

Determining Retirement Readiness

How to answer the client question, “Can I retire?”

by Ken Waltzer M.D., MPH, AIF®, CFA, CFP®

As a wealth manager, nearly every client eventually asks me, “Can I retire?” Especially now that retirement takes so many different forms, the answer is never a simple “yes” or “no.” In addition to determining what retirement means to a particular client, we need to break the above question into components:

- When can I retire?
- Can I maintain or even improve my current lifestyle during retirement?
- Am I covered for unexpected expenses, such as long-term care or serious medical illness?
- What can I leave for my heirs and/or favorite charities?
- And since 2008: What happens if there’s another financial crisis?

Because retirement readiness is core to any financial plan, I spend a significant amount of time on the topic with each client early in the relationship and revisit it regularly before and after retirement occurs. Today, retirement is less an event than a process. Many people choose to work part time during their golden years, either in their same careers or in new ones. Stopping all gainful employment still happens (I have several clients who have done this), but it is becoming less common. Such changes in the nature of retirement make analysis that much more complex.

Going Beyond a Linear Approach

With so many unknowns, analyzing retirement readiness goes well beyond simple arithmetic. It’s no longer enough to merely enter retirement earnings (such as Social Security and pensions),

impute a rate of return to invested assets, and subtract annual retirement expenses. At best, this linear approach will be only a rough approximation; at worst, it will give a false sense of reassurance.

Two techniques that increase the usefulness of retirement analysis are the Monte Carlo method and scenario analysis. The Monte Carlo technique creates multiple iterations of a particular scenario and yields a likelihood of success. Scenario analysis allows one to modify the inputs to the Monte Carlo analysis to create alternative situations, each with its own success rate.

Most financial planning software packages offer Monte Carlo simulations, and many permit scenario analysis as well. Stand-alone products also exist that can be more rich in features than bundled software. I personally use the web-based product Financeware for its flexibility and because it enables the client to participate remotely via the web. Whatever software you employ, make sure it enables you to modify individual variables and create multiple scenarios.

Estimating Retirement Expenses

The first step is, of course, data gathering. These include: dates of birth,

assets and liabilities, annual savings in tax-deferred and taxable accounts, anticipated income during retirement, and an initial estimate of retirement expenses. The last item is crucial and also the most difficult to obtain, but there are shortcuts.

If the client doesn’t yet have a budget, one can use the client’s tax return to estimate current spending. Take gross

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cash income from form 1040 (not AGI, but the sum of line 7 through 21, plus non-taxable income), subtract federal and state taxes, and back out known savings. Clients sometimes stash money in their checking accounts, so ask if their account balances have grown in the past year and add this to savings. What’s left is a reasonable estimate of current spending.

Adjusting current spending for retirement is relatively easy if the client has a budget. Go line by line and add or

subtract from categories that will differ in retirement: savings, union dues, commuting costs, etc. decline or disappear; travel and medical costs increase. If you've used the tax return method to calculate spending, estimates are more difficult, but it's possible to estimate most expenses that change to create a post-retirement budget.

Two specific retirement expenses that can be both large and unpredictable are health care and long-term care. For the former, I typically add an annual approximation of out-of-pocket health care expenditures based on lifetime estimates after age 65 (currently \$240,000 per couple according to Fidelity Benefits Consulting). This works out to about \$5,000 per year in today's dollars using a 3 percent inflation rate. It's important not to double-count, as this estimate includes Medicare Part B and Part D premiums.

Projecting contingent long-term care expenses is far more difficult. For clients with good long-term care policies that cover most expenses, the premium can simply be added to the annual budget. For those who choose to go without long-term care insurance, the issue is more difficult. I typically approach the problem by using a long life expectancy and creating an alternative scenario that includes a large unexpected expense late in life.

There have been some recent debates about how long a life expectancy to use. I first try to determine if there is reason to assume the client will live significantly longer or shorter than average (my medical background is uniquely helpful for this). In most cases, I end up choosing a rather long lifespan, and have recently been pushing it out to 100 for most clients to provide more of a cushion and to help address the long-term care issue.

Getting Into the Comfort Zone

After the required information is entered, one can run the initial sce-

nario. Monte Carlo simulation produces a "success rate" between 0 percent and 100 percent that represents the percentage of simulations that were at or above goal (not running out of money before the end of the projected lifespan). A success rate between 70 percent and 90 percent is considered ideal; this is often called the "comfort zone." Success rates below 70 percent have too high a likelihood of failure, while those over 90 percent are unnecessarily certain. Of course, it's not a problem being over 90 percent if the client's spending projections are already very generous.

If the initial scenario's success rate is within or above the comfort zone, I next try alternative portfolio allocations. Whether to go more or less aggressive than the initial allocation depends on where the success rate falls and the risk tolerance of the client. In general, I aim for the least aggressive portfolio that does the job, although clients with success rates above 90 percent have the luxury of being somewhat more aggressive if they want to invest for greater return.

Stress Testing

Lastly, I stress test the projections with alternative scenarios, most often one with high inflation and one with an unexpected expense, such as long-term care. Clients whose projections are sensitive to higher inflation should add more inflation-resistant assets to their allocations. Those whose success rates drop below 70 percent because of an unexpected expense may want to fatten their cushions by spending less during the early years of retirement, saving more prior to retirement, retiring later, and/or working part time during retirement.

Sometimes the initial success rate is too low. In that situation, any of the options listed to deal with plan failure because of an unexpected expense can be used. Which ones are tried with a particular client depend on that client's individual situation and preferences. The

greatest impact typically comes from retiring later—delaying retirement by just one year can add 5 percent to the success rate. Given how long people are living during retirement now, working part time is often a viable option, particularly as many workaholics have few hobbies and become bored if they're not working.

Implementing the Plan

Once scenarios are developed that the client and adviser can both live with, the retirement plan is implemented. Savings committed to must be maintained, the agreed-upon asset allocation should not vary unless circumstances change, spending during retirement shouldn't drift (or shoot) upward, etc. It's no secret that a plan is only the first step in helping clients attain their goals.

Retirement projections should be updated regularly as the client ages. I typically update them once a year and make adjustments if the client drifts out of the comfort zone.

The process of creating, implementing, and tracking a retirement plan, as with any financial plan, not only increases the odds of success, but also gives both client and adviser piece of mind. Periodic updates also help clients stay on track when markets misbehave. Knowing how much the success rate is affected by a bear market and what adjustments, if any, must be made to stay in the comfort zone may enable the client to avoid throwing a carefully crafted plan out the window.



Ken Waltzer M.D., MPH, AIF®, CFA, CFP®, is founder and president of Kenfield Capital Strategies, an independent wealth management firm in West Los Angeles, California. The firm specializes in retirement planning, non-traditional families, and corporate pension plans. Read his blog at www.kenfieldcapital.com/category/financial-blog/.

Case Study: Can I Retire?

by Paul Palazzo, CFP®, COA

Emily took her seat at the conference room table.

"How are you?" I asked.

"I'll be great if you tell me I can retire," she said.

"When would you like to retire?" I asked.

"Now."

Emily went on to tell us why she wanted to retire and why she had come to see us. The story was familiar: She had worked for the same company for 20 years, rising to become an upper, mid-level marketing executive with stock options and an executive pension. But the job had become less exciting, the company troubled. At 60, she was not interested in searching for a similar job elsewhere.

Having had no history with Emily, we could not be sure that she was really serious about retiring, that this was not a case of blowing off steam. But as the conversation continued, it became apparent that she had thought about this carefully from several perspectives. She would not be bored—her calendar was always spilling over. Among other things, she served on the boards of several nonprofits, was a low-handicap golfer, and had a grandson that she would help babysit. She was past the intangibles; only the financial hurdle remained. If she could afford to retire, she would.

Collect the Data

Our first job was to discuss goals in general. Emily wanted to assume no further job-related income and generally to retain her current lifestyle (comfortable but not extravagant). She would like additional dollars for travel, including living for a year in Italy or Greece. She wanted to keep her Manhattan apartment and her upstate country home, though she would consider selling the second at a later date if money became an issue. She expected no significant inheritances, nor did she anticipate providing financial support for her parents, both of whom had reasonable assets and long-term-care insurance. Substantial college funding for the grandchildren was a high priority. One of her two daughters had a young son, and the other was planning to start a family.

An hour later, the meeting ended and Emily left with our questionnaire, which she would complete to help us understand her finances and investment risk tolerance. In the meantime, she would send us her investment statements, tax returns for the past two years, and documents related to her stock options, pensions, and deferred compensation—previous bonus income that she would receive over the next several years.

Confirm the Details

A few weeks later, with the paperwork returned and the information entered into our financial planning software, we sent Emily a preliminary balance sheet and cash flow statement based on the information she supplied. We asked that she confirm the accuracy of, or correct, our information.

We also included several follow-up questions. The documents we had received left some question of how the stock options would be treated upon her departure. Her monthly mortgage payments, as listed on the questionnaire, did not match the payments we calculated based on the terms as we understood them. Finally, if our projections indicated that Emily's goals were not feasible, we wanted to better understand her priorities in three potentially competing areas—the country home, the additional travel money, and the college gifting for three (expected) grandchildren.

Importantly, our preliminary statement showed positive cash flow of \$40,000 after 401(k) contributions, so we asked Emily whether that approximated her net savings over the previous 12 months. We ask this question routinely and uncover discrepancies frequently. So it was in this case.

After a bit of homework, Emily said her actual cash flow after qualified plan contributions was about \$20,000. The difference was attributable to roof repairs on the upstate home and a week at the shore with her two daughters and their families—Emily had paid for everything. As is often the case, a discussion of these specifics grew into a more expansive and nuanced conversation on how expenses might change over time and how significant one-time outflows might affect her plan.

Lump Sum vs. Annuity

With the preliminary numbers confirmed and assumptions agreed upon, we ran calculations to determine Emily's projected level of financial independence. As is customary in our firm, we ran the calculations in two ways. The first, a straight-line analysis, rests on fixed inputs for investment returns, inflation, and life expectancy. The second, a probability analysis, includes the results of many trials in which those three variables change from trial to trial.

As many financial advisers know, probability analysis adds depth to the calculations. This was particularly true in the case of Emily, who was facing the lump-sum-vs.-annuity decision in regard to two pensions and had asked if she should pay off one or both of her modest mortgages. The

outcomes of both the pension and mortgage decisions would be affected by opportunity cost and inflation, and the pension decision on life span as well. Both decisions, then, would involve risk. We wanted to account for that.

The pension decision was more complicated than usual because Emily had both the standard employee defined benefit and an excess executive pension. The opportunity to roll the former into an IRA and gain 10 years of near-certain tax deferral made that call fairly easy. On the executive pension, the deferral advantage went to the payments. However, the company's lump-sum formula favored that option, in our view. Perhaps more important was credit risk; there was reason to question the company's long-term viability, and in the non-qualified plan the annuity payments would be unsecured. After considerable analysis and discussion, internally and with the client, the lump sum was chosen.

We also had to factor into our retirement calculations our stock option recommendations. Fortunately, Emily's departure would be considered a retirement, and the options would not fully expire for five years. This added considerable time value to the options, many of which were either narrowly profitable or slightly underwater.

Achieve the Best Success Rate

The retirement calculations produced a success rate under probability analysis of about 75 percent, significantly but not drastically below our target rate of 90 percent. Emily said she would be willing to sell the country home later if necessary, so we ran a second scenario in which she sold the country home at age 80. Doing so raised the success rate to just above 80 percent—better, but not good enough.

At this point, we called the client. The choices appeared to be a cut in discretionary expenses, or a reduction in college funding. Emily asked if another year of work would make a significant difference. The answer was no. Although she was paid nicely, her financial security depended more on the strength of her investment assets. One additional year of after-tax compensation was not going to have a big impact.

We briefly discussed—and dismissed—canceling plans for the year abroad. The cost would be partially offset by her renting out her New York City apartment. More importantly, in the context of a retirement plan that could conceivably approach 40 years, a one-off expense was minor compared with ongoing expenses. Finally, the year abroad was something she had dreamed about for a long time.

Ultimately, we suggested a reduction in ongoing discretionary expenses that projections indicated would keep her financially independent at the 90 percent confidence

rate. If that reduction proved too uncomfortable, she would modestly reduce the contributions to the college funds. This approach gave her some additional flexibility. For one thing, she could not know for sure that there would be three grandchildren, as she had asked us to assume. And although not making early contributions to 529 plans would cost the account tax-free growth, she would have the option of making larger contributions later if circumstances permitted.

If, instead, Emily's finances deteriorated over the years, and the 10 percent chance of failure threatened to become reality, the apartment would represent her remaining safety net. She would downsize or rent.

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Review and Revise

Before meeting with Emily to deliver the final report, we went through our typical review and revision process. We revisited the inputs and the calculations. Giving a client the go-ahead to leave his or her job is not to be taken lightly.

Satisfied that the work was sound, we invited Emily in to present the plan. It was an excellent meeting—nearly two hours of questions, answers, and discussion. We closed with the reminder that the future would inevitably turn out to be different from the projections, and that as Emily's financial advisers we would be here to update the plan. The client smiled and thanked us. In the morning she would meet with her boss.

Paul Palazzo, CFP®, COA, is a managing director for Altfest Personal Wealth Management in New York. He heads the firm's financial planning operations and sits on its leadership and investment committees.