Twitter Thread by 10-K Diver

10-K Diver
@10kdiver

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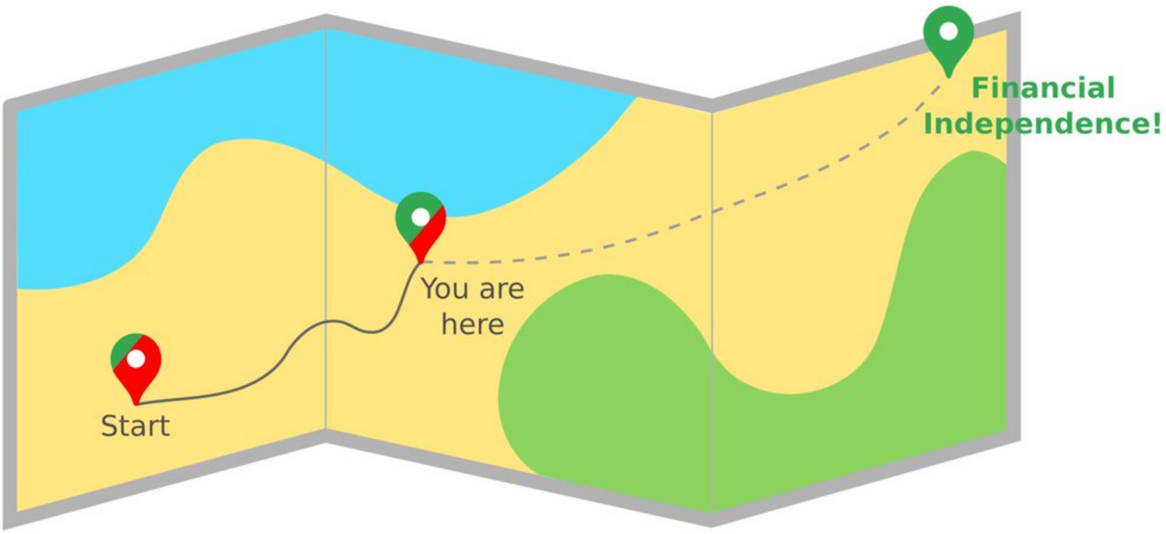
Get a cup of coffee.

In this thread, I'd like to share with you a simple way to measure and track your progress towards financial independence.



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Financial independence is an end goal.

To define this goal properly, you need to answer 2 key questions.

(i) When would you consider yourself financially independent? And,

(ii) In how much time do you want to get there?

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Typically, financial independence means:

a) You won't have to work another day in your life for money, and

b) You and your family will still be able to live comfortably to the end of your days.

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Let's say you want to reach financial independence in the next 10 years.

How much money do you need to amass by that time?

Well, suppose your family's expenses are ~$60K per year now.

If inflation runs at ~2% per year, 10 years from now, your annual expenses will be ~$75K.

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Let's say you want your expenses to be under 3% of your portfolio at that time.

This is called the "3% Rule".

It means your portfolio's size should be about $2.5M (as 3% of $2.5M = $75K).

For more on the 3% Rule and such: https://t.co/FHV5tU9wph

> 1/
>
> Get a cup of coffee.
>
> In this thread, I'll help you work out how much money you need to retire.
>
> — 10-K Diver (@10kdiver) July 25, 2020

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So that's the goal: to amass a $2.5M portfolio in the next 10 years.

Of course, this goal is personal. One size does not fit all.

For example, you may feel comfortable only with a more conservative inflation assumption -- say 4% (not 2%) per year.

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Or in 10 years, you may become eligible for social security benefits.

Of the $75K you need per year, $30K may come from social security.

In this case, your portfolio needs to supply only $45K per year. By the 3% Rule, this means you only need a $1.5M portfolio.

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So, the exact goal you set will depend on your personal preferences and circumstances.

But generally, a good way to arrive at this goal is to, a) estimate the annual expenses your portfolio needs to provide for, and (b) set a reasonable withdrawal rate (like 3%).

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For this thread, let's go with our original "$2.5M in the next 10 years" goal.

That's "Step 1" in planning for financial independence: setting an end state (eg, a $2.5M portfolio) and a time to reach it (eg, in 10 years).

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Step 2 is simple. It's just figuring out your current status -- how far away are you from your financial independence goal?

For example, if your current portfolio is worth $500K, you're already a fifth of your way there. You only need $2M more to reach your goal.

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Step 3 is the real meat: figuring out the various paths that you can take to go from your current state to your goal.

Your path to financial independence will typically involve 2 activities: Saving and Investing.

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Let's say you save $S per year, and your portfolio grows at I% per year (S for Saving, I for Investing).

If your portfolio is now worth $500K, you need to add $2M over the next 10 years to reach your $2.5M goal.

Key idea: Several combinations of S and I can get you there.

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At one extreme, you can rely only on Saving. No Investing.

If you're able to save $200K per year, that's $2M over 10 years. This $2M, plus the $500K you already have, gets you to your $2.5M goal -- with zero investing.

This corresponds to: S = $200K, I = 0%.

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Of course, saving $200K per year is no easy task -- unless your income is super high, or you have a super profitable business or something like that.

But if you can do it, you'll be able to achieve your financial independence goal in 10 years with zero need for investing.

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At the other extreme, you can rely only on Investing. No Saving.

If you can compound your $500K portfolio at ~17.5% per year for the next 10 years, that alone takes you to your $2.5M financial independence goal. No need to save a dime more.

This is: S = $0, I = 17.5%.

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Of course, compounding at 17.5% per year for 10 years isn't easy either, unless you're really good at investing (or really lucky!).

But if you can do it, you'll be financially independent in 10 years -- even if you save nothing during this time.

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Most likely, you won't be at either of these extremes.

You'll be somewhere in the middle -- relying on some *combination* of Saving and Investing to get to your goal.

The more you save, the less you need to rely on returns from investing. And vice versa.

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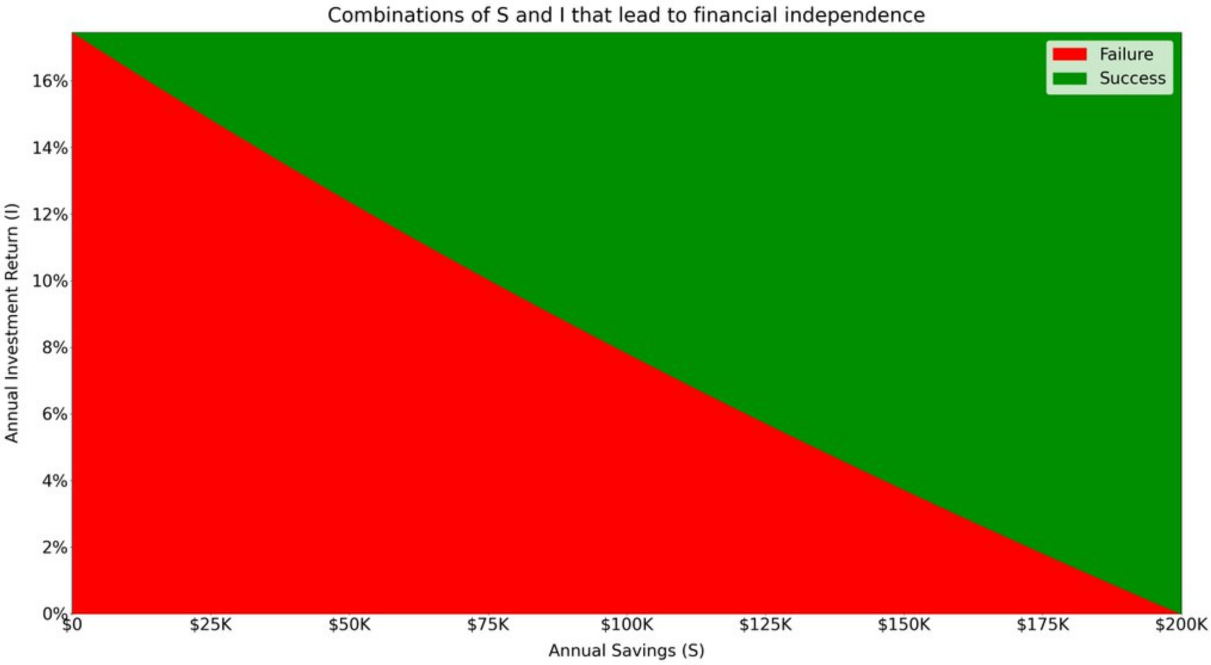
Here's a picture showing various combinations of S and I.

S is on the X axis. I is on the Y axis.

The red region represents failure to achieve financial independence in the time allotted.

The green region denotes success.



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As you can see, the higher your Savings (S), the lower the return you need from Investing (I) to cross over into the green region.

This red/green chart is a super useful tool. It helps you track and measure your progress towards financial independence.

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Key idea: the bigger the red region, the further away you are from financial independence.

Over time, as you make progress towards your goal, the red region will ideally shrink. The green region will expand.

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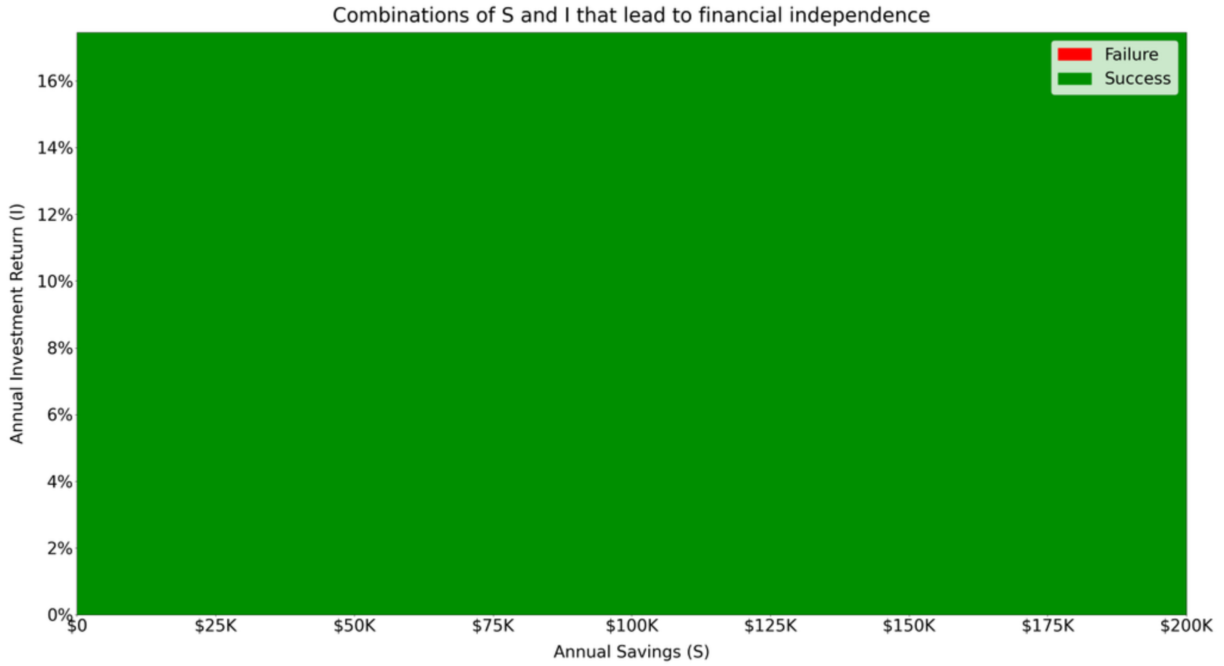
When you finally reach financial independence, the chart will turn all green.

For example, if you already have a $3M portfolio, you need zero Saving and zero Investing. You've already achieved your $2.5M goal, and then some.

Here's how that looks:



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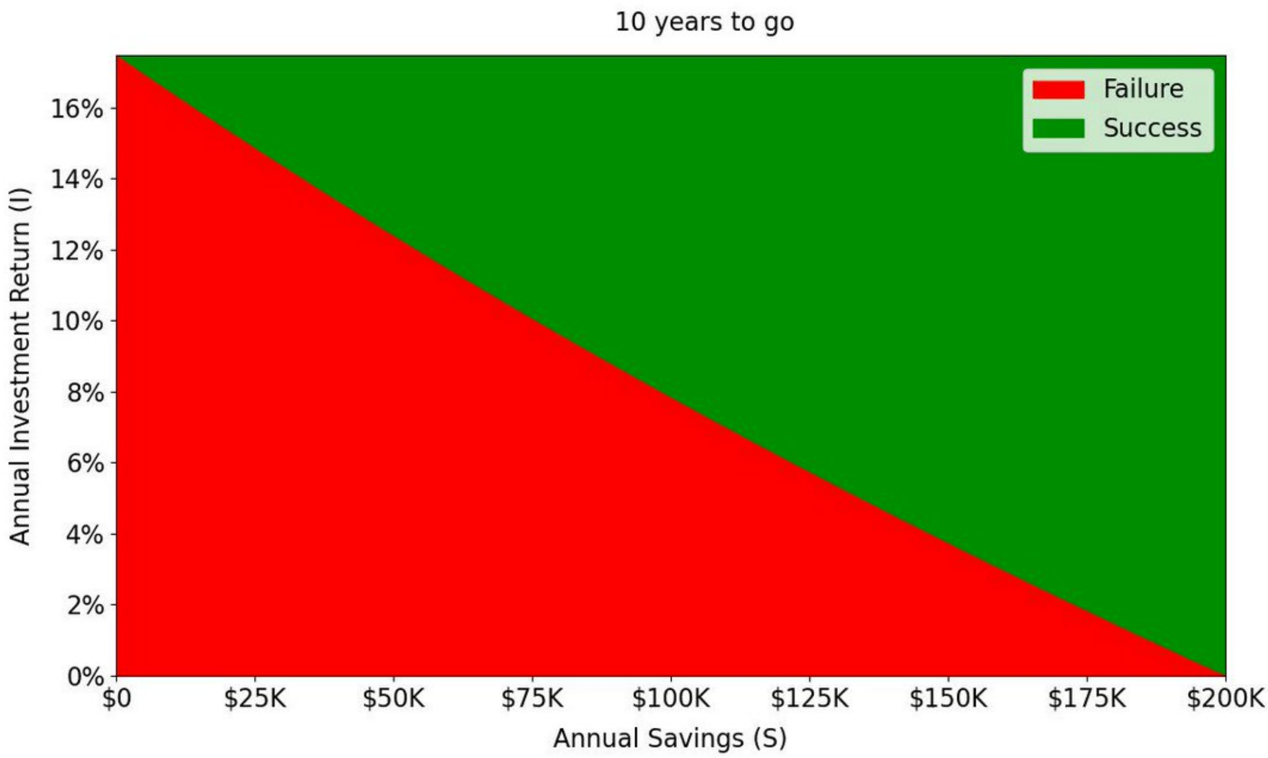
So, you can track your progress by looking at how much the red region shrinks from year to year.

For example, in Year 1, suppose you save $100K, and also get a 20% investment return.

That's progress! The red region will shrink to reflect it.

Like so:



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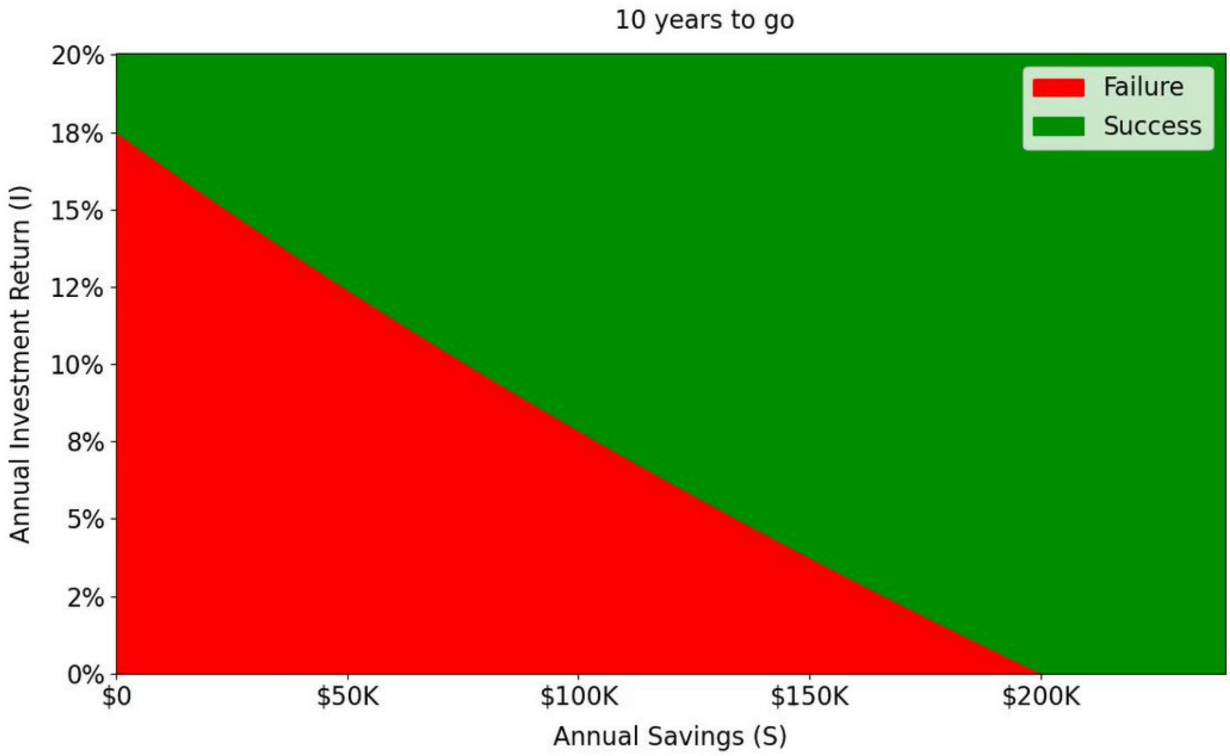
But then, say Year 2 is a bad year for your investments. Your portfolio goes down 30%.

But you partially offset that by saving $75K.

Even so, this is a step back. The red region will expand:



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Let's say your Saving and Investing results look like this for the first 9 years:

Year	Saving (S)	Investing Return (I)
1	$100 K	+20%
2	$90 K	−30%
3	$85 K	+28%
4	$120 K	+32%
5	$130 K	+19%
6	$115 K	−3%
7	$120 K	+17%
8	$115 K	+12%
9	$125 K	+6%

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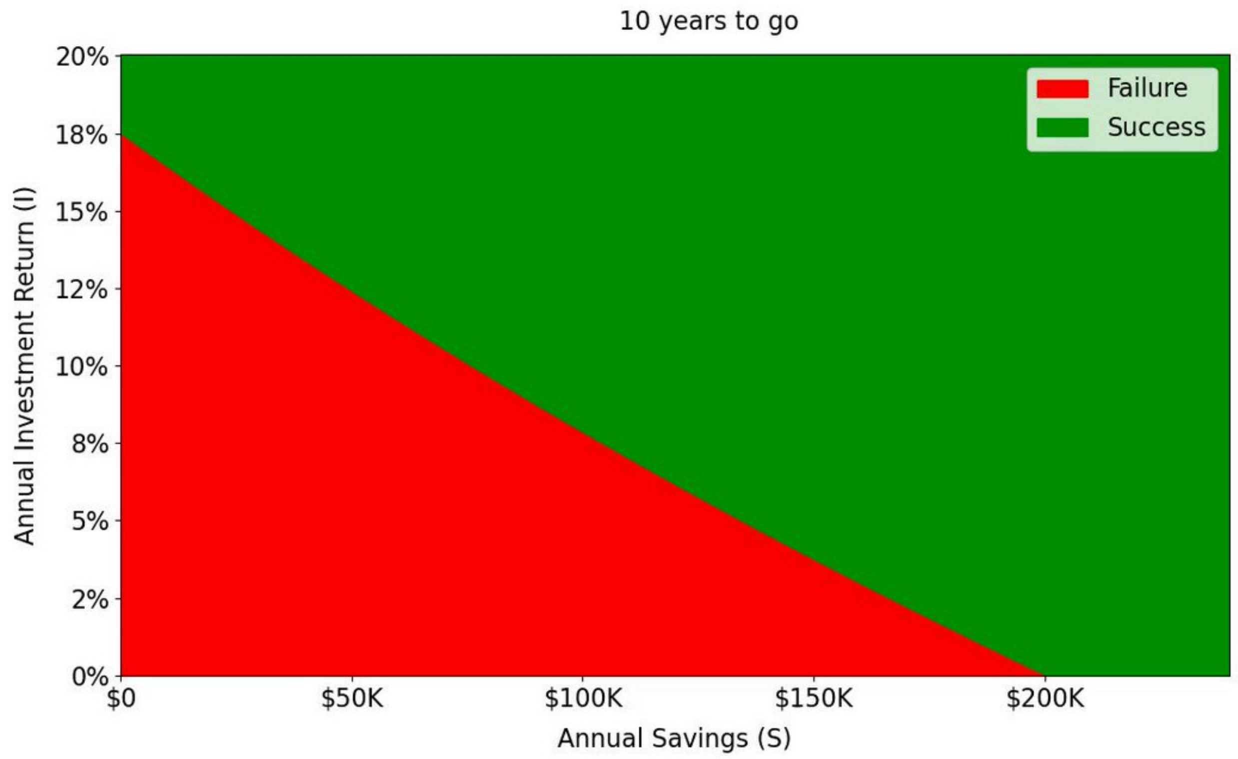
This is progress in most years. But from time to time, there's an occasional setback.

Still, it's enough to achieve the $2.5M goal -- a year ahead of schedule.

Over the years, the red/green chart evolves like this:



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So, here are the key ideas:

Key idea 1: Set a financial independence goal. For example, "to amass a $2.5M portfolio in the next 10 years".

You can arrive at this goal by making reasonable assumptions about expenses, inflation, withdrawal rates, etc.

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Key idea 2: Figure out what combinations of Saving (S) and Investing (I) will get you from your current state to your goal.

You can do this by constructing a red/green chart like the ones I showed above.

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Key idea 3: Periodically track your progress towards the goal.

Progress is measured by how much the red area shrinks from year to year.

That is, over time, the chart should become more and more green.

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This means, over time, you bring down the Saving and Investing thresholds you need to meet your goal.

As these hurdles become smaller, more and more combinations of S and I will get you to your goal.

It'll become harder and harder to miss the goal.

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Also, from time to time, you may need to modify the goal itself.

This is normal.

After all, deciding on the goal is not an exact science. And a large part of it is based on personal preferences and circumstances, which can change over time.

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The important thing is to periodically review the goal, and change it if it no longer makes sense.

Also, if the red area is not shrinking rapidly enough from year to year, you may need to find a way to earn more, save more, or invest better.

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Everything I've said in this thread is fairly simple.

At its core, financial planning is not that complicated.

If you start early, set goals, and regularly track your progress towards them, the odds are good that you'll achieve financial independence in reasonable time.

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For example, here's a heart warming story from @morganhousel's book, The Psychology of Money.

A janitor built a net worth of over $8M -- by starting early, living below his means, saving responsibly, and investing reasonably intelligently.

My favorite Wikipedia entry begins: "Ronald James Read was an American philanthropist, investor, janitor, and gas station attendant."

Ronald Read was born in rural Vermont. He was the first person in his family to graduate high school, made all the more impressive by the fact that he hitchhiked to campus each day.

For those who knew Ronald Read, there wasn't much else worth mentioning. His life was about as low key as they come.

Read fixed cars at a gas station for 25 years and swept floors at JCPenney for 17 years. He bought a two-bedroom house for $12,000 at age 38 and lived there for the rest of his life. He was widowed at age 50 and never remarried. A friend recalled that his main hobby was chopping firewood.

Read died in 2014, age 92. Which is when the humble rural janitor made international headlines.

2,813,503 Americans died in 2014. Fewer than 4,000 of them had a net worth of over $8 million when they passed away. Ronald Read was one of them.

In his will the former janitor left $2 million to his stepkids and more than $6 million to his local hospital and library.

Those who knew Read were baffled. Where did he get all that money?

It turned out there was no secret. There was no lottery win and no inheritance. Read saved what little he could and invested it in blue chip stocks. Then he waited, for decades on end, as tiny savings compounded into more than $8 million.

That's it. From janitor to philanthropist.

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In my experience, when it comes to financial planning, a lot of people struggle with inertia.

The first step is the hardest.

It's not obvious how to get started.

And once started, it's not obvious how to stay on track.

I hope this thread helps with some of that.

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Thank you very much for reading to the end of yet another long thread!

All the best on your journey towards financial independence!

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