

# Pandemic Planning Lessons

by Jonathan Guyton, CFP®

● TAP HERE FOR ONLINE MOBILE-FRIENDLY ARTICLE



Jonathan Guyton, CFP®, is a principal of Cornerstone Wealth Advisors, Inc. in Minneapolis, where they practice what they preach. Guyton also writes for The Wall Street Journal, serves

as a Dean of FPA Residency, and won the Journal's Call for Papers in 2004 for groundbreaking research exploring dynamic withdrawal policies in retirement.

**IN SOME WAYS**, financial planning for retired and soon-to-be-retired clients seems turned on its head since late last winter. However, a closer look reveals reminders of prudent planning techniques holding up quite well. This look also reveals helpful insights. Here are some that strike this financial planner.

## Pandemic Spending is Core Lifetime Spending

Retirement plans frequently overstate the needed amount of financial assets. Overfunding occurs when spending assumed to last an entire lifetime instead begins to fade after 10 to 20 years. Getting this right can accelerate a client's retirement date.

Of course, pinning down the actual level of lifetime spending is often easier said than done. During the pandemic, most empty-nesters and retirees have reduced spending to levels that accurately reflect core lifetime needs. This year's spending reductions and items 'on hold' are most likely non-lifetime (discretionary) items with different funding math. Even after life is 'normal' again, 2020 spending amounts will be helpful retirement planning inputs.

As an example, spending on travel and active hobbies comes to mind immediately. Suppose retirees in their mid-60s estimate \$20,000 yearly for this. Income taxation on necessary withdrawals can easily push this to \$25,000 to \$30,000 on a pre-tax basis. If this were an inflating, annual lifetime expense, the capital needed to fund \$27,500 would be \$550,000 to \$700,000, depending on the sustainable withdrawal methodology employed. However, if this is seen as a non-lifetime amount of \$27,500 for 12 years and \$14,000 for eight more, the capital required to fund this is less than \$450,000.

## Unrealistic Modeling Causes Unneeded Worry

Mid-February to late March was a disconcerting time for retirement planning analyses. I read about one set of Monte Carlo simulations for a pre-retiree showing a 90 percent chance of success last January, only 65 percent by late March and nearly 90 percent again by mid-summer. What is such a client to think (or do) when presented with such volatile advice?

The math in the model's simulations was undoubtedly correct. The problem is the model's assumptions. When they assume static spending (and associated taxation) that does not change, such are the results during times of heightened volatility. But why model the one input variable clients control—spending—as though it is inflexible or unchangeable? Research on dynamic spending policies—or the use of software capable of modeling 'real-time' spending flexibility—can show

the true state of a client's retirement sustainability when they can make small spending adjustments during severe market downturns.

Perhaps more importantly, clients then feel empowered knowing when spending changes are necessary to their financial security—and when they are not—rather than being told not to worry because things will surely get better.

## Life is Shorter Than We Realize

For a number of retired and pre-retired clients, the pandemic has been a wake-up call not to take their active retirement years for granted. Not only are many making plans to accelerate previously planned spending, some are increasing their desired spending totals, too. Beyond questions like, "Do we have enough to retire?" or, "Are we still OK?" clients increasingly ask, "How much extra money do we have for discretionary spending?"

Answering this third question gives retirees great financial freedom. However, it first requires quantifying—and not overstating—the amount of 'take-home pay' needed to fund the (core) spending needed throughout retirement. Not only does this include obvious things like housing, utilities, food, insurances, and transportation, it should also include fundamental quality-of-life items. (In my own retirement plan, I include good food and wine as 'core' and want this maintained even if I someday can't tell the difference!). Knowing this, regardless of a financial plan's income-generation approach,

planners can quantify the capital needed to fund such core spending.

Importantly, doing so also quantifies the ‘extra money’ for discretionary/off-budget items. Knowing this, planners can recommend and update long-term care insurance (or not) and clients can make plans about how aggressively to utilize these assets for travel, bucket lists, home improvements, charitable causes, grandchildren’s educations, parents’ care, adult children’s needs/dreams and the like...all with assets unnecessary to core spending.

Sometimes, however, life’s uncertainties cause a spouse to become widowed far too soon, as the pandemic painfully reminds us. Most of the time, a couple’s sound planning leaves a survivor financially secure as well, usually with most of their prior income remaining. However, this person must now file as an individual taxpayer and enters the higher marginal income tax brackets twice as quickly than as a couple.

This often results in higher marginal tax rates, all the more so if the lower brackets weren’t fully utilized as a jointly-filing couple. The greatest opportunities for opportunistic tax planning—Roth conversions, capital gain harvesting, and/or donor-advised fund contributions—reside between the final years of employment and age 72, prior to RMD onsets, full Social Security benefits, and/or IRMAA taxes on Medicare premiums. No family benefits more from such planning than those unfortunate enough to have premature widow(er)s.

### **Sometimes Portfolio Management Matters a Lot**

Portfolio management matters in a number of ways, starting with asset allocation changes years before anyone retires. Most all successful lifetime investing involves more aggressive allocations in early- to mid-career before becoming more conservative later on. This pandemic reminds us about the risks of being greedy

in the final pre-retirement planning years.

Nothing can wreck the best-laid planning like a big equity decline (followed by a slow recovery) that affects too much of a client’s nest egg too close to their retirement date. The pandemic reminds us that, as in the Great Recession, which required over five years to climb back to its fall 2007 levels, full recoveries can take much longer than the five months required earlier this year. Most pre-retirees need to begin implementing a reallocation plan five to 10 years before retirement, unless their ‘plan’ is to rely on good luck or good timing.

Closely related to this is the reason bonds matter in retirement portfolios. Actually, it’s more correct to say assets that reliably hold their value and are liquid enough fund up to 100 percent of spending needs for up to five or 10 years when equity assets are in the tank matter. Assets which can begin doing so at a moment’s notice are key to offsetting this horizontal risk.

Readers of this column hardly need such a reminder, yet no investment topic is more misunderstood among retirement DIYers, and many of the financial press. They often don’t understand that when it comes to retirement income sustainability, yield is secondary. They may also not understand the differences in how various bonds performed last March until the Fed intervened in corporate bond transactions, or why the highest safe withdrawal rate portfolios hold 30 to 45 percent bonds, even though these portfolios have lower expected returns than portfolios with more equities, or that it is portfolios with U.S. Government (and not corporate) securities that generate these results. Still, in ultra-low-yielding times like these, some retirees ask, ‘Why even own (many) bonds at all?’

Why? Because the right kind of bonds buy time. Time to avoid selling equities at depressed prices to fund next month’s or next year’s spending. Through one’s mid-career, this matters

much less because one’s remaining human capital can fund the next five to 10 years of expenses and buy the time needed to await an equity recovery. In retirement, however, when no human capital remains, needed time is acquired by owning assets that remain unaffected when markets decline severely, fulfilling the description above. But it takes a high enough allocation to such assets to make it through such periods.

Finally, in the face of so severe a downturn as 2020’s first quarter (down 34 to 43 percent peak-to-trough), portfolio rebalancing already matters. An analysis of over 50 similarly-allocated robo-advisor portfolios during 2020’s first six months found returns varying from +0.9 percent to –7.1 percent. The biggest difference-maker? Who rebalanced and who did not.<sup>1</sup>

This is true longer-term. It’s common methodology in safe withdrawal rate research that portfolios are re-balanced at least annually to their target allocation. Sometimes, this involves selling equities while, at other times, buying them. The pandemic reminds us of the impact of being able to implement a client-wide rebalance and the conviction to see it through. I will always remember the feeling, on a certain Monday last March, of watching our previously-set ‘buy’ limit orders execute. By contrast, a recent study illustrated the detrimental impact when such ‘buying low’ rebalancings do not occur, whatever the reason.<sup>2</sup>

Even though the pandemic continues to be costly in so many respects, at least there are some beneficial financial planning lessons and reminders available for those who take notice. ■

### **Endnotes**

1. See Robo Report, Q2 2020, available at [www.backendbenchmarking.com/the-robo-report/](http://www.backendbenchmarking.com/the-robo-report/).
2. See Javier Estrada’s “The Bucket Approach for Retirement: A Suboptimal Behavior Trick?” in the August 2019 issue of the *Journal of Investing*.