

Retirement Planning Facts You Should Know

Michael Snowdon, CFP®

Introduction

Jim and Mary Lou are at the kitchen table with worry marks written all over their faces. Nearing retirement, and having heard how people are living so much longer, they are concerned, and they have lots of questions

- What do the experts say about how long we can expect to live?
- How do we know whether we will have enough money to last that long?
- Will we need to adjust our lifestyle?
- Can we still leave a charitable bequest like we planned to do?
- What if our children or grandchildren need our financial help; will we be able to help them and still have enough for ourselves?
- What about the cost of health care, and what happens if one of us has significant medical needs?
- What if our investments do not return as much as we expect? What impact will income taxes have?
- How do we plan for our retirement when there are so many unknowns?

Good questions all. You may be asking yourself many of the same questions. This report provides some answers.

It's all well and good to tell a 30-something that \$1 million is a good retirement target. However, when that 30-something is a 60-something and is asking whether that \$1 million will be enough, how do you make that decision?

The answer, as is true in much of financial planning, depends on many factors. Jim and Mary Lou touched on most of them: longevity, health, taxes, investment returns (and accumulated dollars), lifestyle choices, specific goals, and the desire to leave a bequest. Add to these factors the ever-present "unknown"—things *can* go wrong and emergencies *do* happen.

The Decision to Retire

The concept of retiring from work is relatively new. For most of the history of humanity, workers did not retire. They simply worked until they no longer could do so—often as a result of death. One of the first—if not the first—systems of social security was developed in 1889, when German Chancellor Otto Von Bismarck created a program based on an idea from Germany’s Emperor, William the First. William suggested that workers who are disabled by age and invalidity have a well-grounded claim to care by the state. The German system initially set the retirement age at 70, and later reduced it to age 65 (of course, this was at a time when life expectancy was only around age 45).

In the United States, Social Security was created as part of President Roosevelt’s New Deal program in 1935. At its inception, the Social Security retirement age was set at 65 years old. At that time, overall life expectancy at birth was just under age 62. However, to put things in perspective, in 1940, the percentage of adults living to age 65 was between 54% to 61% (male/female). Of those making it to age 65, life expectancy was another 13 to 15 years (male/female). This means that, of the 131 million or so people in the United States in 1940, about 9 million were older than 65 (7%). Compare that to the year 2000, when, with a total U.S. population of around 281 million, about 35 million were 65 or older (12.5%). Not only is a higher percentage of people reaching age 65, they are living longer once they get there. Average life expectancy for a 65-year-old today is roughly 20 years.

Why does any of this matter? Simply put, Social Security was not really designed to handle the large numbers of people reaching age 65 and living for so many years in retirement. This is one reason why the Social Security full retirement age has been increasing. A significant event recently happened. In October, 2007, the first official “baby boomer” filed a claim for Social Security benefits. The U.S. Census Bureau estimates there to be around 78 million baby boomers (as of July 1, 2005), and that about 330 people reach age 60 every hour. The *floodgates* have officially been opened for boomers approaching Social Security’s full retirement age. Many people believe that the Social Security system will not be able to handle the incredible influx of retirees. If true, this likely means that people who want to retire in their mid-60s are more than likely going to need significant savings to maintain their desired lifestyles throughout their retirement years.

This brings us to the topic at hand: retirement planning. Unless an individual has assets in the millions, there is a good chance he or she will be at least somewhat concerned about having enough money during retirement. This is often translated as having enough income. However, it’s probably more accurate to

use the term cash flow. Income connotes planning strategies involving money market instruments, bonds, and the like. Cash flow is broader, and includes just about every type of asset that might be able to generate dollars to use for living. This might include, for instance, a strategy of liquidating stock holdings, or income from real estate holdings, or (back to bonds) a series of laddered zero coupon bonds. What most retirees really want is enough money to maintain their desired lifestyle. The source of that money is usually secondary to actually having enough of it.

It seems safe to say that the average retiree is interested in, and perhaps more than a little concerned about, having enough cash flow throughout retirement. If Social Security benefits are cut, or a higher percentage of the benefits become taxable, the retiree will need to generate more cash flow to make up the difference. If company pension (defined benefit) plans are scrapped (as seems to happen all too often), the need to generate cash flow increases significantly. Future tax rates will also have an impact on retirement cash flows. Someone who uses only tax-deferred investments (e.g., 401(k), IRA) for retirement savings will likely face a different scenario than the individual who uses both taxable (and/or tax-free) and tax-deferred investments. For those who use only tax-deferred strategies, future tax-rate increases might have a significant impact on available cash flow.

Retirement cash flow decisions are multi-layered. The more you peel back the outer layers, the more complexity is revealed within.” This module will consider many of the preceding factors and their implications for cash flow in retirement. Of course, planning for retirement should begin long before the event. Choices made in the accumulation years—especially how much and where to invest—will have a significant impact on options in retirement. Even though this is true, we will not address the accumulation stage. Instead, the module will assume that wise investment decisions have been made, and adequate funds of appropriate types are available for retirement.

Along the same lines, insurance-related issues can be significant factors in retirement. Our primary focus will be on factors affecting the decision to retire, retirement expenses (including health care), determining how much will be needed, and withdrawal scenarios (including “safe” withdrawal rate strategies).

Factors Impacting the Decision to Retire

Financial planners tend to think first about financial issues, and with good reason. However, the decision to retire involves much more than monetary issues. For many people, social, cultural, interpersonal/relational, and life

fulfillment play a significant role in the decision to retire. These are the types of factors that the emerging field of financial life planning attempts to address, and we will briefly consider these things here.

It is not uncommon for planners to assume that an individual's primary objective upon reaching retirement age is to retire from work. Therefore, the main goal becomes helping that person to have enough income to allow them to stop working. It's a great objective if that happens to be their goal, but what if it's not? What if they don't actually want to quit working? What if, instead, they want to shift gears and move into another career? Perhaps they would like to go back to college. Maybe they want to start a new business. It's possible that they want to focus on work that provides a community service (e.g., pro bono work). What impact will this have on the planner's assumptions? In a word, huge! So, as we look at cash flow in retirement, our first consideration must be, what does "retire" mean to you? The planner needs to uncover what will make "retirement" meaningful to the individual ... and it may not be *retirement* at all.

What relevance does this have to retirement cash flow? Quite a bit, actually. Even at the most basic level, if an individual continues to earn income into his or her 70s, the assets needed to generate sufficient unearned cash flow are greatly reduced. Working may also provide extended health care benefits along with ongoing income. Even just delaying retirement for five or so years can have a substantial impact. On the other hand, instead of increasing income, the individual may realize that he or she wants to donate time and/or money to charitable causes. This may actually increase cash flow needs. So, understanding *retirement* from the individual's perspective is an essential part of cash flow planning.

At some point, regardless of the direction chosen, the retiree will have to consider the financial side of the equation. Lifestyles have to be funded, and retirement lifestyles will likely have some unique financial considerations. Let's look at several of these.

Social Security

Most retirees can look forward to receiving at least some monthly benefits from Social Security. Yes, there is debate about whether Social Security will stay solvent long enough to keep making those benefit payments. As a result, some individuals recommend not adding Social Security payments into the retirement funding mix. That's fine, but for our purposes, let's consider Social Security as one piece of the retirement funding puzzle.

First, a bit of history. Social Security entered the U.S. retirement scene in 1935. However, it was not really the first *social security* program in our country. That honor belongs to military pensions offered to Civil War veterans and their families beginning in 1862 (for the astute historian, the first military pension plan in this country was authorized in 1776, but it was of a somewhat different nature than the Civil War program). The Civil War program was, in several ways, the precursor to our Social Security program. It began by providing a disability benefit, and grew to include retirement benefits. Following the Great Depression, several states began enacting old-age pensions to help the many people suffering financially as a result of the economic problems of that era.

Numerous plans were proposed during this period—some positive, others of dubious merit—all with the intent of helping people, especially older Americans, survive financially. Many people were living in abject poverty; many more were barely hanging on. It was in this environment that the Social Security Act was created. In 1935, then-President Franklin D. Roosevelt signed the act into law. However, the original Social Security program was not the same as what we have today. At that time, Social Security provided unemployment insurance, old-age assistance, old-age benefits (what we now know as Social Security retirement benefits), aid to dependent children, and state grants designed to provide some forms of medical care (direct medical and disability benefits were not part of Social Security until later).

Relatively few benefits were paid under the new program—it took a while to get people registered and on board, plus, not so many people lived long into retirement. Since that time, benefits have been increased numerous times, and many, many people receive those benefits. As a result, the expectation of receiving Social Security retirement benefits is practically ubiquitous. For more information on the history of Social Security, see the Social Security Administration (SSA) website: www.ssa.gov/history/.

One question that is often asked is, whether it is more beneficial to wait to begin receiving Social Security benefits, or to receive early benefits at age 62 (the minimum age at which retirement benefits are available). The answer to that question involves more than the dollars involved. People should consider lifestyle choices as well. Are they in good or poor health? Will taking the early benefit provide enough income to allow them to change directions in retirement—perhaps going back to college, or starting a new business? Do they need the income? Will an eventual pension benefit (i.e., defined benefit) more than make up any income differential between full and early Social Security retirement benefits? These are some of the questions that should be asked when considering whether to take early Social Security retirement benefits.

There is, of course, a dollar differential as well. If we assume the individual would live to the same age regardless of when benefits begin, we can approximate a break-even point. That is, the point at which waiting to receive benefits makes more financial sense than starting at age 62 (or waiting beyond normal full retirement age). The Social Security Administration provides a calculator to determine a break-even age (www.ssa.gov/OACT/quickcalc/when2retire.html). Using the SSA calculator and a \$1,000 monthly benefit, the break-even point between beginning benefits at age 62 rather than age 66 (assuming the full retirement age is 66) is 80 years and 4 months. In this case *break-even* means that, if the retiree lives longer than 80 years and 4 months, it would be better to delay receiving benefits. The amount of benefit received changes the break-even age. For example, the break-even age for a retiree receiving a benefit based on \$100,000 annual pre-retirement income, would be 79 years and 0 months. For a person whose full retirement benefit begins at age 66 (born between 1943 and 1954), there is a 25% benefit reduction for starting benefits at age 62.

Looking at the other side of the equation—waiting to receive benefits until age 70—shows that in most cases, the waiting does not pay. The differential between full retirement benefits at age 66 and the slightly greater benefits at age 70 has a break-even point of more than 100 years old. So, while waiting until full retirement age (e.g., 66) to receive benefits instead of starting benefits at age 62 might make sense, waiting until age 70 does not seem to be the best financial move.

Realize though, that other factors may impact the decision. For example, if you have the investment expertise to get returns on your money in the 8%–12% range, it might make sense to start receiving Social Security benefits and investing the money. Doing so (if you can get returns in that range or better) would likely give you better results than waiting and letting Social Security invest your money (their returns seem to be in the 5% range). Of course, if your investment expertise is not so good, or if you are particularly conservative, waiting until full retirement age makes more sense. Also, as mentioned earlier, if a retiree has the expectation of either limited or extended longevity, those factors should be incorporated into the decision of when to begin receiving Social Security benefits.

Medicare Eligibility

Medicare is a key component of most retirees' financial pictures. Medical expenses can consume a huge amount of available resources, and Medicare helps limit the damage. The Medicare program has four major coverage areas,

identified as Parts A, B, C, and D. Parts A and B make up what is known as *traditional* Medicare, and generally covers in-hospital (Part A) and out-of-hospital and physicians' (Part B) expenses. Part C offers alternatives to traditional Medicare coverage, and is commonly known as Medicare Advantage. In addition to a Medicare Medical Savings Account option, Medicare Advantage has four main plan types:

- Medicare Health Maintenance Organizations (HMOs)
- Preferred Provider Organizations (PPOs)
- Private Fee-for-Service Plans
- Medicare Special Needs Plans

Medicare Part D provides prescription drug coverage. Essentially, people who have Medicare can purchase insurance that provides Medicare-approved prescription drug benefits.

Most people become eligible for Medicare when they reach age 65. Those who have paid into the Medicare system for at least 10 years (40 quarters) receive Medicare Part A coverage without a premium. The remaining parts of Medicare require payment of a premium, and must be applied for once the individual becomes Medicare-eligible.

Medicare can be expected to pay for roughly half of a retiree's health care expenses (**Note:** This does not include long-term care expenses). As a result, Medicare eligibility is often a significant factor in deciding when to retire. An individual may have everything lined up to allow early retirement, but will often delay, waiting to become eligible for Medicare. We will consider health care expenses in somewhat more detail later. For now, given the potential costs, it often does make good fiscal sense to qualify for Medicare before retiring.

Personal Savings

There are many savings and investment vehicles and strategies. These range from the sophisticated (e.g., options plays, commodities, hedge funds) to the relatively simple (e.g., money market, CDs, annuities). Regardless of the vehicle, the key is to put aside as much money as practical for as long as possible. Since many baby boomers have so far failed to do this in any substantial form, there may be the tendency to bias investments toward the more complex and sophisticated options. For a majority of people, this is not the best plan. It is not generally wise to try to make up for lost time by accepting large amounts of

investment risk, especially when retirement is in the relatively near future. So, while other investments may present viable options for a few people, we will highlight several that probably make more sense for the majority. Once again, because this is not a course on investment strategies, we will summarize a few options just to get an idea of what tools are available.

Cash Equivalents

The savings vehicle with the least amount of investment (i.e., market) risk is the cash equivalent. Whether you consider money market funds, bank CDs, U.S. Treasuries, or even passbook savings, there is little, if any, market risk, and this is appealing to a great many people. Certainly it is true that when you invest a dollar in a cash equivalent, you can be fairly sure that you will receive that dollar at some point in the future. So safety of principal is not the concern. However, there is a major concern: purchasing power. Anyone who has even a basic understanding of compound interest or the time value of money recognizes that a dollar received in the future is not the same as a dollar in-hand today. Why? Inflation.

In 1960, a loaf of bread cost roughly 23 cents and a dozen eggs cost around 63 cents. In 2008, that same loaf of bread costs \$1.30 (and up) and the eggs cost about \$1.99 (on sale). A 1960s Chevrolet Impala cost around \$3,000, while the 2008 version is priced in the low-to-mid-\$20,000 range. The change in prices reflects the impact of inflation. The average annual income in 1960 was \$5,600 or so. In 2006, the median household income had increased to somewhat more than \$48,000 (depending on which statistics you use). This means that most people have been able to keep pace with inflation by means of salary increases. When earned income (i.e., salary) stops, maintaining purchasing power can become somewhat of a problem.

A \$100 basket of groceries today, at a 3.5% inflation rate, will cost approximately double in 20 years. However, \$100 in a money market fund today may or may not quite double in 20 years. Additionally, if the earnings are taxed (which is likely), any shortfall increases. This is the biggest problem for retirees who put all their funds in cash equivalents. That said, most advisors recommend putting at least some money in cash equivalents.

Annuities

In its simplest form, an annuity is a contract from an insurance company that provides tax-deferred growth and a systematic payout plan. During the payout period, some of each payment will be taxable, while some will be a tax-free

return of principal (until the principal is completely returned, then all payments will be taxable).

An annuity can provide a valuable safety net for the retiree. If a life income payout option is chosen, no matter how long the retiree lives, he or she will continue receiving annuity payments. When you consider that average life expectancy is increasing, having the guarantee of not running out of money can provide great peace of mind.

Annuities also present a few potential problems. First, the lifetime income guarantees come at a price. Whether the price is justified is a topic for another time, but the insurance company will levy a mortality charge that reduces the annuity's effective return. As is true with any managed money product, annuities also have management, distribution/administration, and perhaps other fees. Generally, the more options found in a particular annuity, the greater the fees (insurance companies, like almost all other companies, seldom offer something for nothing). Many advisors bristle at the fees charged by annuities. However, the question that should be asked is whether the fees are justified by the benefits they provide. If they are, then the fees should not be considered too much of a problem. If not, then try another option.

The most basic annuity form, the fixed annuity, provides guaranteed, level income payments. In its core form, a fixed annuity suffers from some of the same inflation-related problems as cash equivalents. To deal with these concerns, an annuity may provide some level of inflation protection. This may be done by allowing the interest rate to increase over time, or by means of an automatic inflation-related increase. Additional methods may also be used to increase the annuity payments, while continuing to provide a minimum guaranteed monthly payment.

A variable annuity seeks to provide mutual fund-like returns within an annuity wrapper. All the same pluses and minuses of mutual funds pertain to variable annuities. The biggest plus is the potential to significantly increase account values and eventual annuity payments. The biggest negative is that what goes up can, and often does, go down. This variability of returns can create headaches for retirees trying to maintain a minimum income level. To deal with this, a variable annuity may provide a guaranteed minimum account value or payment amount (remember, most guarantees such as this cost money, so evaluate them on a cost-benefit basis).

Annuities come in a great variety of forms. Some provide inflation guarantees, others vary annuity payments in relation to current interest rates. Equity-indexed annuities are structured to provide the guarantees of a fixed annuity with the

potential to share in market returns (based on returns in an index such as the S&P 500). Combination or hybrid plans allow the individual to combine the benefits of both fixed and variable annuities.

Annuity taxation also presents a mixed picture. On the plus side, increases in account values are tax-deferred. This can help account values to grow more quickly than money held in a currently taxable account. It is possible that income tax rates will be lower when annuity payments begin, thus decreasing the overall tax liability. However, there are a few negatives. First, withdrawals made prior to age 59½ may be subject to a 10% early withdrawal penalty. Second, taxable withdrawals are taxed as ordinary income, not capital gains. The difference between ordinary income and capital gains rates can be significant, and may offset at least some of the tax-deferral advantage. These are the same concerns that advisors may have with qualified retirement plans (e.g., defined contribution plans).

Funds: Mutual and Exchange Traded

Mutual Funds

In 1924, the first public mutual fund was born: the Massachusetts Investors Trust. Today, literally thousands of mutual funds with trillions of dollars in assets are available for retirement (and other) investing. A large part of the appeal of mutual funds is that they offer broad diversification with specific investment criteria (e.g., blue-chip stocks, municipal bonds, etc.), under the oversight of professional money managers. Many funds are actively managed, but quite a few are more passively managed. While this is not a forum to debate active versus passive management, we can say that both have strengths and weaknesses. One weakness of many actively managed funds is that they seldom actually “beat the market.” In other words, investors are paying for something they are not receiving. To be sure, a number of fund managers do beat the market on a regular basis, but they seem to be the exception rather than the rule.

Index Funds

As a result, a significant number of financial gurus recommend not using actively managed funds. Instead, they suggest that many investors should use passively managed funds. These funds, in general, attempt to mirror the performance of a given financial index (e.g., S&P 500). Index funds have been available to the public since 1976 (the first one was made available by John Bogle and Vanguard), and they continue to grow in popularity. Why? They are relatively easy, they normally have much lower fees than actively managed

funds, and they are often effectively tax-managed (i.e., fewer internal stock sales means fewer capital gains taxes passed on to the shareholder). Additionally, when an index fund does its job (i.e., mirrors the performance of a given index), investors get reasonable returns, with little financial drama, that do not require constant monitoring of financial markets.

Index funds present some investing concerns, though. For one, most have a moderately high (several thousand dollars) initial investment requirement (IRA minimums are usually lower). Also, when an investor wants to buy or sell fund shares, he or she can normally only do so at the end of a trading day (as is true of many open-end mutual funds). For some investors, this may be taking *passive* a little too far. Those same investors may also wish they had more index options than are typically available in a mutual fund. These investors may want to consider exchange-traded funds (ETFs).

Exchange-Traded Funds

ETFs were first made available in the United States in 1993. Think of them as index funds with something extra. That “something” is that they can be traded throughout the day, like stocks. ETFs are generally low-cost and tax-efficient ways to invest in baskets of stocks (or bonds), and the variety of available indexes is substantial. ETFs can focus on the major indexes, value or growth, specific industries, bonds, real estate, and various countries (and this is not an exhaustive listing of available ETF options).

They do have a few negatives. ETFs trade like a stock, and stock trades cost money. Most investors have to purchase/sell ETFs through a broker (either full service or discount), and brokers expect to earn a commission on trades. Also, ETFs are subject to the same market dynamics as any other investment. While index funds encourage a buy-and-hold approach, ETFs may encourage a more active trading approach.

Which is better, mutual funds or ETFs? Both, or neither. Each has its own purpose and should be used appropriately. In fact, using mutual funds and ETFs in combination may make a lot of sense for people preparing for retirement. As a general rule, though, an individual considering ETFs should either have a good financial advisor and/or a reasonably high level of financial acumen.

Forced Retirement

So far, the factors we have considered that impact the decision to retire have been based on personal choice. However, the choice to retire is not always left to the

individual. Sometimes, an employer can make the decision for the individual. Other times, poor health can force a person into retirement. Either way, the decision on when to retire is effectively forced on the individual.

The government (federal and state) , has laws on the books against age discrimination. As a result, no one is forced into retirement because of their age. Rather, other means are used in lieu of blatantly stating an employee's release is due to old age. Just as there are laws against sexual harassment—yet it still occurs—age discrimination is a reality, at least for some. According to the U.S. Equal Employment Opportunity Commission (EEOC), there were 16,548 formal age discrimination complaints in 2006, leading to monetary restitution of more than \$51.5 million (not counting results from private litigation; www.eeoc.gov/stats/adea.html). Interestingly, the number of formal complaints has not varied all that much over the last 10 years, which means age discrimination has the potential to be an all-too-real factor in the lives of people approaching retirement age.

Whether by layoff or other reduction in force, job elimination, corporate restructuring, or some other means, older workers may face the possibility of not being able to work for as long as they planned. Apart from the social, cultural, and interpersonal issues that may arise (and these can be significant), there are two concerns that may impact retirement. The first, and most obvious, is the loss of income that comes with the loss of a job. If a near-retiree was only planning to work for a few more months, then this will probably not be too significant. However, if the individual was counting on being able to work for several more years, the premature loss of a job can impact not only the current budget, but long-term retirement plans as well.

Most people are at their highest rate of earnings in their 50s and 60s. At the same time, at least in many cases, discretionary income has increased, because the children are grown. This translates into the ability to set aside more money for retirement. Unfortunately, an unexpected job loss can short-circuit those plans, leaving the individual scrambling to have sufficient retirement funds. At this point, many might choose to actively seek a new job, exposing them to the difficulties of getting hired later in life. While reticence to hire older workers seems to be diminishing, it is still very much a part of the employment landscape.

One option being taken by at least some in this situation is to start their own business. In fact, this can become a key part of a person's retirement plan. The positive side of losing your job, assuming there are sufficient assets, is that it creates an opportunity to explore new directions. Perhaps more education is

desired. This could be a good opportunity to get that education. It might be that the person has always wanted to move into another career field. Now they have the opportunity to do so. Of course, these options are not without potential pitfalls, but they are viable considerations for at least some people. So while the loss of a job may create significant financial difficulties, it may create opportunities as well.

The second loss, which can be just about as significant as losing income, is the loss of health care benefits. Medicare eligibility begins at age 65. It is not related to employment status. This means that, if a person is suddenly unemployed prior to age 65, he or she may have a health care coverage gap. If the gap is short (18 months or less), COBRA can often be used to bridge the gap. Longer than 18 months may mean time without health care coverage, and this can have significant financial implications.

You might think that, though the cost may be high, the out-of-work individual can just purchase their own health insurance. Unfortunately, in all too many cases, you would be wrong. Health insurers can have fairly restrictive underwriting requirements that make it all but impossible for older, pre-Medicare eligible people to purchase coverage. Think of it this way: By the time someone reaches their 50s, there's a good chance that he or she has experienced at least one medical problem. Perhaps they are on high blood pressure medication, or they have high cholesterol. Maybe there is arthritis or a back problem. Perhaps something even more significant, like cancer. It is not unusual for these medical conditions, along with others, to cause an insurer to reject an application, or significantly raise the rates, and/or eliminate the medical condition from coverage. This can leave the forced retiree without coverage and facing the possibility of paying substantial medical bills out-of-pocket. It does not take too much imagination to recognize the problems this can create.

This is another reason why many people in this situation will try to get a job—for the benefits. A recent biography told the tale of an ad executive who was laid off at around age 60. He did not have enough savings to last, and was not a very good money manager. As a result, he found himself rapidly running out of money. He also had some potentially life-threatening medical concerns for which he did not receive treatment, because he had no insurance. His solution? He was offered, and took, a job at a retail food service chain that provided benefits. In his words, it saved his life. This is not that uncommon a scenario—forced retirees taking a “lower-level” job primarily for the employee benefits.

A final consideration in the area of forced retirement also has to do with a person's health. Only this time the focus is on poor health forcing the person to

retire. An increasing number of people are indicating their plans to continue working far past *normal* retirement age. However, just because someone plans to keep working, does not mean their body will let them do so. Illness or injury can have a major impact on retirement plans. Remember that most disability coverage ends at age 65 (give or take a few years). Remember, too, that most disability coverage only covers about two-thirds of pre-disability income. While this certainly can help pay the bills, it may not go too far toward putting aside money for retirement. This situation is probably the most harmful for retirement planning—job loss, income loss, and little or no ability to change things. At this point, careful budgeting, including drawing down existing retirement funds, and reliance on Social Security benefits, is probably in the picture.

Retirement Needs Analysis

It is not only people forced into early retirement who need to evaluate their budget. Just about everyone approaching retirement should begin the process of analyzing expenses to determine a working budget. On the surface, this seems to be a relatively easy task. However, dig a little deeper, and the job gets a more complex.

Normal Expenses and Potential Increases

Regardless of how simplistic it might seem, a reasonable first step is to determine a basic budget. For some, this process is quite easy. Their retirement budget will be just about the same as their pre-retirement budget. Take out expenses directly related to employment, and there's your budget. Many other retirees, though, will need or want to make budgetary adjustments. Increased leisure time often means increased spending: gardening, travel, education, home improvements, money for the grandchildren, hobbies, new business ventures, etc. If a person retires at age 65 and lives for 30 years, there will be plenty of opportunities to explore. From the standpoint of personal development, this is wonderful. Looking at personal finances, though, might present a different picture.

Retirement lifestyle changes have significant potential for increasing retirement expenses. A good starting point might be to ask a few simple questions:

- What does retirement look like to you?
- How do you see yourself spending time in retirement?

- How much do you plan to travel to see the grandchildren?
- Do you plan to make major changes, such as starting a business, getting a degree, or remodeling your home?
- What is it that you have always wanted to do, and now will have the time to accomplish?

From this point, you can begin to quantify those plans and dreams. Consider the goal of getting a degree:

- What field of study?
- Full-time or part-time (how long will it take to complete the program)?
- Which college or university?
- Undergraduate or graduate?
- Are there internship and/or residency requirements?
- Will this lead to new career opportunities?

With this information, you can determine the cost of getting the degree along with the potential overall financial impact. It is not uncommon to find that financial realities are at cross-purposes with a retiree's dreams. This does not mean that the dreams cannot be realized. It does, however, require a more in-depth evaluation of their budget.

Let's assume that the new degree will cost \$75,000 and that the individual wants to take the money from savings. What impact will this have on available resources for a retirement budget? The average American has not saved very much for retirement (more on this later), but let's assume that this retiree has accumulated assets of \$750,000. If we assume a 30-year life expectancy, 3.5% inflation, and a conservative long-term rate of return on assets of 7%, we get an annual inflation-adjusted income of around \$38,862. By eliminating \$75,000 up front, potential annual income is reduced to just under \$35,000. Not much of a difference, but indicative how dream fulfillment can impact the long-term financial picture. Of course, it's entirely possible that earning an advanced degree could lead to a new income source, positively affecting the retirement income situation.

You can see how the fulfillment of even one dream can have a budgetary impact. If the individual has quite a few dreams for retirement, the financial implications

can really start to add up. So, when trying to determine a retirement budget, understanding an individual's goals and dreams—and their costs—is a significant step in the process.

Inflation

Earlier, we saw the term *inflation-adjusted income*. Inflation, and its impact on purchasing power, is one of the most significant factors when doing a retirement needs analysis. We have already seen how the cost of a \$100 basket of groceries will just about double in 20 years with an average inflation rate of 3.5%. Let's explore some of the long-term implications of inflation as it relates to a retirement budget.

Just about any financial advisor recognizes that a dollar today will not be worth a dollar in the future. Unfortunately, not all of the advisor's clients recognize this fact. Too many people seem to think that they can plan their retirement budget on a straight-line basis. Meaning, if it costs me \$5,000 a month to live today, it will cost me the same 25 years from now ... and they plan accordingly. The financial implication of this can be profound. If you plan to have enough money to fund a \$5,000 per month budget for 25 years of retirement, and you can earn a 7% return (compounded monthly), you will need a little more than \$700,000 to fund my retirement budget. However, once you add the inflation factor, you will be significantly underfunded. Instead of around \$700,000, you will need slightly more than \$1 million to maintain an inflation-adjusted budget with equal purchasing power (using an inflation-adjusted rate of return of 3.38 compounded monthly). That \$300,000 shortfall will result in a significant decrease in standard of living as the individual advances through the later stages of retirement.

In order to make up the inflation factor shortfall, the pre-retiree will have to significantly adjust his or her retirement savings plan. To accumulate \$700,000 over a 20-year period, at a 7% rate of return, requires an annual investment of approximately \$17,000. To accumulate the \$1 million necessary to deal with the inflation factor requires about \$24,400—more than a \$7,000 a year increase. Let's look at this from another perspective to really see the impact of inflation. If we assume a 3.5% straight-line inflation rate, the purchasing power of \$5,000 is just about cut in half over a 20-year period.

So, at the end of the retirement period, a time when health care expenses can be expected to be at an all-time high, the retiree's purchasing power has decreased to half of what it was at the beginning of retirement. Greater expenses coupled with diminishing income (purchasing power) is not a recipe for a comfortable retirement.

Health Care Issues

Read just about any journal, magazine, newspaper, or Internet site that deals with things financial and you will invariably see an article or survey stating that people are living longer. In that article you are also likely to see that there are problems associated with this increased longevity. Problems ranging from outliving financial resources to outliving friends and family to significant lifestyle changes. One of the most common areas of concern centers around the potential increased cost of health care for seniors. Even the most positive and upbeat commentator is unlikely to deny that there is a looming health care problem—some have even called it a crisis—in this country.

The increased potential cost of health care as one ages is significant. How significant? According to a study by Fidelity, a couple reaching age 65 who live to a normal life expectancy (around age 85) can expect to have medical expenses in retirement of around \$225,000. This amount identifies costs in excess of what is covered by Medicare, and represents a 4.7% increase over the 2007 estimate of \$215,000 (Fidelity health care study, Boston, March 5, 2008:

<http://personal.fidelity.com/myfidelity/>

[InsideFidelity/index_NewsCenter.shtml?refhp=pr](http://personal.fidelity.com/myfidelity/InsideFidelity/index_NewsCenter.shtml?refhp=pr)). It is important to note that, while this figure includes expenses related to Medicare, it does not include long-term care and a few other types of expenses. An earlier Employee Benefits Research Institute (EBRI) study ups the ante. According to that study, a couple who lives to age 95 could need as much as \$550,000 for medical expenses (July 2006, EBRI Issue Brief #295:

http://ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=3650).

Whether or not those forecasts are strictly accurate, it seems clear that health care expenses have the potential to consume a large portion of a person's retirement assets. When you factor these expenses into the average retiree's financial picture (remembering that many people do not seem to have saved nearly enough money), the picture does not look very positive.

What can be done to deal with the health care expense problem? Perhaps the biggest and best option is to begin, early on, incorporating the need for increased health care dollars into planning solutions. A 55-year-old who wants to accumulate an additional \$500,000 by age 65 would have to increase annual deposits by more than \$36,000 (at a 7% after-tax rate of return). A 30-year-old would only have to increase annual deposits by around \$3,600—10% of the 55 year-old's requirement—to achieve the same goal. Further, the additional time would allow for more equity investments with potentially higher returns, which in turn might allow for lower annual payments. As an example, an 8% return

would decrease required deposits to around \$2,900 per year. Granted, inflation would likely need to be factored, but the principle is sound. Starting to plan for the need sooner rather than later makes the goal easier to achieve.

For those closer to retirement, viable options depend on their financial status. In this, as in many situations, money can make life easier. Self-funding should not be too hard for a retiree who has accumulated millions of dollars and/or has sources of substantial ongoing income. Yes, it may still require careful allocation of those resources, but with proper preparation, which includes setting aside enough money to cover potential health care expenses, there should be no problem living a comfortable retirement.

Part of good planning should also include considering the purchase of applicable insurance policies and/or using other planning tools, such as an annuity. The dollars spent in these areas now may make a substantial difference in retirement. As an example, long-term care insurance premiums can increase substantially as a person ages. A policy that costs \$1,000 per year at age 50 may cost three times that much by waiting to make the purchase at age 65. Purchasing such a policy early enough will almost certainly save money in the long run. A 55-year-old who purchases an LTCI policy (at \$1,000/year) and lives to age 85 will have a potential savings of \$30,000 over a 65-year-old who purchases a policy (at \$3,000/year) and lives to the same age.

Is LTCI Worth the Money?

This is a question many researchers and end-users are asking. The answer, as is true of many health-care-related questions, is not simple and not uniformly applicable. Let's look at some of the considerations.

Two general statements can be made up front. First, if you are very wealthy (i.e., assets in the multimillions) you probably do not need LTCI. You can just pay the expenses out-of-pocket. Second, if you are on the other end of the financial spectrum and very poor, LTCI probably does not make sense. The cost of coverage is likely to be too high. Can you dispute both these statements and show situations in which they are wrong or not applicable? Absolutely! However, both statements can stand as reasonable generalizations (realizing that every person and situation is different and requires individual analysis).

People between those two poles have a more difficult time deciding to what degree LTCI makes sense. Among the factors necessary to consider are quality and availability of LTC, maintaining personal choice and freedom, premium cost, and asset and income protection.

In a capitalistic society, whether we like it or not, those who *have* can generally get better care than those who *have not*. This is not to say that it's fair or the best way for things to be done. This is, however, often the way it is in the United States. The implication of this is, if you have your own funds you can afford to purchase whatever type of care you desire. If you do not have those funds in the bank, LTCI may provide at least a partial solution. With LTCI, insureds can pay for many of the health care services they desire.

So, if someone wants full flexibility in pursuing any and all reasonable forms of treatment, that person will have to have the financial means to do so. In the absence of a large bank account, LTCI can provide all—or at least some—of those funds.

It will do so, however, at a price. Annual premiums for LTCI can be more than \$1,000—often quite a bit more. In addition to being impacted by the benefit amount (e.g., \$150 per day), the premium can be controlled to some extent by adjusting the waiting (or elimination) period and the benefit term. The waiting period is the length of time between when LTC services are needed and when the policy begins paying benefits. The longer the waiting period, the lower the policy premium (up to a point). Choosing a longer waiting period has to be balanced with the resulting increase in out-of-pocket expenses. However, if funds are available, longer is probably better. Many policies have a maximum waiting period of about 180 days. However, some offer waiting periods of up to 12 months.

How long of a benefit period to choose is another big concern when trying to manage premiums. The average length of time someone over age 65 might need LTC seems to be around three years (women slightly longer, men slightly less). So it would seem logical to choose a benefit period of around this length of time. Many people do. Others want a greater margin of error, and prefer a longer benefit period. Some people suggest a benefit period of around five years to coordinate with the *look-back* period if the individual needs to qualify for Medicaid. The problem is that the longer the benefit period, the higher the premium. As a result, people may choose a much shorter benefit period in an attempt to manage LTCI premiums.

Some individuals might combine an extended benefit period with a very long waiting period (e.g., 12 months) in an attempt to keep premiums a little more reasonable. Use of such a plan might be termed a *catastrophic* LTCI policy. Why catastrophic? While the average need for care may only be around two or three years, what happens if an individual needs LTC for longer—say for 10 or 20 years? Had this person chosen a three-year benefit period, he or she would

almost certainly be facing the depletion of available financial assets, perhaps even to the point of having to qualify for Medicaid. For those with the means to pay for an extended initial period of LTC, being able to increase the benefit period would help protect against the eventuality of a much longer need for care (the *catastrophic* need). Certainly this would not be an appropriate choice for everyone, but some people might benefit from going in this direction.

How Much Money Will Be Needed for Retirement?

After reviewing the underlying issues and areas of concern, two primary questions remain:

- How much money will I need to fund my retirement budget?
- How much of my retirement nest egg can I safely withdraw (to ensure my money does not run out)?

Funding Retirement

First, let's consider the question of how much money will be needed to fund retirement. On the surface, this appears to be an easy question to answer. Determine an annual budget, add unusual and extra expenses, decide on a life expectancy and relevant economic factors (i.e., rate of return and inflation), and calculate the present value as of the first year of retirement.

As an example, let's assume that the Smiths are a 50 year-old couple with an annual retirement budget of \$75,000 (in excess of any Social Security benefits and stated in today's dollars). They want to plan for a retirement life expectancy of 25 years (starting at age 65), and assume a 3.5% average inflation rate and a 7% long-term rate of return. The Smiths want to know how much money they will need at age 65 to fund their retirement.

Without going through the calculation details here, the process lets us know that the Smiths will need just under \$2.2 million in 15 years to fully fund their inflation-adjusted retirement budget. Of course, we didn't include any additional expenses such as travel, financing other retirement goals, and health care expenses. Let's do that now.

For most people, the desire to travel seems to be greatest immediately following retirement. As age progresses, that desire often begins to diminish. This would mean front-loading required travel dollars, but for our purposes, let's assume an annual amount of \$7,500 (when retirement begins—this translates to about \$4,500 today). Granted, this may be low for some and high for others, but let's use \$7,500 as a fairly reasonable starting point, and adjust it for inflation throughout retirement. A quick calculation of the present value of our inflation-adjusted \$7,500 annual travel budget for 25 years comes to around \$129,449.

Adding the travel budget to our annual income budget brings the total to \$2,298,174. A calculation of the present value of the assumed \$225,000 health care expenses is \$181,076. This assumes annual expenses of \$9,000 (\$225,000 over 25 years), 5% inflation, and an investment rate (for unused funds) of 7%. Now the total sum needed to fund retirement is up to just under \$2.5 million.

Let's make a few points of clarification. First, if you vary any of the assumptions, you will likely arrive at a very different number than \$2.5 million. Second, the example assumes that everything happens on a straight-line basis, and this is highly unlikely (to the point of being impossible). Inflation, rates of return, and expenditures will all vary—perhaps daily, but certainly year-to-year. Again, this variability will have dramatic results on the amount needed to fund retirement. We will consider some of the impact of variability shortly. For now, let's consider some of the implications of our brief needs analysis.

We have not considered Social Security benefits or any available employer-provided pension benefits, both of which may help considerably. Assuming that the Smiths retire at age 65 (which will be just short of the Social Security full retirement age), and currently earn \$125,000, Social Security calculates the future value of their monthly benefit at \$3,628, or \$43,536 annually (<http://ssa.gov/cgi-bin/benefit6.cgi>). Subtracting this amount from the desired future income of \$125,651 leaves a shortfall of \$82,115. A recalculation brings us to a fund of \$1,417,291 necessary to provide 25 years of inflation-adjusted income.

To accumulate this amount by the time they reach age 65, the Smiths will need to invest just under \$53,000 each year (at 7%). Unfortunately, saving this amount is not likely. Since we are assuming, let's say that their mortgage will be paid off when they reach age 65, and they anticipate home equity of \$750,000 at that time. This is a substantial sum, part of which would certainly be useful in funding their retirement need.

What is the purpose of the exercise with the Smiths? In part, the Smiths' example shows how difficult it can be, even for those with pretty comfortable incomes, to fully fund their desired retirement. It points out that multiple tools may have to

be used in order to provide the necessary funds (e.g., savings, Social Security, home equity, etc.). It also highlights the great advantage to be gained by starting a retirement savings plan early and getting competent advice. As an example, if the Smiths had started saving at age 30, and had invested \$7,000 each year (just under \$600/month), they would accumulate a little more than \$1 million by age 65 (at a 7% return).

The exercise with the Smiths also identifies the need for good financial planning, including a thorough exploration of retirement goals and dreams. As we have seen, retirement costs money—lots of it. While it's relatively easy to dream up a wonderful retirement scenario, it's quite a bit more difficult to fund that dream. This usually requires prioritizing, and perhaps significantly modifying, goals. If we assume that most people do not realize how much money will be required to fund their retirement goals, we can understand how this conversation might result in some consternation. However, the more people are able to approach their retirement (and overall financial) planning with open eyes, the better they will be able to craft a reachable goal.

Variability in Retirement Planning Assumptions

The previous calculations assumed that all the factors remain fixed. Income needs do not change (except as influenced by inflation). Inflation and investment return rates remain consistent throughout the retirement period. Everything remains the same. The problem with this assumption, of course, is that it just doesn't happen that way. Ever. In fact, one of the biggest problems with *traditional* retirement planning is that the process seldom incorporates the variability that most, if not all, advisors recognize as reality.

Inflation provides a good example. In the illustrations so far, 3.5% has been used as the inflation rate. It's a reasonable average rate based on history. However, it's also not particularly accurate on a year-by-year basis. Since the early 1900s, inflation has ranged from around -10% to +20%. Even adjusting for changes in measurement and for various economic conditions, that is a substantial range. More significant than average inflation for the retiree, is the actual impact of inflation *during* retirement. If financial planning is based on a 3.5% rate, but real inflation during a significant part of the individual's retirement is closer to 8%, the retiree will more than likely run out of money.

Leaving a Bequest

If the Smiths want to leave a little something to their alma mater, they, of course, need the money to do so. One of the factors that needs to be determined is *when* they wish to make the gift. The longer they wait, the more time they have for their investments to work, and the less money they have to set aside at the beginning of their retirement. However, the Smiths may want to see the results of their gift, which would require giving it prior to death. This will also mean they have to allocate more money up front to fund the gift.

To illustrate the difference timing makes, let's assume that the Smiths wish to leave a \$500,000 bequest to their alma mater, and they want to know the funding difference between giving it at the beginning of retirement or at the end. The difference is substantial. To give the money at the beginning of retirement means that the Smiths will have to fully fund the gift (i.e., the entire \$500,000). They will not be able to benefit from investing their money over the 25 years of their retirement. If, on the other hand, they choose to leave the \$500,000 as a bequest (as opposed to a lifetime gift), they would only have to deposit \$92,125 at the beginning of retirement.

This assumes an annual return of 7%, and of course, \$500,000 in the future is not worth the same as \$500,000 today. So let's compensate for 25 years of inflation. If we inflate \$500,000 over 25 years at 3.5%, the future value is \$1,181,623. Working a discount calculation of that inflated amount—at 7%—results in a present value of \$217,713. So, even if the Smiths want to leave their alma mater the inflated equivalent of \$500,000, they will benefit greatly by doing so as a bequest, because of the 25 years of investment return (purely from an investment/retirement funding perspective, and not considering additional estate planning factors).

“Safe” Withdrawal Rates

So far, we have been looking at things from the perspective of accumulating enough income to fund retirement. For people who have been saving and those who have quite a few years before entering retirement, the needs analysis approach is a good one. However, to be realistic, many people approach retirement with X amount of dollars already accumulated, regardless of the actual need. These people need to know how much they can regularly withdraw from their funds, while ensuring that the remaining money lasts throughout retirement.

A number of studies have been done in this area over the last several years, most of them attempting to help people determine the maximum possible *safe* amount they can withdraw from retirement funds. Safe, of course, being a relative term, and not often truly achievable. There are just too many variables and unknowns for any withdrawal plan to be considered absolutely safe. Still, people are looking for this information, and available information is helpful in designing appropriate strategies.

William Bengen

Early work in this area by William Bengen put a safe initial withdrawal rate at a little more than 4% for an individual in the 60–65 age bracket (Bengen 1998). In his studies, Bengen found that at around a 4% initial withdrawal rate, with annual adjustments for inflation, just about all well-constructed portfolios would be able to last throughout retirement (at least for 30 years). Of course, there is more to Bengen's study than this brief summary paragraph, but this will be sufficient for now.

The biggest problem most people have with a 4% initial withdrawal rate is that it doesn't normally represent a lot of income. For every \$100,000 in a retirement portfolio, 4% will generate \$4,000. Unfortunately, if that \$4,000 is withdrawn at the beginning of the first year, the portfolio now has only \$96,000 to invest. Assuming a 7% return for the year, the ending portfolio value would only be \$102,720. If inflation for the year is 3.5%, the *real* ending value would be \$99,246. We're moving backward. Things are a little better if the money remains invested for the first year, and the \$4,000 is withdrawn at the end of the year (or the beginning of the second year). In order for this process to work, especially if the retiree wants to keep pace with inflation, investment returns have to perform at least as well as the historical returns on which the study was based (basically, the same returns everyone uses as a guide).

Still, 4% does not represent very much income for most people. Even on a \$1 million portfolio, the initial withdrawal would be only \$40,000. For someone with that size portfolio, it is likely that \$40,000 would represent at least somewhat of a lowered standard of living. As a result, there has been further research to see how high the initial *safe withdrawal rate* could be raised. Even Bengen, in a follow-up to his seminal work, investigated ways in which to safely increase initial—and subsequent—withdrawal rates.

Bengen's more recent work suggests building a *layer cake*. The various layers are modifications—special situations—that may impact withdrawal amounts. The main points of Bengen's theory are highlighted below.

Notice that Bengen continues to suggest a base withdrawal rate of 4.15%. However, some more conservative individuals, especially those wanting more security, may want to reduce the initial withdrawal rate to 4% (or even further in some situations). On the other hand, those who are willing to accept more risk and more uncertainty may be able to increase the initial withdrawal rate to more than 7%. The factors or *layers* Bengen suggests are:

1. Withdrawal scheme (foundation layer)
2. Asset allocation
3. Success rate
4. Rebalancing interval
5. Super-investor (normally capable of better-than-average returns)
6. Desire to leave a legacy
7. Time horizon

Bengen focuses on four fundamental assumptions that must be determined for each individual. The first is the tax status of the portfolio—tax-advantaged or not. Time horizon is the second crucial element. For how long does the individual expect to need income? The third factor is asset allocation, and the fourth is how the portfolio is rebalanced. Another key factor is the required success rate – that is, the degree of confidence that everything will work and the money will last.

As you might guess, there is a significant difference in allowable withdrawals between someone who requires a 100% success rate (i.e., no real possibility that the money will run out), and someone who is willing to accept an 80% success rate. By incorporating these different rules—or “layers”—significant changes can be made in the definition of *safe* withdrawal rate.

Jonathan Guyton

Another individual who has done a great amount of research in this area is Jonathan Guyton. Guyton, in part, built on Bengen’s work to further determine safe withdrawal scenarios in retirement. Guyton has released two major studies, the second revisiting and building on the first. Guyton’s work suggests that, based in part on the portfolio percentage devoted to equities, it may be possible to increase the *safe* initial withdrawal rate to as much as 6.2% (Guyton 2004).

Guyton's paper, in his words, "establishes new guidelines for determining the maximum "safe" initial withdrawal rate, defined as (1) never requiring a reduction in withdrawals from any previous year, (2) allowing for systematic increases to offset inflation, and (3) maintaining the portfolio for at least 40 years."

As was the case with Bengen's studies, the amount of assurance that an individual needs relative to the portfolio lasting throughout retirement, has an impact on initial withdrawal rates (IWR). Guyton focused on two "confidence standards," 99% and 95%. Here are his results (summarized):

- At the 99% Confidence Standard, Max IWR is:
 - 4.5%–4.6% with 50% equities
 - 5.2%–5.3% with 65% equities
 - 4.7%–5.6% with 80% equities
- At the 95% Confidence Standard, Max IWR is:
 - 4.8% with 50% equities
 - 5.5%–5.7% with 65% equities
 - 5.6%–6.2% with 80% equities

Moving from 50% equities to 65% equities definitely made a positive difference. Additionally, a portfolio with 80% equities allows for an even higher IWR, but the level of risk is substantially higher. A portfolio with 65% equities (in various categories) seemed to provide the best balance between risk, return, and maximum IWR.

Guyton's work also requires withdrawal rate freezes based on poor market returns. This means that there is no inflation-adjusted withdrawal rate increase following a year in which the portfolio experiences a negative return. The obvious reason for this is an attempt to build sustainability into the retirement portfolio, while maximizing annual withdrawals. Additionally, inflation-related increases are capped at 6%, even if actual inflation rates are higher. This would potentially have a negative impact on purchasing power, but is necessary to maintain the portfolio in keeping with the two confidence standards.

Notice that the studies of both Bengen and Guyton suggest that increasing portfolio equity percentages (to a point) has a significantly positive impact on

both initial withdrawal rates and subsequent withdrawals, as well as overall portfolio sustainability. This should come as no real surprise to even a casual student of investments. However, it is contrary to what many still consider to be the correct way to structure a retirement portfolio. That is, the percentage of fixed income and cash investments should be immediately and significantly increased upon entering retirement. A better approach appears to be moving the year's required income/ withdrawals into cash, and leaving the rest of the portfolio invested in whatever allocation has been chosen.

Income Versus Cash Flow

We should probably take a moment to address the differences between income and cash flow. The distinction is simple, but has significant consequences. *Cash flow* involves structuring a total return portfolio to fund a retirement budget on a year-by-year basis. Money for the budget may come from many sources, including dividends, increases in an equity portfolio, rental receipts, and the liquidation of assets. When a portfolio is structured around cash flow, it is trying to balance income-generation, while maximizing growth, within reasonable safety parameters, so as to provide the highest levels of inflation-adjusted funding for as long as needed.

Portfolios structured to provide *income* are primarily invested in income-producing investments such as bonds. Income portfolios are the comfort food of retirement accounts. They make account holders feel good about retirement, at least for a while. It is comforting to know that year after year, you will have a known amount of income—not too dissimilar from a paycheck.

Unfortunately, there are two primary problems with an income portfolio. First, if it does not respond to inflation, purchasing power will start to erode. Over time, this normally produces hardship for the retiree. The second problem is related to the first. If an attempt is made to build an income portfolio that can effectively handle inflation, the retiree will have to accumulate significantly more money than with a cash flow portfolio. The inflation-fighting properties are just not normally there with income portfolios. So, when answering the question of how much money will be needed, an important point of clarification is whether you will be building an income portfolio or a cash flow portfolio.

Putting It All Together

While we have barely scratched the surface of all the variables related to retirement cash flow considerations, we have looked at enough issues to begin coming to some conclusions. First, let's review some key factors in determining optimal retirement cash flow portfolios.

Perhaps the biggest issue today, and looking forward, is increased longevity. On the whole, people are living significantly longer than their forebears. As an example, life expectancy (at birth) in 1900 was around 47 years (www.cdc.gov/nchs/fastats/lifexpec.htm). In 2004, the same life expectancy number increased to close to 78 years. That's a 30-year increase in a little more than 100 years (i.e., about 67%). Even looking back to 1960, the life expectancy at birth was just under 70 years, which means we have seen about an 11% increase in just over 40 years. Even though the percentage of increase seems to be slowing (e.g., life expectancy at birth in 1990 was 75.4 years), it is clear that people are living longer. This must be factored into any long-term retirement planning.

Whether it remains level, increases, or decreases, we can be pretty certain that inflation will continue to be a factor to some degree. As we have seen, the loss of purchasing power due to inflation can be the cause of considerable difficulties for the retiree. As an example, at a 3.5% inflation rate, over 20 years, the value of \$100 is essentially cut in half. This means that a \$75,000 annual budget today will need to be \$150,000 in 20 years, with no increase in purchasing power. We can reasonably conclude from this that retirement portfolios must be structured to, at the least, keep pace with inflation. This almost certainly means incorporating a significant equity exposure.

However, with equities comes volatility. Recent events have seen stock markets on a roller-coaster ride of ups and downs. Swings of more than 200 points in one day have been seen many more times than most people prefer. It may be relatively easy for an advisor to feel good about saying that, overall, even though there have been ups and downs, the stock market returned X%, so it's been a good year. However, most retirees don't look at things that way. A 75-year-old facing intraday swings of more than 200 points might not be sleeping very well. When structuring a portfolio, especially for an older person, volatility must be considered, and asset allocations should be chosen accordingly.

Which brings us to asset allocation. As has already been discussed, the idea of a mostly fixed-income/cash-based retirement portfolio is probably not the best idea for most people. While most of the discussion of investment risk focuses on

market risk, especially for retirees, loss of purchasing power represents an equally, if not somewhat more, significant risk. This being the case, our retirement portfolio must include equities. How large a percentage? For our purposes, let's suggest a 65% equity allocation (borrowing from Guyton's study), recognizing that this percentage may need to be adjusted based on current economic and market conditions, and individual risk tolerance.

Our portfolio also needs to allocate about a year's worth of income/budget requirements to cash or cash equivalents. This will take care of each year's withdrawal needs. It would also be prudent to allocate a percentage of assets to an emergency fund. This money should also be held in cash equivalents, or at least something that is reasonably stable and liquid. How much should be allocated to an emergency fund? That depends on the individual situation. We do not have to cover regular expenses from this fund, so there should just be enough so that any emergencies, such as the furnace dying or the need to fly to Singapore for a family emergency, don't break the bank.

Let's assume the Smiths, the retirees from our earlier example, are among the many people for whom owning equities in the form of mutual funds or exchange-traded funds (ETFs) makes the most sense. The real question for the Smiths is what types of funds are most appropriate. "What types of funds" refers to such things as index or non-index (i.e., passive or actively managed), domestic, international, global, large-cap, small-cap, (or mid-cap), emerging markets, growth, value, growth and value, etc. Since, by some counts, there are more than 10,000 mutual funds, there should be no real problem finding funds for the Smiths' portfolio. The bigger problem is in deciding what percentage of the various categories to use (of course, picking the actual funds within each group is also very important, but we will not delve into that process).

Since we are looking at a retirement portfolio, the overall market-risk level needs to be considered in that context. So, while we have agreed on a 65% equity exposure, we probably should bias that exposure to the lower end of the risk spectrum. At least part of that exposure might include dividend-producing assets. However, because the other looming risk is the loss of purchasing power, and the Smiths may live for another 30 years or more, we should include at least some more risk-aggressive assets.

Regardless of the starting point, the question becomes, should the initial allocation remain the same throughout retirement or should it be changed over time?

I think we would probably agree that the allocation should not remain constant throughout retirement. As the Smiths move closer to the end of their lives,

income needs—especially for health care expenses—will likely increase, requiring a greater allocation to income-producing investments (e.g., high dividend equities and fixed income). Additionally, from a psychological standpoint, many, if not most, seniors grow a little more conservative and fearful as they age. The fear is based in reality. They are no longer creating new income/assets, and they need to have confidence that their existing asset base will last as long as they do. This usually results in a gradual lowering of their risk tolerance threshold.

By the time the Smiths reach age 75, they might be more comfortable with closer to a 50/50 equity/fixed income allocation. Over the following 10 years, they might want to reallocate closer to a 35/65 equity/fixed income allocation. Sometime in their 90s (or sooner), the Smiths will probably want close to a 100% fixed income allocation, eventually with all short-term bonds and cash equivalents. Remember though, neither the Smiths nor anyone else knows exactly how long they will live. If all their planning focuses on only 25 or 30 years of retirement, and they actually live for 40 years, they could be in financial distress at the end of their lives.

The point of this exercise is not to absolutely define the one “best” portfolio allocation plan. There are too many variables, too many options, too many unknowns to do that. Instead, we simply have looked at creating an overall flow and built a potential foundation for a sustainable retirement portfolio.

Final Thoughts

Now that we have discussed many of the variables and created potential portfolios, along with a plan for sustainable withdrawals, everything’s set, right? What could go wrong? In a word, everything. Even starting at age 65, we are planning for 25, 30, 40 years, or even more, into the future. A future where negative results can be far more devastating than if we were doing this with a 25-year-old. It’s also a future that, at least at this moment, seems to be filled with more unknowns than have had to be faced by many previous generations. So what does this mean as we consider the area of retirement cash flows?

For one thing, it means we need to be candid with ourselves. We need to consider the reality that we are dealing with the great unknown, so we can be prepared. We also need to evaluate our retirement plan, and perhaps make changes, even on a year-by-year basis. This is not an area where we can do a plan and put it on autopilot. Depending on the current economic environment, some

of those changes may be somewhat painful. However, it seems preferable to take a cut in income for a year or so and be able to have the money last throughout retirement, than to maintain and/or increase income every year, only to run out of money years before we had planned.

For our purposes though, the primary focus should be on what *is*, and what can be done *now*. By incorporating some of the concepts in this report, along with the increasing body of excellent research being done by Bengen, Guyton, and others, you can have a portfolio and retirement plan that effectively supports a vital, vibrant retirement.

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