Hazards to Your Retirement
Market Environment, Programs and Resources

CAA Workshop – March 13, 2012

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Topics covered today

- Low return market environment
- Troubled government programs
- Longer lifespan requires additional resources
- Resources available from Society of Actuaries
- Withdrawal strategies during retirement
- Risks and considerations to withdrawal strategies
## US Federal Deficit As Percent Of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>US GDP</th>
<th>Deficit</th>
<th>pct GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>14,258</td>
<td>1,413</td>
<td>9.9</td>
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<tr>
<td>2010</td>
<td>14,508</td>
<td>1,294</td>
<td>8.9</td>
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<tr>
<td>2011</td>
<td>14,959</td>
<td>1,300</td>
<td>8.7</td>
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</table>
# Federal Gross Public Debt As Percent of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>US GDP</th>
<th>US Billion $</th>
<th>Gross</th>
<th>Public</th>
<th>Average</th>
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<tbody>
<tr>
<td>2008</td>
<td>14,441</td>
<td>14,441</td>
<td>9,986</td>
<td>69</td>
<td>253</td>
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<tr>
<td>2009</td>
<td>14,258</td>
<td>14,258</td>
<td>11,876</td>
<td>83</td>
<td>187</td>
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<tr>
<td>2010</td>
<td>14,508</td>
<td>14,508</td>
<td>13,529</td>
<td>93</td>
<td>196</td>
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<tr>
<td>2011</td>
<td>14,959</td>
<td>14,959</td>
<td>14,764</td>
<td>99</td>
<td>230</td>
</tr>
</tbody>
</table>
Federal Reserve Board
Monetizing Federal Deficit

$877 billion in US Treasuries bought by FRB in past two years

about doubling their US Treasury holdings.

(Feb 29, 2012 balance less Mar 3, 2010 balance)

Temporary measure that cannot be sustained over multi-year period.

http://www.federalreserve.gov/releases/h41/hist/h41hist3.txt
Federal Reserve Board
Monetizing Federal Deficit

Percent change at seasonally adjusted annual rates

<table>
<thead>
<tr>
<th>M1</th>
<th>M2</th>
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<tbody>
<tr>
<td>19.3%</td>
<td>10.2%</td>
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</table>


$9.8 Trillion M2 Money Supply, up 0.9 Trillion

In short run: creating money stimulates the economy

In long run: M2 growth rate > inflation plus real growth

Inflation concerns because of deficit spending and borrowing

US Treasury 5 Year = 0.83% annual yield (March 6, 2012) assumes AAA credit and Zero inflation
# List of Countries by Public Debt

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Debt</th>
<th>Notes</th>
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</thead>
<tbody>
<tr>
<td>Zimbabwe</td>
<td>231</td>
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<tr>
<td>Japan</td>
<td>208</td>
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<tr>
<td>Iceland</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Greece</td>
<td>116</td>
<td>160 before cram down</td>
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<tr>
<td>Portugal</td>
<td>110</td>
<td></td>
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<tr>
<td>Ireland</td>
<td>105</td>
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<tr>
<td>United States</td>
<td>102</td>
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</tr>
</tbody>
</table>
List of Countries by Public Debt

Method different than last year, includes Social Security Trust Fund and Federal Reserve Board US Treasury holdings.
Percent of Gross Domestic Product
2011 CIA and Eurostat estimates

Federal Spending: $3.80 trn
United States - FY 2012

- Defense: 24%
- Health: 22%
- Pensions: 22%
- Welfare: 12%
- Remainder: 20%
Possible Medicare and Social Security Changes

- Doctor and Hospital payments cut
- Newly invented procedures/drugs not covered
- Increasing Medicare premiums
- Increasing deductibles and copayments
- Soc Sec annual inflation adjustments trimmed back
Lower Immigration to US

- Immigration emerges as a prominent component in the calculation: 60% of the population increase in the United States between 1994 and 2050 will be attributable to immigration and the descendants of immigrants.

- From 2005 to 2009, the number of people entering the U.S. illegally declined by nearly 67%, according to the Pew Hispanic Center, from 850,000 yearly average in the early 2000s to 300,000
Positive Emerging Market Economies

- Chinese economy grew at average rate of 10% for 30 years
- Emerging Markets 2012 forecast 5.4% growth (IMF), down from 6.2% in 2011

  - “The emerging markets are at the front of the train but it is a slower-moving train” El-Erian, CEO, PIMCO

- Source Wall Street Journal, May 8, page A8
Challenges for Retirees

- 2000 to 2011 investment performance has been below most planning projections done at retiree retirement
- Some retirees are overspending their original retirement plan
- Some retirees resist reduced expectations and take higher investment risks (increased Beta).
- PT Barnum “A sucker is born every minute” applies also to retirees who want a home run with their investments
Successes for Retirees

- Some fiscally conservative retirees saved considerable money and spend at or below the “4%” suggested level and have the resources to live happily even in this “new normal” economy.
Are we planning for a long enough retirement?

- People are likely to live longer than they think
- Longevity is variable – averages can mislead
- Longevity is positively related to education and income
- Longevity is increasing
- Longevity is expensive
- Longevity is an insurable risk
We can’t plan for individual longevity

- If we plan for survival to 85, more than 50% of men and almost 60% of women will surprise us
- Even if we plan for survival to 95, we’ll underestimate lifespan for 13% of men and 20% of women
- On the other hand, 30% of men and 20% of women aged 65 won’t reach 80
Retirement planning requires...

- Contingency planning for shorter and longer lifespans
- Consider insurance solutions (annuitization)
- Ensuring that single surviving spouses have ample resources
  - E.g., maximum Social Security survivor benefits
  - Especially important for non-traditional couples
Improved Mortality

- There have been major unprecedented mortality improvements for humans in the 20\textsuperscript{th} century
  - First at younger ages
  - More recently at older ages
- Patterns are common across many countries
## US Life Expectancies

<table>
<thead>
<tr>
<th>Age and Year</th>
<th>All</th>
<th>Male</th>
<th>Female</th>
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<tbody>
<tr>
<td>At Birth</td>
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<tr>
<td>1900</td>
<td>47.3</td>
<td>46.3</td>
<td>48.3</td>
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<tr>
<td>2005</td>
<td>77.9</td>
<td>75.2</td>
<td>80.4</td>
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<tr>
<td>At 65 Years</td>
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<tr>
<td>1950</td>
<td>13.9</td>
<td>12.8</td>
<td>15.0</td>
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<tr>
<td>2005</td>
<td>18.7</td>
<td>17.2</td>
<td>20.0</td>
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<tr>
<td>At 75 Years</td>
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<tr>
<td>1980</td>
<td>10.4</td>
<td>8.8</td>
<td>11.5</td>
</tr>
<tr>
<td>2005</td>
<td>11.9</td>
<td>10.8</td>
<td>12.8</td>
</tr>
</tbody>
</table>
Why is longevity change important?

- Societal, employer, and employee choices about retirement and retirement age
- Helping individuals plan for themselves
- Understanding future of society – what public and private resources, goods and services will be needed and by whom
- Development of financial products and approaches
Thinking About Retirement?

- Considered as project for SOA Post-Retirement Needs and Risks Committee
- Addresses risk issues at or near time of retirement
- Committee found
  - Decisions complex and overlapping
  - Trade-offs involved
  - Some decisions are irrevocable, with high financial stakes
- Approach – “Decision Briefs” – short papers on each topic
Decision Briefs

- Topics:
  - Deciding when to retire
  - Dealing with unplanned early retirement
  - Special issues for women nearing retirement
  - Claiming Social Security
  - Methods of generating retirement income
  - Asset allocation
  - Decisions related to health insurance
  - Planning for long-term care financing
  - Housing considerations
  - Estate planning
  - How to find reliable financial advice
Thinking about the decisions: Can they be changed?

<table>
<thead>
<tr>
<th>Irrevocable</th>
<th>Can be changed</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Annuity purchase</td>
<td>• Housing decisions (but can be costly)</td>
</tr>
<tr>
<td>• DB plan elections</td>
<td>• Investment/asset mix</td>
</tr>
<tr>
<td>• Rollover into IRA</td>
<td>• Change long term care insurance – can be costly or difficult</td>
</tr>
<tr>
<td>• Retire from long-term employer</td>
<td>• Decision regarding working in retirement</td>
</tr>
<tr>
<td>• Buy into Continuing Care Retirement Community</td>
<td></td>
</tr>
</tbody>
</table>

Winslow Financial LLC  
Growing Fortunes Financial Partners, LLC  
Pebble Valley Wealth Management
Thinking about the decisions:
Timing Considerations

**Time constrained**
- Benefit elections when leaving employment
- Sign up for Medicare
- Insurance purchase – buy before losing insurability

**More flexible**
- Housing choices
- When to retire (usually)
- Asset allocation
Withdrawal Strategies During Retirement

- Draw upon savings to augment income from other sources
  - Social Security, company pension, part-time income

- The questions are easy: how long and what will assets earn
  - We know the answers are not – longevity and market volatility

- Rules of thumb provide same inflation-adjusted amount yearly

- Additional nuances to consider
  - Taxes - care about what is left to spend, not withdrawn
  - Portfolio strategy – income, total return, bucket segmentation
  - Variable amount needs – when Social Security starts? lump expenses
  - Tax management – withdraw if not need? Capital gains on rebalance
Withdrawal Strategies – How Long?

- Longer than life expectancy; know the mortality table source

### Table 1: Life Expectancy Ages

<table>
<thead>
<tr>
<th>Current Age</th>
<th>Males</th>
<th></th>
<th></th>
<th>Females</th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Social Security</td>
<td>Annuity 2000</td>
<td></td>
<td>Social Security</td>
<td>Annuity 2000</td>
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<tr>
<td>60</td>
<td>80.3</td>
<td>84.6</td>
<td></td>
<td>83.2</td>
<td>87.4</td>
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<td>65</td>
<td>81.5</td>
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<tr>
<td>70</td>
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<td>75</td>
<td>85.1</td>
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<td>87.0</td>
<td>89.9</td>
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<tr>
<td>80</td>
<td>87.4</td>
<td>90.2</td>
<td></td>
<td>88.9</td>
<td>91.3</td>
</tr>
</tbody>
</table>

- Source: “Spending Flexibility and Safe Withdrawal Rates”; SSA Table Finke, Pfau, Williams, *JFP*, Mar 2012
Withdrawal Strategies – Original Research

• “Determining Withdrawal Rates Using Historical Data”

• Source of “4% rule of thumb” plus additional insights
  - Sequence risk (3 periods); value of temporary reduced spending

• Used actual data with blends of US stocks and bonds over time
  - Base assumption of 50/50 allocation; up to 75% equities was attractive
  - Also consider inflation; ’73-’74 hit plans harder than ‘29-’31
Withdrawal Strategies – Original Research

- What does 4% withdrawal rate mean?
  - $4\% \times \text{Original Portfolio} \times (1 + \text{inflation}) = \text{Yr(1) $ Withdrawal}$
  - After withdraw end of year, rebalance to 50/50
  - Each year-end, grow last $ withdraw by inflation, withdraw, rebalance

- 3 Major Financial Events from study in grey
- Recent market updates in blue (note original study used calendar year data)

<table>
<thead>
<tr>
<th>Period</th>
<th>Total return common stocks</th>
<th>Total return inter-term bonds</th>
<th>Change in inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Big Bang&quot; (1973-1974)</td>
<td>-37.2%</td>
<td>10.6%</td>
<td>22.1%</td>
</tr>
<tr>
<td>&quot;Big Dipper&quot; (1937-1941)</td>
<td>-33.3%</td>
<td>16.7%</td>
<td>10.5%</td>
</tr>
<tr>
<td>&quot;Little Dipper&quot; (1929-1931)</td>
<td>-61.0%</td>
<td>10.5%</td>
<td>-15.8%</td>
</tr>
<tr>
<td>&quot;Great Recession&quot; (2008-2009)</td>
<td>-20.3%</td>
<td>11.5%</td>
<td>2.8%</td>
</tr>
<tr>
<td>&quot;Extremes&quot; (Oct '07 - Mar '09)</td>
<td>-55.0%</td>
<td>7.2%</td>
<td>2.0%</td>
</tr>
<tr>
<td>&quot;Great Recovery&quot; (Mar '09 - Mar '12)</td>
<td>115.8%</td>
<td>24.0%</td>
<td>6.9%</td>
</tr>
</tbody>
</table>

Source: Bengen; JFP Oct 1994
Source: PVWM Research; Morningstar Office; Barcap Agg for bonds
Withdrawal Strategies – Original Research

- 4% initial withdrawal assured 100% success of portfolio lasting for at least 33 years (many cases lasted 50 years or longer)


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### Table 2: Retirement Portfolio Success Rates by Withdrawal Rate, Portfolio Composition, and Payout Period in Which Withdrawals Are Adjusted for Inflation

<table>
<thead>
<tr>
<th>Payout Period</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
<th>11%</th>
<th>12%</th>
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<tbody>
<tr>
<td>100% Stocks</td>
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<td>15 Years</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>94%</td>
<td>86%</td>
<td>76%</td>
<td>71%</td>
<td>64%</td>
<td>51%</td>
<td>46%</td>
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<tr>
<td>20 Years</td>
<td>100%</td>
<td>100%</td>
<td>92%</td>
<td>80%</td>
<td>72%</td>
<td>65%</td>
<td>52%</td>
<td>45%</td>
<td>38%</td>
<td>25%</td>
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<tr>
<td>25 Years</td>
<td>100%</td>
<td>100%</td>
<td>88%</td>
<td>75%</td>
<td>63%</td>
<td>50%</td>
<td>42%</td>
<td>33%</td>
<td>27%</td>
<td>17%</td>
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<tr>
<td>30 Years</td>
<td>100%</td>
<td>98%</td>
<td>80%</td>
<td>62%</td>
<td>55%</td>
<td>44%</td>
<td>33%</td>
<td>27%</td>
<td>15%</td>
<td>5%</td>
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<tr>
<td>75% Stocks/25% Bonds</td>
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<td>15 Years</td>
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<td>87%</td>
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<td>30 Years</td>
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<td>50% Stocks/50% Bonds</td>
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<td>25% Stocks/75% Bonds</td>
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<td>84%</td>
<td>35%</td>
<td>22%</td>
<td>11%</td>
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Note: Data for stock returns are monthly total returns to the Standard & Poor’s 500 Index, and bond returns are total monthly returns to high-grade corporate bonds. Both sets of returns data are from January 1926 through December 2009 as published in the 2010 Ibbotson SSBClassic Yearbook by Morningstar. Inflation adjustments were calculated using annual values of the CPI-U as published by the U.S. Bureau of Labor Statistics at www.bls.gov.
Withdrawal Strategies—Predictive Rate Study

- **Preliminary research** but recent crisis shows 4% may not always work
- Don’t spend excess after good years
- Be flexible on spending after severe crisis
- Low actual inflation may help sustainable rate

Withdrawal Strategies – Additional Research

- Advances in modeling capability
  - Studies referenced so far used historic data from US stocks and bonds
  - Expand using Monte Carlo analysis and additional asset class data

- Market environment during early years of withdrawal critical
  - Near retirement, still large % of equity; interest rates when annuitizing

- Look at blending annuities with a portfolio, not “either/or”
  - Different types for different needs - immediate, longevity and variable

- Reflect individual’s risk tolerance and portfolio allocation
  - Different appetites for market volatility and “probability of success”
Withdrawal Strategies – Blend Annuities

- Annuitize a portion of portfolio to manage some risks
  - Rates currently low; balance waiting vs. current income need

- Portfolio + longevity annuity to manage mortality risk
  - Can answer “how long?” but left with market volatility

- Portfolio + immediate annuity for covering base expenses
  - Provide floor, absorb market risk through discretionary needs

- Variable annuity for managing mortality and investment risk
  - Understand features and costs
  - Lose liquidity and tax management flexibility
Withdrawal Strategies – Risk Tolerance

- Incorporate expected utility to capture trade-off of spending more early during retirement at risk of having to spend less later
  - Helps conceptual understanding but difficult to implement in practice

![Figure 3: Inflation-Adjusted Withdrawal Strategy to Maximize Certainty Equivalence for Same-Age Couple, Retirement Age 65, Guaranteed Income $20,000, Risk Aversion 1, Nest Egg $1,000,000](image1.png)

![Figure 4: Inflation-Adjusted Withdrawal Strategy to Maximize Certainty Equivalence for Same-Age Couple, Retirement Age 65, Guaranteed Income $20,000, Risk Aversion 4, Nest Egg $1,000,000](image2.png)

- Source: “Spending Flexibility and Safe Withdrawal Rates”; SSA Table
Withdrawal Strategies – Portfolio Mgt

- After target initial withdrawal rate, still need to manage assets
  - Start with diversified portfolio in all cases

- Income focused portfolio
  - Focus on assets with high coupons and dividends, not growth
  - Watch tax treatment of investment income based on security

- Total return focus and sell assets as need
  - Focus on best total return and liquidate as need
  - Watch capital gain and whether short- or long-term

- Hybrid of setting aside 2+ years of living needs and replenish
  - If market drop, don’t replenish until recover (Evensky approach)
Withdrawal Strategies - Show the Cash Flows

- Nuanced considerations – tax management and lump expenses
  - Withdraw “up to next tax bracket”; capital gains tax for lump expenses

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Conclusions

- Fiscal situation will impact government programs
- Recent market environment challenging retirement plans
- Living longer raises questions about retirement that advisors and Society of Actuaries can help answer
- Traditional rules of thumb on withdrawals need to be understood and monitored
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