

Setting the Floor Level of Retirement Income Needed

By
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Abstract:

At what age do we accept that we have achieved the most affluent lifestyle we will achieve in life? Do we then take steps to ensure that our future lifestyle is never any less affluent? Or do we accept that our level of affluence may change in the future, sometimes by our own design and sometimes by factors outside of our control? How much fluctuation are we willing to accept? How much may we find necessary to accept? What tradeoffs are we willing to make now to have a better lifestyle in the future? These are some of the real world questions that traditional financial and retirement planning tend to skirt in favor of more simplistic assumptions.

Background & Discussion:

Traditional accumulation planning assumes that a retiree will need 60% to 80% of their pre-retirement income to maintain their lifestyle throughout retirement. But 60% to 80% of what pre-retirement income? Aside from the effects of inflation over a working lifetime, income is likely to fluctuate substantially, hopefully upward – but not necessarily, during one’s career. In accumulation, this doesn’t seem to matter a great deal. You simply use the latest info each time you update the plan.

But in retirement, it does matter. Generally, planners deal with it simply by assuming a level or smooth lifestyle throughout the remaining years of life, no matter how long or what happens. But is that a realistic assumption?

Larry Kotlikoff, in his extensive work on consumption smoothing, exposes the virtue of balancing current savings and spending with the goal in mind of ensuring a consistent balance of current lifestyle with being able to maintain that same lifestyle for life². Of course a younger person whose earnings increase significantly gets the opportunity to reset this smooth level of consumption if earnings significantly increase. Presumably, however, no one would want to plan on a lower lifestyle (based on consumption level) in the future, i.e. One happily will increase their standard of living but doesn’t want to ever be forced to reduce it.

There’s a certain undeniable logic to this concept and no doubt many would agree that this represents their objective for their financial future. But throw in the monkey wrench of the uncertainty and unpredictability of the future. How much certainty can we achieve? How much are we willing to pay for if achieving that certainty means being certain of a potentially lower standard of living?

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² <http://www.esplanner.com/>

Enter behavioral finance and the basic truth that most individuals place a higher value on nearer term consumption that is more certain and a lower value of consumption in the distant future when it is both less certain, and the possibility of our living to realize it is less certain. Moshe Milevsky in a presentation at RIIA's Spring Conference in March of 2010³ indicated that this was not only common, it's rational.

Similarly, one common planning approach is to simply match non-discretionary expenses to guaranteed lifetime sources of income, such as Social Security, pensions, annuities, etc. There's also a certain logic to this, since the concept is that no matter what happens, the retiree would always be able to meet their non-discretionary expenses. However, I'm reminded of an Econ 101 lesson that in the long-run all fixed expenses are variable. The categorization of expenses into discretionary and non-discretionary is always somewhat of a subjective exercise and very point in time dependent. We live in one of the richest nations in the world. Most of us have a great deal of room to downsize our lifestyles before we're at the poverty level.

At this point in time, I might consider maintaining two homes, golf memberships near each, two cars and a boat as non-discretionary, but as my health or circumstances change, I might no longer need or desire two homes, two cars, a boat or play golf. On the other hand, I might develop a health condition with a treatment that becomes non-discretionary, but isn't even in my budget today.

So where does this leave us as Retirement Management Professionals in working with our clients to try to balance our clients desire to enjoy the initial stages of retirement, but without creating an undue risk that they won't be able to maintain an adequate standard of living during the later stages of retirement?

Most importantly, there is no one right answer that we should be trying to persuade our clients to accept. Each client will have very strong personal feelings and objectives along with different needs and reasonable expectations of longevity. Retirement has been described as a delayed gratification proposition. This is also true when balancing the initial stages of retirement with the potential of living well past average life expectancies. It's really all about trade-offs, trade-offs that are very personal and individual to each of our clients. Only by thoroughly understanding these, can we propose potential solutions that will provide a sense of confidence and trust. To a large extent, our job as Retirement Management Professionals is to help our clients make informed decisions about these trade-offs, particularly, since many of the trade-offs involve complex issues that the average person won't fully understand.

What are some of the questions that we might ask our clients to develop this understanding and help our clients make informed decisions? Steven Covey gave some good advice, "start with the end in mind"⁴. In this case, it may be useful to help our clients envision the later stages of retirement first, say the stage when they are 80 or 85 years old. Why do I pick 80 or 85? This is the stage when they are reaching their current statistical life expectancy. It's also the point where they are less likely to be able or interested in working and therefore have little if any human capital to fund their consumption needs.

³ www.riia-usa.org

⁴ *7 Habits of Highly Successful People* 1989 Free Press, Stephen Covey

It's also a point when they are likely to be settling into a less active lifestyle and more willing to downsize or give up some of their current consumption (e.g. second homes, cars, boats, etc.).

We could ask our clients, "If you were to think ahead 20 years or so, how do you envision your lifestyle and spending needs compared to what they are today?" Many clients will have very specific ideas, such as, "I can see myself moving into assisted living or I can see myself settling into one small home near my children and grandchildren, etc." With other clients, it may be necessary to ask more specific questions, such as, "Are there current expenditures that you have today that you don't feel you would still need at that stage of retirement?"

Once we have a clearer picture of what level of expenditure the client would be comfortable with in the later stages of retirement, we can propose solutions to put a floor under that lifestyle. For clients in good health and a family history of longevity, longevity insurance or fixed immediate annuities with a COLA, may be a good option. (Of course the fixed immediate annuity will take up a much larger portion of the portfolio, but also provides this same level of flooring throughout retirement, not just for the later stage.) For other clients, Mike Zwecher offers a number of alternatives in his book, *Retirement Portfolios*, including zero coupon treasury bonds, etc.

Creating this floor and earmarking the necessary portion of one's portfolio to provide it gives us as Retirement Management Professionals a lot clearer problem to solve for in developing a flexible long term retirement income plan. If we assume that the floor for the rest of the client's life should be no less than this long-term floor, we can quickly see if the client is underfunded, constrained or over funded.

If the client is underfunded on this simple test, there are a set of alternatives to discuss with the client around improving their financial situation, such as delaying retirement and saving more, working for a period of time in retirement or further reducing minimum lifestyle expectations.

If the client is constrained, we now have a much clearer picture of what resources there are to work with over the next 20 years. E.g. there may be different levels of flooring that are appropriate at different stages of retirement during this 20 year period. However, it may well be that the floor the some client are comfortable with looks more like the long-term floor, so that there are more assets to allocate to upside. For these clients, a better lifestyle in retirement may be dependent on performance of the upside portfolio or the level of employment income, or some combination of the two. Other clients may want to protect a higher level of flooring, trading off less potential upside. Again it involves trade-offs and is a personal decision with no single right answer.

For the over funded client, the decision as to what to allocate to flooring is almost entirely about personal preference. Some might want to expose the majority of their portfolio to upside, knowing that even if things go badly they will still have enough to meet non-discretionary needs. Others may want to protect their basic living expenses first and then let the remaining upside portfolio provide extras and / or increase the amount they are able to leave as a legacy.

Conclusion:

So in conclusion, what are some of the key points we can take away from these simple examples and discussion?

1. The appropriate level of flooring varies from one client to another, even when those clients have similar financial circumstances;
2. The appropriate level of flooring, will rarely be level throughout retirement, due to changing lifestyles and needs and objectives at different life stages;
3. The portion of the floor that the Retirement Management Professional needs to construct at different phases of retirement may be very different for many reasons:
 - a. The level of flooring needed may be different
 - b. The portion of the floor met by pensions or fixed annuities will most likely be steadily decreasing in real dollar terms due to inflation
 - c. Employment income may be part of the flooring, particularly early in retirement

All of this points to both the complexity of the challenges in creating a comprehensive retirement income plan for your clients, as well as the invaluable service you can provide by applying this level of personalized analysis and advice.