Real-World Example
Early Retiree Reality's Story

This article is by Early Retiree Reality and discuss his real-life example of early retirement.

Little did I know when I wrote my first ever article for Seeking Alpha – How I Retired At 45 – that it would generate so much discussion. As of this writing, it has 1,253 comments…

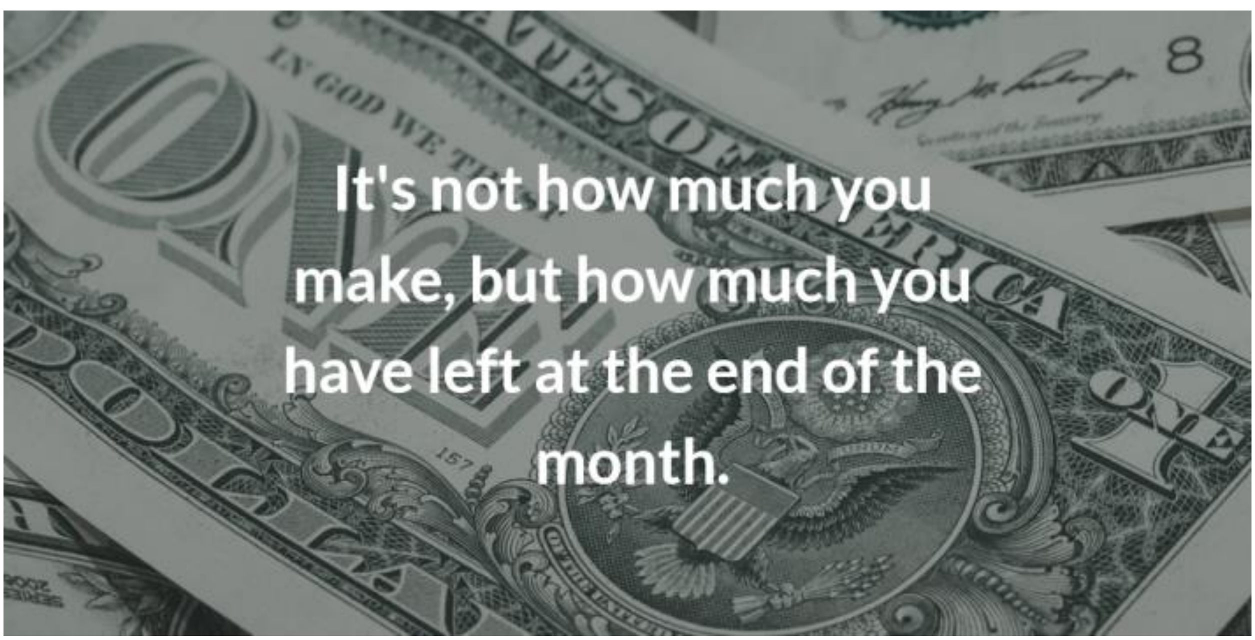
One thing is clear based on the comments: *each person has his or her own idea about how much money is needed for retirement.*

I'm not a financial planner, so I can't give you retirement planning advice. However, what I can do is show you, *by example*, why you might need less than you think to retire early, if that's your goal.

The idea is not tell you step by step what to do, but rather show you the principles that are applicable to everyone. Extreme measures are not involved.

Early retirement shouldn't be all that difficult if you have a decent middle class household income. The first and most important principle is this:

It's not how much you make, but how much you have left at the end of the month.



This simple concept escapes some people for some reason.

A seemingly well-to-do couple who lives in a nice big house and buys a luxury car every few years may very well be ill prepared for retirement. After paying the mortgage, car loans, daycare, credit card bills, and private school tuition, they may be left with little to no savings at the end of each month.

It not only affects every day middle class working folks, but “rich” people as well. A Sports Illustrated article reported that *78% of NFL players are in financial dire straits within just two years of leaving the game, and 60% of NBA players face the same result within five years*. Some of these athletes made tens of millions of dollars during their professional careers. It’s a safe bet to say the top reason is bad spending habits.

Wants Versus Needs

To prepare for early retirement, it’s therefore imperative that you live below your means. That means having a lifestyle that costs significantly less than your disposable income. The sooner you start, the better off you’ll be.

Each person has his or her own idea of happiness. Some can’t do without the material things in life, but some can.

The key is figure out yours.

If you have expensive tastes, it doesn’t mean you can’t retire early. It just means you have to have a bigger income and/or retire later in life. There are “needs” and then there are “wants”; don’t get them mixed up.

“Needs” include food and shelter, but “wants” are things like eating out in expensive restaurants multiple times a week, and living in a McMansion. Therefore cutting your “wants” to as low a level as possible and still feeling happy is the best way to save for early retirement.

Source: [Obama Pacman]

See the people above lining up outside an Apple store to shell out $800 for the latest iPhone? Most of them “want” one, not “need” one.

My Personal Story

I’ve never had expensive tastes even when I was single and making a pretty good salary as a software engineer. My wife, who is a stay-at-home mom, is an even more careful with money than me. That’s the reason my family of four can live on around $20,000 per year, not including unexpected expenses such as medical care.

By the way, this is possible because we live in a lower cost state (Texas), and not in an expensive one such as California, New York, or Massachusetts.

Some might think we live in a crummy house and eat nothing but ramen noodles with that budget. We don’t. Our 2,200 sq. ft. house is new construction, and situated in the best school district in the metro area. We don’t shop at Whole Foods, but we eat well. Everyone in our family has their own iPad and laptop. It’s just that we don’t have a mortgage or car payment (both are paid for), daycare expenses, and other spending we find frivolous.

For some, it might help to draw up a monthly budget and track all expenses. I certainly don’t go that far. I do keep a spreadsheet to estimate our living expenses, but have never kept track of expenses. To me, it’s bothersome since we don’t have a problem with overspending.

What does our budget look like?

MONTHLY BUDGET

INCOME	PER MONTH	PER YEAR
Estimated dividends	$2,083	$25,000
IRA 72(t) distribution	$0	$0
Capital gains (LT+ST)	$1,917	$23,000
IRA to Roth conversion	$167	$2,000
NET / month	$4,167	$50,000

Housing (Monthly)

Property tax	$400.00
Homeowners Insurance	$88.40
Flood Insurance	$0.00
HOA	$50.00
NET	$538.40

EXPENSES per MONTH	
Housing	$538
Utilities	$171
Transportation	$108
Living expenses	$860
State income tax	$0
Federal income tax	$0
NET / month	$1,678

Utilities (Monthly)

Electricity	$26.67
Natural gas	$21.25
Water	$61.50
~~Trash pickup~~	~~$0.00~~
Internet	$61.50
NET	$170.92

NETs	PER MONTH	PER YEAR
Total dividend income	$2,083.33	$25,000
Total expenses & taxes	$1,677.60	$20,131

Transportation (Monthly)

Insurance	$61.67
Auto registration	$6.67
Fuel	$40.00
NET	$108.33

Living Expenses (Monthly)

Groceries	$500.00	
Health insurance (ACA Bronze)	$67.03	~ $200 more for Silver
Dental plan	$16.67	
Dental - out of pocket	$76.25	
Misc	$200.00	
NET	$859.95	

Note that the only income line that matters (for predictable living expenses) is the estimated dividends. Currently I can generate $50,000 per year in income without incurring federal income tax, so I achieve it in the other ways listed, depending on year-to-year variances in dividend income and capital gains.

This is our current budget. The budget prior to my retirement didn't look much different than this. The only significant differences are there was a mortgage and the auto insurance bill was almost twice as high because we had two cars to insure.

We have cash on hand to cover unexpected medical emergencies, fully accounting for the deductibles and maximum out-of-pocket costs in our health insurance plan.

How To Cut Costs Wisely

As you can see, not having a mortgage lowers the cost of living *significantly*. Since I'm retired, we need only one car now, resulting in low transportation costs.

Other things you may notice "missing" from my budget are cell phone bills and dining out. We use a combination of T-Mobile prepaid (legacy plan, Gold status) and FreedomPop cell phones, so *our cell phone cost is around $40 per year*. We give out our Google Voice number, and program it to ring our home phone (legacy Ooma plan, which is free from all monthly charges) and all the cell phones when someone calls. That way, when we're home, we can pick up the home phone instead of a cell phone. As for dining out, we eat out probably less than ten times a year. Home cooking is healthier and cheaper, and many times, tastes better.

The point is, get your budget as low as possible. What are some of the ways we save?

I do most repairs myself, including things like repairing faucet and toilet leaks, replacing carpet with wood flooring, replacing sprinkler heads, changing car oil, replacing brake pads, etc. In fact, the only people we hired to do anything in the last 15 years were house painters and a roofer. Part of the reason is we have bought only new construction homes, so maintenance costs were minimal. We also buy new cars, and take good care of them, so we haven't spent any car repair money for as long as I can remember except for oil changes, air filters, batteries, tires, brake pads, wiper blades, and windshield washer.

Several other saving tips are below:

- We don't hire house cleaners or lawn keepers, stuff we could easily do ourselves.
- Take "staycations" most of the time.
- Wait to buy tech gadgets (never "version 1", which are always expensive and quickly become outdated). For example, our first iPad was the fourth generation one, whose price was reduced after the iPad Air was announced. Today, we have two iPad 4s and two iPad Airs using the strategy of buying the previous generation product after a new one is announced. All of the iPads were purchased for less than $300 brand new during sales events.
- Use the air conditioner less than most people during the summer (plus our new house is quite a bit more energy efficient.)
- Shopped around for the best rate for electricity based on our low usage.
- Shopped around for the lowest auto and home insurance companies from well-known national companies.
- We don't subscribe to cable, opting instead for free over-the-air TV. We don't watch TV much at all anyway.
- We buy discounted gift cards from Raise and eBay for stores we shop at the most (Lowe's, Home Depot, TJ Maxx, Marshalls), familiarizing ourselves with the terms and conditions regarding fraud protection.
- We hunt for the best deals when we shop online, utilizing sites such as SlickDeals, RetailMeNot, eBay, etc.
- For the vast majority of grocery items, we buy the store brand instead of national brands, unless they are on sale and close enough in price. We regularly buy brand names for only a handful of products (e.g., toilet paper and toothpaste).

- We buy in bulk at Costco, but only for things we know we can consume in full before they go bad.
- We buy quality products (at discounts of course) for stuff that needs to last a long time, such as appliances and power tools.

I also use my cash-back rewards credit cards whenever I can, and pay them in full every month. Every little bit counts, and adds up over time. Take people with a Starbucks habit for example. If that person spends $20 a week at Starbucks instead of drinking the free coffee at the office, he'd be spending around $86 a month. If instead he invested that amount each month into the S&P 500 index fund, he would have $380,077 after 40 years at a CAGR of 9%. That's one expensive habit.

Admittedly, saving can be tougher to do if you live in more expensive areas of the country. Housing costs in areas like San Francisco, Boston, and New York can eat up a big chunk of one's budget. If you can and are willing to move, then do so!

If you cannot or unwilling to, then realize that you are paying a premium to stay where you are. As someone who is no longer tied to a job, we are free to move anywhere in the country as we please, as long as it fits our budget.

During my working years, I took advantage of 401(k) programs as much as I could. All of the companies I worked for had company matching, such as a 50% match up to the first 6% in contributions. So not only did I reduce my income tax, but my money grew quicker because of the company matches. My saving did not stop there; I also contributed to my investment account with any disposable cash I had.

That brings up an important point. If you plan to retire early, then you need to plow money into your taxable (non-tax-deferred) investment account, since you need the money before you can withdraw from retirement accounts without penalties. There are ways to withdraw money from IRAs before your normal retirement age without penalty (72t distribution), but having the substantial portion in your taxable account makes things a lot easier.

Between the retirement accounts and the taxable account, I probably saved at least 20% of my disposable income while I was working. (I didn't keep a record, so that's just a rough estimate.) This compares to an average of around 5% for the average US household today:

Source: Y Charts

There are many countries with much higher savings rates. China, for example, is almost at 40%!

The message is clear: if you want to retire early, and don't make a gigantic salary, then you have to save much more than the average US household.

Spending less and saving more is fine and dandy. However, unless you start off with multiple millions of dollars, you have to make your savings grow substantially.

Not only will inflation make your money worth less in the future, but as you age, healthcare costs rise dramatically. Having a written budget is an important first step, since it lets you know how much you need in retirement.

The other half of the equation is getting your savings to produce a rising income year after year to meet your increasingly larger budget.

It's been said "the difference between the poor and the rich is that the poor works for money, but money works for the rich."

find that very enlightening. Even though I don't consider myself "rich", the principle applies: Let Money Work for You.

How I Invest

I'm not going to tell you how to invest your money so it works for you…

People have different risk tolerances and investment skill sets. I am however, going to show you how I am doing it. Maybe you can borrow some ideas, or better yet, come up with your own.

Investing in the stock market is comfortable for me. I have a fairly high risk tolerance level, and I have been doing it for over 22 years. It has been proven over the long term, nothing beats equities. (Some people are more comfortable with real estate, gold, or whatever, and that's fine with me.)

Ever since I retired a little over two years ago, I have been investing in dividend-paying stocks (after investing in growth only stocks prior to retirement).

From our written budget, I knew I needed to generate at least $20,000 annually to cover our predictable expenses. Inflation runs around 2% annually, plus healthcare costs go higher as we age. Therefore, I targeted a 6% annual growth in dividends to beat inflation and healthcare costs, as well as having something extra to pay for future expenses like home repairs, etc.

For a margin of safety, I add $3,000 to the goal. In summary, our goal (starting last year in 2015) was to generate $23,000 in annual dividends, growing 6% each year. This goal is for the taxable account only, since I don't plan to withdraw from the retirement accounts until the year 2035.

There are multiple ways to achieve this goal. The way I have chosen mine is via dividend growth investing plus somewhat of a balanced portfolio approach (stocks and bonds). This can be summarized as follows:

- In the taxable account, invest for the dividends and dividend growth goals stated above, with a balanced portfolio approach for safety.
- In the retirement accounts, invest in dividend-paying companies with excellent prospects of dividend growth.

Let’s discuss the retirement accounts approach first, since that’s relatively straightforward. I categorize investments as follows:

- Income: stocks, bonds, or funds that have a flat dividend year after year. These tend to have highest yield and/or highest safety among the categories. An example is Vanguard Long-Term Bond Index ETF (BLV).
- Low Dividend Growth Rate: dividend stocks or funds that are expected to grow dividends up to 3% annually. These typically have an above average yield and relatively good safety. An example is AT&T (T).
- Medium Dividend Growth Rate: dividend stocks or funds that are expected to grow dividends 3-10% annually. These typically are mature growth companies having an average yield. An example is PepsiCo (PEP).
- High Dividend Growth Rate: dividend stocks or funds that are expected to grow dividends above 10% annually. These typically are companies that have a low payout ratio and/or still growing their revenue at a good clip. An example is Microsoft (MSFT).
- Growth: stocks or funds comprising of profitable, growing companies that have yet begun to pay a dividend. An example is Google (GOOG).
- Speculative: stocks or funds that I believe have potential for price appreciation, either because the price is too depressed and a turnaround is imminent, or the company is in a rapid growth stage. It may or may not pay a dividend, and if it does, it is far too unstable to rely upon. An example is Amazon (AMZN).

In the retirement accounts, I can’t spend the dividends yet, so I don’t care about the current yield. As a result, these accounts hold mostly High Dividend Growth Rate stocks. The idea behind this is if I hold these stocks for a long time, the low yield today may compound into something really significant when I start withdrawing from my retirement accounts 19 years from now. The other benefit is the potential for high capital appreciation. I can partially sell some of these stocks and reinvest them into bonds or safer instruments for income later on.

High DGR stocks I hold in my retirement accounts include: Amgen (AMGN), ARM Holdings (ARMH), CBOE Holdings (CBOE), Costco (COST), Intercontinental Exchange Group (ICE), MasterCard (MA), Moody’s Corp (MCO), Nike (NKE), and Visa (V).

The taxable account of course, is more complex. I have to juggle between safety, income, and dividend growth. “Safety” for me means reducing the “sequence of returns” risk, where multiple years of bear markets in a row can destroy a portfolio in the distribution phase. I have chosen a balanced portfolio as the means to achieve this, by allocating 10-15% of the portfolio value in investment grade bonds. This is a bit aggressive; the typical financial advisor advice is a 60% stocks, 40% bonds mix. For someone with a larger portfolio, say $5 million, a 60/40 allocation makes more sense, but in my case, I need more growth (both capital appreciation and dividend growth) because my portfolio is currently around $1.1M. Should we encounter unexpected expenses and need to withdraw from the portfolio, we have the option to sell stocks or sell bonds, depending on the stock market conditions. (Bonds tend to fare better during bear markets.) Before we do that however, we will use the emergency cash at the bank (18 month's worth.) In other words, "touching the principal" in the investment accounts is a last resort.

Another aspect of safety is diversification. You don't want a single stock crash to permanently damage your portfolio. I'm comfortable with holding around 30-35 positions in my portfolio. Everyone has a different comfort level as far as this goes.

Stock picking is an important topic, but out of scope for this article. To cut to the chase though, I like dividend stocks that have a combination of wide economic moat, revenue growth, low payout ratio, lower debt, and a penchant for growing the dividend for at least 3 years.

Let's take this year as an example and see what my taxable account looks like in my portfolio construction.

Security	Symbol	Div/Sh	Regular Taxable Account			
			# Shares	Value	Annual Div	YOC
Income: Preferred Stocks						
Flaherty & Crumrine Preferred Securities	FFC	$1.63	1,600	$33,008	$2,608	8.23 %
Income: Bonds						
Eaton Vance National Municipal Opportuni	EOT	$1.03	500	$11,370	$515	4.58 %
iShares 20+ Year Treasury Bond	TLT	$3.89	200	$25,876	$778	3.04 %
Vanguard Long-Term Bond Index ETF	BLV	$3.79	300	$28,134	$1,137	4.23 %
Vanguard Long-Term Corporate Bond ETF	VCLT	$4.08	300	$27,363	$1,224	4.70 %
		-TOTAL-		**$92,743**	**$3,654**	**4.08 %**
Low DGR: REITs						
Realty Income	O	$2.39	800	$47,360	$1,912	5.67 %
Low DGR: Other						
AT&T	T	$1.92	800	$31,056	$1,536	4.97 %
Medium DGR: REITs						
Omega Healthcare Investors	OHI	$2.28	1,150	$38,836	$2,622	7.03 %
Ventas Inc	VTR	$2.92	600	$37,272	$1,752	5.51 %
		-TOTAL-		**$76,107**	**$4,374**	**7.11 %**
Medium DGR: Consumer						
Consumer Staples Select SPDR	XLP	$1.23	700	$36,610	$861	2.36 %
Pepsico	PEP	$2.81	400	$41,184	$1,124	3.52 %
		-TOTAL-		**$77,794**	**$1,985**	**3.05 %**
Medium DGR: Healthcare						
Johnson & Johnson	JNJ	$3.00	300	$33,624	$900	3.03 %
Medium DGR: Energy						
Exxon Mobil	XOM	$2.92	500	$44,200	$1,460	3.74 %
Medium DGR: Industrial						
Caterpillar Inc.	CAT	$3.08	400	$31,088	$1,232	3.96 %
High DGR: Consumer						
Nike Inc.	NKE	$0.64	600	$35,364	$384	1.66 %
High DGR: Financials						
BlackRock Inc.	BLK	$9.16	125	$44,541	$1,145	2.75 %
Nasdaq Inc	NDAQ	$1.28	400	$24,684	$512	1.99 %
T. Rowe Price Group	TROW	$2.16	500	$37,645	$1,080	3.03 %
		-TOTAL-		**$106,870**	**$2,737**	**2.66 %**
High DGR: Software						
Microsoft	MSFT	$1.44	500	$24,935	$720	2.67 %
Growth: Consumer						
Under Armour Inc	UA		600	$26,364	$0	0.00 %
Under Armour Inc Class C	UA-C		600	$24,480	$0	0.00 %
		-TOTAL-		**$50,844**	**$0**	**0.00 %**
Speculative: Commodities						
SPDR S&P Metals and Mining ETF	XME	$0.39	1,500	$36,930	$585	3.22 %
				$721,924	**$24,087**	**5.32 %**

How did I come up with this allocation?

Well, it's just a lot of playing around with spreadsheets after narrowing down the stocks and funds I like. I also wrote my own software application that keeps track of my investments and estimates dividends, so it helps a lot in conjunction with the spreadsheets.

So how does it stack up to the requirements mentioned earlier?

***Generate at least $24,301 in dividends this year*:**

Estimated dividends this year will be $25,031 (should be higher as dividend increases are expected for the remainder of this year.) Note that the $24,087 figure in the table above is based on current positions, so it does not include dividends collected from stocks that have been sold earlier this year.

Dividend growth rate of at least 6%:

Currently the estimated DGR is 5.23%. I arrive at this figure by assigning estimated growth rates for each category, and totaling the annual dividends in each as follows:

Category	Annual Payout	Est. Growth	Next Yr. Estimate
Income	$6,262	0%	$6,262
Low DGR	$3,448	3%	$3,551
Medium DGR	$9,951	7%	$10,648
High DGR	$3,841	12%	$4,302
Speculative	$585	0%	$585
Total	$24,087	5.23%	$25,348

I intend to correct this shortfall at the next portfolio rebalance opportunity.

10-15% of portfolio value in investment grade bonds:

Based on a $1.05M portfolio value at the beginning of the year, this means I need at least $105,800 allocated to investment grade bonds. With a current value of $92,743 I am a little shy of the goal. However I intend to correct this issue at the next portfolio rebalance opportunity.

Final Thoughts from Early Retiree Reality

So there you have it.

Living below my means and saving/investing in dividend stocks has allowed me to retire earlier than most Americans, and hopefully an increasing dividend income stream for years to come.

This article gives a real world example of how living below your means and investing in high quality dividend growth stocks can lead to early retirement.