

Financial Planning

What Retirement Means Now

To your affluent clients, retirement anxiety has as much to do with emotional issues as financial ones. The newest thinking adds human capital--everything from earning capacity to feelings of personal satisfaction--to the funding equation.

By Jim Grote

September 1, 2007- As millions more Americans part with the workplace for longer and longer periods, retirement—once considered the reward of a work life well-lived—is proving not to be all wine (at early-bird prices) and roses (from the new garden). Scott Neal, president of D. Scott Neal, Inc. in Lexington and Louisville, Ky., witnessed this in a terrible way. "One of my clients, a surgeon, retired with a six-figure income and a perfect plan for his multimillion-dollar estate," Neal recalls. "About one month afterward, he shot himself. A brief note said, 'Forty-five days ago I was Dr. Jones, today I am nobody.'"

This story tragically illustrates Mitch Anthony's famous line, "Retirement is an unnatural condition." According to Anthony, retirement takes you out of life's race; it eliminates the stimulation of challenges. Anthony and others are looking to replace the binary approach to careers—work versus retirement—with the notion of phased retirement, in which an individual gradually reduces work hours over years. And, they are promoting the concept of "human capital," also called an individual's "career asset"—that is, the value of an individual's earning power, talent and motivation. You can think of human capital on a continuum ranging from a purely qualitative sense of personal fulfillment to a strictly quantitative calculation of the present value of future earnings.

Bob Veres, publisher of *Inside Information*, sees retirement as a brief historical anomaly. "The whole idea of retirement as a total secession from work—as opposed to making work optional—may be an artifact of a single generation. Someday we'll look back and say that this was a waste of human capital, and a very poor way to keep people active and relevant during their later years."

But if everyone loves to work so much, why does almost half of the labor force bail out by age 60? The new concept of retirement, in which individuals work for pleasure as much as for pay, may resonate with your clients—but it also most assuredly may not. If you gauge it by the way financial services institutions brand themselves, a retirement of perfect leisure (gray-haired windsurfers, beach houses for grandparents) still attracts most Americans.

But this retirement ideal is becoming more elusive than ever. According to a new study by Alicia Munnell, Anthony Webb and Francesca Golub-Sass of the Center for Retirement Research, even when adults work until age 65 and annuitize all their financial assets, nearly 45% of American households are at risk of not maintaining their standard of living in retirement. This includes 36% of the top-earning third of American households. The study, entitled "Is There Really a Retirement Savings Crisis? An NRRRI Analysis," also notes that the National Retirement Risk Index (NRRRI) is rising, reflecting "declining Social Security replacement rates, lower real interest rates and the continued shift from defined benefit to 401(k) plans."

So perhaps the new refutation of retirement leisure has an element of lemons-into-lemonade. What matters is that the very idea of retirement, like everything else that touches baby boomers, is now subject to reinvention and customization. Every client will have an individual

take, based on his or her financial capital, human capital, needs and desires. And you will have to help clients find their balance.

VALUING THE CAREER ASSET

According to Neal, the fundamental retirement question is not, "When do you plan to retire?" but rather, "What does retirement mean to you?" Planners such as Michael Haubrich of the Financial Service Group in Racine, Wis., are merging financial asset management with career asset management for the simple reason that, as he says, "your most valuable financial asset is your career."

The boldest attempt to quantify human capital thus far comes from some of the biggest names in the business. In "Lifetime Financial Advice: Human Capital, Asset Allocation and Insurance," a groundbreaking white paper just published by the Research Foundation of the CFA Institute, Roger Ibbotson, Moshe Milevsky, Peng Chen and Kevin Zhu are extending the boundaries of traditional asset allocation to include human capital in their asset mix.

According to study coauthor Moshe Milevsky, professor of finance at York University in Toronto, "Human capital plays a central role in personal financial decisions. People are worth more than their bank accounts and pension plans, and the investment in human capital generates great rewards."

PRESERVING RETIREMENT INCOME

Of course, retirement is not just about fulfillment. How to spend down retirement portfolios without running afoul of longevity risk has attracted increasingly sophisticated analyses from the planning community because, as Veres observes, "people are not particularly good at translating pots of money into an income stream."

This translation problem from assets to income has been exacerbated by the trend away from defined benefit plans, forcing Americans to manage risk as individuals rather than in (decidedly safer) groups. As the Ibbotson study reports, nearly half of the \$14.5 trillion in retirement assets in 2005 comprised IRAs and DC plans, a seismic shift from a generation earlier when benefits, not contributions, were defined. According to the same study, "Current retirees receive almost 70% of their retirement income from Social Security and traditional company pension plans, whereas today's workers can expect to have only about one-third of their retirement income funded by these sources."

While this trend may have alleviated pressure on corporate bottom lines, it has shifted enormous risks onto the backs of individual retirees. Add the looming avalanche of boomer retirees, along with their increased life expectancies. Then consider the fact that nearly half of all men retire, willingly or unwillingly, by age 62, and almost half of all women retire by age 60. Shaken or stirred, you have the makings of a major challenge for advisors.

Some of the best minds in the business have come together to share ideas about financing boomers' retirements. Many of them contributed to Harold Evensky and Deena Katz's book, *Retirement Income Redesigned*, including Mitch Anthony, William Bengen, Laurence Booth, Rick Carey, Peng Chen, Roger Ibbotson, Moshe Milevsky, Louis Stanasolovich and Lewis Walker.

Milevsky believes that all three of the retirement risks he wrote about—investment/portfolio risk, longevity risk and consumption/inflation risk—are greater than they were in the past. One reason, he says, is that seniors spend more on healthcare and housing, both of which have experienced rapid price increases. The U.S. Bureau of Labor Statistics has quantified this

unique inflation index for the elderly. Called the CPI-E, the index has outpaced the broader CPI by one-half to 1% over the past 20 years.

Clients might not feel the effects of inflation all that dramatically until they retire. "In the accumulation phase of the life cycle—while people are still earning a wage in the workplace—their income and salary tend to keep up with inflation, since real wage growth over time has been positive," Milevsky explains. "Likewise, they do not face longevity risk yet, since they have the option of delaying their retirement."

To the three risks of a normal retirement, Evensky adds some behavioral ones. The fact that people stay "young" in retirement—they're healthy, vital and active—means that they are tempted to overspend. So does the lingering attachment to a paycheck-like income stream, which often leads them to withdraw too much from overly conservative, income-oriented investments.

This makes it crucial to develop successful drawdown strategies. The simple gambits of the past, such as the all-bond portfolio, are dangerous, Evensky says. So is the systematic withdrawal strategy of your average equity mutual fund holder. According to Evensky, this strategy of reverse dollar cost averaging is as risk-laden as income portfolios. "Reverse dollar cost averaging results in the average price of positions sold being less than the average price of the positions over the cycle," he explains. "Throw in transaction costs and negative tax consequences and you have a mess."

Evensky's own Cash Flow Reserve Strategy puts enough cash to cover a client's income needs for one to three years into a money market account. The remainder of the portfolio is invested; dividends and distributions go into the money market account. In up markets, equities can be sold at a profit to replenish account levels; in down markets, clients can rely on the cash account to avoid selling core investments at disadvantageous prices. Using this strategy, Evensky's clients weathered the market tests of October 1987 and of 2000 to 2002 without suffering, as he puts it, "undue discomfort."

For those whose assets are insufficient to fund his Cash Flow Reserve Strategy, Evensky recommends using immediate annuities to prevent asset depletion. "The rates for annuities are too low now to make them attractive, but their time is coming in the near future, particularly with the advent of low-cost immediate annuities through TIAA-CREF, Schwab and Vanguard," he says. A generation of retirees who lack a pension will inevitably spark demand. But Evensky wonders how fee-only planners will take to the idea of turning over 20% or more of assets under management to an insurance company.

The case for annuities has been growing. In fact, Ibbotson Associates has been granted a patent on a new method for developing optimal retirement allocations that include both traditional assets and payout annuities.

Here's how the method works. Ibbotson assumes that investors have four basic investment products to choose from: a risk-free asset like T-bills, a risky asset like equities, an immediate fixed annuity to hedge against longevity and an immediate variable annuity to hedge against inflation. Based on an investor's life expectancy, risk aversion and desire to leave a bequest, Ibbotson calculates an optimal asset allocation. Milevsky notes that by the time clients are in their early seventies, "it's very hard to make a case that people should not be annuitizing at least some fraction of their nest egg."

PRESERVING HUMAN CAPITAL

Ibbotson's new study extends the lessons of diversification from modern portfolio theory to include the shadow asset class of human capital. Accordingly, as soon as an advisor starts working with a new client, he or she needs to discern whether the client's career more closely

resembles a bond or a stock. For example, a stockbroker's earnings are far more sensitive to fluctuations in the financial markets than a schoolteacher's. Given the same total wealth and risk tolerance, the study says, "human capital theory recommends that the stockbroker invest a smaller portion of his financial assets in the stock market than the schoolteacher because the stockbroker has implicitly invested his human capital in the stock market."

Haubrich makes a similar observation. In order to properly diversify client portfolios (including financial and human capital), both the velocity (how often they change jobs) and the volatility (how much their income fluctuates) of their careers need to be examined. For instance, a schoolteacher's low velocity, low volatility career resembles a bond, and therefore suggests a financial portfolio heavily invested in equities. On the other hand, a software engineer's high velocity, high volatility, equity-like career suggests a more conservative financial portfolio. Between these extremes one may find high velocity, low volatility construction workers or low velocity, high volatility manufacturer's reps.

Haubrich quantifies these factors into a number he calls a Career Financial Value: The present value of their wages and benefits minus the present value of their employment costs (e.g., transportation, tools, education and training, child care, etc.). He also measures clients' Career Qualitative Value (including job satisfaction, work connections, etc.) and incorporates both of these metrics within a model he calls the Career Asset Management Model (CAMM).

The CAMM helps clients weigh career changes. The net result, often, is that clients will continue to work part-time and phase gradually into retirement. "A client with peak wages of \$150,000 can abruptly retire at age 60—the traditional approach," Haubrich says. "Or, he or she could consider extending his or her career for an additional eight years: the first three at 75% of work time and income, the next three at 60% and the last two years at 40%. If you assume an average income and employment tax rate of 40% and a 6% discount rate, the net present value of the client's extended income stream is \$348,150."

This notion of a phased retirement solves the client's need to stay active and relevant as well as the financial need for a more secure retirement income. Unlike the old industrial economy where a worker's value decreased with age, Haubrich believes that in today's knowledge economy, a worker's value will increase with age. In fact, he says, older workers' knowledge, experience and contacts make them more efficient than younger workers. Haubrich predicts that among those approaching retirement, phasing will spark a movement toward project-based contract work.

Haubrich works closely with career coaches, many of whom complain that their clients want to change careers but balk because of financial fears. "That's where financial planners come in," Haubrich says. "While most firms are out looking for the golden egg (the client's assets), our firm is looking toward the goose that laid the golden egg (the client's career)." By running the numbers on a career change, Haubrich can help clients understand what's feasible.

Scott Neal takes a more qualitative view of human capital. "In addition to my certifications as a CPA and CFP, I went to a seminary to help me with the human side of my business," he says. "One thing I learned was how to help people through major life transitions, retirement being one of the toughest."

Neal identifies four types of retirement client, each with a different driving purpose. The first type wants to maximize security ("if they don't have something to worry about, they create it"). The second wants to maximize possessions ("he who dies with the most toys, wins"). The third, to maximize meaning and purpose ("one of my clients wants to work as a doctor till the day he dies and another intends to give away 40% of his income to charity"). The fourth is content with having enough to get by.

Each retirement type presents a different challenge to advisors. The first will always want to increase his or her rate of return and nest egg; the second will chafe at a retirement budget;

the third will struggle to balance his or her calling with the physical and financial constraints of retirement; and the fourth will continually try to smooth income into a steady stream. According to Neal, "You can't try to change a zebra's stripes or you'll end up with an unimplemented retirement plan. Each type requires custom care and planning."

Retirement planning has clearly morphed into a more complex, but also more integrated discipline: life planning integrated with financial planning, career counseling with retirement planning, human capital with asset allocation and annuities with the optimal retirement portfolio. In the process the traditional notion of retirement may be going the way of the dinosaur. What's clear is that a planner will need an expanding set of quantitative and relational skills to deal with positioning clients in a manner that respects both their human and financial capital.

As Veres concludes, "Retirement is going to be entirely phased out of the planner-client discussion at some point in the fairly near future. What will replace it? The idea of a fulfilling career. So whether the client is 20, 50 or 70, the conversation revolves around: Are you happy doing what you're doing? If not, what can we do to make it better? That often means downsizing and moving away from high-paying, high-intensity positions. One of my favorite lines comes from planner Jim Johnson, in Sacramento, Calif., who told me: 'I help people transition from high-paying crappy jobs to crappy-paying great jobs.'"

In closing, we might question how social forces that are pushing retirees to work can be viewed in such a positive light. The idea of phased retirement is clearly legitimate for workers with high-paying, high-intensity jobs who have stashed away enough capital to be able to downsize their careers and stay relevant. But for the well-documented affluent boomers who have failed to build a nest egg, there is no new-style retirement. There is simply no retirement—and the desperate hope that the workplace will be accommodating.

And there may be no high-paying part-time jobs, either. Many writers on the new retirement assume that the birth dearth that followed the boomer generation will create a demand for "elderly" workers, who will write their own ticket in terms of job flexibility and responsibility. As Mitch Anthony asserts in his book, "The law of supply and demand may be moving to the side of the worker for many years to come."

But in a globalized economy, why would corporate America look more benevolently at older workers than at inexpensive but well-educated foreign labor, or than they would at young, tech-savvy "echo boomers" (children of the boomers)? While human capital is clearly a piece of the retirement puzzle that needs to be taken more seriously, the current valuation of that human capital is still a matter for debate and analysis.

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