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Retirement Income Planning, Part 3*: Risk and Investment Strategy for Retirees

If you are working on the assumption that retirees should still be investing for "growth," you may be providing them bad advice. Here's why the new conventional wisdom is probably wrong for most people.

The New Conventional Wisdom

Until recently, most people believed that, unless you had money you could afford to lose, all post-retirement investments should be conservative. Primary goals were safety of principal and generation of income, not growth. This strategy appealed to people who retired in the 1980s and early 1990s, because most of them had lived through at least part of the Great Depression of the 1930s. They knew from experience that even modest investment risk could lead to financial catastrophe.

People who retired in the 1980s and early 1990s…knew from experience that in the worst-case scenario, even modest investment risk can lead to financial catastrophe.

By the late 1990s, however, financial professionals began advising retirees to pursue growth as well as income. They reasoned that because retirees are living longer, their money has to last longer and their expenses are more subject to inflation. Different studies (usually involving Monte Carlo analysis) and different advisors make somewhat different assumptions and recommendations. But typically they suggest a portfolio with about 50% invested in stocks and, assuming that a high level of confidence is needed that the funds will last, an annual withdrawal of around 4% of the initial balance.

The combination of a relatively high-growth investment strategy and a relatively low withdrawal rate does offer significant advantages:

- Reasonably high assurance that funds will last until death.

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* Part 1 of this series discussed the urgent and wide-ranging planning needs of people facing retirement, and concluded that if financial companies and employers want to serve this demographic group, they need to address *all* these planning needs. In Part 2 we further explored the follow-up question: can a comprehensive financial planning approach really work for retirees and, if so, how?

- Inflation protection: under most scenarios, asset growth will support an increase in annual withdrawals. The longer the time horizon, the more likely that withdrawals can increase, and by a larger amount.
- Asset growth: an excellent chance that the retiree will die wealthy.

At the same time, this kind of investment approach carries important disadvantages:

- The initial withdrawal rate of 4% is very low. A family that needs only $25,000 a year from retirement savings would have to start with $625,000 in principal, an amount a majority of families do not have.
- Adverse results are still possible. The models are built on about 75 years' worth of data; there is no guarantee that the future won't be worse than anything we have seen in the last 75 years. Also, most of the models assume that funds need to last 25 or 30 years. If two married, healthy, non-smoking 62-year-olds retire today, there is about a 5% chance that one of them will live *forty* years or more.
- Asset value fluctuation, which can be unpleasant for younger people, is far less congenial to most retirees. An investment strategy that works financially may prove to be a strain psychologically.

Is a Conservative Strategy Better After All?

When evaluating the trade-offs, we have to keep in mind that retirement not only changes, but in many ways *reverses* the normal financial rules. We will return to this notion shortly, but for now it has two immediately relevant applications:

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- Inflation is not as important after retirement as it is before retirement. Social Security is inflation-adjusted, as are many traditional pension plans. More important, though, inflation slows down or even stops for most people who live into their eighties or nineties. True, a few expenses (medical costs, real estate taxes, energy costs) continue to rise, or even accelerate. But most expenses decline or disappear as the retiree becomes infirm and loses energy. Travel, dining out, entertainment, clothing purchases, home furnishings, auto expenses, and home improvements tend to fade away. Even everyday purchases like groceries, cosmetics, and other incidentals lessen. Overall expenses, therefore, tend to stay relatively flat for most people past their early eighties.
- Asset growth, of key importance to pre-retirees, is not so important a goal after retirement. Under favorable or even "normal" scenarios, a strategy of aggressive investment and conservative withdrawals means that typical retirees die considerably wealthier than they were when they first retired. This outcome, however, does not reflect the true needs of retirees – most of whom would like to leave something behind if they can, but don't rate this a high priority.

Maybe the *old* conventional wisdom is worth revisiting. Until the mid-to-late 1990s, retirees were usually advised to put their money into certificates of deposit, treasury bonds,

high quality corporate bonds, and reliable dividend-paying stocks.

This strategy has one very clear disadvantage:

- There is little or no upside potential: virtually no chance of significant asset growth.

But it also has several important advantages:

- Usually, more than 4% can be earned while taking little or no investment risk. Even in today's unusually low interest environment, some 5-year certificates of deposit pay over 4%, with 10-year CDs at 5%. Longer-term government and corporate bonds pay even more: Moody's AAA bond yield is currently over 5½%. In most years, a diversified conservative portfolio can produce safe returns of 5%-6%, or more. The extra earnings (above 4%) can be added to principal if the retiree does not need to spend them, and this becomes a hedge against inflation.
- These returns can be withdrawn with no expenditure of principal. No matter how long the retiree and/or spouse lives – even to the world record age of 126 – there will still be money. And if an expensive and eventually fatal illness strikes, or if nursing care is needed, the principal could then be tapped.
- If the retiree does not have huge end-of-life cash needs, s/he will still leave an estate for heirs, though one not as large as a more aggressive investment strategy might produce.
- The retiree will not suffer stress watching a portfolio fluctuate.

We believe that the advantages of a conservative post-retirement investment strategy are much more aligned with what retirees really care about.

Why Taking Investment Risk Doesn't Make Sense for Most Retirees

As we suggested earlier, many general rules shift into reverse when people retire. One of these has to do with investment risk. Most people cannot afford to take nearly as much investment risk in retirement as they took before retirement. Here's why:

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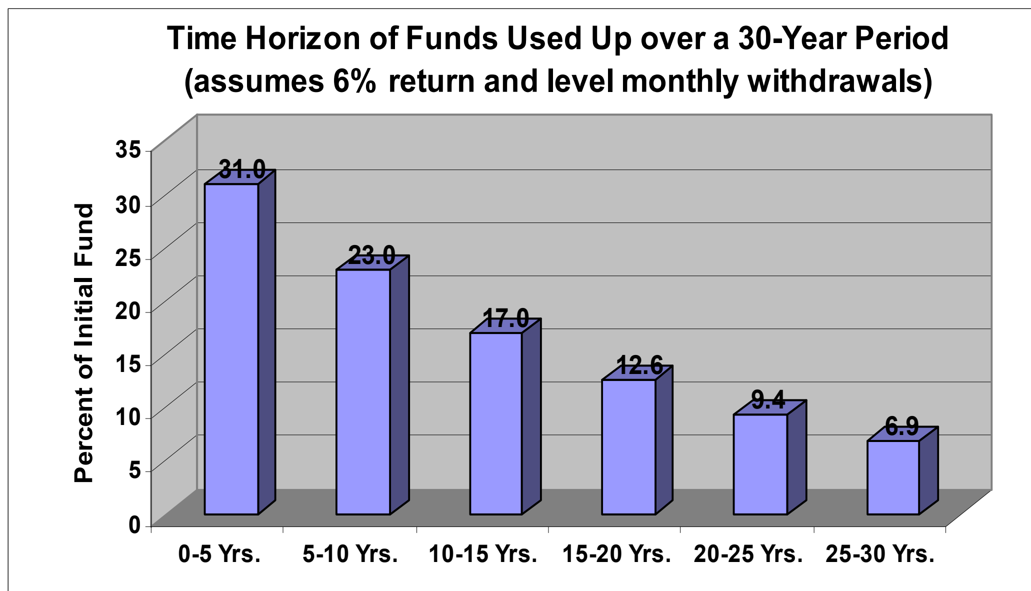
- If things go badly, retirees have few options for recovery. After being out of the workforce for a while, credentials are stale, and a retiree who needs to go back is unlikely to be paid at the pre-retirement level. By the time a retiree realizes that an investment strategy is failing, s/he might not be physically able to work or might be able to get only minimum-wage employment.
- Withdrawing money from retirement funds, rather than putting it in, changes everything. For the same reasons that "dollar cost averaging" works during the accumulation phase, it works against the retiree during the withdrawal phase. The recent models take this into account, but that is why the withdrawal rate they can support is so pitifully low.

- The retiree's time horizon for investments is shrinking. When most people retire, their life expectancy is another 20 years or more, but only a small portion of their money will survive that long. Suppose that we assume that the funds will be amortized over 30 years with a steady 6% rate of return and level monthly withdrawals. Now let's divide the initial nest egg into six pots, each of which will cover the retiree's income needs for one five-year period. The pots that support later withdrawals are smaller because they have time to grow; the initial ones have to be larger, because they will not experience much growth before they are withdrawn. As the chart shows, 54% of the beginning balance has to go into the first two pots, with a time horizon of 10 years or less. Less than 7% of the beginning balance has a time horizon of 25+ years. So it is very misleading to say that there is a 20- or 30-year time horizon at retirement.* Generally, a retiree's initial fund is a short-to-medium-term investment fund. (Ironically, if you do the math, this is even more the case at higher rates of return.)



- Investment professionals tend to look at risk as an investment phenomenon. This makes sense during the accumulation period, but it is another one of those things that reverses direction at retirement. If you instead think of post-retirement planning as a problem in matching retirement assets (including cash flows from pensions, annuities, and Social Security) against retirement liabilities, the vast majority of the risk is on the liability side. On the asset side, initial balances are given, and future income is reasonably predictable. But liabilities are wildly unpredictable. Though ordinary expenses and inflation can be estimated with reasonable comfort, longevity is highly variable. So is health, and the enormous expenses that can be associated with either acute or chronic illness. Family circumstances can also change. Life is simply unpredictable. The significance of this, from our

* For example, the *Ernst & Young Retirement Planning Guide*, while correctly warning that at retirement the investment horizon is not "immediate," goes on to say that "your time horizon is the rest of your life." (2002 Edition, p. 183). Regrettably, this has become a common misconception among people concerned with retirement income planning.

asset-liability matching perspective, is that retirees are already taking a huge amount of risk on the liability side, most of which they usually cannot – or cannot afford to – significantly reduce. In this situation, piling unnecessary risk on the asset side does not make sense.

- As previously mentioned, investment risk produces stress, which can be a health risk for older people. This is too high a price to pay for the possibility of dying rich.

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Determining When Investment Risk Does Make Sense for Retirees

Our general recommendation is to use a conservative investment strategy for any funds needed for essential purposes. If the retiree has initial assets that appear more than sufficient to meet the most essential needs, and if he or she feels comfortable assuming some risk, then the surplus can be invested more aggressively.

In order to properly implement this strategy, however, we need a way to determine the most essential needs of the retiree. This means understanding how the retiree copes with mortality, health, and other "liability-side" risks. We must also determine how a particular retiree household differs from the norm, as it can in many, many ways. Unfortunately, existing models tend to look almost exclusively at the asset side of the equation.

Perhaps better yet, we should take into account that all risks – whether related to assets or liabilities – can be bought off. Inflation risk is bought off by reducing current income, and saving the difference. Mortality risk can be bought off in a similar way, but with the cost varying by age, sex, smoking status, etc. Health risks can be bought off by insurance. The real questions for retirees are: how much risk in each category does each person in the household face, would it be desirable to buy off those risks, and if the retiree cannot afford to buy all of them off, which ones are the best deal for the price? Models that look only at the asset side of the equation cannot begin to provide a valid answer.

At Still River we are focusing on the liability side by building software that will help families and their advisors determine what their needs really are, what their risks and options are, and only then determine what decisions they should be making. When all the needs and all the appropriate decisions are taken into account, then (and only then) can an appropriate investment strategy be determined.

We'd like to hear from you. Our goal is to do this right and to do it better than anyone else, and we benefit from all points of view, not least of all yours.

Still River Retirement Planning Software, Inc., provides both web-based and desktop software offering specialized calculations related to retirement plans and retirement planning.

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