Pension Section News

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INTERVIEW WITH
R. Evan Inglis

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TELL US A LITTLE ABOUT YOURSELF.

E.I: I'm an actuary with experience thinking about investments for pension plans and retirement. I've done a lot of thinking about retirement spending and investing at work and at home in the past few years. I've ended up helping a couple of friends and my parents with their retirement planning. People want to know, "Do I have enough money?" I considered retiring myself a few years ago (although I now expect to be working happily for many years), and I put a lot of hours into developing a pretty sophisticated model for planning retirement spending. Embarrassingly, my happiest hours on earth are spent developing models in Excel, but I also love to exercise and follow the Seattle Seahawks.

WHY IS THE IDEA IN YOUR ESSAY IMPORTANT?

E.I: People need simple guidelines in retirement so they can live their lives without stopping to do a lot of financial analysis. Some of us like to do that, but most people don't have the aptitude or interest for meaningful analysis. The SOA's focus groups and surveys have told us that over and over.

Our current economic environment and, most importantly, the level of interest rates indicate that future returns on stocks and bonds are likely to be much lower than we have gotten used to over the past few decades. It's appropriate to expect equity returns in the 5 to 7 percent range and bond returns in the 3 to 4 percent range, and existing retirement spending guidelines like the "4 percent rule" are inappropriate for those levels of return.

I believe the "feel free" (FF) strategy is superior to the 4 percent rule, which has been the default benchmark for retirement spending. The 4 percent rule was a valuable concept, but it is outdated now. The FF approach is simpler, safer, better aligned with today's economic environment and more consistent with retirees' actual behavior.

WHAT ATTRACTED YOU TO THE ESSAY CONTEST?

E.I: I have a strong belief that the FF spending approach can be a powerful aid to lots of people, and I was looking for a way to publish a description of the idea. The contest was perfect and came along just at the right time. Writing up the essay pushed me to develop some supporting numerical analyses but also allowed me to present the approach in a relatively informal way that is very consistent with the overall nature of the approach. Feel free spending is meant to be fairly intuitive, and rigorous analysis is not needed to understand how useful it can be.

WHAT STEPS, IF ANY, WOULD HELP MAKE THE IDEAS IN YOUR ESSAY A REALITY?

E.I: I think the FF spending strategy can be an important aid to millions of retirees. I will work with my employer and/or the SOA to get this message out.

WHAT ELSE WOULD YOU LIKE TO TELL US?

E.I: "Feel free" to describe this strategy to friends and relatives. That is the point: you can "feel free" to use and recommend this approach because it is safe—*not* foolproof, but very safe. Read the essay for some key considerations, but they are generally common sense (for example, consider whether you have long-term care insurance or not).

Finally, I cannot emphasize enough that in our work and in planning our personal financial futures that it is vital to use reasonable expectations about future investment returns that are not based on our experience of the past few decades. ■

The "Feel Free" Retirement Spending Strategy

R. Evan Inglis

I end up talking with people about retirement income a lot these days. My friends, my parents and new people that I meet all seem to be interested in whether they have enough money saved up. Retirement income strategies and the level of spending that is "safe" or appropriate is something I've done a lot of work on and thinking about. I've developed an elaborate model to help me analyze my own situation that I also use to help others. There are many issues to consider—for example, the impact of income taxes and large one-time expenses.

Even though there are lots of things to think about, for the vast majority of people, very simple guidelines will be most useful. My simple answer to the questions "How much can I spend?" or "Do we have money enough saved?" is that if someone plans to spend less than **3 percent of their assets** in a year (over and above any Social Security or other pension, annuity or employment income), then they have enough money saved and they aren't spending too much. This is a fairly conservative estimate, but people tell me they want to be conservative with their retirement spending. They would rather feel safe than spend a lot of money, and I think that is very appropriate in our current economic environment.

Three percent could be viewed as a more conservative and simpler version of the well-known "4 percent rule." The 4 percent rule fixes a level of spending at the time of retirement and increases it with inflation—there is no adjustment for the level of your portfolio at any point in time. The 3 percent rule that I have recommended recognizes the lower level of returns we are likely to experience in coming years due to low interest rates and other factors such as demographic trends. It is also safer because it adjusts downward when portfolio values drop. That means spending will vary, but it reduces the risk (in fact, it virtually eliminates the risk) of running out money. This approach presumes one has 40 percent to 70 percent of their portfolio in equities and the rest in fixed income. (See Appendix, Section 1.)

In advising my parents (who are in their mid-70s), I realized they could spend a bit more than someone who was just retiring in their 60s. That's a shame since most people want to and do spend more when they are in their early retirement years.[1] However, it makes sense because as you grow older and have a shorter remaining lifespan, the potential to run out of money decreases. The objective of this rule is to ensure that money lasts a lifetime—not to enable the highest level of spending. With that in mind, I developed the "feel free" spending rule described below.

FEEL FREE!

To determine a safe percentage of savings to spend, just **divide your age by 20** (for couples, use the younger spouse's age). For someone who is 70 years old, it's safe to spend 3.5 percent (70/20 = 3.5) of their savings. That is the amount one can spend over and above the amount of Social Security, pension, employment or other annuity-type income. I call this the "feel free" spending level because one can feel free to spend at this level with little worry about significantly depleting one's savings. My belief is that most people would rather spend their money at a safe level than they would spend their time on analyzing their situation in order to be confident in spending a bit more. This perspective is supported by reports from focus groups organized by the Society of Actuaries which show that retirees spend much less time thinking about their finances than pre-retirees do and that most retirees do little planning but a lot of adapting to circumstances.[2] In an economic catastrophe like 2008, one's feel-free level of spending might drop by 20 percent to 30 percent in a year, but people adjust their spending naturally in times of economic crisis anyway. (See Appendix, Section 2.)

If the economic and financial market environment reverts to something similar to what we've experienced in the past, a retiree who follows this rule will have more than enough money and their portfolio will grow, providing for additional spending as time goes on. If we experience a lower return environment as many experts predict,[3] this level of spending is still highly likely to last a lifetime, without depleting one's portfolio in any significant way. (See Appendix, Section 1.)

So, one should feel free to spend a percentage of savings equal to their age divided by 20.

NO MORE!

At the other end of the spectrum, **divide your age by 10** to get what I call the "no more" level of spending. If one regularly spends a percentage of their savings that is close to their age divided by 10 (e.g., at age 70, 70/10 = 7.0 percent) then their available spending will almost certainly drop significantly over the years, especially after inflation is considered. Except for special circumstances like a large medical expense or one-time help for the kids, one should not plan to spend at that level. Purchasing an annuity may allow spending at close to the "no more" level, but no more than that. Anyone who wants to spend more than the feel-free spending level (divide-age-by-20 rule), may want to consider buying an annuity to provide some of their income.[4] Without an annuity, one should do careful analysis and regular updates to a spending plan to safely spend at higher levels. The amount of annuity income that makes sense will depend greatly on one's preferences, including the desire for a bequest. For those who want to feel free to spend at a certain level, it will make sense to purchase annuity income that will allow their remaining spending to be close to the feel-free level of spending for their age at the time of the annuity purchase. Someone who wants to spend close to the no-more level should probably annuitize a substantial portion of their wealth. (See Appendix, Section 3.)

OTHER CONSIDERATIONS

There are all kinds of things that could and should be considered when thinking about retirement spending. Common sense needs to be applied to each person’s circumstances. Here are some of the questions to ask when applying this rule (or other similar rules):

- Do you have long-term care insurance? If you do, you can spend a little more. If you don’t and you don’t plan to have your kids take care of you, you may want to reduce your spending a bit.
- Will you lose a significant amount of annuity income when your spouse dies? Obviously your spending capacity will change at that point.
- Will you pay significant income taxes? You should consider income taxes as part of your spending. Keep in mind that some states have special exclusions for certain kinds of retirement income.[5]
- What if interest rates go up? First of all, you can’t expect that they will. You can probably spend a little more if they do, but if rates go up by 200 basis points, you can’t increase your feel-free rate by 2 percent of your savings. The best advice is to stick to the divide-by-20 rule for the foreseeable future.
- Do you want to pass on a certain amount to your kids or charity? If you have particular wishes about how much to pass on, then you can adjust your spending accordingly.

Another potential complication is when someone retires and expects some kind of annuity income that starts in the future. For example, someone who retires at 55 may plan to start taking Social Security at age 70 or be expecting a pension to start at age 65. A similar situation arises if a large expense, like a mortgage payment, will go away at some point in the future. If one is waiting for an annuity payment to start, it may be fine to spend down savings to some extent. Here are some things to consider:

Keep in mind that it will be difficult to achieve level spending if the annuity is large relative to the amount of savings. Consider someone who retires at age 55, with $600,000 in savings and $60,000 in annuity income beginning around age 65. There is no way to fully adjust the pre-annuity spending to be consistent with the post-annuity capacity without spending down one’s assets significantly.

CONCLUSION

The feel-free spending level is an easy-to-determine and -remember guideline for those who do not have the time, expertise or inclination to do a lot of analysis and who don’t want to hire an adviser for help. Hopefully, this simple rule is useful, even for those who do lots of planning around their retirement. It’s simple and it’s safe. One needs to use common sense about their circumstances, but dividing one’s age by 20 should provide a useful spending guideline for most retirees.

APPENDIX

1. Real Rates of Return

Tables 1A–D show simple calculations of potential real returns for different portfolios in different types of future financial markets. These are intended to help validate the feel-free levels of spending that are unlikely to spend down savings balances no matter how long someone lives. Each table represents a combination of a portfolio approach and a financial market scenario. Compare these real rates of return to feel-free spending levels. If the rate of return is above the spending level, savings will grow. If the rate of return is below the spending level, savings will decrease. Keep in mind that real world market volatility lowers the effective return and that the impact of volatility will be greater for the aggressive portfolios.

Table 1 Real Rates of Return

A. Aggressive, Pessimistic		
	Allocation	Return Above Inflation
Equity	70%	4.00%
Fixed income	30%	1.00%
Total	100%	3.10%

B. Conservative, Pessimistic		
	Allocation	Return Above Inflation
Equity	40%	4.00%
Fixed income	60%	1.00%
Total	100%	2.20%

C. Aggressive, Optimistic		
	Allocation	Return Above Inflation
Equity	70%	7.00%
Fixed income	30%	2.50%
Total	100%	5.65%

D. Conservative, Optimistic		
	Allocation	Return Above Inflation
Equity	40%	7.00%
Fixed income	60%	2.50%
Total	100%	4.30%

2. Comparison of Spending Rule to Life Expectancy

Table 2 shows how long the spending level determined at a particular age would last if it was fixed after the initial calculation. Initial spending is assumed to grow with inflation, with no other adjustments. Investment earnings are assumed to equal inflation. This helps to establish the level of conservatism in the rule and to validate how the spending level increases with age.

3. Combining Guaranteed Annuity Income with the Spending Rule

These scenarios illustrate how the feel-free spending rule can help determine a percentage of wealth to be used to purchase an annuity. Each scenario envisions a single individual planning for an annuity purchase with interest rates and mortality assumptions appropriate for mid-2015. See Table 3. ■

Table 2 Comparison of Spending Rule to Life Expectancy

Planning Age	Spending Level	Years Until Savings Depleted	Age at Which Savings Depleted	Life Expectancy, Male*	Life Expectancy, Female*
65	3.25%	30	95	86.6	88.8
75	3.75%	26	101	88.6	90.3
85	4.25%	23	108	92.2	93.4

* Society of Actuaries, "RP-2014 Mortality Tables" (November 2014).

Table 3 Combining Guaranteed Annuity Income With the Spending Rule

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Wealth (savings)	1,000,000	750,000	1,000,000	500,000	750,000
Age	60	65	65	70	65
Social Security Benefit	25,000	20,000	20,000	20,000	22,000
Annuity price ($ cost per annuity income $)	15.0	13.5	13.5	12.0	13.5
Desired spending	55,000	50,000	70,000	50,000	75,000
Desired spending above S.S. as % of wealth	3.00%	4.00%	5.00%	6.00%	7.07%
No-more-spending benchmark	6.00%	6.50%	6.50%	7.00%	6.50%
Recommended annuity purchase	–	140,000	425,000	260,000	690,000
Annuity purchase as % of wealth	0%	19%	43%	52%	92%
Annuity income purchased	–	10,370	31,481	21,667	51,111
Remaining savings	1,000,000	610,000	575,000	240,000	60,000
Desired spending above annuity income	30,000	19,630	18,519	8,333	1,889
Desired spending above annuity income as % of remaining savings	3.00%	3.22%	3.22%	3.47%	3.15%
Feel-free spending benchmark	3.00%	3.25%	3.25%	3.50%	3.25%

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ENDNOTES

1 See Ty Bernicke, "Reality Retirement Planning: A New Paradigm for an Old Science," *Journal of Financial Planning* 18, no. 6 (2005).

2 Mathew Greenwald & Associates, "2013 Risks and Process of Retirement Survey," Society of Actuaries–sponsored report (2013); Mathew Greenwald & Associates, "2005 Risks and Process of Retirement Survey," Society of Actuaries–sponsored report (2005).

3 Up-to-date return forecasts for different asset classes are published at ResearchAffiliates.com and GMO.com.

4 As of mid-2015, when 10-year Treasury rates are at about 2.20 percent, a fixed annuity might allow spending of about 6 to 7 percent of the single premium and an inflation-adjusted annuity would provide income of almost 5 percent of the savings spent on such a policy. An investment-only variable annuity can provide higher levels of income but with less certainty about the amount.

5 "State-by-State Guide to Taxes on Retirees," last modified October 2015, Kiplinger.