The Evolution of Retirement Planning

by Ed McCarthy, CFP

Retirement planning has changed considerably over the past two decades. In the eighties and early nineties, advisors often followed a standard sequence to forecast clients' retirement needs:

- Project desired income for the first year of retirement. The usual rule of thumb was to start with 70 percent of the last working year's spending levels.
- Adjust that desired income for expected annual inflation and project it over the client's life expectancy.
- Project income sources available to meet the estimated expenses and forecast each year's surplus or shortage.
- Calculate a present value (as of the retirement date) for any shortages and develop a savings plan to provide the additional required funds.

There's nothing wrong with this analytic sequence. For many clients, the results provided their first inkling of the large sums needed to fund a comfortable retirement. If that realization motivated them to increase savings or select a more appropriate investment mix, then the calculations served a valuable purpose.

But the assumptions used in these calculations played a critical role in determining the results. For example, if the advisor plugged in a high inflation rate based on his or her experiences from the late seventies and early eighties, the clients' projected living costs in later life were astronomical. An example: At an assumed constant, annual inflation rate of 8 percent, a first-year income of $75,000 swells to almost $238,000 in 15 years. Drop the inflation rate to three percent and the projected cost is roughly $117,000 after 15 years. Assumptions about asset returns played a similar critical role. If the forecasts assumed bullish returns—at least toward the upper end of historical norms—for the pre- and post-retirement periods, asset values would grow significantly. The resulting analysis could lead clients to believe they needed less pre-retirement saving, could spend more after retirement without depleting funds too quickly, or both.

The lack of variability in the plan's key assumptions affected analyses, as well. Most projections assumed constant (inflation-adjusted) spending patterns, inflation and tax rates, and investment returns. Advisors and clients knew from experience that these items would vary, but retirement plans often assumed they were predictable and fixed.

Fast-forward to 2002. Although many advisors still follow the sequence of steps described above, they are much more conscious of the assumptions behind the forecasts. As a result, retirement plans have become much more flexible and, ideally, realistic. What caused the movement away from earlier assumptions and forecasting methods? To a large extent, as academics and practitioners started focusing on retirement planning research and publishing their findings, advisors began to modify their methods and models. The *Journal of Financial Planning's* online article archive (www.journalfp.net/fpajournal/retire.cfm), for instance, lists dozens of retirement- and benefits-planning articles published since 1979. Several of these articles, such as those discussing sustainable retirement plan withdrawals and applications of Monte Carlo simulations, have had widespread influence on advisors' thinking.

The *Journal* recently asked several financial planners, all with ten or more years' experience in retirement planning, to discuss how their approach to retirement planning has changed in the past decade. Although their individual perspectives differed, most cited the same major influences on their work:

- Recognition that clients' retirement spending patterns change with age
- Software that allows variability in asset return and inflation assumptions
- Recognition that sustainable withdrawals from retirement plans are lower than previously thought
- Increased role of quality-of-life issues

Client Spending Patterns

Do your clients increase their spending each year by the inflation rate from retirement to death? It's unlikely. Expenses can fluctuate dramatically, influenced by one-time events like major trips, car purchases, changes in health

and so on. Eileen Sharkey, CFP, a principal with the financial advisory firm Sharkey, Howes & Javer Inc. in Denver, Colorado, has long recognized that retirement income needs did not plot along a straight line. "For years I've used what I call a saddle approach to retirement income flows," Sharkey says. "When you're dealing with a 30-, 40- or 45-year span of time it is not, in my estimation, realistic to assume that somebody will retire with "x" amount of money and then get a pay raise every year for the rest of their lives. Most of them didn't get a pay raise every year when they were working, so there is no point in assuming they will get a pay raise every year when they are retired."

Sharkey recognized that many of her clients' spending patterns are age-dependent. "In my observation, clients need more money for fun in the younger retirement years," she says. "So we tend to front-end the inflation rates and everything else for the young retirees, ages 55 to 75 or 80, on the theory that they are not rocking-chair material and are just as subject to inflation as their working counterparts. In the middle years of retirement, we find that people don't do quite as much. They've already been to Rome nine times and they don't need to go again, so perhaps the traveling slows down and the income need is much less for maybe five to six years. In the later retirement years, the early- to mid-90s, if there hasn't been a health problem before, that may be when the chronic health problems start to materialize. That may require more income, so the income stream should be greater at the beginning and end but probably less in the middle."

The research confirms Sharkey's observations. In 1999, Tacchino and Saltzman published an article in this journal titled, "Do Accumulation Models Overstate What's Needed to Retire?" The authors examined existing research data and reached several surprising conclusions that challenged the assumptions behind many plans:

- Almost 50 percent of retired households continued to save and build assets eight years into their retirement
- There is a gradual reduction in spending starting shortly after retirement. At age 75, spending is approximately 20 percent less than initial spending levels for retirement at age 65.
- Households age 75 and over spend less than those age 65–74.
- Large, one-time expenses also require modeling flexibility. Ten years ago or so, many retirement planning software packages could not deal with these special events. "In 1990, the typical retirement planning software would say, 'What is your current income and then assume you're going to retire on 70 percent of that,'" says Dan Moisand, CFP, president of Optimum Financial Group in Melbourne, Florida. "It would do just very basic time-value-of-money calculations, whereas now, you can program different income streams to stop and start at different points in time. You can account for one-time expenses at various points in time like a wedding, college or a new car every few years. You can turn different income streams on and off, inflate some, non-inflate others, those types of things."

Mike Vitkauskas, president of Money Tree Software in Philomath, Oregon, echoes Moisand's comments. Money Tree sells several popular retirement planning programs that allow complex cash flow modeling. "It was probably about ten years ago when we started revising the models to allow people to make changes to the expenses in retirement multiple times," he says. "If the clients need $4,000 when they retire, it's possible that five years later they'll need $6,000 a month because they're going to travel around the world for a year. Then after that's done, their expenses might go down to $3,000 a month. We saw that our planners, and our planners' customers, were looking for something where they could have a more fine-tuned projection, so we developed Golden Years, which is more of a cash-flow approach. For every year in the analysis, it shows income, expenses, assets, rate of return on each asset group, and income taxes using real IRS tax-rate calculations and indexing."

Accounting for Uncertainty

Can you imagine telling a client that her investment portfolio will earn a 12 percent return (or 8 or 10 percent), year-in and year-out, and then basing her retirement plan on that assumption? It sounds unrealistic, particularly in light of the markets' recent volatility. Yet the assumption of a historically based, constant return has been the norm behind many future-value projections. The problem, of course, is that the investment markets refuse to cooperate by producing the average return in any given year.

For a growing number of advisors, Monte Carlo simulation (MCS) has become a useful tool for dealing with uncertain outcomes. Curt Weil, CFP, president of Weil Capital Management LLC in Palo Alto, California,

recalls how the limited assumptions influenced his work with clients. "Back then, we had a simple spreadsheet that did discounted present value and automatic calculations for variables such as inflation," he says. "Of necessity, we had to use a fixed life expectancy for the participants and we had to use a straight-line rate of return for market return. Today's software allows for Monte Carlo analysis both of life expectancy and rates of return, and it's just a far more complete—I don't want to say exact—but it's a more accurate form of computation. That said, I tell clients that what we're doing with Monte Carlo analysis is simply a more scientific form of guessing."

This journal played an important role in exposing advisors to the benefits of using Monte Carlo simulations in projections. In particular, Lynn Hopewell's work as editor and contributor led to the inclusion of numerous articles on analyzing the uncertainty in critical personal finance variables. Retirement planning software developers have responded to the growing interest in MCS by including it in their programs. Both Money Tree Software and EISI, the Winnipeg, Canada-based developers of the NaviPlan programs, now offer MCS in their packages.

As MCS gains acceptance among advisors, however, some observers are questioning its usefulness, signaling the start of a new phase in the profession's adoption of the technology. In November 2001, David Nawrocki, a finance professor at Villanova University, published an article in this journal challenging the models used in several MCS articles. He argued that (1) MCS is often not the appropriate analytical method, and (2) using MCS with normal distributions for investment returns and failing to include relevant serial- and cross-correlations between and among data series produces flawed results. "The problem with Monte Carlo simulation is the assumptions that have to be made in the model in order to easily deploy Monte Carlo simulation," he summarized. "Since few planners have formal training in operations research, they will tend to make these assumptions without understanding their implications."

Sustainable Withdrawals

Without exception, the planners interviewed for this article cited William Bengen's series of articles on sustainable portfolio withdrawal rates as an important influence on their work with clients. Bill Bengen, CFP, president of Bengen Financial Services Inc. in El Cajon, California, published his first article in this journal in October 1994, and he has since expanded the work into a four-part series. Before Bengen's research, many advisors relied on rules of thumb to determine the amounts clients could safely withdraw from their retirement accounts. David Rhodes, a planner with Lincoln Financial Advisors in Dallas, Texas, recalls his experiences. "Back in the mid-nineties, it was just, 'Well, let's assume that the portfolio gets x percent, whether it's five or six percent from age 65-on, and then the withdrawal rate gets based upon what the client needs,'" he says. "If nothing else, we would pick a number like four or five percent and go with that. The research that has come out recently about how well portfolios sustain, given inflation and market turnaround—it's just so much more accurate now. I think the plans we give clients are much better."

Curt Weil also incorporates Bengen's findings and other research results in his plans. "People like Bill Bengen have done some wonderful work on what rates of withdrawal are likely to impair the chances of success for the client," he says. "Consider the recent work that looks at the place that annuities may have in the investment mix and what they do to the probabilities of success," he says. "Look at the studies on life expectancies. In my opinion, all of those are important for practitioners to at least be aware of and make a decision about whether they want to incorporate that into their practice. Because of some of these studies, for example, I counsel my clients to plan on a withdrawal rate of not much more than four percent. I tell them the greater the withdrawal rate, the greater the likelihood of failure."

Bengen's influence has extended beyond advisors. As the personal finance press learned about his articles, they exposed advisors' clients to the sustainable withdrawals concept. "When his (Bengen's) and others' research came out, we would talk to clients about it," says Greg Friedman, CFP, principal of Friedman & Associates in Novato, California. "Before it really hit the mainstream press, it was a more difficult conversation to have with a client. Interestingly enough, in the last few years, the research has reached the mainstream press and people are aware of it. I'll bring it up and they'll say, 'Yes, isn't it around three to four percent withdrawal from capital?' I just think that's great. It saves me a whole bunch of work, and it's been one of the

better tools for articulating the importance of expecting lower returns."

Other Concerns

Retirement planning often goes beyond merely crunching the numbers. Having adequate funds is an important goal, but many advisors have found that clients are just as concerned about the quality of their post-retirement lives. "I have some clients now approaching their mid- to late fifties who are looking to retire early," says Bill Bengen. "They require special help to get them ready for that period of time, particularly in the area of what they plan to do during retirement and how they plan to structure their lives. People want more out of life than simply going off to some South Sea island and spending the next 30 years sipping cocktails on the beach. They still want to be actively involved in their community and contributing and feel they are leading a useful life, even though they are not going to work per se."

It's common for younger retirees' parents to be alive, and dealing with their aging parents can be an unexpected challenge for the recently retired. Dan Moisand has encountered this with several clients. "I am grappling with how I can better help my clients navigate the ins and outs of elder care, which is not necessarily a financial, number-crunching type of issue," he says. "I see a lot of clients whose parents are failing health-wise, and it is very difficult for them to navigate through that mess. Very few of the 80-plus generation have long-term care insurance. They don't have any plan, really, to take care of things other than, 'We will make do as best we can, as we need to." There are issues such as whether we need to look at assisted-living facilities. From an outsider's perspective, that may seem like a wise idea because it's the best form of care for that particular person, but the person doesn't want to do that—he doesn't want to move into a facility—that's where people go to die. He wants to stay at home and have the kids take care of him, sometimes. There are all kinds of issues there."

In an effort to assist clients in these circumstances, Moisand has become involved with the local chapter of the State Guardianship Association, and through that organization, he has become associated with several geriatric care managers. These professionals help assess the parent's progression, review housing options and so on. "There are also attorneys and other people concerned with these issues," Moisand says. "It has been a good resource and a sounding board, but I am still trying to get my hands on exactly how to make this easier for my clients to deal with."

With hindsight, clients' concerns about retirement haven't changed much in the past decade. They still want portfolios that will let them sleep at night while generating sufficient income to fund their lifestyles. Advisors approach the issues differently, however. Flexibility has replaced certainty, and this caution is reflected in the more sophisticated models of investment returns and spending patterns. Forecasts are offered now as starting points for discussion, not final solutions. In an uncertain world, that approach offers benefits for clients and advisors.

Ed McCarthy, CFP (ed@edmccarthy.com), is a freelance writer living in Warwick, Rhode Island.