Retirement Income Planning, Part 3

by **Wade Pfau, Ph.D., CFA**

August 1, 2017

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

7. Start by assessing all household assets and liabilities

A retirement plan involves more than just finances. Rather than beginning at your savings, the starting point for building a retirement income strategy should be the household balance sheet. This fundamental lesson has been proven several in various retirement frameworks, including Modern Retirement Theory, the Funded Ratioapproach, and the Household Balance Sheet view.

At the core of these different methodologies is a desire to treat the household retirement problem the same way pension funds treat their obligations. Assets should be matched to liabilities with comparable levels of risk. This matching can either be done on a balance sheet level, using the present values of asset and liability streams, or it can be accomplished on a period-by-period basis to match assets to ongoing spending needs.

Structuring the retirement income problem this way makes it easier to keep track of and to make sure each liability has a funding source. This also allows you to more easily determine whether you have sufficient assets to meet your retirement needs, or if you may be underfunded. This organizational framework also serves as a foundation for choosing an appropriate asset allocation and seeing clearly how different retirement income tools fit into an overall plan.

The following table provides a basic overview of potential assets and liabilities a household balance sheet should consider.

Household Balance Sheet	
Assets	**Liabilities**
Human Capital	Fixed Expenses
Continuing Career	Basic Living Needs
Part-time work	Taxes
	Debt Repayment
Home Equity	
	Discretionary Expenses
Financial Assets	Travel & Leisure
Checking Accounts	Lifestyle Improvements
Brokerage Accounts	
Retirement Plans	Contingencies
	Long-Term Care
Insurance & Annuities	Health Care
	Other Spending Shocks
Social Capital	
Social Security	Legacy Goals
Medicare	Family
Company Pensions	Community & Society
Family & Community	

8. Distinguish between technical liquidity and true liquidity

An important implication from the household balance sheet view is that the nature of liquidity in a retirement income plan must be carefully considered. In a sense, an investment portfolio is a liquid asset, but some of its liquidity may only be an illusion. As I stated in the last point, assets must be matched to liabilities. Some, or even all of the investment portfolio may be earmarked to meet future lifestyle spending goals.

Curtis Cloke describes this in his Thrive University program for financial advisors (which I have attended twice) as “allocation liquidity.” You are free to reallocate your assets any way you wish, but the assets are not *truly* liquid because they must be preserved to meet the spending goal. While you could decide to use these assets for another purpose, doing so would jeopardize your future spending. In this sense, assets are not as liquid as they appear.

This is different from true liquidity, in which assets can be spent any way you want because they are not earmarked to meet existing liabilities. True liquidity comes when excess assets remain after specifically setting aside what is needed to meet all household liabilities. This distinction is important because there could be cases when tying up part of your assets in something illiquid, such as an income annuity, may allow for the household liabilities to be covered more cheaply than could be done when all assets are positioned to provide technical liquidity.

An income annuity that pools longevity risk may allow lifetime spending to be met at a cost of twenty years of the spending objective, while self-funding for longevity may require setting aside enough from an investment portfolio to cover thirty to forty years of expenses.

Because risk pooling and mortality credits don't require as much to be set aside to cover the spending goal, there is greater true liquidity and therefore more to cover other unexpected contingencies without jeopardizing core spending needs. Liquidity, as it is traditionally defined in securities markets, is of little value as a distinct goal in a long-term retirement income plan.