The Northwood Perspective

The Critical Role of Expenses in Family Cash Flow Planning

Northwood Family Office is Canada's leading independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ for wealthy Canadian and global families.

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Cash Flow Planning Inputs

At Northwood Family Office we spend a lot of time working with clients to get an in-depth understanding of their financial situation. As part of that, we work with them to understand their goals and then prepare cash flow projections to plan for the capital they will require during their lifetime and for their estate.

Cash flow projections will obviously not be 100% accurate, nor are they meant to be - ultimately 'life happens' and the results will change based on actual experience. Having said that, projections are our best tool to provide 'goal posts' for planning and to help clients make informed decisions. We revisit the cash flow projections every few years based on clients' life changes.

There are only four inputs that impact the results of any cash flow projection:

1. Income – From employment or return on invested capital
2. Expenses – For lifestyle spending or other goals
3. Time Horizon – The amount of time you will live
4. Other Assets – That can be converted to liquid investments to produce income or fund expenses

Each of the four inputs has an impact on the cash flow results, but by far the most important is expenses. Why?

Expenses require after-tax dollars, and take funds away from potential investments that could grow and produce future income. Given that, the impact of increasing spending has a negative compound effect on a projected portfolio or estate. Add to that, the ever increasing cost of inflation.

Figure 1 on the following page shows the output of four scenarios and the 'compounding' impact of varying levels of expenses. Here are the assumptions for this example:

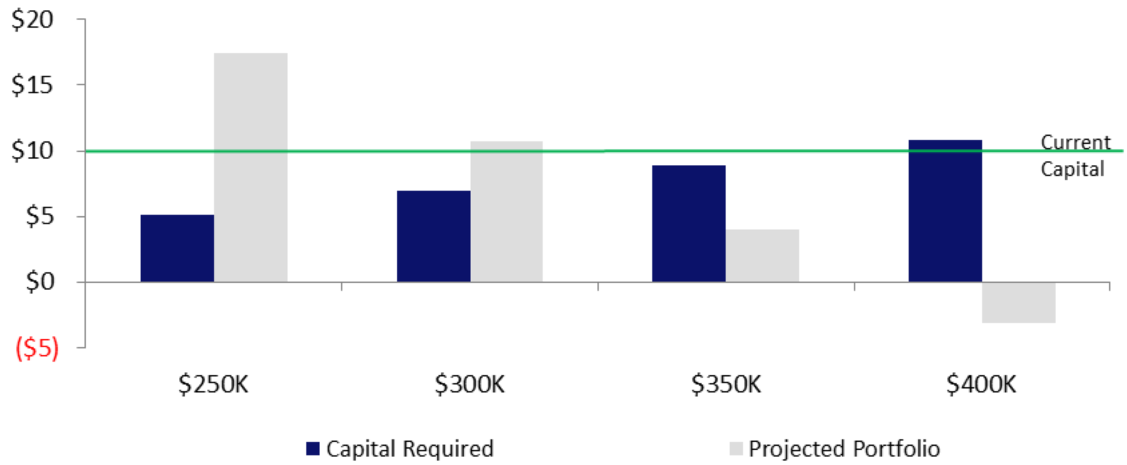
- A 50 year old couple with a $10.0M taxable portfolio
- One spouse is a high-income-earner, making $400K / year, while the other stays at home
- The high-income-earner will work to age 65 and the couple is expected to live to age 95
- Assume no CPP, OAS
- Portfolio returns of 5%, before fees of 1%
- Inflation of 2%

We project two results:

1. The amount of capital required today to fund the couple's life to age 95
2. The projected future value of their portfolio, starting with their existing $10.0M balance

Figure 1: Cash Flow Projection Results

Spending Level	Portfolio Capital Required Today ($M)	Projected Portfolio Value at Age 95 ($M)
$250,000	5.1	17.4
$300,000	7.0	10.7
$350,000	8.9	4.0
$400,000	10.8	(3.1)



Based on the assumptions outlined on the previous page, the couple needs $5.1M in capital today to fund $250K / year in expenses (adjusted for inflation). That expense level should be manageable since they have $10.0M in capital today, and it will also allow them to leave a substantial estate ($17.4M in future dollars). In fact, in all scenarios, the couple will have sufficient capital to fund their desired lifestyle for their lifetime, with the exception of the $400K spending level. Here are some key highlights:

- The incremental capital required today for the couple to spend an additional $50K per year each year of their life is $1.9M. For instance, raising their spending level by 60% from $250K to $400K, results in more than double the capital required today to fund their lifetime spending goals ($10.8M vs. $5.1M), as you can see from the table above.
- The increased spending level from $250K to $400K also reduces the final estate value by over $20.0M ($17.4M vs. a $3.1M deficit), as shown in the table.

This last point demonstrates the long-term 'compounding cost' of the incremental annual expenses. The actual difference in the sum of the future expenses between the $250K and $400K spending levels is large ($11.1M), but the longer term cost to the final estate value is massive ($20.5M).

There is no right or wrong answer in this situation. Some clients may want to deplete their capital by the end of their lifetimes, while others may want to maximize their estate. Either way, it is important to design a framework to achieve those goals. The impact of expense levels is a very important input to consider in this process. While it's not a lot fun reviewing and compiling a year's worth of credit card statements and projecting future expenses, it may be one of the most valuable exercises a family can do.

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Northwood Family Office is Canada's leading independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ for wealthy Canadian and global families. Northwood also serves as a Chief Investment Officer (CIO) for client families, helping them assess their objectives, design an appropriate investment policy, select and manage investment managers and provide comprehensive reporting.

Northwood client families typically have $10 million or more in family net worth.