Wealth Reflections

Insights on building, preserving and passing wealth
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The Consumption Curve - a wave to reckon with

By Gwen K. Harvey, B. Comm., CFP, CLU, TEP

There is a growing, silent undertow in the waters of wealth. Capital that exists today or is in the process of being built for the future has a predator lurking. The consumption curve is quietly circling wealth and taking hold.

For every $30,000/year of after tax indexed income needed for the next 35 years, $1,000,000 is required. At the end of 35 years, the $1,000,000 will be gone. This is based on a compounding after tax return of 4% and inflation at 3%. If consumption runs at $40,000/year, the capital will be gone in 28 years. If consumption runs at $80,000/year, the capital will disappear in just half that time.

With a more optimistic 5% after tax investment rate, capital lasts a little longer. Withdrawing at an indexed $30,000/year will exhaust capital in 53 years, at $40,000/year in 34 years and $80,000/year in 15 years.

How can a base of $5,000,000, $20,000,000 or $50,000,000 not provide lifetime security? How could it be so completely depleted that the intentions to share good fortune with children and grandchildren are reluctantly modified?

If the indexed, after tax withdrawal rate is greater than 3% of the capital today, the amount spent compared to the capital base may "feel" fine. In fact the consumption curve feels relatively safe in the early years. However as inflation kicks in and investment returns predictably stray from record highs, there is a point where spending is greater than earnings and quietly capital begins to be consumed. As the markets deliver their predictably varied returns, the consumption curve will gradually reach up and overpower the capital, leaving a rather bewildered wealth holder.

Why does it take so long for the problem to be spotted? My observations from working with a wide range of families are the following:

- The spending rate grows simply "because it can". There is money to pay for every purchase made.
- People "compare up" and believe they are not over spending because they spend less than a selected sample they compare themselves against.
- The "math" has never been done. When you index consumption needs, it presents a drastically different picture than simply projecting current needs forward on a flat basis.
- When properties are bought and the desire is to keep them in the family they have two substantial financial effects. First, their purchase removes capital from the income generating investment pool and second, they become an expensive new carrying cost, devouring more capital.

So what can be done to ensure that those who are growing their financial independence or those that believe they have financial independence can fully rely on their resources?

First - Do the "math". Understand what you have or what you are building and how that relates to providing a lifetime indexed income.

Second - Come to terms with the truth behind the numbers and set parameters for spending that will allow you to enjoy lifetime security.

Third - If the income seems to be lower than the world you compare yourself to, open up that world. Contributing time and effort to help those who are significantly less fortunate than you, will make your comforts that much more evident.

Fourth - Respect the dollar made and saved. It has much greater value than the dollar spent. To sustain long term income and personal financial independence, consumption must be tamed so that its curve is gentle and not a self-made tsunami.

If you have any questions about this, please give us a call.

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