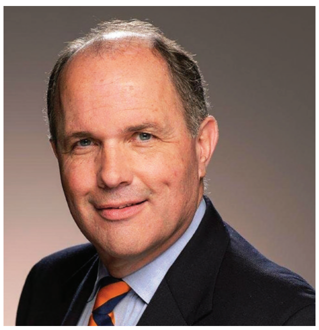
Save less

A retirement plan funding strategy



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People generally do not have limitless resources to meet their financial needs and wants. For many, retirement savings is often a victim of limited resources because the liability is quite a ways off and distance becomes the enemy of urgency.

The timing of our need to fund retirement is one thing that moves it to the back burner; capacity is another. Our financial lives are balancing acts where we need to juggle the funding of immediate needs, emergency needs, ongoing needs and long-term needs. Some make bad choices with reckless or unnecessary spending while others diligently fund their important obligations before their discretionary spending. Somehow most of us get through it in one way or another. However, we often feel that we can do with more resources to make this exercise easier.

Many retirement savers do not realize that funding their retirement may have more flexibility than we originally thought. There are intelligent and prudent ways to reduce retirement plan funding levels without increasing our financial risk or reducing the level of expected retirement income. This concept, “Saving Less” aims to intelligently reduce retirement funding to free assets for more current or more pressing needs.

The unknowns

The two key and common unknowns in both accumulation planning and retirement income planning are expected market returns (impacting your wealth and income at retirement) and expected inflation (impacting the real, inflation-adjusted value of that wealth and income). There is one more key unknown related to retirement income planning and how that unknown is managed can greatly impact us. This third retirement income planning unknown is our longevity.

Longevity risk can be managed in one of two basic ways. A person can either do it themselves or leave it to professionals.

Do-it-yourself longevity management

Managing our own assets for retirement also means managing our own longevity estimates or the amount of time that we will be alive to spend our accumulated retirement savings. Many people estimate their own longevity based on the longevity of deceased parents or family members, but much research has shown that there is very little predictive ability here with one study noting only a 6% correlation (100% correlation is best) between the lifespans of parents and children.[1] We also know that improved diets, lifestyles, health habits and healthcare have led to steadily increasing longevities over the decades. Thus, all else equal, a person turning 65 today is likely to live longer than a person turning 65 in the 1960s. So, if we try to predict our own longevity, we are likely to be off the mark—possibly by many years.

Since our longevity is a key unknown, it is safe to have a substantial cushion to last an unexpectedly long lifetime. The good thing about a cushion is that it may be sufficient to provide for that unplanned extended life and, if not needed, it is something that can be left in our estate. Of course, the negative is that creating a sizable cushion means we need to live more frugally in retirement and/or save more during our working years to create the cushion. This is fine if you have a lot of wealth or income to spare, but most people do not.

Leaving longevity management to the professionals

The second way to manage longevity is to enlist professionals. No, there are no professionals who can guess your longevity with any degree of accuracy, but there is an approach used by professionals which has the potential to yield solid results. That approach is an annuity contract, and the benefits of this approach can be substantial. In its simplest form, an annuity will pay you some amount per year for as long as you live in return for an upfront payment. As an aside, various options are available to assure a minimum number of payments and/or lifetime payments for a spouse as well.[2]

How can an annuity benefit an individual? A well-priced annuity has the potential to deliver more income through retirement per dollar invested than can be prudently withdrawn from a mutual fund portfolio. There is a retirement spending rule-of-thumb used in our industry based on a historic analysis of stock and bond returns and inflation rates done in the 1990s by William P. Bengen. He stated, essentially, that one may prudently spend about 4% of at-retirement real wealth per year through retirement (based on historical analysis using a 50/50 stock/bond asset mix).[3] Commentators more recently have said that 4% per year in our low-interest-rate environment is too generous and something closer to or even below 3% might be more realistic. But let's stay with the 4% rate. So, someone with appropriately-invested wealth (50/50 per the original analysis) of $1,000,000 can have real income for life of $40,000 per year. Assuming markets and inflation and longevity cooperate together, this individual should be able to make it through retirement with sufficient wealth and perhaps even a remaining bequest for an heir, based on Bengen's original analysis.

A person who annuitizes $1,000,000, on the other hand, may have an initial income payment of $50,000 to $60,000 or even more, depending on the annuity terms and the insurer selected. How can an annuity provider pay so much? An individual managing their own affairs essentially is taking a very big risk on the life expectancy of one person—themselves.

Annuity providers, on the other hand, work with large numbers of people, so they do not have to be right in estimating a single person's longevity; they just need to be right in estimating the average longevity of everyone in their annuity pool. Since an individual's estimate of their own life is subject to significant error, they need a sizable cushion in reserve to cover the possibility that they may run short. This is a much easier task for insurers because they can use historic and predictive statistics of large population pools to determine, with significant accuracy, the *average* life expectancy of someone in their insurance pool. They don't need to be accurate with each individual. They just need to be accurate on average—a much easier task than that facing the individual predicting their own demise.

Saving less

The asset cushion, discussed above, to cover an unexpectedly long lifespan has potential benefits but also potential risks. First, a participant typically needs to save throughout their working years to accumulate that cushion, and then in retirement those assets are generally kept on reserve, thus often resulting in a lower spending level and living standard. Eliminating the need for a contingency cushion translates to reducing retirement savings ("Save Less") and increasing opportunities to use these assets more productively during working years or perhaps saving them more productively for retirement or estate-planning purposes.

The illustration below shows two hypothetical participants with hypothetical portfolios. At age 65, Participant #1 was able to have an initial retirement income of $40,000 by withdrawing 4% from their $1,000,000 accumulation. Participant #2 had the same $40,000 initial income from a much smaller accumulation because they annuitized their balance and the annuities paid out at an initial 6% rate.

Wealth and income at retirement for two hypothetical participants with identical allocations and returns in accumulation

Hypothetical Participant #1 **Mutual fund strategy**		Hypothetical Participant #2 **"Save Less" strategy**	
A balanced portfolio of *Bond and stock mutual funds*		*A balanced portfolio of* *Fixed and variable annuities*	
Monthly contribution in accumulation:	$1,000	Monthly contribution in accumulation:	$667
Wealth at retirement:	$1,000,000	Wealth at retirement:	$666,667
Mutual fund withdrawal rate:	*4%*	Annuity payout rate:	*6%*
Initial retirement income:	$40,000	Initial retirement income:	$40,000

Using an annuity-based "Save Less" approach in retirement is one way to potentially minimize contributions in accumulation without sacrificing retirement income. In our hypothetical example, this strategy frees up $333 per month ($1,000 versus $667) that would have otherwise been contributed to a retirement plan. Freeing this amount monthly might allow a participant to carry a higher mortgage balance, enabling them to buy the "move up" home initially instead of the "starter home." By doing so, our participant might potentially save tens of thousands of dollars in commissions, fees, moving and other costs that would have been incurred if they purchased a "starter home" and then a "move up" home a few years later. Alternatively, the $333 could be used to pay down or eliminate credit card balances, pay off student loans, help to fund children's higher educations or fund necessary home repairs or other critically needed items today.

In essence, the "Save Less" approach helps us to better balance lifetime expenditures by reducing or eliminating the need for the contingency cushion in retirement. By letting professionals "manage" our mortality through the use of annuities, we can potentially benefit from the economies of scale afforded to annuities in data and mortality analysis. This is somewhat similar to the way that we might benefit from a provider's economies of scale when we get our oil changed or have a package delivered. Dedicated, professional organizations can deliver goods and services more cheaply than we can do ourselves because of their specialization, expertise and volume-buying power. So the rationale for buying an annuity is really no different than the rationale behind most purchases. The purchased items can represent a better value for our dollars than trying to do it ourselves.

The employer's desire to "Save Less"

To this point in our paper, we've focused on the needs of individual participants, but employers too have pressing financial needs. Rising costs and reduced fundings are putting many employers in a bind. They may need to reduce staff levels, services, staff compensation and benefits, or take other measures to manage the gap between income and expenses.

The "Save Less" concept can also be useful for employers currently funding Defined Contribution (DC) plans. As we discussed earlier, a person saving for their own retirement needs to build a healthy financial cushion in the event that they live an unexpectedly long life. If they live to only an average life expectancy, the cushion becomes a surplus that can be passed to their estate. Since an employer is funding the plan, they are, in some respects, also funding participants' estates. For employers, this predicament is the necessary evil of DC plans because we leave mortality management to the novices—our individual participants. But if an employer funded plans with annuity strategies and encouraged or mandated annuitization in retirement, they could potentially reduce contributions by a substantial margin. Instead of accumulating in mutual funds then managing their own spending in retirement, participants could accumulate in annuity strategies and annuitize their accumulations at retirement for levels of income that could rival the income provided by systematic withdrawals from mutual funds with a much higher asset base.

If we think this approach through, it really is bringing the retirement experience full circle for many American employees. In the post-war era, the large corporate Defined Benefit (DB) plan was the gold standard for workers. Retirees in these plans received a regular monthly "paycheck in retirement" for as long as they or their spouse lived. In the 1980s, the DB plans began to rapidly disappear—replaced by DC plans—as their costs and balance sheet management became unsustainable. Unfortunately, DC plans put much of the management and some funding burden on participants, who were not equipped for this role. So, while participants were now able to actually own an asset base instead of a future promise of retirement income, they had to manage their DC asset base. This meant creating an income stream from these assets to generate the equivalent DB monthly check. That process involved many complex investment, legal, tax and actuarial decisions, and a significant increase in risk of running out of money for the participant. With annuitization in a DC plan at retirement, a participant enjoys all of the benefits of a DB plan at an individual level—a *personalized* DB plan. They can annuitize all or the majority of their assets for income and keep a small amount liquid, if they choose, for other expenses. And, they can tailor their retirement income to meet their own specific needs. For the plan sponsor, the use of fixed annuities in retirement means their participants will receive sustained income for life, and this income assurance would likely be delivered at a materially lower cost than could have been achieved through a traditional DC plan. Using variable annuities might also add significantly to income. But, their use will introduce market risks associated with those contracts that might jeopardize their ability to deliver safe, secure, or stable income in the same way that marketable investments are exposed to these same risks. An employer might not be able to "Save Less" by as much as we illustrated in the above graphic, but sizable reductions to employee contributions could be possible.

Conclusion

This paper illustrates some of the benefits of using annuities to deliver retirement income. In today's marketplace, too many people consider annuities to be akin to a mutual fund, but that is a real misunderstanding. Variable and fixed annuities provide valuable features, such as guaranteed lifetime income, that can't be replicated with investments like mutual funds. The value and power of these features are starting to become understood and appreciated as more and more Americans face the prospect of financially challenged retirements.

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[1] ShareCare, "How does my parents' lifespan affect my lifespan?" Dr. Michael Rozen, MD, November 21, 2018.

[2] Guaranteed are based on the claims-paying ability of the issuer. However, payments from variable annuities are not guaranteed and the payment amounts will rise or fall depending on investment returns.

[3] Journal of Financial Planning, October, 1994. "*Determining Withdrawal Rates Using Historical Data,*" William P. Bengen

Annuities are designed for retirement and other long-term goals. They offer several payment options, including lifetime income. If you choose to invest in the variable investment products, your money will also be subject to the risks associated with investing in securities, including loss of principal. Withdrawals of earnings from an annuity are subject to ordinary income tax plus a possible federal 10% penalty if you make a withdrawal before age 59½. The value of a variable annuity is subject to market fluctuations and investment risk so that, if withdrawn, it may be worth more or less than its original cost.

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