Article from

Securing Future Retirements Essay Collection

2018 Call for Essays

Smart Decisions Older Workers Can Make for Retirement

Steve Vernon

How will ordinary workers retire in a defined contribution (DC) world? How will they decide if they have enough savings to afford retirement? How can they generate reliable periodic retirement income?

These questions began to nag at me when I started replacing defined benefit (DB) pension plans with DC plans in the late 1980s in my role as a consulting actuary working in the private sector. During the next two decades, I transitioned more than 20 DB plans. All that time, the questions continued to haunt me.

I didn't think it was a good idea to ask American workers to be their own investment managers and actuaries. This thought led me on a 30-year quest to help older workers and retirees find viable retirement income solutions—that's been a primary focus of my current encore career as a retirement researcher and educator.

Most Workers Don't Plan Like Actuaries and Investment Managers

To address the opening questions, employers often suggest workers consult a financial planner. But only about one-third of workers contact financial advisers for any purpose.[1] And finding an adviser who's both skilled with retirement income planning and isn't conflicted by how they're paid can be a roadblock for workers.

Without anyone to consult, only about half of older workers attempt to calculate how much money they need to retire.[2] In fact, the "planning" most older workers do is to estimate their monthly retirement income, then reduce their living expenses to that level.[3] But most workers don't have the skills to successfully convert their savings into a reliable, lifetime retirement income.

Retirees tend to exhibit two distinct strategies for deploying retirement savings:

- Conserving savings for a rainy day by minimizing their withdrawals and treating savings as an emergency fund,[4] or
- "Winging it" by treating their savings like a checking account to pay for current living expenses, often withdrawing too rapidly at an unsustainable rate.[5]

Neither strategy seems optimal in a DC world.

We Need Straightforward Retirement Income Solutions

There's a clear need for older workers to be able to "pensionize" their individual retirement and DC accounts. This would enable middle-income workers to plan for their retirements more effectively and make the most of the savings they've so carefully set aside.

The good news? Recent research by the Stanford Center on Longevity (SCL), collaborating with the Society of Actuaries (SOA), identifies a straightforward retirement strategy that can work for most middle-income retirees and be implemented in virtually any traditional IRA or

1 Transamerica Center for Retirement Studies, "17th Annual Transamerica Retirement Survey: A Compendium of Findings About American Workers," TCRS 1335-1216 (December 2016), *https://www.transamericacenter.org/retirement-research/17th-annual-retirement-survey/retirement-survey-of-workers-full-survey-results.*

2 Employee Benefit Research Institute, "2017 Retirement Confidence Survey," March 21, 2017, *https://www.ebri.org/surveys/rcs/2017/.*

3 Society of Actuaries, "Society of Actuaries 2015 Risks and Processes of Retirement Survey," January 2016, *https://www.soa.org/Files/Research/Projects/research-2015-full-risk-report-final.pdf.*

4 James M. Poterba, Steven F. Venti and David A. Wise, "The Drawdown of Personal Retirement Assets," National Bureau of Economic Research working paper no. 16675 (revised January 2013), *http://www.nber.org/papers/w16675.*

5 Steve Vernon, "A Retirement Literacy Quiz You Need to Pass," *MoneyWatch*, CBS, May 4, 2017, *https://www.cbsnews.com/news/a-retirement-literacy-quiz-you-need-to-pass/.*

401(k) plan.[6] This research provides a framework for assessing different retirement income generators (RIGs) and navigating the tradeoffs older workers face when making retirement income decisions. The research team included myself; another actuary, Joe Tomlinson, FSA; and retirement researcher Wade Pfau, Ph.D.

To learn more about the analyses that support the strategy and how employers can help their older workers, see these essays:

- "A Smart Way to Develop Retirement Income Strategies"
- "Smart Steps Employers Can Take to Help Older Workers Transition Into Retirement"

A Systematic Comparison of Retirement Income Strategies

The SCL/SOA project examined 292 retirement income strategies, including various combinations of:

- Starting Social Security at age 65
- Starting Social Security at age 70
- Single premium immediate annuities (SPIA)
- Systematic withdrawal plans (SWPs), including the IRS required minimum distribution (RMD)
- Guaranteed lifetime withdrawal benefits (GLWB)
- Fixed index annuities (FIA)
- SPIA/SWP combinations
- FIA/SWP combinations
- Tenure payment from a reverse mortgage

To systematically compare these retirement income strategies, we used stochastic forecasts and efficient frontiers, analytical techniques that many large pension plans use to devise funding and investment strategies.

Introducing the Spend Safely in Retirement Strategy

Our analyses identified a straightforward strategy that produces a reasonable tradeoff among various retirement planning goals for middle-income retirees. This strategy delays Social Security until age 70 for the primary wage-earner and uses the IRS required minimum distribution to calculate income from savings. We call this the "Spend Safely in Retirement Strategy."

The strategy has a significant advantage: It can be readily implemented from virtually any IRA or 401(k) plan without purchasing an annuity, something many retirees are reluctant to do and many 401(k) plans don't want to offer. Many administrators can calculate the RMD and automatically pay it according to the frequency elected by the retiree.

Implementing the Strategy

The best way for an older worker to implement the Spend Safely in Retirement Strategy is to design a thoughtful transition from full-time work to part-time work to full retirement. This would entail working just enough to pay for living expenses until age 70 to enable delaying Social Security benefits. In essence, "age 70 is the new 65." To make this method work, retirees may also need to significantly reduce their living expenses.

If a worker isn't willing or able to delay retirement, the next best way to implement the strategy is to use a portion of savings to enable delaying Social Security benefits as long as possible but no later than age 70. While analyzing this latter approach, we assumed the worker retires at age 65 but uses a portion of savings to enable delaying Social Security until age 70.

With remaining savings (after optimizing Social Security), retirees would use the RMD to calculate retirement income. The RMD rules can be translated into a series of withdrawal percentages, which are shown in the Appendix of the accompanying essay "A Smart Way to Develop Retirement Income Strategies." At age 70, the initial withdrawal percentage is 3.65%, and it increases each year thereafter. For workers who retire before age 70, we assumed a withdrawal percentage of 3.5% from ages 65 to 70.

Building a "Retirement Transition Bucket"

In the years leading up to retirement, an older worker might want to use a portion of their retirement savings

6 Wade Pfau, Joe Tomlinson and Steve Vernon, *Optimizing Retirement Income by Integrating Retirement Plans, IRAs, and Home Equity: A Framework for Evaluating Retirement Income Decisions* (Stanford, CA: Stanford Center on Longevity/Society of Actuaries, November 2017), *http://longevity.stanford.edu/2017/11/29/optimizing-retirement-income-by-integrating-retirement-plans-iras-and-home-equity-a-framework-for-evaluating-retirement-income-decisions/*.

to build a "retirement transition bucket" of money that enables them to delay Social Security benefits. While there's some judgment involved with the size of this bucket, a starting point would be an estimate of the amount of Social Security benefits the retiree would forgo during the delay period. The retirement transition bucket could also provide a buffer if the older worker is uncertain about the timing of retirement and could protect the worker against stock market crashes in the period leading up to retirement.

The primary disadvantage of using savings to enable delaying Social Security benefits is that it can substantially reduce the amount of remaining assets and liquidity throughout retirement. This disadvantage must be weighed against the potential for permanently increased, guaranteed retirement income from a delay strategy.

Investing With the Strategy

The retirement transition bucket could be invested in a liquid fund with minimal volatility in principal, such as a money market fund, a short-term bond fund or a stable value fund in a 401(k) plan. This type of fund could protect a substantial amount of retirement income from investment risk as the worker approaches retirement since the retirement transition bucket would be invested in stable investments and Social Security isn't impacted by investment returns.

Our analyses support investing the RMD portion significantly in stocks—up to 100%—if the retiree can tolerate the volatility. The resulting volatility in the total retirement income portfolio is dampened considerably by the high proportion of income produced by Social Security, which doesn't drop if the stock market drops. However, our analyses project reasonable results with a typical target date fund for retirees (often a 50% stock allocation) or balanced fund (often a 60% stock allocation); these funds are commonly available in IRA and 401(k) platforms. These lower stock allocations would reduce expected income but would also produce lower downside volatility, compared to a 100% stock allocation.

These results can significantly simplify retirement investing; to implement this strategy, a retiree could select a low-cost index fund, either a target date, balanced or stock fund. Many 401(k) plans, as well as many IRA providers, offer low-cost index funds as part of their investment choices.

Refinements to the Strategy

The Spend Safely in Retirement Strategy can be a starting point for devising effective retirement income strategies, with refinements to meet other retirement planning goals and personalize the solution to individual circumstances.

First, it's recommended retirees maintain an emergency fund that wouldn't be used to generate retirement income. Such a fund could be used to pay for planned large, one-time purchases or for large unforeseen expenses, such as house repairs.

Some retirees express a desire to spend more money in the early years of their retirement while they're active and healthy, often for travel expenses. In this case, they could dedicate a portion of their retirement savings to a special bucket for these purposes; this bucket would not be used to generate retirement income. For example, if a retiree plans to spend an extra $5,000 per year on travel for each of 10 years, they could set aside $50,000 that's not used to generate retirement income. Instead, they would withdraw from this savings bucket to pay for their travel expenses.

Another refinement might be appropriate for retirees who desire more guaranteed income than what's produced by the strategy. In this case, they could use a portion of savings to purchase a low-cost single premium immediate annuity, guaranteed lifetime withdrawal benefit or fixed index annuity. Another possibility, if the retiree has significant home equity, could be to use a tenure payment reverse mortgage to generate additional monthly income.

If a worker is unable or unwilling to work longer to postpone drawing Social Security benefits, one possible financial strategy would be to use a reverse mortgage line of credit as a pool of funds to help cover living expenses while delaying Social Security benefits.

Finally, the Spend Safely in Retirement Strategy works best when a retiree delays Social Security until age 70, but delays until earlier ages, such as 67, 68 or 69, still provide significant advantages.

Communicating the Strategy

Older workers and retirees should think of Social Security as a secure monthly "retirement paycheck" that can be used to pay for basic living expenses. They should consider the RMD withdrawals as a variable annual "retirement bonus" that can fluctuate in value, which can be used to pay for discretionary living expenses. Many middle-income workers are accustomed to managing their finances with secure paychecks and variable bonuses, so it's natural to continue this financial discipline in retirement.

The Spend Safely in Retirement Strategy helps underscore that it's smart for retirees to:

- Delay drawing down Social Security and retirement savings; for workers with modest retirement savings, it's essential to squeeze every dollar from available retirement resources
- Automate the payment of retirement income, which will be very helpful for older retirees when they reach their 80s and 90s and are less interested in managing their finances
- Use low-cost index funds for invested savings
- Phase from full-time work to part-time work to full retirement; the right transition will be unique to each retiree's circumstances and goals
- Adjust withdrawals from savings for investment gains and losses throughout retirement
- Maintain some accessible savings to respond to changes in circumstances throughout retirement

The strategy can be characterized as a navigational guide to help older workers decide when to retire and how to best deploy their retirement savings.

Strategy Won't Compensate for Inadequate Savings, Other Risks

By itself, the Spend Safely in Retirement Strategy won't compensate for inadequate retirement savings. However, that's not a criticism of the strategy, since our comparisons show that other retirement income solutions will deliver equal or less retirement income.

Our analyses show that the strategy helps address modest savings by squeezing as much income as possible from existing resources. Furthermore, our analyses show that many older American workers may fall short of typical retirement income goals commonly advocated by planners, such as targeting a retirement income that equals 70% to 90% of preretirement pay. This goal may be unattainable, given the prevalent levels of savings for older workers. Such retirees may need to live on incomes that fall short of these goals.

Also, the Spend Safely in Retirement Strategy won't address other retirement planning risks, such as the cost of high medical expenses or long-term care (LTC). Once again, this isn't a shortcoming of the strategy since most other retirement income solutions don't address these risks either. One smart risk management strategy is to convert large, unpredictable medical costs into predictable monthly premiums through Medicare and Medicare supplement policies, which can then be budgeted from retirement income.

An expensive LTC event can overwhelm most retirement income strategies and rapidly drain savings. Addressing this risk calls for separate strategies, such as purchasing long-term care insurance, holding home equity in reserve, and/or dedicating a separate investment account solely to LTC expenses and not using it to generate retirement income.

Minimizing Taxes Should Take a Lower Priority

Our analyses show that most middle-income retirees will experience significant decreases in their marginal federal income tax bracket in retirement, commonly falling from a 22% bracket to a 12%, 10% or even a 0% bracket. This results from:

- Low levels of taxable income generated by modest retirement savings
- The extra federal income tax deduction for taxpayers age 65 and older
- Part or all of Social Security benefits being excluded from taxable income

As a result, strategies to minimize income taxes should take a lower priority compared to maximizing expected income and liquidity. Since Social Security benefits enjoy unique tax benefits, maximizing Social Security benefits will help reduce retirees' income taxes.

The Strategy Helps With Important Life Decisions

The Spend Safely in Retirement Strategy represents a straightforward way for middle-income workers with between $100,000 and $1 million in savings to generate a stream of lifetime retirement income without purchasing an annuity and without significant involvement from financial advisers. This group might represent as many as half of all workers age 55 and older.[7]

The strategy can also help older workers make important life decisions, such as how long they should continue to work full time, whether they should transition into retirement with part-time work, when they can fully retire and how much money they can spend in retirement.

I've been studying retirement for my entire professional career, and, at age 64, I've been seriously thinking about my own retirement. This actuary will be using a version of the Spend Safely in Retirement Strategy, based on my 30+ years of study.

My life-long quest for answers may be finally coming to an end!

Steve Vernon, FSA, MAAA, is a research scholar at the Stanford Center on Longevity in Stanford, Calif. He can be reached at *svernon@stanford.edu*.

7 Employee Benefit Research Institute, "2017 Retirement Confidence Survey," March 21, 2017, *https://www.ebri.org/surveys/rcs/2017/*; Stephen A. Sass, "Is Home Equity an Underutilized Retirement Asset?" Boston College Center for Retirement Research, Center for Retirement Research at Boston College issue brief no. 17-6 (March 2017), *http://crr.bc.edu/wp-content/uploads/2017/02/IB_17-6.pdf*.