real tuition per year
2. Four years of medical school at $70K real tuition per year
3. Three years as an intern/resident earning $62K real per year
4. Earns $195K real from 29 to retirement 62 as a PCP
5. Repays $64K nominal in student loans for 25 years starting at age 26
If California Jane Becomes a Plumber...

- Salary rises from $50K real at 18 to $100K real at 28
- Earns $150K real from 29 to retirement at 62 as a Master Plumber
Which Career Offers Higher Lifetime Spending?

Jane’s lifetime discretionary spending is $105,407 higher as a...

PLUMBER!
Plumbing Supports $105,407 Higher Lifetime Spending

Lower Lifetime Resources:

- Lifetime labor earnings decrease by $926,820.
- Special receipts decrease by $780,000.

Much Lower Lifetime Costs:

- Tuition and loan repayments decrease by $1,549,266.
- Federal and state taxes decrease by $434,886.
- Medicare Part B premiums decrease by $1,250.
Which Career Offers Higher Lifetime Welfare?

- Jane is severely cash constrained prior to becoming a PCP
Alpha – Safe Ways to Raise Your Living Standard – Available Everywhere You Look!

- Choosing your career
- Changing jobs
- Shopping for housing
- Shopping for mortgages
- Contributing to retirement accounts
- Deciding when to retire
- Taking Social Security
- Optimizing retirement account withdrawals
- Prepaying high interest loans
- And on and on!
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