

What's Your Number?



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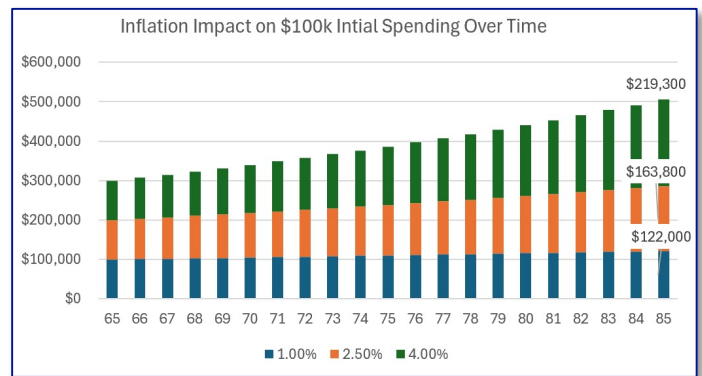
“What’s your number?” is THE retirement planning question that nearly everyone thinks about at some point – The “number” being the portfolio size someone needs to retire comfortably. Is it one million? Two? Five? Ten? Twenty? Of course, that’s a highly personal calculation and nothing about retirement planning can be simplified down to a single number. It’s also important to realize that “your number” depends on several other numbers, including:

- **How much will you be spending** when you first retire?
- How much is **your spending going to increase** during retirement? In other words, for forecasting purposes, what “inflation” rate should you assume?
- How much risk will you take and what level of **investment returns do you expect** to achieve?
- What **other sources of income** – pension, social security, rental income, etc. – do you have to support your spending in retirement?
- And, **how long do you expect to live?**

With a 20+ year retirement, tweaking any of these numbers in a financial planning software’s assumptions will yield vastly different results. Even small changes in assumptions compound to big numbers over time. It’s all so unpredictable, yet the process is critical for seeing a range of outcomes and judging probabilities of success.

Of all these inputs, the strongest burden on the retiree is to identify an accurate figure for the first – *What’s your budget?* That’s why whenever someone asks us...” *How much do I need for retirement?*”, our very prompt response is...*First tell me how much you’re going to be spending.*

While important, your starting retirement budget is just that, a starting point. Your assumption about how your spending is going to grow throughout your retirement is also very important. Let’s see how small differences in that assumption compound over time. This chart shows how \$100,000 spending at age 65 increases under three different inflation assumptions – 1.0%, 2.5% and 4.0%.



By age 85, the difference in annual spending varies from \$122,000 (1.0% inflation rate) to \$219,300 (4.5% inflation rate), while a 2.5% inflation rate boosts spending to almost \$164,000 – Obviously, **your spending growth rate matters a lot!** It’s no wonder that in a recent survey by Allianz, “inflation” was the primary reason that 64% of respondents cited “running out of money” as their greatest fear - more than dying!

We have some good news. While inflation is likely a meaningful risk for the unfortunately large number of Americans with meager savings and those who rely on Social Security for more than half their retirement income, most readers are likely more prepared for retirement than the average American and for those who are, **concerns about inflation in retirement are likely at least somewhat overblown.** What? Did you read that correctly? Yes. We are not saying you do not have to worry about inflation at all in retirement. But to us, there are three parts of this

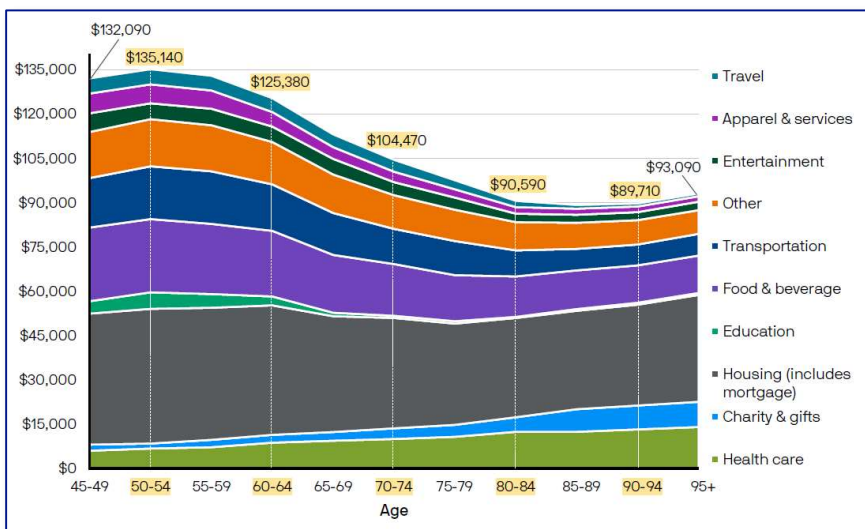
puzzle that fuel our optimism about the intersection of inflation and retirement planning:

1. Your **retirement spending is unlikely to increase at the rate of inflation that you assume.**
2. There are several financial planning and wealth management tactics that can mitigate this risk.
3. There are effective **investment tactics that we can employ to address inflation** risk in portfolios.

Let's tackle these one at a time, starting with spending inflation. First, in real life, spending in retirement may not be consistent with most planning projections. Think in terms of "phases of retirement" – When you first retire, many spend a lot of money on checking things off their bucket list. Traveling. Eating out. Going to concerts, sporting events, joining new clubs. Whatever you want! But at some point, maybe 10-15 years into retirement, either your list or your energy will shorten. Then, many transition to a slower (but still fulfilling) period of retirement - one that simply **costs less money** to live.

Yet, most retirement plans assume a constant, never declining and forever increasing level of retirement spending. If you're wondering if there are any real studies or evidence on this subject...well, yes there are. One of the country's major banks (Chase) peered into the banking and credit card activity of their tens of millions of customers to see what spending patterns they would find. This graph illustrates spending by category and age group for households with investable wealth between \$1-3 million:

This enlightening chart shows important patterns:



- Throughout our lives, spending follows a trajectory in the shape of a park slide – rising into middle age, peaking between 50-54 years of age, and then consistently declining until our early 80's, before increasingly slightly for those who live into their 90's.
- As we age, spending falls across all categories except for health care and charity. Not surprising.

This chart is a snapshot, not a forecast, and does not reflect inflation. So, it means that, at any point in time, folks in their 80's spend less than folks in their 70's, who spend less than those in their 60's, who spend less than folks in their 50's. From the perspective of retirement planning and inflation, it does not mean that your spending is likely to go down over time (although it might), rather it's more likely that it won't go up as much as expected and may even stay relatively flat over time.

So, the good news is that, IF you have correctly identified your starting point for a retirement spending budget, and if your retirement plan assumes that spending grows at a rate anywhere near inflation, then your plan may be stronger than you think. But if you want to consider other financial planning and wealth management tactics to further help mitigate inflation risk, we can think of several:

1. **Maximize Social Security** – Since Social Security benefits are subject to annual inflation increases, and are guaranteed for life, maximizing your Social Security benefits can be useful toward defending your retirement plan against inflation.
2. **Buy don't Rent/Lease** – While maintaining a home will certainly expose homeowners to maintenance and repair inflation, at least you won't be subject to supply/demand driven inflation in your housing market. Extend this concept to more than just your house. Leasing a new car every 36-48 months may have been fun in your 30's or 40's, but it's a different calculus in your 60's and later.
3. **Pre-Pay Big Ticket Items** – If there's one thing the last few years have taught us all, it's that big-ticket expenses can skyrocket in price, seemingly out of nowhere thanks to a supply/demand shock. Maybe it's a new roof or new driveway for your home. Or if you're thinking big, a 2nd house on the lake or at the beach? Or that private golf club membership. Maybe it's a sports car. It could be either a

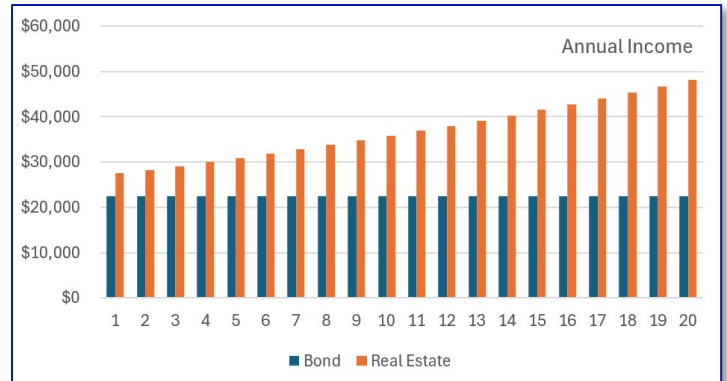
necessity or a luxury. If there's something you "know" you'll want or need in retirement, if your financial plan supports it, and if it's reasonably priced today, consider making the investment now and not waiting – the price may go up a lot if you do.

4. **Save for HealthCare** – For those who can, funding a tax-advantaged Healthcare Savings Account (HSA) and letting it grow for a couple of decades could help cushion against a spike in healthcare costs later in life.
5. **Use Debt Wisely** – Most people want to be debt free in retirement. But often that preference is more emotional than a numbers-based decision. Inflation-concerned retirees should be open minded about the use of debt. For example, if you were smart or lucky enough to lock in a low-rate mortgage (under 4.0%), then you should consider keeping it instead of rushing to pay it off. After all, inflation means that money in the future will be "worth less" than today, so you may want to pay the bank in cheaper future dollars.

Turning to the investment side, we think it's important to understand that preserving wealth and defending against inflation in retirement is a much different assignment than accumulating and building wealth while working. As portfolio designers, we're fond of the following investment categories for retirees:

1. **Dividend Growers** – We like companies that grow their dividends regularly over time - a feature of a healthy and shareholder friendly company. Growing dividends can help grow income during inflationary periods.
2. **Floating Rate Debt** – Not all "bonds" or fixed income investments are created equal. In an inflationary and rising interest rate cycle, fixed rate bonds (like most U.S. Treasuries and Corporate Bonds) do not adjust their yields higher. Instead, their prices get adjusted lower by the market. The yield on Floating Rate debt, like an Adjustable-Rate Mortgage, will adjust higher. Private Credit, with its robust yields and its low volatility, is an attractive vehicle in this category. There are liquid options available as well.
3. **Real Estate** – While real estate valuations can certainly be hurt by the rising interest rates that can come with inflation, real estate business fundamentals often allow them to recover and thrive over time because real estate income (rent) often grows strongly in an inflationary environment. Consider this simple hypothetical illustration of the income on a \$500,000

investment in a bond yielding 4.5% (and generating \$22,500 of income each year for 20 years) compared to the income from the same sized investment in Real Estate yielding 5.5% - but with the Real Estate income also growing 3.0% each year.



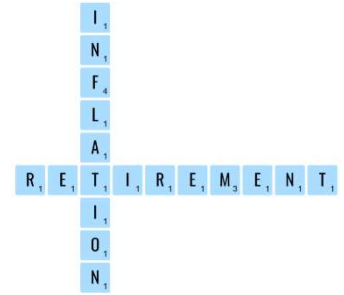
In this hypothetical, the Real Estate would yield \$27,500 in the first year, \$35,800/yr after ten years and \$48,100/yr after 20 years. After 20 years, the sum of the income in the bond would be \$450,000. The real estate's income total would be \$737,400. Of course, there's a big difference in risk and liquidity between buying a high-quality bond and investing in Real Estate. And we're not suggesting investors invest in and manage real estate properties themselves (Do you really want to be a landlord, or have a very concentrated real estate portfolio in retirement?) However, the right sized investment in a professionally managed and well diversified real estate strategy could be an important source of inflation-beating income in retirement.

4. **Diversifying Alternative Strategies** – This is simple. Inflation shocks are usually hostile to BOTH stocks and bonds. For those who forgot about the 1970's, the most recent inflation spike in 2022 served as a good reminder as both stocks and bonds dropped over 14% in 2022. Alternative strategies, by definition, seek to provide returns that are not correlated or dependent on the direction of core stock and bond markets. We think it's entirely reasonable and prudent to allocate 10-15% of a portfolio to this category.
5. **Non-U.S. Investments** – A weakening currency is a potential source of inflation. Holding all your assets in U.S. Dollars may seem like a sound strategy, but it's a risk. Would many other countries' citizens confidently maintain their entire portfolio in their home currency? There are many great companies around the world and having exposure to non-U.S. stocks may open up important growth opportunities while simultaneously diversifying currency risk.

This is not an exhaustive list. There are other tools in the toolkit, including Infrastructure Stocks, Commodities, and TIPS. But we think the investments listed above are the “easiest to own” through different cycles and offer the most reliable risk/reward profile for investors.

We also **caution investors against holding too much cash**. Yes, we advocate keeping some “money in the bank” and today’s yields are attractive compared to the near-zero yields of not that long ago. But “cash” as an investment rarely keeps pace with inflation for more than just a few years and thus, should not be a big part of anyone’s long-term investment portfolio.

As we grow older, it’s not uncommon to say, “**age is just a number.**” So is the spending inflation number embedded in your retirement plan. Like the other inputs in your retirement plan, they are all important numbers. Yet they’re all just educated guesses that are likely to be at least a little wrong in the long run. But it’s not a futile exercise - working with a qualified financial professional to build a robust plan, understanding the likely slow-growing arc of your retirement spending, making good financial planning and spending decisions, and properly allocating to the right mix of investment vehicles, can all help mitigate inflation risk and make sure your numbers add up. And if they do, when your birthday numbers start with a “7”, “8” or even a “9”, you won’t be concerned about inflation, you’ll just be worried about making sure you blow out all the candles on the first try.



P.S. – We wrote about this subject at the request of a friend. If there’s a topic that you’d like us to address, feel free to ask. We can’t make any promises, but we’ll sincerely consider writing about it.

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