

THE PROCESS OF MANAGING RETIREMENT INCOME

THE LANGUAGE OF RETIREMENT INCOME PLANNING



The oldest of the baby-boomer generation is now 63 years of age and moving ever closer to the age when a “traditional” retirement would begin. Much has been written on the impact the baby-boomer generation has had on society and what retirement will look like for them going forward, but there hasn’t been enough written on the topic of retirement income planning, from a process point of view.

The road of retirement should be paved with more than good intentions. Soon-to-be retirees need to develop and follow a retirement income plan that balances current lifestyle and long-term sustainability of the retirement portfolio. The *Road of Retirement* series provides some best practices for accomplishing this balance.

It seems that the financial services industry has equated the term “retirement income” with a discussion of various products and features versus a discussion of a process. Simply stated, if you bring your hard-earned retirement savings to a financial adviser and ask for his or her help to convert your savings to a monthly spending amount that has a good probability of sustaining a 30- to 40-year retirement, the answer should begin with a definition of a process versus the latest and greatest product.

The baby-boomer generation can be broadly categorized into three groups relative to their state of preparedness for retirement. There are those who are fortunate enough to have enough money whereby annual spending amounts are of small concern and planning the estate, philanthropy, and determining a legacy are more of a focus. At the opposite end of the spectrum, there are those who have not prepared well for retirement, have not amassed sufficient savings and will need to work well past the traditional retirement age of 65. The third group is somewhere in between and we believe represents the majority. These are the soon-to-be retirees who have some retirement and savings, maybe a small pension from a previous job and need to plan on how to balance current spending needs with positioning the portfolio to provide the 30, 40 years and beyond of financial support. This is the group that this *Road of Retirement* material is geared towards.

In advance of reading the various articles, it is important to be acquainted with the unique language of retirement income planning. It has emerged in the past ten to fifteen years

as academics study the unique issues facing the baby-boomer generation. While this is not meant to be an exhaustive list, it will provide some of the essentials for the topics addressed in this *Road of Retirement* series.

- a) **Longevity** is synonymous with “life expectancy” and has a direct effect on all aspects of retirement income planning. With advances in medicine and healthier lifestyles baby-boomers are expected to enjoy unprecedented longevity as compared to previous generations.
- b) **Sustainability** is the capacity of a financial portfolio to endure and support the spending for the retirement time period.
- c) **Purchasing Power** is the amount of goods or services that can be purchased for a dollar. For instance, a dollar in 2010 will purchase less than what a dollar purchased in 1970. The difference in that amount is referred to as “loss of purchasing power”.
- d) **Initial Spending Rate** is expressed as a percentage of the retirement savings being spent in the first year of retirement. To calculate, take the amount you desire to spend in year one and divide it by the amount of retirement savings accumulated. For instance, if you desire to spend \$50,000 in year one and you have retirement savings of \$1 million, your initial spending rate is 5% ($\$50,000/\1 million).
- e) **Current Spending Rate** is the amount of next year’s spending divided by the current value of the portfolio determines the current spending rate for each subse-



quent year in retirement. This can be a good gauge of the health of the plan.

- f) **Spending Policy** determines how the annual spending amounts will be calculated.
- g) **Accumulation Phase** is the time period that assets are being saved for retirement. The **Distribution Phase** is when retirement begins and savings are converted to monthly spending amounts. This phase is also referred to as the “decumulation” phase.
- h) **Reverse Dollar Cost Averaging** is the negative effect upon the retirement portfolio of having to sell more shares of an investment in a down market to provide for spending.
- i) **Sequence of Returns** is simply the order in which returns are realized by a retiree. A common mistake in many retirement plans is that a long-term historical average of a particular investment is used for future planning purposes. Since the retiree will be making systematic withdrawals from the retirement savings, the order in which investment returns are realized is of much more relevance than the long-term historical average.
- j) **Legacy** is the assets to be left to family heirs or charity at the end of the retirement period.
- k) **High and Growing Dividend Stocks** are equity investments in common stocks of publicly traded companies that have the ability and willingness to pay a high and growing dividend. This type of investment has the potential to provide retirees with the rising dividend income stream and capital appreciation needed to balance current spending and preservation of purchasing power.
- l) **Real Returns** are investment returns after the effects of inflation. In simple terms, if the nominal return is 8% and inflation is 3%, then the real return is approximately 5%. An even more appropriate measure for retirees is termed “real real returns” which accounts for the cost of inflation, investment expenses, and taxes.
- m) **Real Return Hurdle** is an annual return that needs to be realized after subtracting inflation, investment expenses, and taxes. This hurdle rate is calculated using the initial spending rate, legacy amount, and retirement period. This can be a valuable tool in comparing various investment options for the retirement portfolio.
- n) **Income Replacement Ratio** is the percentage of the spending needs that can be provided for by interest and dividend income from the retirement savings portfolio.

Best Practices

The use of a trusted financial advisor to help you thoughtfully develop and adhere to a retirement plan during your journey on the road of retirement is highly recommended. While baby-boomers are expected to spend many years in retirement, with this extended time will come many changes in the financial markets, family needs, health concerns, and legacy issues. These changes will result in times of challenge and prosperity. A good financial advisor will provide the last line of defense between you and yourself during both.

Disclosures:

Following these strategies does not assure or guarantee sustainability of a retirement portfolio or better performance, nor do they protect against investment losses.

The views expressed in this article are subject to change.

Before investing, carefully consider the investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor. Read it carefully before investing.