Did You Know You're an Actuary?

By Jim Lorenzen, CFP®, AIF®

The Three Big Risks potential retirees face today are timing, inflation, and longevity.

Inflation risk is scary because it's like a case of glaucoma—it's not so obvious in the early years; but highly impactful in the later years. For seniors receiving Social Security, the government's computation for benefit increases doesn't match the index most reflective of senior spending.

2016 Inflation for Social Security Retirement Benefits

	Sept14-Sept15 Δ	Weights CPI-W	CPI-E	CPI-U
Food and beverages	1.45%	15.7%	12.8%	15.0%
Housing	2.13%	39.2%	44.5%	40.2%
Apparel	-1.46%	3.6%	2.4%	3.5%
Transportation	-7.39%	18.7%	14.5%	16.5%
Medical care	2.49%	5.6%	11.3%	6.9%
Recreation	0.86%	5.5%	5.3%	5.9%
Education and communication	-0.34%	6.7%	3.8%	6.7%
Other goods and services	1.74%	5.1%	5.4%	5.3%
	Weighted Average	-0.12%	0.43%	0.09%

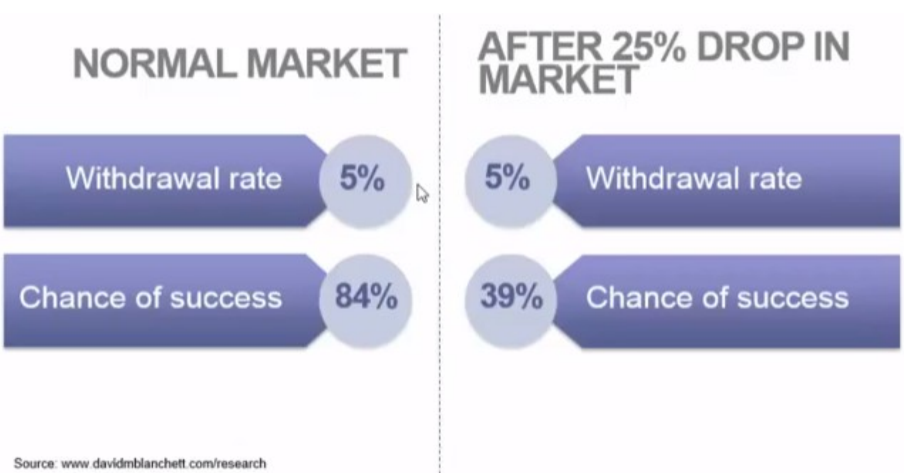
Source: Bureau of Labor Statistics

You've no doubt heard of the CPI—consumer price index. Did you know there's more than one? The government uses the CPI-W index, which applies to worker's spending habits and therefore weighted differently than the CPI-E index, which relates to the spending patterns of the elderly.

As you can see from the 2016 numbers on the right, the CPI-W actually declined –0.12%, while the CPI-E increased 0.43%. (CPI-U is an urban spending index).

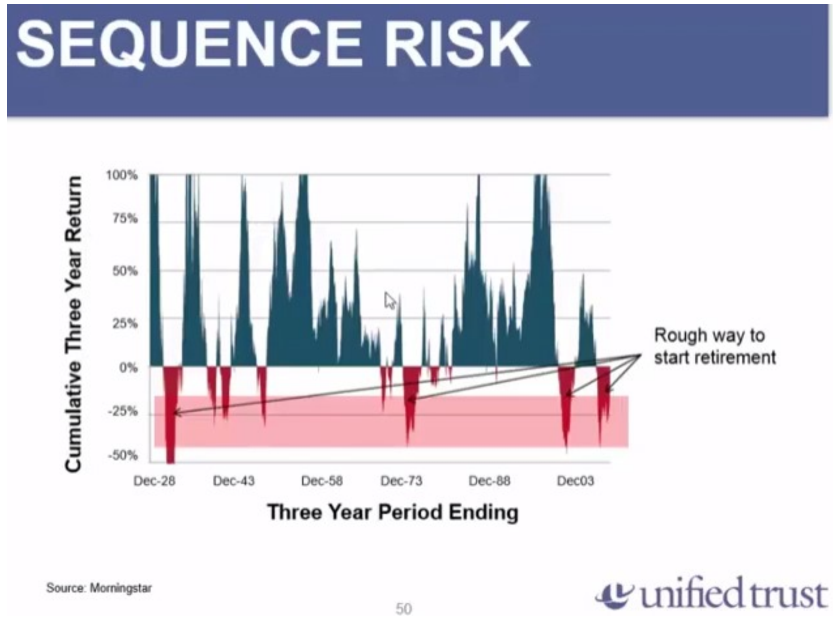
As you can see, the elderly spent less on transportation and apparel, but medical spending was almost twice as much. Bottom line: Inflation affects retirees more than it does those of working age primarily due to health care's increasing costs.

Timing risk is scary because Murphy's Law says we'll pick the wrong year to retire. As you can see, someone who retires after a 25% market drop using a 5% withdrawal rate will likely have only a 39% chance of retirement success, as opposed to someone who retired in a normal market who has more than double the chance of success.



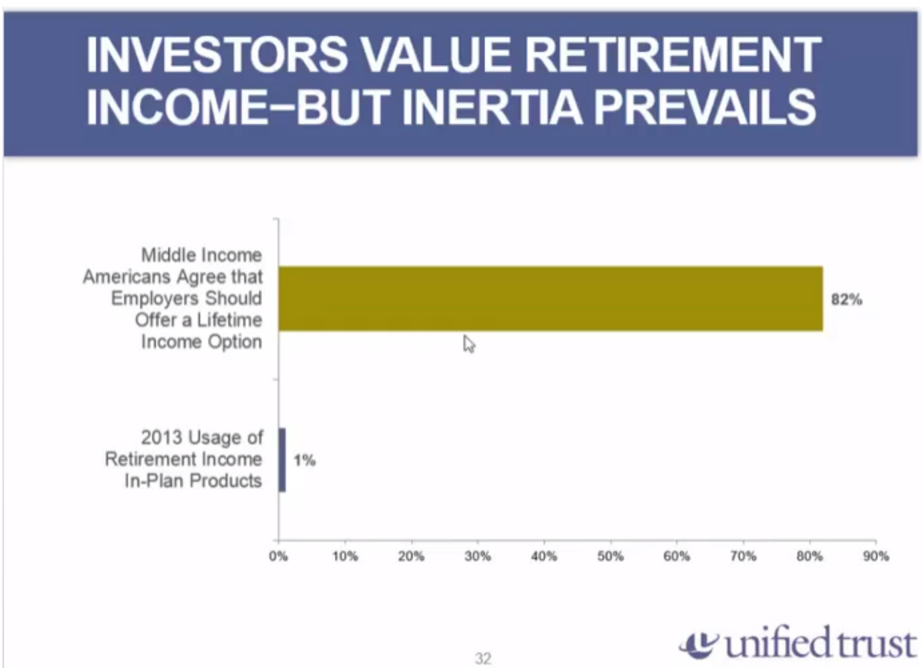
Now, these probabilities are calculated using something called Monte Carlo analysis—a risk management calculation process that got it's start in the early days of manufacturing quality control and later adopted by other industries for risk management probability analysis. Monte Carlo, like other tools, however, shouldn't be blindly accepted as 'the answer'. For example, if you want your spending to last for 30 years of retirement and all your goals are 100% funded for 29 years and 11 months, the one month at the end, even if the shortfall is small, is still considered a failure under Monte Carlo; however, it's still useful for probability analysis provided the analysis is repeated on some regular schedule, providing a trend.

This chart from Unified Trust, a company with a significant presence in the 401(k) marketplace, shows just how much of a gamble retirement date timing risk can be.



Historically, traditional asset management has addressed this issue through basic asset allocation among asset classes (stocks, bonds, real estate, commodities, and cash) and investment styles (large, mid-size, and small companies both domestically and internationally) in order to reduce the correlation of portfolio holdings while managing for total return, versus interest yield, to achieve investor objectives. However, timing risk, when factored against our next risk, longevity risk, has created a demand of new strategies to address the changing demographics.

Longevity risk—people are living longer and are afraid of running out of money—has become a huge issue as more and more baby boomers are retiring—about 10,000 each day! And, fewer of these enjoyed the pensions their parents had. What's more, despite the fact they say they want pensions, few really do much about it. As you can see, while 82% of middle income workers want a lifetime income option in their company plans, only about 1% actually use it.



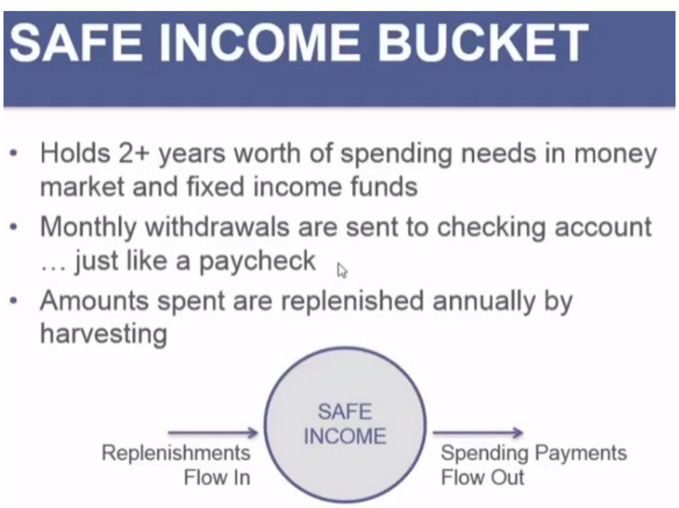
While some retirees are comfortable dealing with probabilities rather than certainties, those who want certainty often find there are trade-offs to be made. But, then, the trade-off for taking on probabilities is the lack of certainty—something that usually arrives at advanced ages. After all, the risk for most retirees isn't that they'll run out of money in the first five years; the real risk is when they're in their mid-80s having experienced twenty years of inflation and tax law changes.

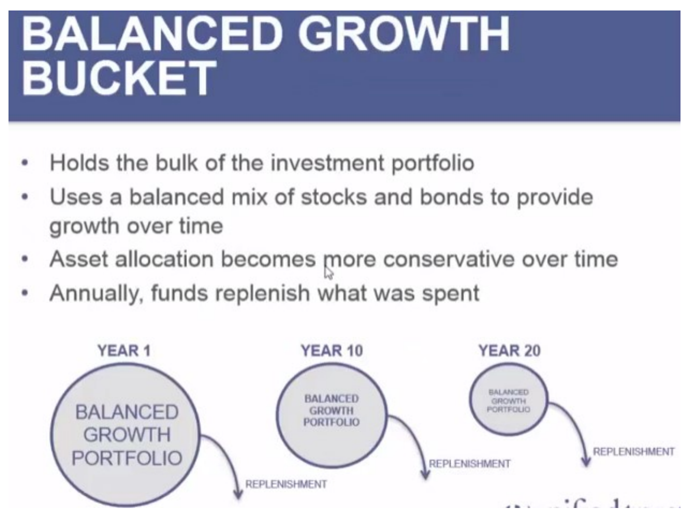
Asset management techniques have evolved to address longevity, timing, and inflation risks. The most recent iteration involves a segmentation strategy, often referred to as "bucketing". Under this strategy, money is simply allocated into time segments or buckets in order to meet needs as they arise in later years.

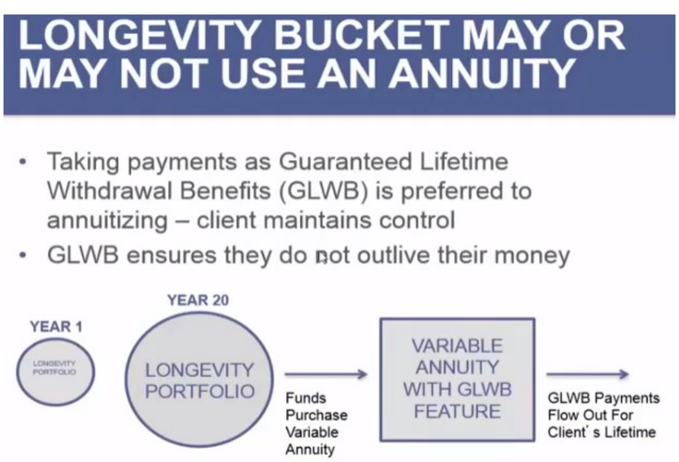
Time segments can vary. For example, some recommend a 5-year segment for bucket #1, based on the traditional belief in the 5-year market cycle. A 5-year time frame would theoretically give sufficient time for markets to revert to their long-term averages while money in bucket #1 would be invested in a combination of cash and short-to-intermediate-term bonds—a mixture of government and high-grade corporate.

The second bucket would contain assets that are managed for a longer period and contain money beyond years 2 or 5 out to ? Years. And, the third bucket would be created to hold money earmarked for "late-life income" - money designed to be there to support late life spending even if everything else goes south.

The asset management process , for those comfortable with probabilities vs certainties, works something like this: The cash bucket is replenished from the short-intermediate term bond bucket during the first time segment. This bucket can theoretically be spent-down over the bucket's time segment, because as time goes by,







the second, balanced, bucket becomes more conservatively allocated and is used to replenish spending over it's segment. This bucket can be spent-down over the length of it's segment because bucket #3, which has been growing since day #1, was designed to provide for late-life income.

There are different theories as to what vehicles are best suited to fund this segment. And, as they say, what's right for a given individual 'depends'.

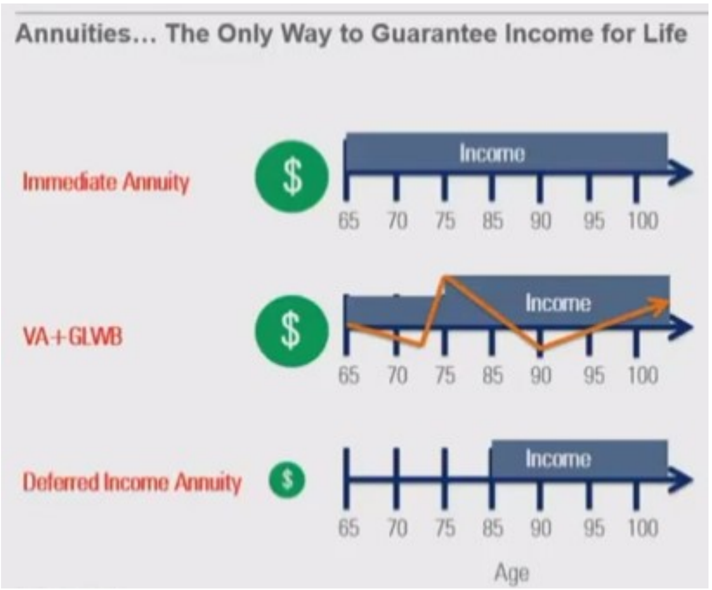
Again, it's about probabilities vs. certainties.

Late life income

For many, if not most, investors, achieving a high probability of retirement security beyond twenty-plus years usually means some type of insured solution. Pensions (remember those?) were insured solutions. So is Social Security. But, in these days of investors taking responsibility for their own financial future—which means acting as your own actuary or getting help—insured solutions tend to be the best available path. This, of course, means changing the way we've been taught to think about insurance, usually by people who knew little about it.

Those who plan early enough, say in their 50s, in good health expecting a long life, and comfortable planning in the world of probabilities, have a number of options available to them. One, in particular, offers excellent tax advantages and, if structured properly and illustrated responsibly, can offer a high success probability.

Another alternative widely used is the annuity. Note: An annuity is the **ONLY** way on this planet you can arrange for a ***guaranteed*** lifetime income. ***No other financial tool exists that will do it***. So, if you want guarantees, annuities are the only game in town; however, there are more than one type of annuity—and the confusion this causes is why so many hear about one type and confuse it with the others.



The immediate annuity accepts your deposit and pays an income for life, or two lives, and/or some specified period, depending on how it's structured. You're 'buying' an income for life.

The variable annuity is like a group of mutual funds with an insurance wrapper. The wrapper is what buys the tax deferral. Many feature a guaranteed lifetime withdrawal benefit.

The deferred income annuity accepts your deposit and begins to pay income at a later date you choose. The income payout options are similar to the immediate annuity.

It's the variable annuity that usually receives the bad press for it's high expenses; though there are no-load products available with low expenses, as well. The only potential negative I see is the fact that because these are mutual fund clone portfolios inside an insurance wrapper—and withdrawals are taxed as ordinary income—the investor using taxable dollars to fund the vehicle is turning future capital gains into ordinary income taxable at very different rates. If, conversely, you use tax-deferred (IRA) money to fund it, you're really not gaining anything beyond the guaranteed lifetime withdrawal benefit and there are other ways to address that issue using the other two products (immediate or deferred annuities) which don't have the same expenses and can be structured to accomplish the same goals. **The key: it's not an 'all or nothing' proposition.**

Remember, before adopting any strategy, be sure you have a formal written plan. After all, you wouldn't build a house without a blueprint, would you? Getting some qualified guidance might be a good idea, as well.

Hope this helps.

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