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Can You Afford to Retire Early?

The Five-Year Rally in Stocks Has Bolstered Workers' Nest Eggs.

But Consider These Six Issues First.

By Liz Moyer - August 1, 2014

Early retirement can provide more time for athletics and other leisure activities. Here, a Tennessee Senior Olympics competition in 2012. Zuma Press

Here's one result of the five-year rally in stocks: Investors who once wondered when they would be able to retire comfortably can now at least ponder the possibility of making the leap early.

The temptation is understandable. Some investors have hit savings milestones years sooner than seemed likely when the market bottomed in 2009, though a pullback in recent days is a reminder that stock prices can also fall. Others are getting close and are letting their minds wander to what early retirement might look like.

"The market is up and everyone's feeling better and there's a lot of pent-up, 'I want to make a change' feeling," says Catherine Schnaubelt, who helps clients with financial planning at Atlantic Trust, the U.S. wealth-management arm of Canadian Imperial Bank of Commerce. CM.T -0.70% "I've talked to three different doctors about it recently."

Are You Saving Enough for Retirement?

But don't jump to conclusions. Deciding whether to kick up your feet a few years ahead of schedule is more complicated than adding up account balances to see if they have reached a magic number.

To begin with, that number may need to be higher if the money has to last a few extra years. And don't neglect other factors that may be trickier to quantify. Think first about whether you can live on a budget, and how to tap your assets in the right order to minimize your tax bill.

Take time to plan for potential health-care problems or other unforeseen emergencies that could become costly in a hurry. And don't play down the risk that retiring early could leave you bored and restless when peers are busy and satisfied.

Here's a checklist of six issues to consider before taking the plunge.

Have You Saved Enough?

Retiring during a bull market may be easier on the nerves. But it can also make the math more complicated.

The S&P 500 dove in 2008, but it has generated a positive return every year since. An investor who had $500,000 in the index when it hit the financial-crisis low in March 2009 would have $1,599,581 as of Thursday, including dividends—a cumulative return of 220%, according to Chicago-based investment researcher Morningstar.

That could feel like money in the bank. But stocks routinely give up some gains, and a selloff that starts just after you stop drawing a paycheck could do serious damage if you are forced to sell off assets at low prices to cover living expenses.

“Anchoring your plans to the new high-water mark in the market isn’t an accurate measure of your prospects in retirement,” says Steve Utkus, the director of the Center for Retirement Research at Vanguard Group, the large fund manager.

One way to compensate: Discount the current value of your portfolio to account for the possibility of a prolonged and pronounced drop in the market. Investors with 50% of their portfolio in stocks and 50% in bonds should consider shaving as much as 20% off the overall value of their investments and using that lower number to try to determine whether they have enough socked away. Those with a bigger dose of stocks may want to take 25% off the top, he says.

There is another way to measure whether your savings will still suffice if you move up your retirement date—figure out how it would translate into an immediate annuity, an insurance product that generates regular payments.

Take the example of a man with $1 million in savings and monthly expenses of about $4,600. If he is 66 and retires soon, he could turn the savings into an annuity that would pay him and his 62-year-old wife $4,620 a month for as long as either of them lives, according to ImmediateAnnuities.com, an online annuity brokerage. The annuity payments would not grow with inflation.

If he is 63 instead, and his wife is 59, the same savings could buy only $4,390 in monthly income, and the couple would have to find some way to make up the roughly $2,500 annual shortfall or pare back their lifestyle.

Can You Live on a Budget?

Controlling spending is crucial to making savings last. That is harder than it sounds.

One way to see whether you can pull it off in retirement is to live on a strict budget for six months, at a rate that would translate to 4% of your savings a year, a common benchmark for annual withdrawals, experts say.

Another way to look at that 4% “safe withdrawal” number is that you need to save 25 times your expenses to cover them in retirement.

Darrow Kirkpatrick, a former software engineer now living in New Mexico, retired in 2011 at age 50. He says he began thinking about leaving the working world in his late 30s, and started carefully tracking household spending and saving more. He now blogs about his experiences at CanIRetireYet.com.

Mr. Kirkpatrick suggests looking at each recurring expense—the monthly cable bill, for example—and multiplying it by 300, which represents 12 monthly payments a year, times 25. A $50 monthly cable bill would translate to $15,000, without adjusting for inflation.

“That monthly expense might seem insignificant, but it really adds up,” he says.

Moving into a less-expensive home can be another way to cut expenses. Atlantic Trust's Ms. Schnaubelt says she had a client who lived in a home that cost a lot of money to maintain and came with a large tax bill.

Ms. Schnaubelt told the woman, who was 56, that her retirement savings would run out when she was 73. Selling the home and buying one with lower maintenance costs and lower taxes added $1 million to her savings and meant she wouldn't run out of money until her 90s.

Which Money Will You Spend First?

Not all income sources are the same. That is particularly true for early retirees.

For one thing, it is often a smart move to postpone taking Social Security benefits until age 70. Delaying from 62, the youngest age of eligibility, until 70 can increase the monthly payout by 76% or more, says Steven Sass, program director of Boston College's Financial Security Project.

But that means early retirees have more years during which they have to cover living expenses in other ways.

Ms. Schnaubelt recommends making a list of all potential sources of retirement income, including tax-deferred 401(k)-style plans, individual retirement accounts and taxable brokerage accounts. Then come up with a strategy for drawing on them in the order that will make the money last the longest.

Withdrawing some money from a taxable account and some from a tax-deferred account can often be a smart approach for an early retiree. Taxable accounts are useful because long-term investments and dividends are taxed at the rate for capital gains, which can be as low as 0% or as high as 24%. By contrast, money withdrawn from an IRA or a 401(k) is taxed as ordinary income, which could be taxed at a higher rate. In addition, withdrawals before age 59½ often come with penalties.

Still, taking out some tax-deferred savings earlier in retirement can be worthwhile, if doing so will lower the amount of the mandatory withdrawals from tax-deferred accounts that must begin at age 70½.

Those required withdrawals can push account owners into a higher tax bracket. Moreover, there is a 3.8% levy on investment income for married couples who have more than $250,000 of adjusted gross income ($200,000 for singles).

Roth IRAs offer greater flexibility than other types of accounts, as there are no mandatory payouts and withdrawals can usually be tax-free.

How Will You Pay for Health Care?

Getting older can be hard on the body and the wallet—particularly if you call it quits before age 65, when federal Medicare benefits kick in.

The Kaiser Family Foundation says that as of last year, 28% of companies with more than 200 employees offered health benefits to retired workers, and only 5% of smaller companies did.

That means early retirees often need to find another way to fill the gap. Many companies with more than 20 employees offer departing workers Cobra coverage, which typically allows them to keep the coverage they had while working for at least 18 months.

But that isn't cheap—the average monthly cost is $500 for an individual and $1,390 for a family, according to AARP.

Insurance exchanges that sprung up as a result of the Affordable Care Act also offer plans. "The good news for early retirees is the ACA has given them more health-care options than before," says Joe Baker, president of the Medicare Rights Center, a nonprofit consumer-advocacy group in New York.

The bad news: Coverage can also be costly, though premiums can vary by state. For example, the average monthly premium for mid-level insurance coverage for a 62-year-old in Dallas is $612 before tax credits, while similar coverage in Cleveland would cost $558 before tax credits, according to government figures.

Even after Medicare kicks in, health-care costs can add up quickly. Monthly premiums for supplemental plans to help cover services not included in the federal insurance program can run about $200 to $250 a month, Mr. Baker says.

Also, long-term care isn't covered by Medicare or private health insurance. Long-term care insurance can help offset those costs, but often not all of them. A typical private room in a nursing home costs $229 a day, according to government figures, while insurance may cover only $100 of that.

Do You Have a Backup Plan?

Retirement seems like a dream come true for many people. But it is worth giving some thought to nightmare scenarios.

Poor health, unanticipated expenses or a downturn in the financial markets could wreak havoc on the most careful retirement planning.

The first line of defense is emergency cash. Retirees should have enough on hand to cover six months to a year of expenses. Stash it in an account that is easy to access and protected from volatile swings in value, such as a money-market fund or a short-term bond fund.

Doug Nordman retired in 2002, when he was 41, after serving for 20 years in the U.S. Navy's submarine service. He and his wife live in Hawaii, and his military pension covers much of their living expenses. That allows him to feel comfortable investing up to 90% of his savings in the stock market, Mr. Nordman says.

He keeps the remaining 10% in cash, enough to pay for two years of expenses that wouldn't be covered by his pension. His approach is shaped, he says, by the market plunge in 2008 and a desire to be able to ride out a similar downturn without selling stock investments at a loss.

If something does go wrong, think about whether you could cut expenses or return to work. Early and recent retirees may be able to generate new income more easily than people who have been out of the workforce for a decade or more, but reversing course is still likely to be difficult in many cases.

Like Mr. Kirkpatrick, Mr. Nordman blogs about his experiences, at the-military-guide.com, which is focused on early retirement for military personnel. He makes extra money by selling space for advertisements on the site, and donates the blogging income to military charities.

What if You Don't Enjoy It?

Of all the nightmare scenarios, the possibility that retirement won't be fun may seem the least likely.

But retirement isn't for everyone. Affluent individuals are more than twice as likely as other people to keep working in retirement, according to a July survey by Bank of America's Merrill Lynch and Age Wave, a research firm based in Emeryville, Calif., that specializes in aging populations.

Some 33% of retirees with $1 million to $5 million in assets are working, as are 29% of those with more than $5 million. Most say they do so because they want to, not because they have to, according to the survey.

Half of affluent working retirees have shifted to a different line of work, most often because of greater flexibility of scheduling, the opportunity to experience new things, and the pursuit of a passion or interest, the survey found.

The results show how important it is to consider what you will do with your time and to think hard about whether that will be satisfying.

When he isn't blogging, Mr. Nordman says he spends his days surfing the waves off White Plains Beach in Oahu and doing home-improvement projects.

Living in Hawaii isn't cheap, he says, but he doesn't face steep heating and cooling bills because of the temperate climate, and he spends less on gasoline than he might elsewhere because he and his wife often bike around town.

"It's all a lifestyle choice," he says. "If you live a frugal life, it's easier to retire early."