PENSION TRENDS

BY INDEPENDENT ACTUARIES, INC.

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Making Retirement Savings Last a Lifetime (or Two)- Planning for the Unknowable

This newsletter is the second in a two-part series on making retirement savings last. Visit our Pension Trends Archive to read Part 1.

For years you have set aside savings for your retirement. Now you are ready to retire. Social Security will provide you and your spouse with steady monthly income, but it is not nearly enough to meet all your expected expenses. The rest of what you and your spouse will need to live on each month will have to come from your savings. Maybe you would like to spend a little extra in the first few years to enjoy retirement while you are still relatively healthy. Or maybe you are considering downsizing to a smaller house in hopes you can add enough extra to your savings to enable you to live more comfortably in retirement? How can you know how much you can afford to withdraw from your savings and still feel confident that you will not outlive your assets?

Unfortunately, you cannot know with certainty how much you can withdraw now and in the future without the risk of depleting your savings before your death. You are trying to plan for the unknowable.

You cannot know with any degree of reliability how long you and your spouse will live. You cannot know with any certainty the investment return you will earn on your savings. Future Medicare premiums and other healthcare related costs? Who knows?

Still, there are prudent steps you can take to help you deal effectively with the unknowns. In this article we will discuss three strategies for dealing with the two uncertainties of your life expectancy and unpredictable rates of investment return earned on your savings. We will evaluate how each strategy helps you accomplish the fundamental goal of maximizing how much you can withdraw from your savings each month without leaving you with inadequate retirement income in your later years.

Strategy 1 – Buy an Annuity

This is a very simple strategy, and for the most part eliminates *all* of the uncertainty associated with both unknown life expectancy and unknown investment return. You take all of the money you have saved and turn it over to an insurance company. In exchange, they provide you with an annuity contract that guarantees that as long as you are alive, or alternatively as long as either you or your spouse or alive, they will pay you a fixed amount per month. For example, you might give the insurance company $300,000 and they will guarantee that as long as you are alive they will pay you $1,550 per month.

If you live to be 100, they will continue to pay you $1,550 every month you are alive. Payments stop only upon your death. Of course, if you die one year after you purchased the annuity, payments stop at that time. All of the remainder of the $300,000 you turned over becomes profit to the insurance company.

To deal with the risk of dying early and leaving a huge profit to the insurance company, you could, for example, purchase an annuity that guarantees payment for 20 years. If you die before the 20 years is up, payments continue after your death until the end of the 20 years. There is, of course a cost associated with guaranteeing for 20 years. Instead of getting $1,550 for as long as you are alive, you might get only $1,350 if payments are guaranteed to last at least 20 years.

Alternatively, you could purchase what is called a joint and survivor (J&S) annuity. A J&S annuity guarantees payments as long as either you or your survivor – generally a spouse – is alive. The survivor payment is either the same (100%) of the amount payable while the primary annuitant is alive, or some smaller percentage (commonly 50% or 75%) of the amount. For example, if you purchase a 100% J&S annuity with your $300,000, the insurance company might guarantee you $1,175 per month for as long as either you or your spouse is alive. For someone with a younger spouse, the amount the insurance company is willing to pay will be less because it expects to have to make payments for a longer period of time.

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Author Profile:

This article was written by Alan J. Stonewall, FSPA, EA, MAAA and Steve Diess, EA, MAAA. Alan is a former IAI consultant and continues to be a frequent collaborator on actuarial matters. Steve is an IAI owner and consultant. He specializes in defined benefit plan design, retiree medical plan consulting, and public and private employer accounting for pension and OPEB plans.

INDEPENDENT ACTUARIES, INC.

4500 Kruse Way, Suite 200
Lake Oswego, OR 97035
Phone: 503.520.0848
Fax: 503.520.1147
IndependentActuaries.com

email:
info@indact.com

You can also buy an annuity that provides for an annual cost of living increase to help keep monthly payments keep pace with inflation. Adding cost of living protection will further reduce how much the insurance company is willing to pay you each month, at least in the early years. It might decrease your $1,175 J&S annuity payment to an initial $875 if you want a 2% annual cost of living increase.

The advantage of the annuity is obvious. There is no life expectancy or investment rate of return uncertainty. The insurance company assumes all of the risk associated with how long you and/or your spouse lives and the investment return earned on the $300,000 while they are making payments. The principle downside to buying an annuity is cost. Insurance companies charge a hefty premium to assume all of the risks. Of the three strategies, buying an annuity will likely result in the lowest amount of monthly income in your retirement.

Strategy 2 – The 4% Rule

This strategy is based on study dating back to 1994 that found that if withdrawals are limited to no more than 4% of the amount in your initial retirement savings account (invested in a mix of stocks and bonds) each year, you can safely expect to not outlive your savings over the next 30 years. In our $300,000 savings account example, the 4% Rule would result in an initial monthly withdrawal of $1,000.

Each year payments increase in line with increases in the cost of living. Assuming cost of living increases of 2% per year, your monthly withdrawal in year two would be $1,020, in year three would be $1,041, etc.

A principle advantage of this strategy compared to buying an annuity is that in the event of an early death, the remaining funds would pass to your spouse or heirs rather than add to the profit of an insurance company. This is only logical since under the 4% Rule, you, not the insurance company, bear the risks associated with life expectancy and rates of investment return. If you or your spouse live more than 30 years (e.g., beyond age 95, if you are both age 65 when you retire) the assurance of the 4% Rule does not necessarily apply. This does not mean you should expect to run out of funds at age 95, but the statistics do not provide the same kind of assurance of adequate funds for someone living beyond age 95. For most people, an age 95 end date is acceptable.

Interestingly, one of the disadvantages of the 4% Rule is that other studies have shown that there is a high probability that the 4% Rule will lead to excess wealth accumulation in later years. In other words, studies show that under most – but not all – investment scenarios, if you limit your annual withdrawals to 4% plus cost of living increases, there is a good probability that your retirement savings will continue to grow throughout your retirement, which brings us to our recommended corollary to the 4% Rule: Re-evaluate your withdrawal schedule on a regular basis.

Strategy 2a - The IAI Corollary

Regularly, but not necessarily annually, evaluate the rate at which your savings is growing. For example, if in year four your account has grown to $340,000 from better than expected investment rates of return, you might consider increasing your withdrawals rather than forgoing something that would make your retirement more enjoyable. Unfortunately, there is no magic formula to use to determine just how much excess investment accumulation you can safely withdraw. It is always possible that next year's investment performance will be so poor as to bring you back in line with what the 4% Rule anticipated. If you withdraw too much this year you might find that your "excess wealth" accumulation is now in a deficit position. The odds are it will correct itself over time, but there is, of course, no guarantee.

Bottom line with the 4% Rule – It produces a steady, predictable income flow for you, but comes with a high probability that you will accumulate excess funds in your account down the road. Consider periodic re-evaluation of your withdrawal amount to make sure you are not short changing yourself during your retirement.

Strategy 3 – The RMD Approach

The Internal Revenue Service has a table of factors by age[1] used to determine how much someone is required to take from his or her IRA each year – called a Required Minimum Distribution (RMD) – in certain situations. Each factor represents the taxpayer's life expectancy or in the case of a married taxpayer, the expectancy that either the taxpayer or spouse is alive. For example, at age 71, the factor for taxpayer and spouse (the number of years at least one of them is expected to be alive) is 20.9. In other words, at that point in time there is an expectation that at least one of them will live to age 91.9.

[1]Factors can be found in IRS Reg 1.409-(a)(9)-9

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INDEPENDENT ACTUARIES, INC.

4500 Kruse Way, Suite 200
Lake Oswego, OR 97035
Phone: 503.520.0848
Fax: 503.520.1147
IndependentActuaries.com

email:
info@indact.com

An RMD is the amount of withdrawal from an IRA that is expected to use up the amount in the IRA during the applicable lifetime. For example, if a married taxpayer and spouse of the same age have $300,000 in an IRA at age 71, the RMD that year is $300,000 divided by 20.9 years, or $14,354.

The RMD Approach to withdrawing retirement savings over your lifetime uses the same concept. Each year your distribution equals the amount of your savings divided by your lifetime, or your joint lifetime if married. Using our example of $300,000 of savings for a couple retiring at age 65, the first year's withdrawal would be $300,000 divided by 26.2 years, which works out to be $11,450 per year, or $954 per month. If in year two your savings increases to $320,000, your withdrawal will be $320,000 divided by 25.3, which equals $12,648 ($1,054 per month).

Because the RMD Approach recalculates how much you withdraw each year based on the amount of your savings at the start of each year and your life expectancy or joint life expectancy from that date going forward, so long as you can live on the amount of your RMD withdrawal, you will never outlive your savings. The principal shortcoming of the RMD approach is that the amount of each year's RMD Approach withdrawal can vary widely with how well your investments perform. A bad investment year can result in lower withdrawal than you had the year before; a year of double digit investment return will result in an unexpected financial windfall – at least for that year.

Variations on Each Strategy

Not surprisingly, there are variations on each strategy designed to minimize its shortcomings or adapt to special circumstances. For example, a variation on the annuity strategy would be to use only a portion of your retirement savings to buy a deferred annuity – an annuity that starts at a later date, such as age 80 – to more efficiently protect against the risk of outliving your savings. We have already discussed a variation on the 4% Rule by suggesting you re-evaluate your withdrawals from time to time to make sure you are not accumulating excess funds that would be better used today. With the RMD Approach you might set aside a small reserve account which you could dip into in years when, due to poor investment performance, your RMD withdrawal in one year might be less than you were counting on.

Recap

Buying an annuity provides the greatest security at the greatest cost. Depending on how long you live, some amount you have saved toward retirement will end up in the profits of the insurance company, but in return you know what your monthly income will be and you have no worries about managing your investments. The 4% Rule should provide a steady, predictable stream of retirement income, but you remain responsible for managing your retirement assets, and should re-evaluate where you are from time to time to make certain you are not overbuilding rather than enjoying your retirement savings. The RMD Approach also requires you to manage the investment of your retirement savings, and has a high variability of income from year to year depending upon how well your investments perform.

While each of these strategies have shortfalls, employing any of them, or a modification or combination of these strategies, is better than merely hoping your savings will last for your lifetime.

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