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Interview with Charles S. Yanikowski

Tell us a little about yourself.

I first became interested in retirement in 1980, when my dad asked me at age 62 whether he could afford to retire then. I did what I could without benefit of software, and advised him to hang in there until he was 65. This worked out well for him, but the real lesson for me was that even most people who are smart and mathematically inclined (my dad was a mechanical engineer with numerous patents to his credit) are clueless about retirement finances. For that matter, so was the financial industry (and by the way, it pretty much still is). Eventually I reoriented my entire career toward contributing to solutions in this field.

What attracted you to the Essay Contest?

As I began to ease into my own semi-retirement last year, I realized that I had a couple potentially practical ideas that I had never done anything with in my own retirement software business. The essay contest presented a fine opportunity to put those ideas into the public arena, where perhaps someone else could use them—or maybe they would inspire even better ideas from someone else.

What steps, if any, would help make the ideas in your essay a reality?

My essay describes a manual approach to a difficult subject. Soft¬ware could be developed that would do the same thing in a way that was simultaneously more sophisticated in its decision-mak¬ing process and less difficult for the individual consumer to use. I am beyond the point in my own career where I want to develop this kind of product on spec, but I would be happy to consult with anyone who wanted to pursue it—or equally happy to see them run with it on their own.

What groups would need to be involved?

There are four kinds of groups that have a big stake in sound re¬tirement planning by consumers: financial companies that want to sell financial products, financial advisers who want to sell financial services, employers and employment-related groups (such as pension funds, professional organizations and unions) that are interested in the welfare of their employees or mem¬bers, and organizations of consumers that consider the financial welfare of their members to be part of their mission. Any or all of these could justifiably pursue such a project.

What else would you like to tell us?

I wish to state clearly, for the record, that I consider the ideas in my essays to be in the public domain once they are published by the Society of Actuaries, and I disclaim any ownership or other entitlement if some other person or entity chooses to use them either in their current form or in some other form. ■

Dealing with Multiple Post-Retirement Risks in the Middle Market

By Charles S. Yanikoski

Retirees face many financial risks, some of them related to the intrinsic uncertainty of investment, others to health, economic or family issues that are largely unpredictable, still others to financial and lifestyle choices whose consequences cannot be clearly foreseen. Dealing with any one of these can be daunting, but the larger problem is that most older Americans currently lack a clear path for dealing with all of them as a totality.

NARROWING THE FOCUS

This is not a problem for everyone. Retirees who are wealthy—or merely "affluent" but wise enough to manage their resources at all prudently—rarely need to worry about impoverishment from retirement risks. Nonetheless, many of them choose to insure against some such risks because they want to reduce the odds of substantial financial losses to themselves or their dependents or heirs, or to assure peace of mind among that circle of potential beneficiaries. But these are usually nice-to-haves, not must-haves, for the affluent/wealthy.

At the opposite end of the spectrum, low and low-middle income folks generally can't afford to insure against *any* of these risks. In that respect, sadly, their lack of options makes their strategy fairly simple: Be smart consumers and take advantage of whatever benefits or other revenue opportunities they might have. Meanwhile, they may be able to ameliorate their financial risks by other means—usually by relying on family, friends, churches, charities and/or government agencies.

The hardest decisions, therefore, generally apply to the middle and upper middle financial classes, who are the focus of this essay. They have, or could have (if they can be economical) enough resources either to insure against only *some* risks or to insure *in part* against *all* risks.

THREE WAYS TO ADDRESS RISK

But let's take a step back before investigating that particular choice. People can address risk in three ways: by purchasing insurance products, by self-insuring and by reducing their exposure. (They can also ignore risk, but that isn't exactly "addressing" it, though it can be a rational response sometimes.)

Purchasing Insurance Products

Purchasing products such as life insurance, annuities, health insurance, long-term care insurance, investment return guarantees of various kinds, or products that offer some combination of these benefits is generally ***not*** a plausible stand-alone solution for people in our middle-income group, for two reasons. First, some risks are not insurable, such as, for example, the loss of pension or Social Security benefits, or financial stress caused by a divorce. Second, even where insurance or guarantees are available, middle income people generally cannot afford to buy into all of them.

Given these limitations, furthermore, it is necessarily the case that for any given risk for which they do purchase insurance, they are expending assets that could instead be used to help cover other contingencies. That is, *every choice for a middle or upper-middle income person or household to purchase a financial product to reduce a specific retirement risk entails a trade off: reducing exposure to that risk at the cost of increasing exposure to other risks.*

Self-Insurance

Self-insurance is one way to eliminate that problem. This strategy involves a conscious decision to "insure" against risks by applying most or all of one's financial resources on the universal risk reducer we call "wealth." Wealth (whether in the form of cash, savings, investments, home equity or other assets), especially wealth that is fungible (liquid, or able to be liquidated without risk of significant loss), can be used to deal with, or at least help deal with, any financial adversity. Having wealth rather than individual insurance arrangements against one or more risks means that you are insured (in this case, self-insured) against all risks, not just one or a few risks. You are even "insured" against risks that you cannot buy financial products to cover.

This is a tremendous advantage, but it also comes with disadvantages: (1) it is less effective against many individual risks than financial products designed to defend specifically against those risks; and (2) for a middle income family, a particularly bad outcome in even one of the 15 risk categories could wipe out the household's wealth, and therefore leave them completely exposed to future contingencies of all kinds.

Reducing Exposure to Risk

This approach can help defend against specific risks, and often also can increase wealth, and therefore directly or indirectly help defend against all risks. Reducing exposure is achieved in a number of ways, most prominently, by

- Being more economical in one's lifestyle, which, for example, reduces the risk of living too long because it becomes less

expensive to do so, and enhances one's ability to increase or at least preserve wealth already accumulated.
- Looking for opportunities for additional income.
- Making shrewd trade-offs in forced decisions (such as Social Security claiming, or the choice of a defined benefit plan retirement option).
- Making prudent financial decisions in other areas.
- Choosing a healthier lifestyle, which can have a mixed effect: reducing medical expenses and perhaps extending one's ability to earn money, but also increasing the risk of "living too long."
- Strengthening social relationships, thereby providing personal or community networks that can provide help in times of need and reduce out-of-pocket costs when adversity does arise.
- Adjusting attitudes—mainly accepting certain "adverse" outcomes as tolerable: for example, agreeing to end up in a Medicaid-paid nursing home, if the need arises, even if it means you have to share a room with someone you don't know.

Such choices, as already noted, are often the only options for the poor or near-poor, but they can be of financial benefit to everyone. Still, on their own they can rarely reduce every risk to an acceptable level.

These three strategies—insurance products, self-insurance through personal wealth and risk reduction—complement one another, and together they should be able to make a significant difference in improving the lives of people of retirement age.

OPTIMIZING THESE STRATEGIES

But how, exactly, can this work? Specifically, in any given personal or family situation, how can the combination of these strategies be optimized (or, to use a more appropriate term, managed most prudently)?

Clearly, a sophisticated decision-making model would be desirable. A model that enabled people to make the most prudent possible decisions would need to take into account both detailed financial calculations and the emotional impact of choosing to leave certain risks uncovered or only partly covered. No such tool exists.

However, we can put together a high-level template for creating such a model—or a non-automated and simplified version of such a model—by identifying the key questions to be asked and the order in which this should be done. This would give retirees a basis for better decision-making, which would not only help them financially but also improve their peace of mind (as well as that of their children, or others who worry about them).

People who are permanent living companions should, of course, pursue such a process together, or else separately but with a follow-up discussion. Where choices have financial or caregiving implications for children or other heirs, it can be sensitive and sensible to bring them into the discussion as well.

Step 1. Assessment of Financial Risk Exposure

What risks do you *not* have to worry about because

- They don't apply to you?
- Their likelihood is negligibly small in your case?
- Their financial impact would be negligible (either very small, or offset by other financial consequences)?
- You would not care (or care much) about the consequences?

For each risk you *do* have to worry about,

- What nonfinancial steps can be taken to reduce the risk (or reduce the impact of the consequences)?
- What is the remaining range of financial or other personal consequences (best case to worst case)?
- How high is the risk of consequences at the top, middle and bottom of that range?
- How important is it for you to find a solution for each level of the range of consequences?

Step 2. Financial Risk Abatement Capacity

What portion of your wealth do you need to set aside to cover your normal expenses?

- Start by estimating future income from all sources other than liquidating your wealth, and subtracting the projected expenses until life expectancy, or ideally at least five years beyond that. Assume a normal conservative rate of return on savings.
- Include inflation on expenses but also expected decreases in many expenses in old age.
- Important: Consider different levels of lifestyle, and costs associated with them: ideal, current, reduced but still doable without high levels of sacrifice, and minimal acceptable.

Make a preliminary decision on how much wealth to set aside for financial risk abatement.

- At each of the four levels of lifestyle listed immediately above, how much (if any) wealth do you have left over for risk abatement?
- At each level of lifestyle, how does the level of pain (if any) suggested by that standard of living compare to the level of pain that arises from the risks still present after Step 2 above? Take into account,
  - The probability of future risks, which by definition is less than 100 percent, compared to a reduction in lifestyle, which is virtually 100 percent certain, if you opt for it.
  - The possibility of more than one risk turning into a reality.

- What ability you have to adapt comfortably to a simpler lifestyle, or maybe even prefer it, once you get accustomed to it.

- Decide what living standard represents the best balance between reduction in lifestyle and reduced exposure to future harm. This is an important preliminary pointer to your most prudent risk strategy.

People can address risk in three ways: by purchasing insurance products, by self-insuring and by reducing their exposure.

Step 3. Assessing Financial Products for Risk Abatement

For which risks that concern you could you obtain insurance?

- For which risks does some kind of insurance exist?
- Can you qualify for it?
- What does it cost?

Is a financial risk abatement product a good choice?

- What is the most important risk you are exposed to for which you could purchase complete or partial insurance?
- If you made that purchase, how much would it cost in terms of wealth reduction (short term and long term)?
- How much would that wealth reduction reduce your ability to cover other risks?
- If reducing the exposure to this one risk is more important to you than any resulting reduction in ability to cope with other risks, then such a purchase is a sensible choice for you. Otherwise, it probably is not.
- Make a similar assessment for other risks that you care about and that you could also purchase insurance against. It might be worth paying to insure even a minor risk if the cost is small enough.
- If more than one insurance product or guarantee passes this test, then assume a commitment to the product that seems the most compelling. Then repeat Step 3 to evaluate whether any additional purchases still make sense. If so, pursue as many of these as continue to make sense.

Step 4. Reality Test

- Are you comfortable with the implications of this plan, taking into account,
- The possible financial consequences of any risks you are still exposed to?
- The possibility of multiple risks turning into reality for you or your family?
- Any ongoing stress that exposure to these risks might involve?
- Any reduction in standard of living you will experience?

If not, return to the beginning and re-evaluate, taking the sources of this discomfort into account.

ADVANTAGES OF THIS APPROACH

A Holistic Approach

Most discussions of (and most tools and products for) dealing with post-retirement risks address only one risk, and rarely more than two or three. Single-risk approaches are valuable in determining how to alleviate a given risk but do not provide prudent advice about whether alleviating that risk is actually a good idea. Such an evaluation is possible only in the context of weighing the relative importance of all risks and the consumer's financial ability to cope with them.

Mind over Math

Risk management has important mathematical components, but fundamentally it is about something that is not mathematical at all: an individual's happiness. Risk matters to us because, if certain events occur, we expect them to make us unhappy (or to make others whom we care about unhappy). There is no mathematical way to measure the unhappiness that future contingencies might create, or to weigh those against the present and future unhappiness created by the costs of protecting oneself against those contingencies. People's attitudes toward death, illness, financial security, uncertainty, deferred gratification, the welfare of dependents and toward money itself, are complex, amorphous, highly individual and changeable over time. Risk abatement that ignores these issues produces results that may be mathematically defensible, but that are in no way truly adequate to the problem.

Preserving Wealth as "Universal Insurance"

While single-risk approaches, when competently devised and presented, do help people cope with individual risks, they also can encourage people of modest means to leave themselves overly exposed to a variety of other risks. As noted earlier, for many people, retaining assets that can be turned into cash protects against virtually all risks simultaneously. The proposed methodology respects this reality, while leaving open the possibility or even likelihood that action against certain specific risks is warranted.

ENHANCING THE MODEL

A fully developed and at least partially automated version of this model might include

A mathematical evaluation of the magnitude (financial impact and likelihood) of each significant risk as it applies to a particular individual or family, and of the cost of ameliorating it, as well as combinations of risks that tend to offset one another (most obviously, but not exclusively, the risk of dying too young vs. the risk of living too long).

Additional help for consumers trying to understand what the risks mean, their likelihood, their consequences and potential nonfinancial ways of ameliorating them.

Perhaps some weighting strategy to help balance the immediate financial costs, the long-term financial costs, and the psychological plusses and minuses of each alternative—supplemented by an easy way for the consumer to override any such evaluations. ■

Charles S. Yanikoski is the president of RetirementWORKS Inc. He can be reached at *csy@StillRiverRetire.com.*