Chapter Two

The New Retirement

"You can avoid reality,
but you cannot avoid the consequences of avoiding reality."
– Ayn Rand

"By failing to prepare, you are preparing to fail."
– Benjamin Franklin

Retirement investing used to be so easy. Work until age 65, retire, and live off income for the five or so years you had left. The strategy was simple: count on a pension and Social Security for most of your nut, and cover the rest of your income need with bonds. Simple.

That has changed. It's not so simple anymore. Retirement is no longer a short-term affair—it's a 30-year crapshoot, maybe even longer. Retirement can last as long as your work life: work from 20 to 60, and then retire from 60 to 100. Yes, it can happen. But there's a downside to today's longevity: How do we fund such long retirements?

There's another challenge: relatively few retirees are blessed with pensions. You may have a 401k and an IRA, but we all know what happened to those during the 2000-2002 and 2007-2009 bear markets. Both times, the stock market lost about 50% at their low points. To recover from a 50% loss you need a 100% gain, and those don't occur too often. Of course, Social Security doesn't amount to that much anymore, and its future is in doubt anyway. The scenario is not pretty.

Now, let's take it up a notch. Can you imagine funding a 30-year retirement with interest rates at today's levels: about 2% for a 10-year Treasury bond? Funding $100,000 per year in retirement income at 2% interest rates requires at least $5 million. Chances are, not every reader of this book has $5 million sitting around.

Retire with Confidence (and a Very Clear Plan)

Retirement is no longer an easy proposition. Not only are we now living in an age of low interest rates, we live longer, better and expect the finest in healthcare—regardless of cost. All these factors are coming together to present a perfect storm of challenges to retirees.

Let's face it: retirees now live in a brave new world. We need to be smarter about retirement, how we invest and how we generate income. Viewing the stock market as a hobby doesn't cut it anymore; the stakes are too high, the risks are too great. Investing needs to be productive or our retirement could be seriously compromised.

As you near retirement age—even within a decade or so—stop what you're doing and start some serious financial planning. Work with a professional who uses sophisticated software and understands the nuances of retirement planning. Make sure your professional is focused on your best interests, rather than juicy commissions and fees.

Retiring with confidence is developing a plan that makes sense, executing it, and reviewing it every few years to make sure you're on track. The plan is going to be wrong; you know that. But as long as you continue to update the plan and make course corrections as needed, you should be able to retire with confidence and enjoy peace of mind through your lifetime. And that's a very good feeling.

An integral part of executing that plan is investing sensibly and managing risk to avoid large losses. This book offers a strategy you can execute easily and confidently. It's a strategy that recognizes the nature of investing and human behavior, and should enable you to successfully manage one of the most important retirement risks you face: your investment portfolio. Let's take a deeper look at those risks.

Assessing Retirement Risks

As you prepare for retirement, you need to consider a number of risks. Put simply, there are risks we know and risks we don't. In truth, we don't really know the "risks we know," since the magnitude can vary so much. For example, with today's longevity, you could live to 85 or 100; both are a long time, but the financial implications could be very different.

Risks we don't know can present tremendous challenges. Health circumstances can change your life overnight, forcing you to quit work or plunge deeply into your cash reserves. Family responsibilities, such as caring for a parent or a sibling, can have a major impact on your finances and lifestyle. Your work life is always at risk, whether it's your own business or you're employed. Even the safest job can be undone by a merger or a change in technology. And in today's highly litigious society, lawsuits can alter our life in an instant.

At some point, at least one of these or other unknown risks is likely to throw you off your financial plan. You don't know when it will happen or what it will be, but it's a reasonable bet to expect the unexpected. This uncertainty places an even higher responsibility on you to make sure your financial house is in order and your investments are productive.

Risks We "Know"

The risks we know (but don't know the magnitude) are key levers in any financial plan. Change one and the assets you need during retirement can change dramatically. Let's review each of these "known unknowns."

Risks we know:	Risks we don't know:
Longevity	Health
Inflation	Family responsibilities
Portfolio returns	Business or employment uncertainties
Living costs, especially healthcare	Lawsuits
Length of work career	Unforeseen events

Longevity

Most all of us would like to live a long life. Ironically, longevity can place a tremendous strain on your financial resources. As medicine and healthcare progress, life spans increase and so do the challenges of a long-term retirement. Industry statistics suggest that relatively few are financially prepared to meet the challenge of living longer.

Chuck had a quadruple bypass in his late 60s and soon retired. He enjoyed a retirement filled with travel, friends and family. But along the way, he realized something unexpected was happening to him: he was living far longer than he anticipated. By his late-80s, his finances were becoming tight and a source of great concern. The travel stopped and he sold his second apartment. With such poor health in his 60s, he never expected to live so long. Longevity is one very pleasant surprise that can eventually become uncomfortable. Don't be surprised: plan for it.

The average 65-year-old man can expect to live to 85; the average woman to 88.[2] If you're married, your chance for a longer life increases (yes, I've heard the jokes, at least some of them). A 65-year-old couple has a 50% chance that one spouse will live past 92, and a 25% chance that one spouse will live to 97. It sounds great, but if you have had experience with long living, you know that a lot of challenges can arise and the costs can be enormous. Presently, unless you have some serious health risks or unfortunate heredity, it makes sense for you to base your planning on a 95-year life span.

Inflation

During the past few decades, inflation hasn't been much of a problem. For the most part, it has been in the 2-3% range. But don't get too confident. Even at 3%, your costs could double in 24 years. An uptick

in inflation to 4% would mean that your annual living expenses could double in 18 years and then again in the next 18 years; that's a potential 4x impact over the course of your retirement. In other words, the $125,000 in annual living expenses that you're planning for in the first year of your retirement could easily be $500,000 by the end of your life.

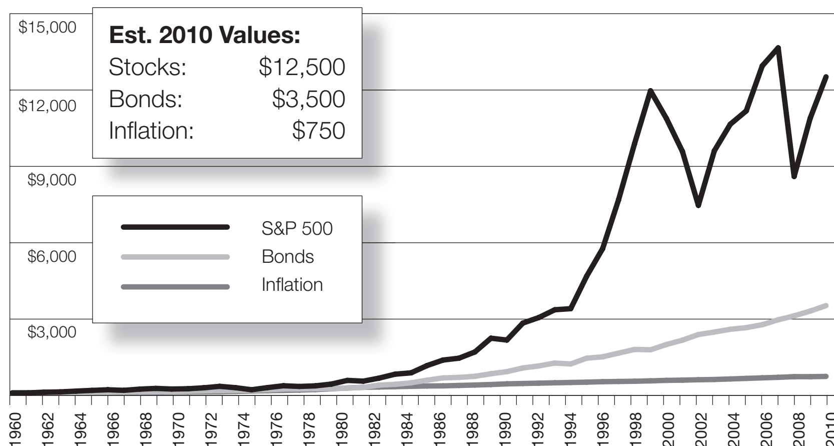
Currently, it makes sense to base your plan on an inflation rate of about 3.5%, since medical costs can add to a retiree's inflation rate. Keep a watch on inflation rates—especially medical costs—and adjust your planning as needed.

Inflation is an important factor as you consider your investment objectives and rate of return requirements. Over the long term, it's imperative to generate investment returns that beat inflation, or your portfolio could shrink rapidly. That's one of the risks retirees face by only investing in bonds: they generally don't beat inflation by a large enough margin to sustain a portfolio over the long term.

The chart on the next page demonstrates that over the long term, stocks significantly outpace bonds and inflation.[3] It's important to note that bonds tracked closely with inflation from 1960 through 1981, until a large and steady decline in interest rates propelled bonds to a 30-year bull market. That bull market in bonds is likely to end some day, and the next market cycle may not be so kind to bond investors. Clearly, stocks are the best way to beat inflation over the long term—not bonds. But stocks come with a serious price: much more volatility and a greater chance of loss.

Interestingly, Warren Buffett wrote an article in February 2012 for *Fortune*[4] bluntly entitled, "Warren Buffett: Why stocks beat gold and

Stocks, Bonds and Inflation
Growth of $100
1960-2010



Over the long term, stocks are your best bet to beat inflation.

bonds." The article states that stocks are a much more effective way to beat inflation over the long term than bonds or gold. Buffett tells investors that despite the current popularity of bonds and gold, stocks hold the most potential over the long term. He concludes the article with a statement that stocks will also be the safest investment among the three choices:

> *"I believe that over any extended period of time this category [stocks] of investing will prove to be the runaway winner among the three we've examined. More important, it will be by far the safest."*
>
> – Warren Buffett, Chairman of Berkshire Hathaway

Portfolio Returns and the Risk of Major Losses

The returns you generate on your portfolio are critical to sustaining your assets through retirement. Financial planning software programs often provide you the flexibility to plug in a number for returns over two periods: 1) until retirement, and 2) during retirement. That sounds great, but it's not so simple.

Market returns are not linear. You are not likely to earn 8% every year before retirement and 6% during retirement as a computer program might suggest. Returns are dynamic: they're lumpy and unpredictable. There are no straight lines. Since 1960, the S&P 500 has either gained or lost in double digits on a calendar-year basis more than two-thirds of the time—that's a lot of volatility.[5] The notion of extrapolating an 8% return over a lifetime fails to take into account the wild ride that is often the nature of investing.

Advisors like to look at risk from the standpoint of standard deviation, which is the variation above and below the mean. That's not good enough. For investors who are retired or pre-retired, the downside is too important. The risk you really care about is the possibility of a major loss—say 15% or more in a single year.

Large losses are dangerous. Once you enter the general time zone of retirement—perhaps five to ten years before retirement—investing becomes a very serious venture. If investing was a game to you, it isn't any longer.

Imagine you had a portfolio with $3 million in 2007. You decide to retire with the expectation of withdrawing about $120,000 per year. That's just a 4% annual withdrawal rate on the $3 million—no problem. But things change. Your portfolio gets hit with a 30+%

Impact of Major Decline	Before Decline (2007)	After Decline (2009)
Portfolio Assets	$3,000,000	$2,000,000
Income Withdrawal Planned	$120,000	$120,000
Remaining Balance	$2,880,000	$1,880,000
Next Withdrawal at 4% Rate	$115,200	$75,200
Shortfall in Your Income	—	$40,000

decline in the 2007-2009 bear market. Let's say you still decide to take the $120,000 withdrawal, despite the decline in your portfolio.

Look at what happens (in the table above) to the next withdrawal if you decide to stick with a 4% withdrawal rate and the portfolio doesn't grow. The portfolio that declined 30+% can only distribute $75,200 in the following year. This leaves you with a shortfall of $40,000 compared with the original portfolio, a pretty serious difference when you're depending on that income to live. To make up the difference, you may need to sell assets at depressed prices. Big losses can cause your plans for retirement to implode.

In the decade before retirement and during retirement, the #1 priority is capital preservation. Never get hit by a big loss, period.

Living Costs, Especially Healthcare

One of the most surprising parts of going through a financial planning exercise is to see the impact of living costs. While most people seem to focus on building their portfolio, living costs are often the most powerful lever in a plan.

Here's the good news: you can control living costs (unless you're affected by a major event risk). When a financial plan doesn't work, some people try to trick the system by juicing up their portfolio returns. In most cases, the trick is on them. Raising returns usually means raising risk levels, and getting too aggressive can lead to disaster. Instead, look objectively at what you're spending—that's one place you can largely control.

Unfortunately, there is one wild card with respect to living costs that you may not be able to control: healthcare expenses. Think of all the possibilities. Will you be healthy or incur serious illnesses? If you get sick, will it be a brief episode or a long-term problem? If those aren't enough wild cards, what about the current healthcare legislation—how will that evolve?

One thing we do know about healthcare is this: costs have been outpacing general inflation for years, and it's likely to continue. Current research suggests that healthcare costs will more than double in the next 30 years.[6]

Consider these widely quoted statistics from the Urban Institute[7] in its February 4, 2010 report:

- By 2040, the median annual real out-of-pocket costs for Americans age 65 and older will more than double in constant 2008 dollars

- In 2040, half of adults age 65 and older will spend at least 19% of their incomes on health care, up from 10% in 2010

As you plan your retirement, keep in mind that as you grow older, you are likely to become a greater consumer of healthcare. Since healthcare costs have outpaced inflation in recent decades, your personal inflation rate may actually exceed the Consumer Price Index (CPI) you see quoted in the media.

In fact, the Bureau of Labor Statistics calculates an experimental consumer price index, called CPI-E, for Americans age 62 and older. From December 1982 through December 2007, the CPI-E rose at an annual average rate of 3.3% compared with 3% for the general population.[8] A big part of the difference was due to medical care costs, which were a larger part of a retiree's typical budget and have significantly outpaced the growth of other consumer costs. Healthcare is currently a hotly contested political issue and the outcome of this debate is entirely up for grabs. However, you can be fairly certain that medical costs will be a meaningful part of your living expenses going forward.

Length of Work Career

More and more, people are deciding to retire at an age other than 65: some higher, some lower. During the strong economic period of the 1990s, it seemed popular to talk of retiring early. In 2011, after two devastating recessions and a "lost decade" of flat market returns, the talk has shifted to working past age 65.

From a financial planning standpoint, it is amazing to see the impact of working longer than originally planned. Working longer

becomes a powerful lever, largely as a result of two benefits:

- Gain additional income
- Have fewer years of withdrawals from your portfolio

As you can imagine, working longer can fix a lot of shortfalls in your financial plan. Plus, it can be rewarding. Some retirees have lengthened their work life by beginning second careers that satisfy a personal passion. Others have found they enjoy working in the same job when the hours aren't so long. So if your financial plan seems to fall a bit short, lengthening your work career can be an effective and often rewarding solution.

Notes:

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2. Annuity 2000 Mortality Table.

3. Source for Stocks (S&P 500), Intermediate Bonds, Inflation: Ibbotson SBBI Yearbook, Bureau of Labor Statistics, iShares.com. Note: You cannot invest directly into an index; returns from a non-index will be diminished by costs.

4. "Warren Buffett: Why stocks beat gold and bonds," by Warren Buffett, *Fortune*, February 27, 2012.

5. Data source: Ibbotson SBBI Yearbook. Indexes: S&P 500 and Barclays Capital US Aggregate Bond Index (Intermediate-Term Government Bonds prior to 1992).

6. The experimental consumer price index for elderly Americans (CPI-E): 1982-2007. By Kenneth J. Stewart, Bureau of Labor Statistics, *Monthly Labor Review,* April 2008.

7. Will Health Care Costs Bankrupt Aging Boomers? By Richard W. Johnson and Corina Mommaerts. The Urban Institute, February 2010.

8. The experimental consumer price index for elderly Americans (CPI-E): 1982-2007. By Kenneth J. Stewart, Bureau of Labor Statistics, *Monthly Labor Review,* April 2008.