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Longevity Risk

*A Discussion with Wade Pfau, PhD, CFA®, RICP®;
Moe Allain, RMA®, CPWA®, AAMS®; and Robert Powell, CFP®, RMA®*

INVESTMENTS & WEALTH INSTITUTE®

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A DISCUSSION WITH WADE PFAU, PHD, CFA®, RICP®; MOE ALLAIN, RMA®, CPWA®, AAMS®; AND ROBERT POWELL, CFP®, RMA®

In this discussion, Wade D. Pfau, PhD, CFA®, RICP®, talks with Investments & Wealth Monitor *editorial board members about concerns around longevity risk, including retirement-income distribution planning, safe withdrawal rates, Monte Carlo analysis, and probability. This is Part 2 of the discussion. Part 1 appeared in the November/December 2022 issue of* Investments & Wealth Monitor.

Wade Pfau is a professor of retirement income at the American College of Financial Services and director of retirement research for McLean Asset Management. He hosts the Retirement Researcher *blog, co-hosts the* Retire with Style *podcast, and is a monthly columnist for* Advisor Perspectives, *a contributor to* Forbes, *and an expert panelist for the* Wall Street Journal. *His most recent book is the* Retirement Planning Guidebook. *Pfau earned a PhD in economics and an MA from Princeton University, and BA and BS degrees from the University of Iowa.*

Moe Allain, RMA®, CPWA®, AAMS®, is a vice president with Baird Retirement Management. He is co-chair with Roger Mussa of the Investments & Wealth Institute's Retirement Management Advisor® (RMA®) Commission and a member of the Investments & Wealth Monitor *editorial advisory board.*

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(l-r): Wade Pfau, PhD, CFA®, RICP®; Moe Allain, RMA®, CPWA®, AAMS®; Robert Powell, CFP®, RMA®

Allain: Do you have any thoughts, one way or the other, about allocating to a variable annuity with living benefits for a younger pre-retiree who has time for the living benefit to compound? And as a follow-up, what are your thoughts about RILAs [registered index-linked annuities] or other annuities that might be used for accumulation?

Pfau: If we're talking about retirement-income styles, one of them is risk wrap, which is where you believe there's a risk premium from the stock market. You're probability-based, but at the same time you want guardrails or some sort of commitment to a strategy. Personally, I do have more of that risk-wrap style, so I do look in particular at variable annuities. Now, I just turned 45 this year, which makes me eligible. Most of the variable annuities with living benefits, you can't buy them before age 45.

But as I do simulations, most of the variable annuities that have rollups—so that they're automatically increasing the benefit base—only last for a finite period, and it doesn't look like it makes sense to be buying these too early, e.g., 20 years before you might want the income to turn on.

But certainly, by the time you're getting to be 5–10 years before retirement, if you have a variable annuity that allows more investment freedom so that you can invest for upside, and if you are willing to take advantage of that, I think it can make sense. It's part of that risk-wrap strategy where you can still participate in the market. There's going to be a fee drag, so you don't get the full market upside, but you also can calibrate your worst-case scenario better at the same time. If that makes you more comfortable with your retirement planning, I do think that can make sense.

A RILA is part of the same general conversation. RILAs grew in popularity because interest rates got so low and therefore fixed index annuities could not offer much upside potential with their principal protection. The RILA is just a different trade-off. It's saying: "Okay, interest rates are low and a fixed income annuity doesn't give you much upside potential. How about you take a little bit of downside risk?" There are different options here.

But the more downside risk you're willing to take, the more upside market growth you'll be able to receive. Then you have some flexibility. What I generally see is that the buffer RILAs worked better than the floor RILAs. So, for example, a 10-percent buffer RILA would eat the first 10 percent of losses and then you experience any loss beyond that.

So, if the market was down 18 percent, you would lose 8 percent. If the market was down 9 percent, you would lose 0 percent. Accepting that sort of risk can give you more of the upside market participation than a fixed index annuity.

That's also part of this risk-wrap type strategy of putting some sort of guardrails on the downside risk. But to do that, we have to have a belief in the upside market potential; otherwise, there's no point. If we thought the markets are going to do absolutely terrible in the future, that might push us more in the direction of a fixed index annuity. So, if you do have that general market expectation for growth, then a RILA—a variable annuity with a living benefit that allows for aggressive investment allocations—can be an option worth considering.

Allain: I'm going to borrow your phrase "risk-wrap strategy" because I like it and I think that clients will really get attached to it. As retirement-centric advisors, we're taught about the four overall retirement allocations: flooring, upside, reserves, and longevity. Based on your experience and research, what might be your suggested allocation percentage range for the longevity hedge for the average retiree?

Pfau: That's a great question. As part of the Retirement Researcher website[1] that I run and the community we now have there, we have these retirement-income challenges that include funded ratios. We give them a retirement-income style awareness, and then we also do a funded ratio as part of the same week. We look at the same sort of issue you just described, but it's slightly different because it's your reliable income assets, your diversified portfolio, and your reserves, which have some mapping to what you just described. We see that the numbers are all over the place. Most people seem to have a flooring gap, but not everyone. For the typical American who may not have a lot of investment assets, Social Security may already be enough floor, so that they don't need to allocate any more of their asset base to flooring.

At the same time, I also don't really want to put a cap on the flooring either. To make this sound more palatable to people, an allocation to a lifetime income floor of 20–30 percent of the investment base could potentially make sense for those for whom that longevity flooring is comfortable. They have more of a safety-first contractual protection type mindset, and they're comfortable committing to a strategy.

When I was working as a curriculum director for the RMA designation, in 2012, flooring was viewed as lifetime flooring. But that's not the only way you might define flooring.

Then you have reliable income to cover your core longevity expenses. Now you're less vulnerable to market volatility and t o sequence-of-returns risk because it's not as catastrophic if you deplete other assets. So, then you might feel more comfortable investing. The rest is more upside for upside opportunities and growth, and that can lay a foundation for a stronger retirement plan. So, I don't know if I entirely answered the question, because it is hard to say what's a good allocation for a general person, but I wouldn't put it too high. I do know a lot of people don't necessarily need a specific allocation of flooring. But when it's relevant, maybe somewhere in the ballpark of 20–30 percent might make sense.

Allain: What we actually see in our practice is that we're typically taking 12–15 years' worth of living expenses to define our flooring to begin with. So, if you go back and look at—and you would know the data much better than I do—every rolling 10-year period in history, I think equities are always positive. So, we go a little bit further. We put in 12–15 years of fixed income as the flooring from the beginning, so that we don't have to worry about any of that from the start.

Pfau: When I was working as a curriculum director for the RMA designation, in 2012, flooring was viewed as lifetime flooring. But that's not the only way you might define flooring. This actually became a factor in the retirement-income style awareness, that some people have more of a preference for perpetual flooring, which I think is the longevity allocation that you're talking about. Or do you have more of a preference for time-based flooring, which then speaks to a time-segmented, fixed income to cover the front end of retirement expenses and so forth. Remember, we were talking about at-risk flooring, which Michael Kitces would say something like the 4-percent rule is a floor.

Zvi Bodie would not appreciate that type of statement at all.[2] But it's a different perspective around what exactly is meant by flooring. So, you may be thinking, "How do I want to think about having a front-end fixed income floor?" Deciding that I want to have these 10–15 years covered might be a relatively conservative way to approach it, unless there is no lifetime longevity component later. But there's a lot of flexibility ultimately about how someone might want to think about flooring.

Allain: Switching gears a little bit, does placing the maximum $200,000 of a client's traditional IRA [individual retirement account] money into a QLAC [qualified longevity annuity contract] make sense if the client has a lot of longevity and a family history of longevity? And is there any downside that you can think of to using a QLAC strategy like that?

Pfau: It's a great question, and it's something I'm keeping on my own radar.

This is longevity insurance—a deferred income annuity that can help put a hedge on potential longevity. If I now have a lifetime income that will start at age 85, that's going to cost a lot less and it's going to help to protect me from the event of living a very long time in retirement.

The QLAC gives you a little bit of a tax boost as well, because the assets you put into the QLAC aren't counted as part of the required minimum distribution calculations, so you can have smaller RMDs between ages 73 and 85. Then the annuity payments are just fully taxable at that time. The downsides of it are—and we see this now with inflation picking up again—that you're not going to have any inflation protection. You know what the nominal value of those annuity payments will be, but if they're not going to begin for 20 years, their real purchasing power is a real mystery for you at this point. I think a lot of people really struggle with, "I'm going to write this big check to an insurance company under the assumption that it's still going to be an operating business 20 years from now."

These large insurance companies have been around since the 1800s in many cases. At the same time, I do think that psychologically it can be a challenge for people. Those are probably the two biggest downsides—the unknown inflation as well as the faith needed that you'll receive those payments when they come due.

Allain: I'm starting to talk with more and more clients about the QLAC. As far as longevity and health care sometimes intersecting and the need for long-term care, do you have any thoughts about maybe using an unneeded Roth IRA, a reverse mortgage, or possibly cash value from a life insurance policy, to pay for traditional long-term care premiums? Not the more modern or hybrid type things, but for traditional long-term care premiums that just seem every year to be going up. Clients call me all the time fussing about it. Does that make sense to potentially consider those as sources to pay for the traditional long-term care insurance premiums?

Pfau: I think it was the Boston College Center for Retirement Research that a few years ago had that study that showed it's really tragic that a lot of people lapse on their long-term care insurance a couple years before they need it [Hou et al. 2015]. Now part of that could be related to cognitive decline

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and forgetting to make premium payments, which is extra tragic. But part of it is also that many people keep getting surprised by premium hikes, and at some point they just decide they're not able to afford it. So they drop the coverage. That's where having some sort of reserve asset available may be very worthwhile—a reverse mortgage line of credit or borrowing from the cash value of whole life insurance, or just a side reserve, whether it's Roth IRA funds or cash holding.

But yes, back to this asset-liability matching type thing that retirees face. Once you have assets to cover your core longevity expenses and your lifestyle expenses, you might be thinking about a legacy, although ultimately in many cases legacy may just be what's left over after considering everything else. But then what do you have available to cover spending shocks? And a form of spending shock is premium increases for the long-term care policy.

Another form of spending shock is having to pay out-of-pocket for a significant long-term care event. In many cases, it's quite reasonable to use reserve assets to not lapse on a long-term care insurance policy that someone may have held for years and years and now they're getting to the point where they might need it. That's unfortunately not a great time to be lapsing on that type of coverage.

Allain: People have been receiving statements from the insurers saying basically: "Okay, you can continue your policy. Just send us 25 percent more than you were sending us last year." Now the insurance companies are putting together these charts, giving clients all these options. You can either reduce your coverage, you can keep the same premium, they'll change your waiting period, they'll change your inflation factor, or whatever. And people at that age can't sort through that. There's no way that they can make those decisions. So, I tell them all the time, if you get one of those letters, just call me. It makes no sense that older people have to make these very complicated decisions about something that's so important like long-term care.

Pfau: That's a great point. In principle, having that type of option available is good. But in practice, I agree with you 100 percent. Giving those options to someone who already may be starting to experience some cognitive decline is not a great scenario. So, yes, to the extent that you're able to help your clients with that sort of decision, that is really important.

Powell: Recently the Center for Retirement Research at Boston College published a paper in which they analyzed actual versus perceived risk [Hou 2022]. They discovered that people were more focused on market risk when they should be more focused on longevity risk. Given that, what do you think would be the most appropriate planning horizon for people to use? Life expectancy, a personalized life expectancy calculator, or just age 95?

Pfau: Just saying age 95 would definitely be the easiest. You can be done with it. Of course, there are many calculators where you can do a DNA test and everything else. But the Society of Actuaries created the website, longevityillustrator.org. With that, you can just put in for one person or for a couple, age, birth date, gender, smoking status, and then just assess your health as poor, average, or excellent. That's all you put in, and then they'll give you these longevity projections tailored to you by percentiles.

For people who are more concerned about outliving their money, they might want to look at the 10th-percentile projection. For people who are willing to take a little more risk, and that just means plan for a shorter retirement and therefore spend more today, the 25th percentile might be the number you'd want to go with. The 50th percentile would be the median life expectancy; half of people will live longer than that, half of people won't live that long. But you've got to really go beyond that. Whether you go with the 25th or 10th percentile, I think those are the guardrails that you can think about.

If you're really worried about outliving your money, you could even pick a higher number than the 10th percentile, but that's probably a pretty good default. The other thing to remember too, for a couple, is the probability for two people living a long time. There could be a 10-percent chance that the longest living member of that couple makes it to age 102. That's important to keep in mind for couples.

Powell: When you think about the tools that we have available to manage and mitigate longevity risk—for example, Social Security, a pension, income annuities—are there some that you would regard as the best possible ways that people can improve their outcomes?

Pfau: At least for the high earner in a couple, delaying Social Security benefits would be step one of longevity management, just because it's an inflation-adjusted, government-backed, protected lifetime income that includes a survivor benefit for the spouse.

So, that's always going to be step one of longevity protection. Beyond that, if people have pensions and are making the decision between a lump sum or lifetime income, they might look at, if they took the lump sum, what would they be able to buy from a commercial annuity provider? If the pension is offering something really generous relative to a commercial annuity provider, they might seriously consider taking the lifetime income from the pension. Commercial annuities are another option. Those are really the core ways to manage longevity. And in the investing world, it's more, let's invest aggressively, let's benefit from the risk premium, and then if we're willing to be flexible with our spending, maybe we don't have to be as conservative initially with the spending.

But if we don't want to be flexible with the spending, that's where we're back to that sort of 4-percent rule discussion, where we have to look at a pretty low spending number. It's not a very good way to manage longevity risk at that point. Because it's, "Well, what if I live to 100?" That just means, "Okay, I have to spend that much less." It's not really a fun conversation of looking at the trade-off between time horizon and sustainable spending numbers.

Powell: My next question is around this notion that you've indicated that the financial services profession is divided into these two camps, those that focus on investment solutions and those that focus on insurance solutions. You've indicated that the more efficient thing to do would be to have an integration that looks at both these ways of approaching it.

Pfau: Specifically with the idea of integrated strategies, it's really about the fixed income in retirement. A risk-pooled approach to fixed income works a lot better to meet a retirement spending goal over an unknown time horizon than traditional bonds. The punchline there is instead of stocks and bonds for retirees, it's stocks and income annuities, or stocks and some sort of protected lifetime income.

If the pension is offering something really generous relative to a commercial annuity provider, they might seriously consider taking the lifetime income from the pension.

Now, this is getting into the idea of the retirement-income styles. If you're a total return person, you don't want annuities because you believe the market will do fine. You want as much optionality as possible, and you have an accumulation mindset post-retirement. You still think about maximizing returns. You don't care about predictable income. So, you don't really need the annuity and it's not really going to resonate with you. But if you have more of this income-protection style, which is safety first, I don't want to have my core spending exposed to the stock market, I do have a commitment orientation. I'm comfortable committing to a strategy, and I have more of a distribution mindset where I care more about predictable income than I do about maximizing market growth. Then replacing some of my bonds with annuities can help get all the mathematical benefits of this sort of integrated strategy.

So, Client A might be total returns. Client B might be income protection. Client B will use an annuities part of the strategy. Client A is fine with investments only. Having advisors who are comfortable navigating between the different silos and providing solutions that resonate best with the style of the person that they're talking to is important. Ultimately, I think that's the best way forward—to make sure people have retirement plans that they're comfortable with, and that they'll stick with and not panic and sell all their stocks after a market downturn, and all the other things that can happen if someone is positioned with a strategy that's really not the right strategy for them.

"Annuities are not right for everyone, but you are exhibiting preferences that suggest this might really be something that will work for you. And so let's talk about this further, how does it work?"

Powell: And what needs to be done from an education perspective to help us move from where we are to where we need to be?

Pfau: From an education perspective, this retirement-income style awareness has really become step one of how I talk about retirement planning. It was chapter one of my *Retirement Planning Guidebook* [Pfau 2021]. I hope it can really just help with the education all around. Not everyone understands different retirement strategies are available, and they don't know where to start. If at least there was this third-party tool that is not telling everyone to buy an annuity; it will tell some people, okay, it looks like total returns is the approach for you.

But for other people, you might want to consider an annuity. Then when they say, "Oh, but I heard this commercial that said I should hate annuities, what's up with that?" the conversation can be around: "Annuities are not right for everyone, but you are exhibiting preferences that suggest this might really be something that will work for you. And so let's talk about this further, how does it work?"

You can have that conversation with the people it's relevant for. For the total returns person, who's never going to resonate with the annuity, you can just skip having that conversation, so you can focus the education resources on who it might be the best fit for.

Allain: Wade, you've been talking about preferences. It's interesting because at the Institute's ACE Academy 2022 in Nashville, Roger Ibbotson[3] gave a presentation, and he talked about things that he'd come up with years and years ago where now preferences are added into that. Retirement planning sounds like it's going in the same direction, which makes sense. If you think about behavioral finance and its impact, this is such exciting stuff.

Powell: The client may have a preference for this or that. The advisor has to be in a position to deliver on those preferences and have the knowledge to deliver on those preferences.

Pfau: Right. So that's still where there's going to be a mix. Some advisors are very much adhering to one particular strategy, and they think all the others are nonsense. So, they're probably going to remain in their silo. But in the long run, there's going to be enough advisors. More and more advisors are saying: "Okay, I was a total return advisor. I was an investment manager. But I get the joke now. I realize that's not necessarily best for everyone, so, how do I learn more about navigating the different styles? How can I tailor a strategy for different types of retirement styles?"

As more and more advisors are comfortable navigating and personalizing those types of strategies for different clients, they're going to be best positioned to win in the long term, not the person who is narrowly focused in only one of the silos.

Allain: The neurons in my brain are firing in all different directions here. This is such great stuff. It's been so exciting for me. I'm going to borrow some of your phrases, Wade, in talking with clients. I've certainly have enjoyed visiting with you.

Pfau: Absolutely. Thank you both.

Powell: Thank you, Wade. It's always a pleasure.

ENDNOTES

1. See https://retirementresearcher.com/.
2. Zvi Bodie, PhD, is Professor Emeritus at Boston University, where he taught from 1972 to 2013. He has served on the finance faculty at the Harvard Business School (1992–1994) and MIT Sloan School of Management (2008–2009). He has published widely on pension finance and investment strategy in leading professional journals and is best known for applying modern financial theory to lifecycle saving and investing.
3. Roger Ibbotson is Professor Emeritus in Practice of Finance at Yale School of Management. He is also chairman of Zebra Capital Management, LLC, an equity investment, index, and hedge fund manager. His 2022 ACE Academy presentation was "The Popularity Premium: A Bridge between Classical and Behavioral Finance."

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