Monday, August 2, 2021

Saint Diego
Civic Center Plz
San Diego, CA 92101

Dear Diego,

Thank you for using our investment adviser services. We discussed several investment topics on our recent call.

You are 51 and single. As a Programmer for the City of San Diego, you earn $110,000 annually. You estimate your living expenses at $32,000 per year, when not including large one-time expenses. At age 60 in 2029, you expect an inflation-adjusted pension benefit of $53,000+ per year.

In addition to over $100,000 in cash, you have $1.7MM in investment accounts. $1.25MM of this is in tax-deferred retirement accounts.

You are looking to retire as soon as possible. You anticipate financially supporting your parents given your mother's illness and are considering purchasing them a house out-of-state for $200,000.

You are looking for help with investing, tax strategies for retirement and making sure you don't run out of money in retirement.

Here are your financial planning *To-Dos* in light of your goals from our call:

- ☐ **TRACKING SPENDING FOR RETIREMENT PLANNING:** Continue tracking your spending. Tracking your spending can help you better estimate your future expenses in retirement.
- ☐ **RAINY DAY FUND:** You have $100,000+ in cash savings. Continue maintaining at least six months of living expenses in cash as your rainy day fund.

Tax-Advantaged Investment Accounts

- ☐ **TAX PLANNING:** Confer with your tax professional before moving forward on any of the below.
- ☐ **HEALTH INSURANCE & HEALTH SAVINGS ACCOUNT (HSA):** Take advantage of a Health Savings Account (HSA) eligible High-Deductible Health Plan (HDHP) – so long as it meets your health insurance goals. Despite the higher out-of-pocket costs with an HDHP, using an HDHP can save you money. You may be eligible to change health insurance plans at the next open enrollment. Learn more here.

  If you decide an HDHP meets your health care goals, contribute the maximum to your HSA annually. Invest in low-cost index funds. Pay for medical expenses with cash, letting HSA investments grow tax-deferred. Save all receipts for qualified medical expenses forever. Learn more here.
- ☐ **ANNUAL ROTH IRA CONTRIBUTIONS:** Continue to contribute $7,000 to a ROTH IRA – so long as you qualify to contribute given the income limitations. Doing so allows you to take advantage of the unique tax treatments of these accounts.

- ☐ **EMPLOYEE 457(b) CONTRIBUTIONS**: Contribute the maximum annually to your 457(b) ($19,500 + 6,500 catch-up for 2021) to take advantage of the tax savings available by using this account.
- ☐ **ROTH VS TRADITIONAL CONTRIBUTIONS:** The rule of thumb suggests contributing to your traditional 457(b) – since you are in your peak earning years. However, a strong case can be made for contributing to the Roth account. This is given the marginal difference in tax brackets between where you are today and where you could be next year in retirement (just 2%) *and* a large projected first-year required minimum distribution (~$100,000), which could push you across multiple tax brackets. Therefore, you would be just fine contributing to either the traditional or Roth option – so long as you do contribute the full $19,500 + 6,500 catch-up to your employer-provided retirement plan. Because there is no early withdrawal penalty for 457(b) plans, you have all the more reason to contribute in light of your early retirement goals.

Tax Planning

- ☐ **YEAR-END TAX PLANNING:** Each December, work with a tax professional to determine the appropriate year-end tax moves. Given your wage income for the year, tax-loss harvesting likely makes the most sense in 2021. See the following section on *Tax-Loss Harvesting*.

  Assuming full retirement next year, consider partial Roth conversions and tax-gain harvesting beginning in 2022.

  - Partial Roth Conversion: Beginning in 2022, distribute the full amount of your standard deduction ($12,550 for 2021) from your traditional tax-deferred 457(b) retirement plan. If you do not need that distribution for living expenses (and instead decided to draw down your savings because you decide *not* to purchase your parents a home), you can convert that $12,550 to your Roth IRA.

    By distributing only enough income from your tax-deferred 457 account in the amount of the standard deduction, you can convert that much money from your traditional 457 to your Roth IRA free of federal taxes. However, you will still be liable for California state income taxes.

    The amount you can convert tax-free is equal to your standard deduction. This amount must be decreased by any bond interest or savings account interest. Learn more here.

  - Tax-Gain Harvesting in 2022: Having used up your standard deduction to make a partial Roth conversion, next harvest long-term capital gains (LTCG) at the 0% LTCG tax bracket – up to $40,000 for single taxpayers. Learn more here. The amount of any qualified dividends earned that year decreases this $40,000 figure.

    If you do not need the money for living expenses, immediately buy back the positions sold. This raises your basis tax-free. However, you will still be liable for state income taxes.

    Once you have no more long-term capital *gains* to harvest, proceed to tax-loss harvesting. Tax-loss harvesting can offset $3,000 of income from a partial Roth conversion each year, allowing you to convert more from your traditional to your Roth account tax-free.

  Consider these strategies each December with your tax preparer. Re-evaluate these strategies once you receive your pension income at age 60. Learn more here.

- ☐ **ASSET LOCATION:** Matching the tax efficiency of your investments with the tax treatments of your accounts is a contentious topic. The value of the strategy varies with the assumptions used and the length of the investment period.

Less contentious is investments with the highest potential for appreciation – i.e., stocks funds– can be held in Roth accounts. Do not hold bonds in Roth accounts. This includes bonds held in target-date funds, as is the case with your Roth IRA today. Exchange this target-date fund for the low-cost stock funds outlined in the *Investments* section.

Tax-Loss Harvesting

Tax-loss harvesting (TLH) can generate some annual tax savings. TLH is appropriate to offset employment income and income from distributions from your tax-deferred 457 plan.

- **TRACKING TAX LOTS:** Opt for "Specific Identification" instead of "First in, First out" (FIFO), "Last in, First out" (LIFO), etc., with your investment custodian.
- **DO NOT RE-INVEST DIVIDENDS:** Allow interest and dividends to flow into the money market fund. Use that cash plus any extra cash to buy more ETF shares of one fund where it's needed. This will make the number of tax lots you have manageable.
- **SELL LOTS AT A LOSS:** When the stock market falls, sell tax lots at a loss and harvest the tax losses.
    - Tax losses can offset capital gains from other investments to reduce taxes.
    - You can also offset up to $3,000 per year in ordinary income. If your net capital loss exceeds this limit, you can carry the loss forward to later years.
    - Immediately buy a similar "swap" fund so you're not out of the market. It is not a "tax wash" because they are different funds from different investment companies.
        - Swap Vanguard Total Stock Market into the iShares Core S&P Total U.S. Stock Market ETF (ITOT – 0.03% fee).
        - Swap Vanguard Total International Stock into the iShares Core MSCI Total International Stock ETF (IXUS – 0.10% fee).
- If the markets continue down, you can swap back after 30 days. BE CAREFUL not to buy any fund you sold for a loss within 30 days of the sale, including your retirement accounts. If so, you will cancel the tax loss. Learn more here.

Investments

- **457(B) Retirement Plan:** Do ***not*** roll your employer-provided retirement plan into your IRA at Vanguard. Instead, leave the plan's funds with your employer. Governmental 457(b) distributions are not subject to the early withdrawal penalty. This makes your 457 plan the perfect account for your early retirement. Whatsmore, the plan offers excellent low-cost investment options.

- **COWBOY ACCOUNT:** The prudent approach suggests limiting speculative investments (anything but the asset allocation described below) to no more than 5 of your liquid investable assets. Learn more here.

- **ALLOCATION:** We discussed a 30% stock and 70% fixed income portfolio, excluding at least six months in cash for emergencies. As you move through retirement, increase your stock allocation by 2% annually. Once you receive your inflation-adjusted $53,000+ pension benefit at age 60 – and therefore need less portfolio income – you should re-visit your portfolio equity allocation.

  The strategy of starting retirement with a lower equity allocation – to be increased later – mitigates sequence risk: the risk that poor investment returns show up at the beginning of retirement, impacting the long-term sustainability of your investment portfolio. Learn more here. For your financial plan, mitigating sequence risk is critical because your early retirement requires that your investment portfolio provides for all your living expenses. The initial target allocation is:

- The U.S. stock default is a total stock market index fund.
  - Vanguard Accounts
    - Vanguard Total Stock Market Index Fund ETF (VTI) – 20%
  - 457(b)
    - Vanguard Institutional Index (VIIIX) – 16%
    - Vanguard Extended Market Index (VEMPX) – 4%
- The international stock default is a total international stock index fund.
  - Vanguard Accounts
    - Vanguard Total International Stock Index Fund ETF (VXUS)
  - 457(b)
    - Vanguard Total International Stock Index (VTPSX)
- The bond default is a total market bond fund.
  - Vanguard Accounts
    - Vanguard Total Bond Market ETF (BND)
  - 457(b)
    - Vanguard Total Bond Market Index (VBMPX)

- [ ] **TRADING:** Limit your trading risk by using "limit orders" when buying and selling stocks and Exchange-Traded Funds (ETFs). Learn more by reading this paper from Vanguard.

- [ ] **DISTRIBUTIONS & REBALANCING:** In retirement, your portfolio can fund your living expenses. Therefore, distribute dividends and bond interest payments from your taxable account – not re-investing them back into your funds – to fund living expenses. Not re-investing dividends and capital gains can also simplify tax lots. Learn more about rebalancing here.

- [ ] **INVESTMENT POLICY STATEMENT (IPS):** Create an IPS to help hold you accountable for your investment strategy. Learn more about Investment Policy Statements – and download a free template – here.

Social Security

- [ ] **DELAY FILING:** Before claiming Social Security retirement benefits, run an analysis. It almost always makes sense to wait to claim benefits until age 70. However, you can re-evaluate this decision once you are eligible to claim benefits – at age 62. Learn more here.

Estate Planning

- [ ] **BENEFICIARY DESIGNATIONS:** Review the beneficiary designations on your investment and retirement accounts, bank accounts, and life insurance policies to determine if they still reflect your goals.

- [ ] **ESTATE DOCUMENTS:** With an estate attorney, discuss the value of creating a Will, Power of Attorney, and Advanced Health Care Directives.

- [ ] **SIDE LETTER:** Complete a Side Letter of Instruction listing professionals and account login information. Share this information securely with the appropriate parties (trustees, executor, attorneys-in-fact) via a password manager, such as *LastPass* or *1Password*. Alternatively, store a hard copy of this information along with your estate planning documents. You can use this template. Learn more here.

Health & Life Insurance Planning

- ☐ **LIFE INSURANCE:** You may be financially supporting your parents in a limited capacity in the future – in that you wish to purchase a $200,000 home for them. However, your parents are the intended beneficiaries of your $1.7MM investment accounts. You do not need life insurance.

- ☐ **DISABILITY INSURANCE:** Disability insurance replaces a part of your income when you cannot work from illness or injury.

  If you do *not* intend to retire this year, review your employer-provided disability insurance policies for any shortcomings. And, if you wish to increase your spending in retirement materially, then you can work with a disability insurance agent to determine if you can purchase a private policy offering more robust coverage than your employer-provided policy. Only purchase LTDi if you anticipate retiring later, *and* you want to spend more in retirement. Otherwise, you can self-insure for disability.

  If you do decide to purchase LTDi, any benefit should:

  - be inflation-adjusted, having a cost of living adjustment (COLA) rider,
  - have an "own occupation" clause to pay you if you can work, but not in your industry, and
  - include a partial disability provision.

  Unfortunately, a high-quality private long-term disability insurance policy will not be inexpensive. You can save money on a policy by opting for a larger deductible and making annual payments – instead of monthly. Learn more here.

- ☐ **SHOP FOR LONG-TERM CARE INSURANCE (LTCi):** Shop for LTCi policies providing between $300,000 - $500,000 in benefits. (You can handily self-insure for any smaller benefit.) Consider if you are willing to pay the cost of coverage.

Property & Casualty Insurance Planning

- ☐ **UMBRELLA INSURANCE MAINTENANCE:** Umbrella insurance increases the liability coverage of your auto and renter's insurance. Maintain your umbrella policy of $1MM to cover any claims against you that may exceed your underlying policies' insurance (auto insurance, etc.). Given that most of your assets are in tax-advantaged retirement accounts (receiving some amount of creditor protection), $1MM is sufficient coverage. Remember to maintain your underlying liability coverages at $300,000 – or the amount required by your umbrella policy – on your various policies (auto insurance, etc.).

- ☐ **AUTO INSURANCE:** To save money, consider declining Comprehensive & Collision coverage on your automobile policy. You have sufficient assets to self-insure. You can learn more about optimizing your auto insurance coverage here.

  - **Underinsured/Uninsured:** Opt for the highest limit on Underinsured/Uninsured coverage.
  - **"Additional Coverages:"** Consider stripping additional coverages to save money via self-insurance, such as *rental car reimbursement* or *windshield glass replacement*.

- ☐ **ROADSIDE ASSISTANCE:** To keep your auto insurance cost lower, only purchase roadside assistance through a provider that is not your automobile insurance company, such as AAA. Using roadside assistance provided by your insurance company may count as an at-fault claim.

- ☐ **RE-SHOP YOUR POLICIES:** Re-shop your property and casualty (auto, homeowners, renters, umbrella) insurance policies every three years (or more frequently) to ensure you are paying a competitive rate.

Cyber Security

- ☐ **PASSWORD MANAGER:** Store account logins and other sensitive information in a password manager. Consider LastPass, Dashlane, or 1Password. Learn more here. Do not store your passwords unsecurely, such as with an unencrypted spreadsheet, unencrypted Word document, or written down or printed on paper held outside of a physical safe.
- ☐ **FREEZE YOUR CREDIT:** To protect against identity theft, freeze your credit with all three credit agencies. You can learn more here.
- ☐ **TWO-FACTOR AUTHENTICATION (2FA):** If available, enable 2FA with the various financial institutions you use: your bank, your investment custodian, for example. Learn more here.

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To stress-test your early retirement plan, we assumed no investment growth on your assets (0% real return) between now and when your $53,000+ inflation-adjusted pension benefits begin in 2029. Even in that case, your portfolio of $1.7MM would provide for living expenses and still have $500,000 left to manage any future possible long-term care expenses. Your modest spending ($32,000), even when considering taxes (~$5,500) and your projected health care expenses ($15,000), makes this possible. Because of your great saving habits, you're on a great track.

This covers most of our discussion and a little more. Your biggest risks are:

- no estate planning documents (solved by working with an estate attorney), and
- a market correction at the outset of retirement (mitigated by holding a conservative asset allocation at the outset of retirement).

Please send me an email at hello@jonluskin.com if you have any questions.

Good luck!

Best regards,

Jon Luskin, CFP®