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I have suggested that people would be better off if they massively increased their savings rates. The aggregate Personal Savings Rate (PSR) is defined as the difference between disposable (after-tax) income and consumption spending. It is reported each month by the Department of Commerce and has recently been running around 4%, compared to a 50-year range of 2% to 15%. My proposed savings rate is derived from my recommended spending rule, which is to spend each year 3% of your total wealth, including both financial wealth (the value of all assets less the amount of debt) plus the present value of future net earnings. For example, consider the median income family with head of household aged 40 and income of $50,000 per year. This family has a present value of future income of around $1,000,000 and therefore can spend about $30,000 per year according to my spending rule. The implication of this consumption rule for the measured savings rate is quite variable across families, but in the aggregate amounts to about 30%, or more than seven times the current observed savings rate.

The rationale for my proposal is that spending 3% of your wealth each year is consistent with maintaining the value of wealth over time (that why it is called the Sustainable Wealth plan). The advantages of this are both macro and micro. From a macro perspective, the proposal would mean greater growth in the overall capital stock, productivity and real wages. From an individual perspective, people would build and retain valuable options as they get older; options to retire early, to support family education, business or charitable activities, or to spend more. My proposal flies in the face of much conventional thinking in economics and financial planning.

One criticism is simply one of feasibility. How can people increase their savings seven-fold? Of course, some people cannot. If you are living at or near subsistence then you can't lower consumption very much. In order to build up your savings, you need to focus on building income.

However, most of us are way past subsistence levels of spending. There is a very interesting blog called "Mr. Money Mustache" (MMM) that is written by a fellow who decided that his primary goal was to build up a sufficient investment portfolio that would enable him and his wife to drop out of the work force and focus on enjoying themselves and raising their young son. After appropriate study, they determined that investment income of $25,000 a year would provide for their needs. Then, estimating the future rate of return on a broad equity index fund to be about 4%, they calculated that they needed a portfolio of $25,000/.04=$625,000 in order to retire. Both husband and wife were software engineers enjoying pretty high incomes, approximately $100,000 after tax. If you combine a 75% savings rate (savings of $100K-$25K, divided by $100K) and a 4% real investment return you will achieve your required retirement portfolio in just seven years. They ended up accelerating this process by earning better than 4%. In just a few years they had achieved their portfolio objective and retired. MMM and his wife were quite young when they put their plan into action, and they were able to retire in their early 30s. This opportunity is available to anyone, so long as you can save 75% of income and earn a decent return on investments. If your savings rate is lower it will take longer.

I see two messages in this story.

First, the level of spending that MMM determined to be fully satisfactory for he and his family is surprisingly low. Most families spend a lot more than this. Based on this one example, many if not most families have the ability to dramatically increase their savings rates.

Second, even though we come up with similar recommendations (save a lot more than you are currently doing, and don't dissipate your wealth in retirement) MMM approaches the problem of optimal financial planning quite differently from me. Instead of starting with his projected lifetime earnings stream and attempting to preserve that value, MMM starts with a desired consumption level and uses that to determine the earliest possible retirement date. Both of us target sustaining your wealth in retirement, instead of allowing it to dissipate. MMM's approach is to cut short the value of future earnings as soon as a satisfactory level of financial capital is achieved.

Fragility

Many financial planning proposals are fragile in the sense that they depend on a long list of assumptions including investment returns, rates of inflation and non-occurrence of various debacles like major illness or job loss or collapse of financial counterparties (like, for example, companies that sell annuities). In general, any plan that seeks to maximize lifetime consumption is likely to be fragile, unless it is built on extremely conservative assumptions.

The MMM plan is pretty good on this score, largely because expense levels are low relative to earnings ability. Should MMM suffer a calamitous stock market decline or medical emergency that causes a major disruption in the amount of financial capital, he and his wife could presumably return to the workplace and build back up their portfolio in just a few years to a level satisfactory to handle their consumption needs.

The plan would be even more robust if the spending rate were lower. Instead of spending 4% of wealth each year, if MMM were to spend just 3% (or better yet 2% or 1%) of their wealth each year, then the exposure to a market collapse is much lower. But then again, this would require a larger portfolio and would take more time to accumulate.

My Sustainable Wealth plan is robust as well. The basic idea of the plan is to maintain your wealth indefinitely by keeping spending at or below investment income. Once you are on the plan, subsequent negative shocks to wealth (for example, market downturns) do not necessarily trigger decreases in consumption. The idea is to maintain a stable consumption path. According to the plan, you only "retrench" your spending when the value of a fixed annuity based on current wealth and a conservative estimate of mortality drops below last year's spending level. In general, it will require a sizable drop in wealth to trigger a spending retrenchment. And even should that occur, you can look for guidance and wisdom in spending retrenchment from Mr. Money Mustache. Like him, you might find that this is a blessing in disguise.