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Retirement As A Mess Of Maybes
By Lewis Walker

Is planning for retirement a design challenge? In an article called "No Accounting For Design?" that appeared in Fast Company, writer Bill Breen offered a nugget applicable to the current retirement planning conundrum, asking the question: How do you survive retirement without arunning out of money?

Breen deals with the conflicts that arise in a bottom-line focused company when creative design types meet accountants and engineers. The latter demand "numbers," proof that something will work before moving forward. The creatives, however, are drawn to what Whirlpool Corp.'s design chief Chuck Jones calls the "Las Vegas approach." Here, "you're basically asking people to roll the dice and hope for the best."

With disdain for the Las Vegas approach, deep-thinking members of our profession seek quantifiable metrics that will increase assurance for a clients that they will not deplete financial resources before death. With a tip of the hat to author Lee Eisenberg, the Holy Grail is THE NUMBER! "The number" being the withdrawal rate from a retirement portfolio that creates the highest probability of sustainability until assumed mortality.

Bob Veres, publisher of Inside Information, has kept the discussion lively in his newsletter by examining the work of thought-leaders such as Michael Kitces and William Bengen. In a January 15, 2007 e-column, "Paradox Lost," Veres played with "the Kitces Paradox"—how to apply percentage-based withdrawal rates to client portfolios with changing values based on market fluctuations and potentially different "take out patterns."

"The Number" is a big deal. But what number, and what mix of assets constitute a rational choice?

Glenn Ruffenach, writing in a December 11, 2006, Wall Street Journal report, "Encore: A Guide to Retirement Planning & Living," cited Bill Bengen's mid-1990s research that gave rise to the "4% rule." Essentially, Bengen postulated that retirees can withdraw about 4% annually from their liquid asset base with a high probability that savings will last 30 years. (Given the mortality statistics that get tossed around, three decades seems sacrosanct.) Take out more than 4%, and the odds of sustaining financial independence begin to decrease. Bengen's number actually is 4.15%, but that is only one ingredient in what he calls a seven-layer cake of varying asset allocation mixes, return assumptions, withdrawal schemes, rebalancing tactics and client risk tolerance.

Helpful advice is everywhere, but retirees and preretirees may wonder if we are creating a numerical Tower of Babel. Wall Street Journal Getting Going columnist Jonathan Clements in a January 17, 2007, article entitled "How to Survive Retirement—Even if You're Short on Savings," noted varying solutions to the withdrawal enigma. One approach is "to limit the yearly portfolio withdrawal rate to 3% or 4%, equal to $3,000 or $4,000 for every $100,000 saved." (At this point you may want to have a shot of scotch or a crying towel handy for the less-than-mega-wealthy client who stares slack-jawed and mumbles, "That $3,000 ... is that per month or per year?")

Clements opines that 3% to 4% "is well below the 5% and 6% withdrawal rates that used to be advocated and reflects, in part, a concern about today's lofty stock valuations and low after-inflation bond yields." Clements pushes the envelope further south, quoting William Bernstein, an advisor in North Bend, Ore.: "Two percent is bulletproof, 3% is probably safe, 4% is pushing it and, at 5%, you're eating Alpo in your old age. If you take out 5% and you live into your 90s, there's a 50% chance you will run out of money."

Quantifying The Unquantifiable?

Pick a number between 2% and 6%. Sounds like Las Vegas again!

Go back to the design analogy. At Whirlpool, chief designer Chuck Jones focused on customer preferences. Staffers asked consumers what their expectations were for an appliance. What do they want it to do? What do they prefer? Ideas and design prototypes were shown to customer focus groups to test reactions. For Whirlpool, the idea that if customer wants and expectations (client metrics) drive design, profits will follow, seems to be working out. Jones' approach suggests a compromise between a quant-driven effort to synthesize "the Number" and a Hail Mary "Las Vegas" approach.

When numbers confront real-world wants, needs and fears, conflicts arise. Suppose that a need for $100,000 per year in after-tax cash flow is identified for a client. This amount, $8,333 per month, is in today's dollars, net of Social Security or pension payments. Here is how that might appear on a grid:

Academic studies, statistics and probabilities may be one thing, reality may be something else.

Selena Maranjian, in a January 19, 2007, posting on The Motley Fool (Fool.com), "Prepare for a Gruesome Retirement," offered results from a 2005 Retirement Confidence Survey (RCS). The survey reflected total savings and investments by age group, not including the value of the primary residence. Here are the grim results for those age 55 and over as they consider retirement: 39% have saved less than $25,000; 12% have from $25,000 to $49,999; 7%, $50,000 to $99,999; 23%, $100,000 to $249,999; and 19%, $250,000 or more.

Look again at the eye-popping numbers chart. Cut monthly income in half to $4,167 per month ($50,000 per year) not including Social Security, and between 2% and 5%, a person needs a capital pool of $2,500,000 down to $1,000,000. According to the RCS study, only 19% of respondents had more than $250,000!

To paraphrase Dr. Phil, "How's that workin' out for ya?" Do we tell clients to "go long on Alpo"? There is a real-world disconnect between "pretty sure" numbers and net worth feasibility for large numbers of Americans.

The Maslow Conversation

Like our design chief who asked consumers what they wanted, in a holistic approach to financial advice we start with the client's articulated expectations gathered in conversations. When it comes to the money conversation, Mitch Anthony has provided useful insight into client wishes and priorities in his book, The New Retire-mentality: Planning Your Life and Living Your Dreams ... At Any Age You Want, 2nd Edition (Kaplan Publishing, 2006). Clients are asked to define cash-flow needs and expectations based on Abraham Maslow's famous hierarchy of needs. These questions are designed to match emotional needs to financial decisions. Money needs are divided into five levels of an emotional pyramid:

1. Survival Income: The money one has to have to make ends meet.
2. Safety Income: The money needed to meet life's unexpected turns.
3. Freedom (Fun) Income: The money needed to do things that bring enjoyment and fulfillment to life.
4. Gift Income: The money needed for people and causes that one deeply cares about.
5. Dream Income: The money needed for the things one has always dreamed of being, doing or having.

A guide to "The Maslow Conversation" may be found in the book Retirement Income Redesigned: Master Plans for Distribution, edited by Harold Evensky and Deena B. Katz, Chapter 2, Maslow Meets Retirement, by Mitch Anthony and Lewis J. Walker (Bloomberg Press, 2006). This writer has found the Maslow conversation invaluable in determining what clients want and need in order of psychographic priority.

Once these things are determined, you can match desired cash flows, minus sources of income like pensions or Social Security, with cash-flow producing assets to determine the annualized average rate of return needed to meet goals. Does the client have sufficient horsepower to meet expectations? A "yes" answer takes you in comfortable directions. A "no" requires harder and realistic creative decisions.

Here is another reality check. A cousin to the 800-pound gorilla is inflation. A person in an average marginal tax bracket of 25% who is spending 4% net of taxes, at 3% annualized inflation, requires a gross average annualized return of 9.33% (7/.75).

How does that square with academic studies? Bengen looked at historical returns and found that a mix of 40% intermediate-term U.S. bonds and 60% large-company stocks, with a withdrawal rate of 4%, sustained virtually every 30-year period going back to 1926.

An investor retiring on January 1, 2007, faced an inverted yield curve with intermediate-to-long-term Treasury bonds yielding less than 5%. If the fixed-income portfolio of $40,000 yields from 5%-6%, the 60% allocated to equities must average 11.6%-12.2% to deliver our targeted return of 9.33% over time. In an era of "diminished expectations," does that fly?

In countless conversations with retirees, a total return target of 7%-9% seems about average. If a mix of equities greater than 60% is required to meet performance targets, volatility becomes an increasingly crucial factor and we are back to Bob Veres' paradox question again.

Mr. Buffett's Bear Market

Those financial planners with roots in the 1960s and 1970s remember that equities as a whole delivered low returns with high levels of volatility. Inflation and high marginal tax rates destroyed fixed-income yields.

Most advisors, however, came of age post-1982 after the Reagan tax cuts and Paul Volcker's taming of inflation ignited one of the greatest bull markets in history for paper assets. Meanwhile, the baby boomer wave, known because of its demographic bulge as the "pig in the python," and those ahead of them, were moving toward "retirement." The mantra was accumulation, growing the financial pile.

The rolling returns for many paper asset classes from 1982 to 2000 were far outside the long series

norm on the positive side of the curve. When money is pouring into investment buckets and returns are generous, high commissions and lucrative compensation trails are tolerated.

"Reversion to the mean" has been a sobering fact of life as the boomer wave laps at the shores of economic and statistical reality. Past rates of return for asset classes or specific securities, if used in a linear projection, are highly misleading. Often the numbers used are pretax, gross before expenses, and are based on money not being withdrawn from the pile.

The distribution phase in the investment life cycle is a vastly different ball game. Here is a graphic instructional tool. On the Internet, click on bigcharts.com, and enter the symbol "BRK.A" for Berkshire Hathaway Inc. Click on "1 decade" for a ten-year performance chart.

In late-January 2007, the chart revealed a price of approximately $35,000 a share in early 1997, with the most recent 52-week high at $114,500. Very impressive! Warren Buffett, the Oracle of Omaha, has earned his stripes as an investment genius. He has legions of fans who have owned BRK.A or BRK.B for long periods, content to let the holding grow.

Study the chart closely. Use it as a client tutorial. Notice the occasional spurts—the jumps in value over relatively short periods of time. Notice, too, periods of sharp decline and long stretches of "go-nowhere" performance. It was not until late 2003 that BRK.A again reached the value attained in mid-1998. By some measures, that's a bear market exceeding five years.

Again, it was mid-2006 before BRK.A exceeded its high point of early 2004. Drill the point home. "Mr./Ms. Investor, had you withdrawn any money from BRK.A to sustain your retirement at any time in the last decade, especially during down cycles on the stock's price, your rate of return (ROR) would be well below the ROR widely touted for Berkshire Hathaway."

Recognize that the financial services industry was built around a growth-oriented accumulation model during both a demographic and market-performance anomaly. Base future assumptions on an anomaly, and you virtually guarantee error. The distribution conversation, how to take money out of investment buckets, is a fee-based conversation, not one based on incoming transactions. A different mindset is required for both advisor and client.

Knowing What We Don't Know

Start the planning process with the Maslow conversation, and clearly understand client concerns, fears and challenges; the alternatives they and you might see; the resources at their command (assets, earning power, cash-flow sources, insurance, family and support networks); and most important, client expectations for and assumptions about their future, what lawyer and advisor Dan Taylor calls the C.A.R.E. model in his book The Parent Care Conversation: Six Strategies for Dealing with the Emotional and Financial Challenges of Aging Parents.

Next, we must clearly define what we do not know. Tools like Monte Carlo analysis are useful in demonstrating that markets are volatile and that static assumptions about ROR are spurious. But, are there dangers in their application? Jim Otar, a CFP licensee and an advisor in Thornhill, Ontario, has a science and engineering background and is as "quant-savvy" as anyone. But in a January 8, 2007, article in Investment News, he says he finds Monte Carlo analysis lacking, as it does not "fit the markets." In the article Otar notes: "The markets are random in the short term, cyclical in the medium term and trending in the long term. Monte Carlo is random. But markets are far from being random in the long term. In real life, you get bulges in the tail ends [of the distribution curve during] secular bull markets or bear markets. Most Monte Carlo models can't simulate that. Even if they do, they still can't simulate the correlation between asset classes."

Otar is spot on: Who really knows what the future pattern of a specific asset class, security or portfolio will be? With the spread of global investing, derivatives and hedging vehicles, who knows how correlations will play out? With the political divide rancorous and fractured in a way not seen since the Vietnam era, who knows what tax policy will be? How do we factor in inflation, especially in the service sectors (like health care and elder care) that are more likely to impact seniors?

With the client, we can only estimate cash-flow needs. We do not know his date of death or future health-care needs. Accidents, illnesses, home and car repairs, declining mental and physical capabilities, even the propensity for elders to bail out children and grandchildren who need help—all take a toll on finances.

Yet, if we hit a client with a ream of numbers that suggest that if they tweak their portfolio or their distribution rate, the odds of not running out of money prior to death improve from 58.9% to 86.3%—do we infer that we have a magic black box? Are we providing fodder for a lawsuit filed by disgruntled clients and/or their offspring if projections do not pan out? Then the numbers may be legal landmines. Perhaps the antidote for numerology is a dollop of common sense.

Your Paycheck Fund

An engineer and longtime client of mine seemed troubled about his upcoming retirement. When pressed about the source of his anxiety, he blurted, "Lewis, I don't know where my paycheck is going to come from!"

Anyone who has worked for a salary for a long time knows what will be received each pay period. That certainty is lost when we contemplate distribution from a portfolio whose value and viability are

threatened by a host of unknowns and "a mess of maybes."

Going back to Mitch Anthony's Maslow conversation, safety income may be seen as "what-if" money. Rather than an income stream, it may be viewed as a monetary reserve designed to handle upcoming large expenses (a new car, home renovation, any major purchase) and as a source of emergency funds. What if it also became a "paycheck fund," or, for well-off bons vivants, as Mitch would suggest, a "play-check fund"?

Looking at major market averages like the S&P 500 index or the Dow Jones Industrial index, the worst bear market since the Great Depression lasted three years from 2000 to 2003. Not a great time to take money from a portfolio.

Here is a conversation that as an advisor you might have with a client: "Suppose, dear client, we took three years of monthly cash-flow needs, say $8,333 per month times 36 months, and put $300,000 into a Federal Deposit Insurance Corp.-guaranteed liquid repository like a money market fund. This is where your paycheck will come from every month. For the first year we will draw zero from the balance of your portfolio. Periodically after that, every year, or every six months, we will make a tactical decision as to where to draw funds to replenish your paycheck fund."

For large enough portfolios, separately-managed accounts (SMAs) are useful. Each money manager who manages a specific asset class represents a distinct bucket from which money can be withdrawn depending on market conditions. With an SMA, for personal money you have a good handle on realized and unrealized short- and long-term capital gains, facilitating tax management. In the mix also may be mutual funds, ETFs and CDs.

We may not know exactly how various asset classes will correlate going forward. We do know that styles (growth, value, core) will vary, as will asset classes (short, intermediate and long-term bonds in fixed categories; U.S. stocks and non-U.S. stocks; large-, mid-, and small-cap stocks; utilities; REITs; convertible bonds; preferred stocks; natural resources; and commodities). Where an asset class is on either side of the standard deviation bell curve will have an influence on a decision to withdraw money.

We will also see periods of normal volatility, as well as abnormally high volatility due to unforeseen market shocks. These may be "lightning events," bolts out of the blue like 9/11 or the crash of 1987. Such events depress prices but do not destroy the companies at large that undergird a well-diversified portfolio. Clients get that, and if they are secure in having sufficient money in a "paycheck fund," and perhaps also in short-term paper or CDs, they can ride out any storms that occur. This simple logic is a great relief. This is applied common sense, with no numbers that can come back to haunt you.

The clients know that they are not being put on autopilot. You will be with them as an advisor to make course corrections and take detours as necessary in their quintessential journey through active retirement, or "restylement," as Ben Combs calls it, into the Valley of Elder-Care Dependency and matters of legacy.

Reality Check

Even if you use a 5% withdrawal yardstick, telling some clients that they need $1 million in assets for every $50,000 per year ($4,167 per month) of desired cash flow is enough to cause a stroke or other forms of apoplexy. Some clients will not be able to retire in a classic sense at age 60 or 62; they cannot afford to do so!

This opens the door to the "discernment conversation." Maria C. Forbes, a consultant in Alpharetta, Ga., has been using tools originally developed to help people discover God-given gifts (or "charisms") for application in religious ministries and community volunteer work. Seeing a correlation with other diagnostic tools designed to help people understand their unique abilities, Maria helps people to discern potential second career paths based on forward-focused energy, passion and purpose. The discernment conversation is but one of a portfolio of processes and conversations that creative planners will offer to clients.

With the entitlement crisis looming and politicians dithering, self-reliance and self care, as well as "wealth care," will become watchwords. In addition to pushing clients to "save more early and often," we should encourage the payoff of all debt, including the home mortgage, by a targeted retirement age. With the growing development of reverse mortgages, home equity may become a safety valve, to be used only as a last resort as a source of cash flow.

Clients should avoid taking Social Security early, deferring benefits at least until full retirement age. We know that in some cases annuities have been over-hyped and mis-sold. However, new-generation contracts are emerging that can provide guaranteed lifetime income with an upside, without annuitization. For some clients, immediate or deferred annuities could become a "fixed-income surrogate," and a key element in safety income under the Maslow concept.

Insurance planning remains a critical element in retirement planning scenarios. We know about long-term care (LTC). Here, too, contracts are improving with "shared care" options and expanded benefits for care at home. Yet how many surviving widows or widowers are left underfunded after the death of a spouse, especially where last expenses for a critically ill loved one diminished assets? A capital needs analysis should be part of all pre-retirement planning.

Run "in-force illustrations" on all cash-value life insurance policies to be sure they are not in danger of blowing up. The low returns of recent years have placed many policies in jeopardy.

Also, how many aging drivers are motoring around with only basic liability coverage? Do not assume that adequate umbrella liability coverage is in place.

FutureThink

Management guru Peter Drucker (1909 to 2005) said, "The best way to predict the future is to create it." Futurist Faith Popcorn, CEO of BrainReserve, asks, "If you could know everything about tomorrow, what would you do differently today?" Asking that question on her Web site (www.faithpopcorn.com), she then says, "Let's talk." Perhaps that is a segue into a discussion of all of the "maybes" that surround retirement and aging.

One trend common to all retirees and preretirees is a desire to create and exercise control. Faith Popcorn, in an article in the Arizona Reporter entitled "Faith Popcorn's Predictions for 2006," says she sees two cultural trends that play into our conversations about retirement, discernment, elder care and the "money conversation:" "cocooning," our desire to shelter ourselves from the harsh realities of our world, and "fantasy adventure," our hunger for the new and unconventional.

As for "cocooning," we can't protect our clients from harsh reality with numbers and statistics. We can help them to frame their expectations and assist in creating the future they want with solid and practical contingency planning.

We also don't want to scare them with dour scenarios to the point that Fantasy Adventure is restricted to a Happy Meal at Mickey D's. There is a feasible middle ground somewhere between "the Number" and Las Vegas. Popcorn says that "today's baby boomers define 'old age' as starting at (age) 80 – three years after the average person is dead." This "age thing"—this retirement riddle—it is a new conversation!

It gets more interesting every day.

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Eye-Popping Numbers
Target: $8,333.33 per month

Annual Withdrawal Rate	Capital Pool Required
2 percent	$5,000,000
3 percent	$3,333,333
4 percent	$2,500,000
5 percent	$2,000,000
6 percent	$1,666,667

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