Retirement Researcher

Retirement Income Planning, Part 2

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Today, we continue our discussion of the core points of our retirement planning philosophy. If you missed part one, you can go back and read it here.

4. Avoid plans that require high returns

Higher assumed future market returns imply higher sustainable spending rates, which basically means if you expect to make more money in the future, you will spend more money today. It's only natural.

Stocks offer the potential of higher returns than bonds, but it's important to remember that those returns are only possible because stocks carry higher risk than bonds. Their "risk premium" is *not guaranteed* and may not materialize during your retirement. That's not to say that you should avoid stocks, but you must spend accordingly.

Retirees who spend more today because they are planning for higher market returns than they can get with bonds are essentially amortizing their upside when the markets could collapse tomorrow. They are spending more today than bond investments justify, based on the assumption that higher returns in the future will make up the difference and justify their higher spending.

The fundamental nature of risk for retirees is the threat that poor market returns will permanently lower their standard of living. Retirees must decide how much risk to their lifestyle they are willing to accept. Spending more today based on assumed future earnings is risky business. It may be reasonable behavior for the more risk tolerant among us, but most people aren't comfortable with it. The consequences must be considered in advance.

5. Manage risks by integrating strategies

In order to build a retirement income strategy, you must combine several income tools to meet your goals and effectively protect against the risks standing in the way of those goals. A list of the unique risks you will face in retirement could fill an entire book, but some of the more major areas include:

- Longevity and the unknown planning horizon (i.e., how many years should your plan account for?),
- Market volatility and macroeconomic risks,
- Inflation, and
- Spending shocks that can derail a budget.

Different income tools with different relative strengths and weaknesses must be implemented to address each risk. No single solution can cover every risk.

6. Don't put all your eggs in one retirement income tool

The financial services profession is generally divided into two camps: those focusing on investment solutions and those focusing on insurance solutions. Either side is full of adherents who see little use for the other side. As is the case in most situations with two extremes, the ideal approach is somewhere in the middle.

The most efficient retirement strategies require that we integrate investments *and*insurance. It is potentially harmful to dismiss entire subsets of retirement income tools without a thorough investigation of their purported role. Proponents of one side or the other miss the point when they describe the stock market as a casino, lump income annuities together with every other type of annuity, and dismiss reverse mortgages without any further consideration.

For the two camps in the financial services profession, it is natural to accuse the others of conflicts of interest and biased advice, but each side must reflect on how their own conflicts color their advice.

On the insurance side, insurance agents receive commissions for selling insurance products and are only held to a "suitable" standard for advice. On the investments side, advisors charging a percentage of assets naturally wish to make the investment portfolio as large as possible, which is not necessarily always going to be in the best interests of clients who are only seeking sustainable lifetime income and proper retirement risk management. Meanwhile, those charging hourly fees naturally do not wish to make their recommendations so simple that they forego the need for an ongoing planning relationship.

These hurdles must be overcome in order to make decisions based on math and research, not an allegiance to any one tool. This requires starting from a fundamentally agnostic position.