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Retirement Income Planning Lessons from the Economic Meltdown

The grand theories and hypothetical retirement models that have been red hot for almost a decade have finally melted down along with the rest of the economy. And we've learned some unhappy lessons.

Of course, all kinds of people in all areas of the economy (and the world) have been hurt. But we'll focus on the unique lessons pertaining to retirement income planning.

#1. Most retirees should keep enough assets in safe, liquid investments to cover at least three years of living expenses.

We all hope, of course, for a rapid economic recovery. But almost no one is predicting that. The current consensus is that we won't hit bottom until late in 2009, at the earliest, and that a full recovery will take two more years after that. Or longer.

Retirees who are living mostly off their 401(k) and IRA balances or other investments that are in marketable securities are in tough shape. Many of them have to liquidate twice the number of shares today than they had to liquidate a year ago just to pay their ongoing bills. This means not only that they run out of shares faster, but that when the markets do recover, they have fewer shares left to participate in the recovery – so the hit they take on the downside is never made up for on the upside.

But for retirees who have several years' worth of assets socked away in certificates of deposit or similar instruments paying 4% or 5% or 6%, their money is still intact (federally guaranteed in the case of CDs, if not over-concentrated in one bank). More importantly, when these retirees also have a significant amount invested in marketable securities, they can leave their securities untouched until the market recovers, while they live off their safe savings. They will then get the full benefit of the upswing when it comes – and they may well come out ahead in the long run.

#2: The old-timers were right: Retirees, and near-retirees, should invest more conservatively

When the dot.com boom busted, and took the entire stock market down with it, many people who were about to retire had to postpone that happy event, some of them indefinitely. Many who were already retired went back to work at whatever jobs they could get. Retired people who were unable to go back to work because they were too old, too infirm, or too busy taking care of a failing spouse, were simply stuck, with no good options in front of them.

We didn't quite learn the lesson that time. Maybe we will learn it this time. Retirees who are at risk should be saving and investing conservatively, not aggressively. The same goes for people who are still working but planning to retire soon.

This used to be common wisdom, but during the '90's investment specialists (and their followers in the financial press) began encouraging older people to invest a large portion of their money in equities. The rationale was that with everyone living longer lives, and therefore having longer investment horizons, higher risk investing would pay off. Also, longer lives mean more time for inflation, so that income growth stemming from asset growth was necessary.

We argued strenuously and at length against this strategy before the current economic crisis, and we won't repeat the details here.[1] The gist of it is that the arguments in favor of aggressive investing for seniors are seriously faulty and the risk is not justified by the hypothetical reward.

Older people who have enough assets that they are not at much risk of running out of funds can afford to take investment risk and become even wealthier if they have the stomach for the ride. But those who *are* already at risk of running out of money cannot decrease their overall risk by taking on still more risk in the form of aggressive investing. Thinking they can and should is the kind of twisted half-reasoning that has brought so much of the financial industry, and so many of its clients, to their knees in recent months.

Retirees at risk need to reduce the risk they *can* control by investing more conservatively, and living within their means. Better still, they should be *increasing* their means if they can by taking on part-time or temporary employment, or by *reducing* their expenses, or by making other non-adventurous adjustments to their finances.

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[1] See "Half-Baked Investment Concepts for Retirees" from April of last year, available at: http://www.stillriverretire.com/Downloads/Half-Baked_Investment_Concepts_for_Retirees.pdf and "Risk and Investment Strategy for Retirees" from May of 2004 (almost five years ago!), at http://www.stillriverretire.com/Downloads/Retirement_Income_Planning_3.pdf. See also "Can You Afford to Take Investment Risks?", dated March 15, 2005, on our consumer site: http://www.retirementworks2.com/pdfs/Can_You_Afford_to_Take_Investment_Risks-UNU.pdf
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#3: Systematic withdrawal models are unreliable

The typical investment firm (and 401(k) plan provider) attempts to serve its retired patrons by advising them how much they can safely withdraw from their portfolio on a regular basis, with an acceptably low risk of running out of money before death.

To determine this supposedly safe level of withdrawals, they usually rely on Monte Carlo analysis and other similar mathematically sophisticated models. But these models provide results that have very little application in the real world.

There are dozens of reasons why people's need for cash during retirement will not be a constant, or smoothly inflating, amount. Some years the need for cash spikes higher (e.g., a relative needs a loan, or a daughter gets married), while in other years the need for cash disappears because of a one-time influx (e.g., an inheritance or an insurance payout is received). In some years the need may increase suddenly and permanently (e.g., a serious illness develops, or a sunbelt retirement condo is purchased), and in other years the need may suddenly and permanently decrease (e.g., a mortgage is paid off, or a child or grandchild goes off to live independently).[2]

So these models are essentially pointless unless they take such cash flow variations into account. They are, in fact, worse then pointless, because they tend to encourage people to start out withdrawing either too much (increasing the likelihood of running out of money) or too little (unnecessarily crimping the retiree's lifestyle).

And now we have confirmation that these models lead to catastrophe, because they not only miss the boat on retiree cash flows, but they also miss the realities of the financial market. They are based on historical data, but as the ads say, past experience is not necessarily an indicator of future performance. We all knew that, but most of us ignored it. We assumed that because historical data was the best indicator we had, it was good enough. What we have now learned is that it isn't. We need a different approach.

#4: Retirees need a financial cushion for contingencies

Even if several years' worth of expenses are in safe, liquid investments (Lesson #1) and even if most or all of a retiree's assets are conservatively invested (Lesson #2), there still must be an allowance in case things go bad (which the models we discussed in #3 don't take into account).

Right now, most retirees are suffering from problems relating to the economic crisis. Even those who have not lost assets are hurting from the free fall in interest rates.

But that's just scraping the surface. Retirees are vulnerable to many kinds of adversity. So are the rest of us, but the difference is that most retirees are unable to make a financial comeback. They generally can't go back to work in any lucrative way, their incomes are fixed, and their expenses are often already too small to cut significantly without real pain.

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[2] We offered a detailed list nearly four years ago, in "Toward Truly 'Holistic' Planning," at: http://www.stillriverretire.com/Downloads/Retirement_Income_Planning_7.pdf.

So if an expensive illness strikes, if a financial disaster occurs, if assisted living or nursing care is needed, if inflation shoots through the roof, if a pension fund fails, if a child or grandchild moves in, if uninsured home damage occurs, or any number of other calamities strike – there is often little recourse other than to dig into savings and hope it doesn't hurt too much for too long.

Retirees who were not advised to set part of their nest-egg aside for contingencies are now seriously at risk. Those who did have contingency funds to cover the present crisis may be getting by, but they are still vulnerable to new problems – which are likely enough to arise, sooner or later.

#5: Market guarantees are a time bomb

We have been saying for a while that new products are not what retirees need. Even if the new products come with guaranteed withdrawal options or guaranteed floors for investment performance, the cost of these options makes them less desirable than diversification in conservative investments as a way to reduce risk.[3] Retirees who bought such products might be feeling pretty good right now – though mainly because they don't know they could have done as well or better with a less expensive strategy.

But the big losers here are the *insurers*, and if there is a silver lining, it's that these products haven't been around long and they haven't sold well. If they had, we might see insurance companies going under at the same rate that banks and securities firms are.

One problem with these products is that they are based on the same kind of inadequate historical investment data that the systematic withdrawal models use, and therefore are always vulnerable to just the sort of market mayhem that has happened. What is more serious about them is that unlike most insurance products, they magnify rather than reduce institutional risk. The fundamental concept of most insurance is *risk pooling*: some people win while some people lose, but the insurer gets a balance of both. But when you insure against adversity in the public financial markets, everyone loses at the same time, including the insurer. This is a fine recipe for catastrophe.

Presumably, insurers hedged this risk. But that means they just passed it along to someone else who now has to survive the same general catastrophe. And what we now know (and should have anticipated) is that there is no assurance that anyone, including the federal government, can bail out everyone at the same time. We will find out some day how much these guarantees cost insurers, and it will be interesting to see if they continue to offer them.

But if larger sales of these products could indeed have brought down some insurance companies, retirees who did buy them dodged a bullet, too. Their luck may not hold next time.

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[3] We first touched on this theme in April 2006, with "Are New Products a Solution or a Stopgap?", at http://www.stillriverretire.com/Downloads/Retirement_Income_Planning_9.pdf. We also dealt with it in *Nine Keys to Winning Baby Boomer Assets in Retirement* (2007), which is available at http://www.stillriverretire.com/SRRPS_NineKeys.asp.

#6: Monte Carlo doesn't cut it

There is nothing wrong with the Monte Carlo technique as a decision-making tool. But like all tools, it has good applications and bad ones. Using it for asset allocation, systematic withdrawals, and other cases where market risk is at issue is not a good application. While it can be useful as an indicator, it is not good enough to be relied on for final decisions, and certainly not for anything resembling fine tuning.

We have been riding this hobby horse a long time.[4] But the recent crash has reinforced our main argument: the models are fundamentally flawed because they rely on a base of historical data that is not extensive enough to measure investment risk at all accurately; they are not suitable for retirees because they do not take account of all the risks that retirees face; and they tend to promote as acceptable risks that are actually quite high (do you really want your mom to have a one-in-ten or even a one-in-twenty chance of becoming destitute?). And those are just some of the problems.

We need, for ourselves and for our clients, to let go of these beguiling but deeply flawed models. There are better ways of serving retirees and near-retirees - and younger investors and even institutions.

Is a financial "Great Awakening" at hand?

Several times in history, large masses of people realized that their focus on material advancement had led them astray, and wide-scale religious revivalism took hold in what, even at the time, have been called the Great Awakenings. Let us hope that we now have a financial great awakening.

And if that does not happen, perhaps we can at least have our own personal awakenings. Immanuel Kant, a contemporary of the First and Second Great Awakenings, had an epiphany of his own, though not a religious one, that he later said "awakened me from my dogmatic slumbers."

"Dogmatic slumber" might, in fact, be the most apt description of the financial industry's thinking about serving the retiree market. Perhaps our current crisis will shake us awake.

Still River Retirement Planning Software, Inc., provides both web-based and desktop software offering specialized calculations related to retirement plans and retirement planning.

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[4] Our first assault dates back to 2002, in "Asset Allocation for a New Decade," which you can find at http://www.stillriverretire.com/Downloads/Asset_Allocation_for_a_New_Decade.pdf. In connection with retirees in particular, we produced "Beyond Monte Carlo", in 2004, at: http://www.stillriverretire.com/Downloads/Asset_Allocation_for_a_New_Decade.pdf. Our most recent blast (2008) was "Piercing the Monte Carlo Mystique in Retirement Income Planning," at http://www.stillriverretire.com/Downloads/Piercing_the_Monte_Carlo_Mystique.pdf.