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Managing Retirement Assets

A discussion with Stephen "Moe" Allain, RMA®, CPWA®, AAMS® and Dana Anspach, CFP®, RMA®

INVESTMENTS & WEALTH INSTITUTE®

Managing Retirement Assets

Investments & Wealth Monitor *(I&WM) asked two advisors to provide their perspectives about how to assess retirement readiness and help clients deal with the risks they face in retirement.*

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I&WM**:** How well prepared do you think most Americans are for retirement? How did COVID-19 affect their retirement plans?

Allain: Many individuals wait until retirement has snuck up on them to put together a baseline household budget and give serious thought as to what they want retirement to look like. Without a baseline budget, it makes it difficult to determine if someone is overfunded, constrained, or underfunded for retirement.

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A recent Fidelity Investment survey found than more than 80 percent of Americans said the pandemic had affected their retirement plans. An estimated one-third said that they'll need two to three more years to get their retirements back on track. Retirement advisors should be working with clients by putting on their teacher, coach, and psychologist hats and helping clients set realistic expectations.

Anspach: My firm works with high-net-worth [HNW] households, so we predominantly see people who are well prepared for retirement. However, we are keenly aware of the statistics that show that most Americans are not as well prepared for retirement as the demographic slice that we spend the most time with.

Of our firm's clients, about half already are retired and the other half are within 10 years of their desired retirement dates. Because we follow the concepts in the RMA® [Retirement Management Advisor®] designation of first building a floor of income, our retired clients saw no financial impact from COVID-19. Their incomes did not change, and they maintained their portfolio structures throughout the volatility.

Our working clients fall into the upper half of the K in the K-shaped recovery. Some accelerated their retirement plans by choice, and a few received severance packages and happily accepted that they would retire a year or two earlier than planned.

I&WM**:** How do you assess a client's readiness to retire?

Anspach: We use a comprehensive cash-flow-based projection model with a defined set of assumptions to administer three specific retirement readiness tests. With each test, we have a metric that we apply, and for us to consider the client to be retirement-ready, the client's plan needs to meet or exceed a passing grade.

All three tests begin with the client's current amount of financial capital and then assume customized inflation-adjusted withdrawals are taken for life. The first of the three tests is a standard Monte Carlo analysis using 5-percent returns with a 13.85-percent standard deviation. We like to see an 80-percent success rate.

The second test is a fundedness test derived from a concept in the RMA program that works much like a pension plan's annual fundedness analysis. To apply this, we discount the client's projected withdrawals by 4 percent to determine their present value. We compare this to the current financial capital and want to see a fundedness ratio of 110 percent or greater.

The third test is an historical audit, or what's sometimes known as an "aftcast." We send data to our investment partner, Asset Dedication. They run the historical audit, which shows how the portfolio would have held up in the past given that sequence of withdrawals.

Allain: I believe there is a two-pronged approach to assess retirement readiness.

The first step involves asking some tough questions of the prospective retiree, such as: "What are you going to retire to?" and "Have you given any thought about what your spending needs might look like in your first year of retirement?" If the individual hesitates or doesn't quite seem to understand the question, I'll normally suggest that they continue working because they probably are not mentally ready to make the transition.

The second is about the numbers and has two parts. Part one involves putting together a household balance sheet and getting the client's guess as to what the spending need may look like in the first year of retirement. This will tell us about assets capable of generating income, current liquidity, financial flexibility, and information about any debt load that is currently being serviced.

Part two involves a quick comparison of estimated living expenses with a 3–5-percent bumper-guard distribution range of withdrawals from the client's asset base. This number added to any future contribution from Social Security or a defined benefit pension plan will provide us with a comparative number to help us determine if there is an income gap or surplus.

***I&WM*:** What are the biggest risks to retirees? How can advisors help retirees anticipate and plan for these issues?

Allain: The biggest risks are spending risk, household shock risk, healthcare risk, and longevity risk. These unsystematic risks are found in the distribution phase.

Clients look to advisors to help them become educated about these risks. This education should create client awareness. I like to use the Two Category Risk Exposure Map from the RMA curriculum, drawing a solid line between the systematic and unsystematic risk, then ask clients if they feel they are exposed to any of these risks. This gets a really good conversation going.

I also like to refer to Jim Sandidge's article, "Chaos and Retirement Income," that was published in the *Retirement Management Journal [RMJ]*.[1] It talks about retirement accumulation planning being a linear process and distribution planning being a nonlinear process. This nonlinearity in the distribution phase is where the additional risks get added and extra caution is needed. This paradigm shift needs to be communicated by the advisor and understood by the client.

Anspach: The Society of Actuaries does a fantastic job of laying out risks in its Post-Retirement Needs and Risk Survey.[2] One risk that has remained consistent is that retirees routinely think they will work longer but, in reality, they end up retiring sooner, sometimes by choice and sometimes not. A job may come to an end sooner than expected, or they end up burned-out a few years earlier than anticipated and find they're not up for the work anymore. Advisors can help their clients plan for a retirement that may arrive earlier than expected by encouraging them to maintain emergency reserves and max out savings while in their peak earning years.

***I&WM*:** Most capital market assumptions are projecting substantially lower equity returns, and we all recognize that bond yields are near their recent all-time low levels. If equity returns and bond yields are well below historical norms over the next 10–20 years, what impact will that have on retirees? Will they have to work longer, spend less, or change their allocations?

Anspach: The impacts on retirees will depend on the assumptions they used to build their plans. If they assumed their portfolios would average 8–10 percent, they likely are going to have to recalibrate their spending in retirement. Working longer is not an option for everyone, and taking on more risk in the portfolio to seek higher returns is likely not prudent. Clients are happy when reality exceeds expectations, so it is best to use conservative assumptions. Give reality a chance to deliver something better than you projected and you'll have happy clients. Remind clients who are still working that the one item they can control is their savings rate, and the more they save, the better prepared they will be for whatever the future may hold.

Allain: COVID-19 has caused lots of premature retirements, heathcare issues, and household shocks. Working longer may not always be an option. If someone is healthy, enjoys work, and has a non-stressful work environment, I would encourage working longer. If someone is unsure of what they want to retire to, I also would suggest continuing to work, because they may not be mentally prepared to make the transition.

Retirees need to have a pretty good handle on their household budgets to clearly separate the essential expenses from the discretionary expenses, and they need to have some wiggle room to even consider spending less than they budget. Advisors may want to consider dynamic withdrawal rates for retirees based on their current cash-flow needs and their individual timelines to Social Security benefits.

You want to be careful with allocation changes so as not to use up too much of the client's risk budget. Potential changes to clients' asset allocations may include an increased allocation to income-producing developed markets and emerging market equities, and the addition of some lower credit quality and even foreign fixed income. Usage of fixed annuities will increase, especially as clients enter their 60s and the rates increase because of their lower life expectancies.

***I&WM*:** How should advisors think about generating tax-efficient income for their clients? What types of investments and products should advisors consider—high-yield, private credit, real estate, etc.? How might they allocate those products and investments across the various types of accounts clients have such as 401(k) plans, IRAs [individual retirement accounts], Roths, and taxable accounts?

Allain: The traditional thought process for tax-efficient income withdrawal sequencing is first from taxable accounts, then tax-deferred accounts, and finally from Roth accounts. A more modern approach between the ages of 60 and FRA [full retirement age] for Social Security is to start taking small withdrawals from 401(k) plans and traditional IRAs, filling up the lowest tax brackets possible, then defer taking the Social Security benefit until at least the FRA of 66–67. Some may even consider waiting until age 70, capturing the 8-percent-per-year deferred Social Security retirement credit. This strategy of deferring Social Security until age 70 is like having an inflation-adjusted government pension with survivor benefits. Once RMDs [required minimum distributions] start at age 72, it can be easy to lose control of your tax bracket and experience tax-bracket creep.

Roth IRAs are good for tax diversification. Roth IRA contributions may provide some liquidity advantages, so putting investments that are illiquid in a Roth may not make the most sense if liquidity is one of the goals. Many employers have added Roth 401(k)s to their retirement savings choices. You can contribute three times more to a Roth 401(k) plan than to a Roth IRA, without regard to your income. After meeting the five-year holding period on a Roth IRA and having attained the age of 59½, Roth 401(k) monies rolled over into a Roth IRA can be withdrawn as income, without penalty, and are tax-free. Roth IRAs are normally thought of as a good place for mutual funds, bonds, REITs [real estate investment trusts], qualified and non-qualified dividend paying stocks, short-term capital gains investments, ETFs [exchange-traded funds], and long-term appreciation investments such as growth stocks.

Tax efficiency in taxable accounts, such as single, joint, and trust accounts, is critical. Stock or stock mutual funds that pay qualified dividends, tax-free dividends, or little to no capital gains investments work well.

For traditional IRAs and pre-tax 401(k)s, mutual funds, taxable bonds, REITs, qualified and non-qualified dividend-paying stocks, mutual funds, and short-term capital gain investments work well. Private credit may be an option here depending on the firm, client risk tolerance, and investment objectives. Physical real estate often comes up as a potential asset to allocate here. Many firms don't allow the holding of physical real estate, forcing the client to transfer part of the IRA to a specialty custodian trust company that can do this. There are lots of rules and penalties. You'll want to advise this client to hire a tax professional to make sure this gets done correctly. For individuals who are charitably inclined and don't need all of their assets to live on, a non-taxable QCD [qualified charitable deduction] also can be taken from the traditional IRA (up to $100,000), and as long as the client is at least 70½, and the distribution is sent directly to a qualified charity.

Tax efficiency in taxable accounts, such as single, joint, and trust accounts, is critical. Stock or stock mutual funds that pay qualified dividends, tax-free dividends, or little to no capital gains investments work well. Additionally, tax-free municipal bonds and municipal bond funds work well in this type of account. Some clients also may consider a tax-deferred annuity within a taxable account. This also can offer creditor protection, depending upon the state the client lives in.

Anspach: Tax efficiency is an area where knowledgeable advisors can add alpha to a retirement-income plan. To do it well, you must use software or tax-projection tools that allow you to model different withdrawal patterns and Roth conversions. In our firm's view, the first layer of tax efficiency is not at the product level; it's at the planning level in terms of where cash flow will come from each year. Once that is dialed in, you can begin recommending products within each account.

In general, we place assets with the highest expected long-term returns in the Roth, investments that produce ordinary income in the IRAs, and investments expected to pay qualified dividends and long-term capital gains in the non-qualified or non-retirement brokerage accounts. However, as a client gets near retirement, we specify what amount should come out of which account types and align each account allocation to its upcoming cash withdrawals. Hence, at times, this entails adding more fixed income to the non-qualified or non-retirement brokerage accounts.

***I&WM*:** What role does an annuity play in generating income? Are annuities misunderstood?

Anspach: Too often, salespeople frame annuities as investments. They are insurance. When viewed in the context of ensuring a life-long income, they work well. The problem is people compare the potential outcome to an investment portfolio. Instead, an annuity is hedging a risk—longevity risk. It is challenging to manage longevity risk with an investment portfolio but easy to do so with annuities. Our preference is to follow the framework outlined in the RMA curriculum and recommend annuities to constrained or underfunded households to secure a minimum level of retirement income for life. We also look at how much of a client's basic expenses are covered by guaranteed income sources such as Social Security or pensions by the time they'll be in their early 70s. If guaranteed sources cover less than 50 percent of their expenses, then we discuss annuities as an option.

Allain: Annuities are tax-protected vehicles designed to provide a guaranteed income that cannot be outlived. An annuity works best at taking care of essential floor expenses like groceries, medical, and mortgage related costs. An annuity also can be a solution against longevity risk.

Annuities can range from fixed to variable to indexed and can be immediate or deferred. Each annuity has its own separate contract, and contract specifics vary from insurance company to insurance company. The costs can range from low to high. They can vary in the level of liquidity. You can access the markets through sub-accounts or choose not to access the markets. Because you have to make so many different decisions in the selection of an annuity, they are often misunderstood.

It is the retirement advisor's responsibility to educate the client on all aspects of the annuity being considered, so that the annuity can meet the client's needs.

***I&WM*:** What role does Social Security play in generating income for your clients?

Allain: Social Security provides one-third or more of the income for the average American in retirement. According to a 2020 analysis by the Bipartisan Policy Center,[3] age 62 is the age at which the largest percentage of Americans start receiving Social Security benefits. An individual whose Social Security FRA is 66 but takes benefits at 62 gets a benefit that is reduced by 25 percent permanently.

For HNW clients, the role of Social Security may be a little different. HNW individuals are in a position such that many can defer taking their Social Security benefits until the FRA and sometimes even age 70. They may start IRA withdrawals in their early 60s and just let the Social Security benefits compound.

It is a myth that Medicare will cover all healthcare-related costs. It is true that premiums may be lower than the pre-65 employer retiree related premiums, but there will be deductibles, co-pays, and non-covered items (dentures, hearing aids, etc.). Social Security benefits can be used to offset these uncovered healthcare costs.

Social Security also can play the role of paying property taxes and maintenance costs on primary residences, because these costs continue to increase each year.

Anspach: For most of our married clients, their combined Social Security income has a net present value of more than $1 million. That means even if it is a household with $10 million in financial assets, Social Security represents 9 percent of their portfolio value in present value terms. It's not insignificant.

Social Security planning adds real value to your clients, and they expect you to know the ins and outs, make recommendations, and show them how it fits in with the other aspects of their plans.

***I&WM*:** Do you create a retirement policy statement or something similar for your clients?

Allain: Clients seem to be more engaged when retirement planning parameters are put in the form of a one-page checklist that is not too intimidating.

The first item I put on the list is the client's before-tax distribution percentage in year one of retirement. It's also good to have a dollar value for the emergency fund that's going to allow your client to sleep well at night. The advisor and client also need to establish a target equity bumper-guard range that includes a plan to increase risk capacity.

That checklist also should include annual inflation adjustments—with an eye on tax-creep minimization by using multi-year planning of "lumpy spending." It needs to include a discussion about reversion to the mean and how this ties into rebalancing, as well as a discussion about the importance of timing when applying for Social Security benefits and finessing the transition from employer-provided healthcare coverage to Medicare. I also want to make sure that clients are aware of the unsystematic risks they are exposed to.

The final items I like to include on the checklist are just the nuts and bolts of our working relationship, including the types of investment tools we'll use in the various accounts and how frequently we'll get together live, virtually, or via the phone for review sessions.

***I&WM*:** How can advisors learn more about addressing the changing needs of investors?

Anspach: I was in the inaugural class of RMA certificate holders in 2010, so I am a bit biased in favor of this designation. The RMA curriculum was the catalyst for my book *Control Your Retirement Destiny* because I felt the entire industry was focused on accumulation, and when it came to retirement-income planning, they were doing it wrong.[4] I wanted to lay out a path of what it looks like when you do it right.

It has been with great joy that I've seen this curriculum evolve and more planners join me on the quest to bring peace of mind to those entering the decumulation phase of life. There is no possible way to express how amazing it is to sit across the table from a client with whom you've

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worked for 20 years and have them thank you, with tears in their eyes, for how secure they feel in their retirement years.

Allain: I recommend earning the RMA® designation if the advisor's practice is composed of pre-retirees and retirees. I would also suggest earning the CPWA® designation if the practice is composed of HNW individuals and corporate executives. The combination of the RMA® and CPWA® works well for HNW retirees.

Most of my learning comes from the IWI [Investments & Wealth Institute] continuing education webinars, podcasts, live and virtual conferences, the *RMJ*, and the *I&WM*. IWI's new HIVE community platform and knowledge centers also can be a great resource, a place where advisors can connect and help each other.[5]

Most importantly, you learn the most by volunteering on various boards, committees, and commissions within IWI. I am constantly learning from other professionals that have perspectives that are different from my own.

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ENDNOTES

1. See Jim Sandidge, "Chaos and Retirement Income," *Retirement Management Journal* (2019, 8, no. 1: 17–30).
2. See https://www.soa.org/research/topics/research-post-retirement-needs-and-risks/.
3. See Jason J. Fichtner, Shai Akabas, Gary Koenig, and Nicko Gladstone, "How to Help Americans Claim Social Security at the Right Age," Bipartisan Policy Center (August 26, 2020), page 14, https://bipartisanpolicy.org/report/how-to-help-americans-claim-social-security-at-the-right-age/.
4. See Dana Anspach, *Control Your Retirement Destiny: Achieving Financial Security Before the Big Transition* (Fort Collins: CO: A Book's Mind, 2016).
5. See https://hive.investmentsandwealth.org/home.

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