Retirement Special: Planning for the New Old

BY **SAMANTHA ALLEN**
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Dallas Salisbury spends the better part of his time at work researching the probabilities of retirement success for American workers. So when Salisbury, the chief executive of the Washington, D.C.-based Employee Benefit Research Institute, is calculating his own retirement plan, he uses figures he calls "very conservative."

But to most planners, Salisbury's figures may sound alarming — or just plain crazy. His plan must get him to age 108, he says. He sets projected rates of return at 1% over inflation and, when analyzing annuity products, he sets inflation at 8% compounded annually.

"I don't want to have any chance of outliving my money," he says.

At 65, Salisbury plans to continue working for some time. That's also part of his retirement plan. "Most financial planners would look at our situation and they'd say we've saved too much," he says. "My wife says we haven't saved enough."

WHAT IS ENOUGH?

The question of how much money is enough leads to another question, which is perhaps the most difficult and most central issue advisors face when helping clients plan for retirement: How long should you expect clients to live?

Getting this variable exactly right is virtually impossible. Getting it wrong can have a profound impact on a client's quality of life, lifestyle and legacy.

Will your clients live to 85? 95? 105? Underestimating life span can leave clients vulnerable to outliving their assets — and forced to live on Social Security benefits alone. (For those worried about the stability of the Social Security system, this is an even scarier thought.)

Yet being overly conservative with your longevity assumptions could mean clients enjoy their money (and their lives) far less than they could have — both before and during retirement.

"There's a fundamental tension," says industry researcher, blogger and Financial Planning columnist Michael Kitces of Pinnacle Advisory Group in Columbia, Md., who has questioned whether advisors may be too conservative in their assumptions. "Choosing an arbitrarily long time horizon ensures that clients don't overspend, but they die with money left over."

Some planners also argue that longevity fears are overblown, because minor adjustments to life expectancy wind up having relatively minimal impact on a spending or investing plan. "Once you are planning beyond 30 years, you don't gain that much by shortening" the time horizon, says David Yeske, managing director of Yeske Buie, with offices in San Francisco and Vienna, Va.

Similarly, he adds, a fairly conservative estimate means that clients will still be safe with even longer life spans: "Once you plan for your money to last for 30 years, it's likely going to last a lot longer."

MEASURING LONGEVITY

Advisors may start their planning by looking at life tables, but for most clients, average life expectancy is of limited help. After all, if the average life expectancy of a 65-year-old female is about 85, there is a 50% chance that she will live past that age — an unacceptable basis for planning, advisors say.

Besides, it's clear that clients are above average when it comes to longevity. The healthier, wealthier and more educated people are — which is to say, the more likely they are to be a planning client —

the longer they are likely to live. And the older they are, the longer they can expect to live. The life expectancy of a newborn is 76 years for a male, according to the 2010 Social Security period life table. A 65-year-old male, however, has already beaten infant mortality and other early-onset ailments; as a result, he is expected to live to 82.5.

Marriage also adds another dimension — because in any couple, there's a greater chance that at least one member will live longer than either is expected to live individually — a factor Kitces says many advisors fail to recognize. The joint life expectancy for a 65-year-old couple is 27.1 years, based on the 2000 annuity mortality table. And, of course, the expenses for the surviving spouse aren't simply half of what they might be for a couple — an important planning consideration.

Yet planning for both members of a 65-year-old couple to reach a certain age — say, 95 — may make plans more conservative than advisors realize, Kitces argues. Let's say those clients have an 18% chance of at least one spouse living to 95 — and their portfolio plan has a 90% success rate in Monte Carlo tests. That means the 10% chance of running out of money will only be relevant for the 18% of scenarios in which at least one has lived to 95. "The true joint probability of failure is only 1.8%," Kitces explains. "Their plan is actually 98.2% successful now, not 'just' 90% from the Monte Carlo software."

EMOTIONAL BIASES

There are also emotional issues that complicate the calculations. One of them is guilt, Kitces says: Advisors don't want to be the one who lets clients outlive their assets.

Both advisors and clients also have built-in biases. "Another factor creeps in — advisors' own money scripts," says Jonathan Guyton, principal of Minneapolis-based Cornerstone Wealth Advisors, who has done research on retirement horizons and withdrawal strategies. "In my upbringing, if I were exposed to a fear of running out of money, unless I'm really self-aware, it's going to influence my advice."

The same can be said for clients. If clients have seen many people in their lives live to their late 90s, or are caring for elderly parents, they are more likely to be adamant about using a longer horizon. But if the reverse is true, clients are likely to resist higher longevity assumptions.

Of course many argue that the trade-offs are unequal — that outliving one's assets is a far worse outcome. This, and other conspiring factors, means advisors often take a more cautious approach.

No matter what, it's clear that client longevity assumptions are a gamble. Advisors who want to be almost certain that clients won't outlive their assets are approaching this conundrum in a variety of ways.

AVERAGE WITH PADDING

Karen McIntyre, managing director and senior financial advisor at Philadelphia-based Wescott Financial Advisory Group, uses a strategy common among planners: "We overestimate the things that will negatively impact projections and we underestimate things that will have a positive impact so clients are more likely to meet their goals. We build in a cushion."

With couples, she plans for the youngest spouse to reach age 95. "Twenty years ago that might have been a pie-in-the-sky estimate, whereas now it's more of a reality — and we present it to clients that way," she says. For clients who are currently in their 80s, McIntyre further extends life expectancies.

Yeske points out that the only way to have a high probability of success is to follow a plan that likely ensures you die with a lot of money — but for most clients, that's not really a negative outcome. Investors often have other goals, whether it is to live comfortably or leave money to their children or a charity, Yeske explains: "The 'conservative' path means they have enough money for their other goals."

ASK HARD QUESTIONS

McIntyre also digs deeper with individual clients, trying to tease out the most realistic life expectancy for each one. She typically asks clients whether there are any major health issues or terminal illnesses, what health issues are present in the family and what the history of longevity is in the family.

These topics can be painful, but they're important, she says: "That's where a little empathy comes into play."

McIntyre tells clients: "We may not have talked about this before, but it impacts your planning and we want to make this as meaningful as possible."

Cheryl Krueger, an hourly, fee-only planner in the Chicago area, says she talks about longevity with clients — but only so far as they need to feel comfortable with the assumptions made. "It's really a conversation about how flexible you are. … It's so uncertain," she says. "You don't want them to be scared, but you also want them to have a realistic understanding."

In an effort to get even more accurate estimates and make sure clients feel comfortable with the assumptions being used, some advisors say they have pointed clients to customized life expectancy calculators. The one on livingto100.com takes clients through a series of questions and bases the calculations on a study of centenarians. Developed by Dr. Thomas Perls, the founder and director of the New England Centenarian Study, it takes about 10 minutes and goes into much more depth than most planners or planning software programs do.

Yeske contends that one of the most important question advisors can ask is this: Are you a smoker? Because smoking can dramatically reduce one's life expectancy, "it would be disingenuous" to put their life span assumption at age 100 and force them to spend accordingly, he adds.

KNOW SOFTWARE LIMITS

In fact, this is one of three important questions used by MoneyGuidePro financial planning software, according to Bob Curtis, the founder and CEO of PIETech, the designer of the software.

Those questions are:

- Are you a smoker?
- How is your general health? Poorer than average, average or above average?
- How is your family health history? Poorer than average, average or above average?

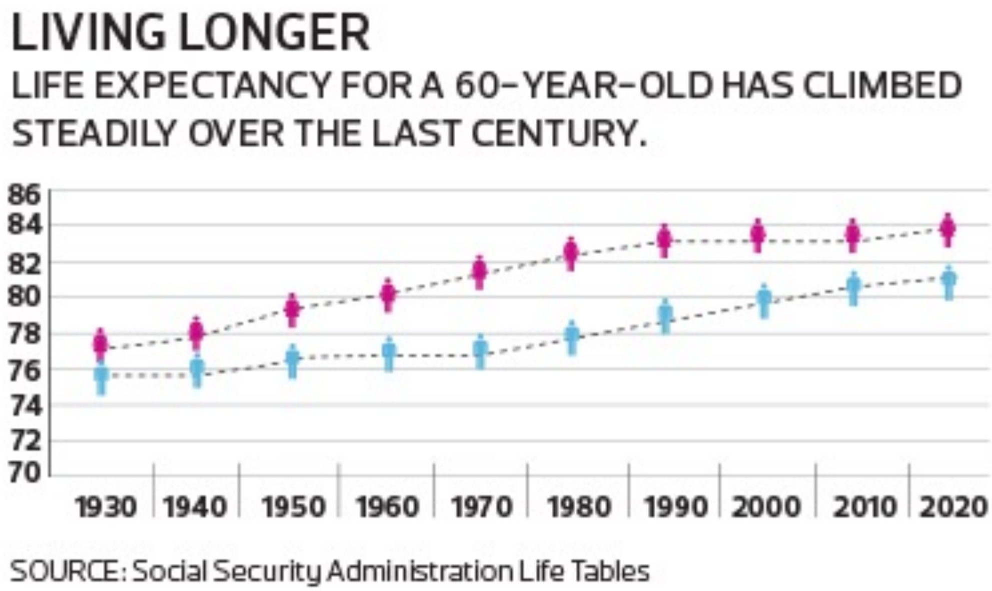
MoneyGuidePro uses the answers to generate a wide range of life expectancies — from 82 for a 65-year-old male smoker to 97 for a 65-year-old male with above-average health and a family history of longevity.

In an attempt to balance between assumptions that are too conservative or too aggressive, MoneyGuidePro's default setting gets clients out to an age with about a 30% probability — for a 65-year-old, that's 90 for men and 93 for women. Advisors can customize those assumptions — by having clients answer the three health history questions or selecting another age — and also adjust assumptions on inflation, market returns and spending.

Yet advisors say that some planning software has trouble incorporating up-and-down adjustments of spending rates. "Software programs have a hard time addressing nuances," McIntyre says. "It's harder to project that some lifestyle expenses increase at 4% or 6%, while some stay flat."

For Guyton, this flexibility in clients' spending and withdrawal rates is a critical element of his strategy — and part of what he says makes planning software ineffective for him.

Even smart expense assumptions, once entered into many programs, he says, become too static. "When [the software] starts to get bad runs, it assumes you do nothing — that's not how the planning relationship works," he says.



KEEP WITHDRAWALS FLEXIBLE

In reality, says Guyton, clients need to be able to adjust to changing conditions. “Most rules people follow that say, ‘This spending amount is safe,’ assume that you never, ever plan to make adjustments along the way,” he says.

Guyton’s strategy to maximize withdrawal rates assumes the opposite. His method is at once more conservative — he uses a 40-year retirement — and more flexible, because spending increases can be frozen or cut as needed. After all, he says, most people are accustomed to making adjustments in their spending habits before retirement, he argues, and will be willing to do the same during retirement.

“If you will make adjustments, then you can withdraw nearly [one percentage point] higher” than the classic 4% withdrawal rule would permit, Guyton says.

And if you start with a higher withdrawal rate and are forced to alter it due to market conditions — either freezing or cutting inflation increases — the plan eventually ends up looking a lot like the 4% rule, he says. “Soon the numbers are the same as if the scenario hadn’t been bad,” he says. “The flexible, evidence-based spending approach will get you to the same place as if you’d known it would have been so bad.”

Guyton’s strategy has another key element — categorizing expenses as fixed or discretionary and then separating clients’ assets into these different buckets. While the assets in the fixed-expense bucket must be able to reach that 40-year horizon, the discretionary money can be spent down at whatever rate the clients want — presumably more at the start of retirement — but once it’s gone, it’s gone.

TOO CONSERVATIVE?

In the end, perhaps conservatism isn’t the right way to think about longevity assumptions. “The whole concept of conservative is misleading because it makes for an aggressive decision on the other side,” says pioneering planner Harold Evensky.

“We ignore costs and consequences taking an age that one couldn’t reasonably expect to live to,” adds Evensky, who helped develop the MoneyGuidePro software. “Unless clients have all the money in the world and it doesn’t matter, then they either have to spend less during their lifetime or invest more aggressively — that’s not exactly conservative.”

Using the MoneyGuidePro defaults and client questionnaire, Evensky also uses assumptions that get clients to around a 30% probability of living past the chosen age. “There’s no such thing as conservative; we just try to do the most reasonable thing we can,” he says. “If someone’s got enough money and a reasonable risk level, it’s not a problem, but most people aren’t in that circumstance.”

For clients who aren’t well prepared for retirement, adjustments will have to be made, advisors say. There’s no way to have it all, Guyton says. Clients may choose to spend less, work longer or die earlier — but of course, not all of that is in their control. “Most planners don’t want to be too conservative,” he says, “but they want to be conservative enough.” FP

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