3 Ideas for Preserving the Financial Security of New Retirees

by Mathew Greenwald, Ph.D.

There can be no doubt that the huge generation starting to enter retirement faces unprecedented financial challenges. A confluence of factors will make it hard for many to maintain their desired lifestyles, or even lifestyles they consider acceptable, throughout their retirements. Chronic under-saving for retirement by members of this generation and their higher life expectancy at age 65 are not the only factors. We can add a much lower likelihood of having guaranteed lifetime income provided by traditional pension plans, high lifestyle needs, and a strong likelihood of higher health-care costs. Some experts warn of: (1) a "new normal" equity market with lower than traditional returns, (2) a likelihood of higher taxes in the face of our country's debt problem, (3) cutbacks in entitlement programs, (4) the possibility of high inflation as the U.S. budget deficit becomes a bigger problem, and (5) a depressed housing market. Even if none of these threats materialize, it is still clear that the next generation to retire will face genuine financial constraints. The most difficult but addressable risk is of clients getting into real financial difficulty after the first decade of retirement.

Under current circumstances, financial advisers will have to adapt new strategies to help preserve the financial security of retirees. The key question is whether something more is required, and what exactly it is. I have three suggestions.

More Use of Life Annuities

After World War II, the basic idea for financial security in retirement had been the "three-legged stool" of basically one-third of income from the government in the form of Social Security, one-third from employers in the form of traditional pensions, and one-third from personal savings. One of the good things about that approach was that two-thirds of the challenge of retirement income was covered by guaranteed lifetime income payments. Individuals were largely protected against longevity risk.

Now, corporations have substantially cut back on pension plans. Social Security benefits are increasingly reduced by the rapidly growing Medicare Part B and Part D premiums deducted from these benefits. A substantial amount of longevity risk has been passed back to individuals.

Life annuities (also known as immediate annuities and payout annuities) guarantee income for life and have several benefits. They provide much more money and therefore protection to the people who live longer than average—the best deal possible for them. But they also provide higher cash flow than other fixed investments from day one. This higher cash flow permits a higher allocation to equities, and that is likely to be beneficial over the long run. Further, it is easier to make decisions about how much to save and how much to spend if you have guaranteed lifetime income to plan around. One of the main concerns people approaching retirement have is the possibility of outliving their money. Life annuities protect against this risk. It is time to recognize that more longevity risk has been placed on individuals, and use life annuities to help shield them from this risk.

> "The most difficult but addressable risk is of clients getting into real financial difficulty after the first decade of retirement."

Better Measures of Client Tolerance to Longevity Risk and Long-Term Care Risk

Measuring risk tolerance is beneficial. Asking the questions often focuses clients on the risk and educates them. Getting the answers helps advisers understand how to position a solution and guides them to the best solutions. Advisers typically measure investment

risk tolerance, but do not measure or discuss tolerance to two other risks that can financially devastate their clients: the risk of needing to pay for long-term care, and longevity risk—the possibility of outliving resources.

Studies my company has done have shown that different people have different levels of tolerance for these risks. Some people, for example, have high tolerance for the risk of being unable to finance long-term care for a variety of reasons—they believe their children or spouse will care for them, they do not feel a need for care at home or high-quality nursing care, they expect to use their home equity to pay for any needed care, or they do not worry about spousal impoverishment for a variety of reasons. Others have low tolerance for that risk and feel it is crucial to be able to afford long-term care at home, value high-quality care, do not want to burden family, and do not want to draw down assets a surviving spouse will need. They cannot tolerate high exposure to the risk of not being able to afford good long-term care.

It is similar for longevity risk. Some believe they can depend on their children; others feel that being a burden on their children is almost a fate worse than death.

Overall, it is important for advisers to discuss longevity risk and the risk of needing long-term care with their clients. You will learn something and so will your clients. These discussions will lead to better strategies targeted to those who have low tolerance for the risk, and more client acceptance of your recommendations.

> "Most of the plans I have seen are simple projections that do not discuss what happens if something goes wrong."

A Road Map for Retirement

During the accumulation period, clients tend to shield themselves from risk with insurance products such as life insurance and disability insurance. Many clients can adjust to setbacks by putting off retirement and working longer. Advisers really can focus on just one finance-related risk—investment risk.

After they retire, clients are less likely to use insurance, the number of risks they face goes up, and their ability to protect themselves goes down. In terms of finance-related risks, retirees remain exposed to investment risk, but they are also exposed to:

- Withdrawal risk: the possibility of taking out too much money from their assets
- Sequence of return risk: the possibility of a market downturn early in their retirement that could lead them to have to sell assets "low" to produce the income they need, and make it hard for them to recover
- Longevity risk: the possibility of living a long time, which can put a strain on resources. Further, while one can often put off retirement at age 65, it is hard for someone who gets into trouble at age 85 to find a job to rebuild assets.

My firm has done a good deal of research on written retirement plans prepared by financial advisers and financial firms. Most of the plans I have seen are simple projections that do not discuss what happens if something goes wrong, and they do not give guidance in advance on the level of assets clients should maintain.

With the increased risks retirees face, it is important for financial advisers to develop a road map for clients at the start of retirement. The road map would identify the specific asset levels clients should aim to have at each specific year of their lives—the road they must follow. Clients would be told in advance what would be required if their assets fall below that level in terms of reduced spending, possible sale of their home and downsizing, and new and more conservative investment strategies. With this approach, clients will be in a better position to monitor their financial situations and avoid overspending. They will have a specific target to shoot for and will know in advance the consequences of missing the target.

Different times call for different strategies. This is a time not only to be concerned for clients who are starting to retire but to adopt new approaches to help protect them against the risk of ending their lives in deprivation.

Mathew Greenwald, Ph.D., is president and CEO of the market research firm Mathew Greenwald & Associates. He is a leading financial and research expert and an elected member of the Market Research Council.

To purchase professional reprints of *Journal* articles, contact Wright's Reprints at (877) 652-5295.