Bloomberg BNA

Pension & Benefits Daily ™

Retirement Planning

Focus on Average Outcomes Increases Risk Retirement Money Runs Out, Report Says

Basing retirement decisions on average potential outcomes increases the risk that people will run out of money during retirement, according to a report released Jan. 15 by the Society of Actuaries' Pension Section and Pension Section Research Committee.

The report, *Measures of Retirement Benefit Adequacy: Which, Why, for Whom, and How Much?*, also stressed the need for a holistic approach to retirement planning and cautioned against what it called a "one-size-fits-all" measure of benefit adequacy. It also said that the purchase of a retirement annuity "is not automatically the best choice."

"We hope this report is the beginning of an enhanced way of thinking about some of these issues that will improve the way that certain kinds of retirement decisions are made," report co-author Anna Rappaport told BNA Jan. 17.

"What was very clear from the results and turned out to be a wake-up call is [that] if you don't have enough money for an emergency fund, you shouldn't be annuitizing," Rappaport said. "You need enough money for a good emergency fund before annuitizing. If you don't have enough money, you can't buy enough of an annuity to be meaningful, " she said.

Simulated Cash Flows. The report used a simulation model to estimate retirement income needs and adequacy. The model estimated a likely range of outcomes by making multiple simulations of randomly selected conditions. The actuaries' report ran the hypothetical retirement cash flow 50,000 times for each of six combinations of pre-retirement income and nonhousing wealth at retirement. The simulation incorporated longevity, inflation, investment, health, and long-term care risks.

The report analyzed the impact of investment wealth on a couple's retirement income prospects, including all forms of invested savings, individual retirement accounts, and employer defined contribution plans. In the model, the wealth is accessible to the household and can be converted to cash or used to purchase an annuity.

Asset requirements can increase or decrease based on various actions, such as whether a person postpones retirement, Rappaport told BNA. The report tested only some combinations of actions, she said. She also indicated that a follow-up study is under way to test the implications of having a defined benefit income as part of one's personal resources.

Median Income Couple. One of the scenarios the study looked at is a husband age 66 and a wife age 63 when they retire with $60,000 in household pre-retirement, pretax annual income, which, according to the Federal Reserve Board's 2010 Survey of Consumer Finances, is approximately the median for their age group. The model presumes that, in retirement, the couple desires to maintain their pre-retirement standard of living.

If the couple has about $100,000 in nonhousing wealth at retirement, the report said, the couple would have a 29 percent chance of having enough money for the full length of their retirement. To have a 50 percent chance of having enough money, they would have needed $169,628, and to hit the 95 percent confidence level, they would have needed $686,264.

If the couple had $200,000 in nonhousing wealth, they would have an 81 percent chance of fully meeting their retirement needs. To hit the 95 percent confidence level, they would need $686,533, the report said.

Vickie L. Bajtelsmit, a real estate and finance professor at Colorado State University, who conducted the research for the report, told BNA that the figures excluded housing equity because researchers were interested in "spendable wealth" that can be used to cover a couple's living expenses without requiring a major lifestyle change. "The median pre-retiree couple actually does have some housing wealth, but this is only a factor in our simulations if the couple sells their house when the second spouse goes into long-term care," she said.

Risk-Mitigation Strategies. The report discussed a variety of strategies for mitigating the risk that a couple will outlive their retirement savings, including delaying retirement, which the report said is "the most effective risk management strategy for the median income household."

The report said that reducing household spending "is a logical retirement strategy" if a household has insufficient wealth to maintain their pre-retirement standard of living. For example, it said, a moderate- or higher-income couple could successfully retire with 20 percent less savings if they reduced their discretionary spending by 15 percent.

Reducing discretionary spending, however, will not significantly improve outcomes for median-income couples, the report said, because "shocks," or unexpected events—such as major declines in financial asset values and/or investment returns, major illness, divorce, serious disability or dementia, unusual longevity, or death—"are the biggest driver of asset depletion."

Individuals should take unexpected events into account in financial planning because ''they are more likely to derail an individual's retirement plan, especially at lower income levels,'' than expected events that can be planned for, the study said.

Annuity Trade-Offs. The report also simulated the outcome if a couple purchased an annuity with part of the nonhousing wealth they had at retirement—either 25 percent of 50 percent—to mitigate the risk of outliving their retirement savings. Annuity payments were to begin in the first year of retirement and continue on until the surviving spouse died. No cost-of-living increases were included.

For the couple with $60,000 in pre-retirement annual income and $200,000 in nonhousing wealth at retirement, both levels of annuities would provide them at least a 50 percent chance of having enough money for retirement but would leave them with less of a chance of having money left over at death.

''Annuity purchase provides longevity protection and reduces income risk at later ages, but it comes at a cost,'' the report said. Although the annuity increases guaranteed lifetime income, it leaves fewer resources available to meet unexpected events, the report said.

If a couple does not annuitize and they run out of investment wealth, they will have only Social Security income, the report said. On the other hand, it said, if the couple purchases an annuity, they will have greater annual income than without the annuity if they exhaust their other investment wealth.

By Joe Lustig

The report is at http://www.soa.org/Files/Research/Projects/research-2013-measures-retirement.pdf.

