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10 Planning Issues When Considering Retirement

In 2011 the Baby Boom generation started turning 65 at a rate of 10,000 people per day and will continue to do so until 2030 (at which time roughly 18% of US citizens will be 65 or older). This represents a meaningful percentage of the population for which considering retirement is becoming a reality as opposed to looming on the distant horizon.

In response, we have identified 10 issues to focus on when planning for financial well-being in retirement. There are certainly more than ten issues to consider, but we believe this is a good starting point for people nearing retirement, as well as those with working years still left to plan.

1. Life Expectancy

Life expectancy, while often unknown, affects many aspects of retirement planning. The standard retirement age of 65 was set in 1935, based upon the German retirement system. At the time, retirement was not what it is now – the average U.S. life expectancy was 61.2. The standard age is still 65 today despite the fact that life expectancy is significantly higher (78.7 in 2010).

Our standard suggestion is to plan for a life expectancy of 90 (a 25 year retirement for those retiring at 65), but this should be used as a basic starting point. Family history, life-style and health history can be important factors that influence life expectancy and should be considered when making decisions such as: when to retire, expected budget for health & nursing costs, how much savings to accumulate, when to claim Social Security, among others.

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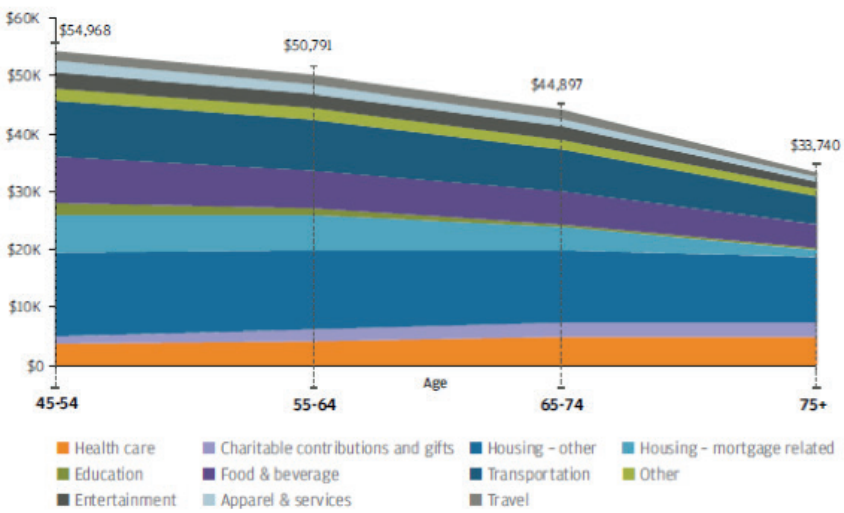
Sources: http://www.pewresearch.org/daily-number/baby-boomers-retire/
U.S. Centers for Disease Control, Health, United States, 2012, www.cdc.gov/nchs/data/hus/hus11.pdf#022
National Center for Health Statistics, National Vital Statistics Reports. Web: www.cdc.gov/nchs.

2. Budgeting

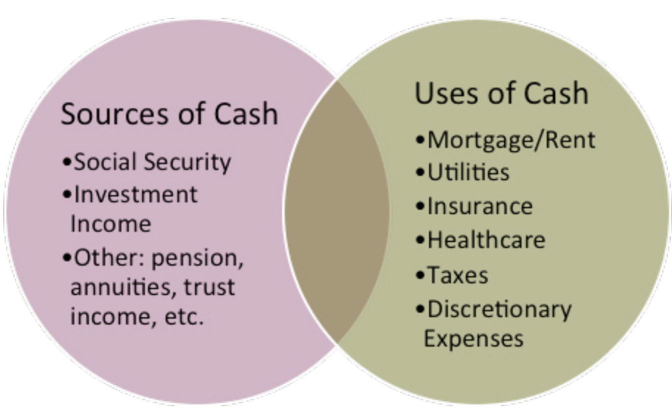
For many, the greatest risk to manage during retirement is excessive spending, yet this is the variable retirees can control the most. Typically, one's spending allocation shifts over time, as the graph below shows, with living expenses declining for housing and transportation and rising for health care costs as the need for medical care increases with age.

Spending patterns by various groups



Source: J.P. Morgan Asset Management. Estimates based on average consumer expenditure from the 2013 Consumer Expenditure Survey (BLS) for each age group excluding pension contributions. Average household size for age 45-54 is 2.7; age 55-64 is 2.1; age 65-74 is 1.9 and age 75+ is 1.6.

Overall spending often declines in the latter stages of retirement with the exception of unforeseen circumstances. As with anything, individual circumstances (inheritance, genetics, spousal age differences, health care needs, etc.) will drive adjustments to your budget.



In determining a retirement budget, it is important to start by identifying your sources and uses of cash. Your sources of cash might include Social Security, pension income, and/or portfolio withdrawal (both income and principal). Your uses of cash include your fixed expenses (mortgage payments, utilities, insurance, healthcare, taxes, etc.) plus your discretionary and lifestyle expenses. In retirement, your sources of cash will no longer include your salary, so tallying up your replacement sources is imperative. It is not always necessary to replace 100% of your current earned income, but your sources of cash must be sufficient to cover your uses of cash. Linked below is our budgeting spreadsheet to help identify both your sources and uses of cash in retirement.

A key component of retirement budgeting is keeping your fixed expenses at a modest percentage of your total uses of cash, thus allowing greater flexibility in your retirement spending. For example, many retirees struggle because they carry large mortgage debt into retirement. Consider your financial priorities (e.g. large house with mortgage or more lifestyle spending in retirement) and understand the financial tradeoffs when making your decisions. If retiring early is a priority, adjustments to your budget may be necessary.

Click here for our budgeting spreadsheet.

3. Saving

With traditional pension plans fading away and Social Security funding under pressure, more and more of the financial responsibility to save for retirement lies with you. Funding retirement begins with saving. How much you must save each year is dependent on several factors: the duration of your retirement, how much you plan to spend in retirement, and how many years you have before retirement.

Retirement duration plays an important role in the amount you must save for retirement. The longer your retirement duration, the more you must accumulate to provide for you over that extended period of time.

Another factor is how much you plan to spend. Many people ask how much they can reasonably spend each year from their portfolios in retirement. A common rule is that, over a 25 year period, a reasonable annual withdrawal is 4% (principal and income combined) of your retirement-year portfolio value. For a $1.2MM portfolio, the initial annual 4% spending amount would be $48,000. Use this 4% rule as a guide when determining all of your sources of cash in retirement.

Saving continued

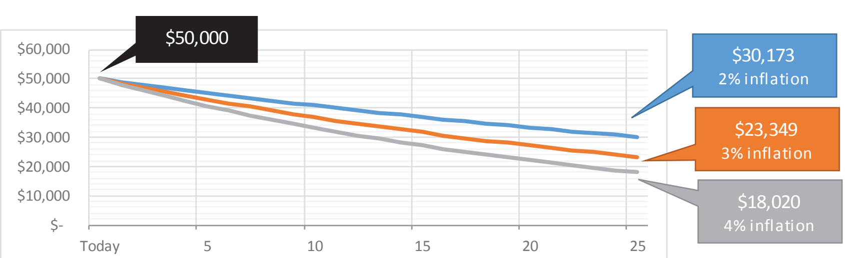
You can use the 4% rule to help set a goal for your portfolio's value at retirement by subtracting your yearly estimated non-portfolio sources of cash from your total uses of cash to determine your yearly portfolio need, and then dividing this amount by 0.04. For example: $75,000 total uses of cash minus $27,000 in non-portfolio sources of cash (e.g. Social Security) equals $48,000 of portfolio need, divided by 0.04 equals $1.2MM of necessary savings.

The next factor to address is how much time you have before retiring. The amount of time you have is important as investment returns compound over time. When you choose to start saving/investing will have a tremendous impact on achieving your savings goal. For example, a 30 year old who begins saving $10,000/year, generating a 6% annual return, with plans to retire at age 65, will accumulate approximately $1.2MM at retirement. Comparatively if he or she does not begin saving until age 40, he or she must double the savings rate to $20,000/year to attain $1.2MM at age 65. A 50 year old must save $47,000/year to achieve the same results! (Note that bonds are unlikely to provide a 6% rate of return given current low yields.)

4. Inflation

Inflation affects the costs of goods in the future. It also reduces the purchasing power of fixed income sources such as pensions, fixed annuities, or long term care policies that do not have inflation riders. A budget needs to account for increasing expenses as a result of inflation throughout retirement, particularly as it relates to real estate costs, food, medical expenses, energy and utilities. Even modest rates of inflation over time can have a sizable impact on your financial well-being. The graph below illustrates the effect different inflation rates (2%, 3% and 4%) have on the purchasing power of a fixed income of $50,000 over a 25-year period.

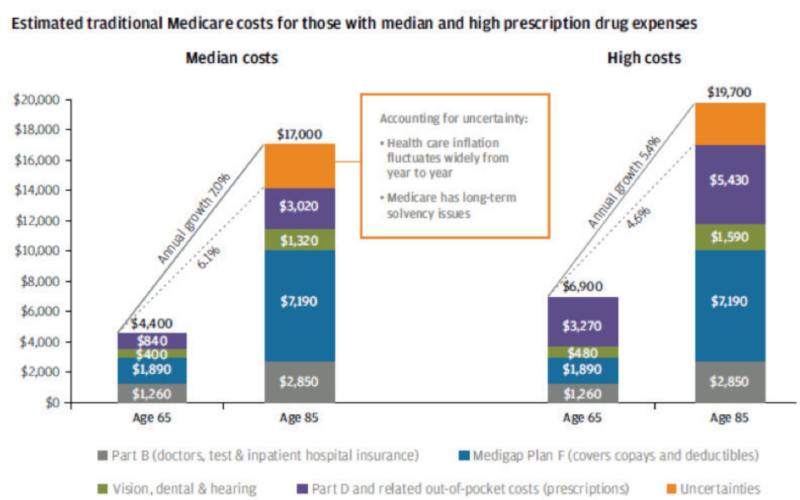
With 2% inflation, your purchasing power is reduced to approximately 60% or $30,173, with 3% inflation: 46% or $23,349, and with 4% inflation: 36% or $18,020.



Proper consideration needs to be given to account for rising prices over the course of retirement. Social Security, at best, will keep up with inflation. Fixed income sources may provide stability to your cash flows in the short term, but they will almost certainly reduce your standard of living over the long term simply due to inflation. It is critical to have other resources that can offset this inflation risk, such as stocks that pay not just dividends, but dividends that rise over time.

5. Health Care Costs

Health care is the budget line item that is most likely to increase over your lifetime at a rate higher than inflation. Medicare Part B, Medigap Plan F, vision, dental, hearing, nursing care and other uncertainties comprise the various health care costs in retirement. For retirees, median health care costs have increased nearly 7% per year. It is estimated that over the course of retirement a couple should reasonably expect to spend between $220,000 and $250,000 just for health care expenses.



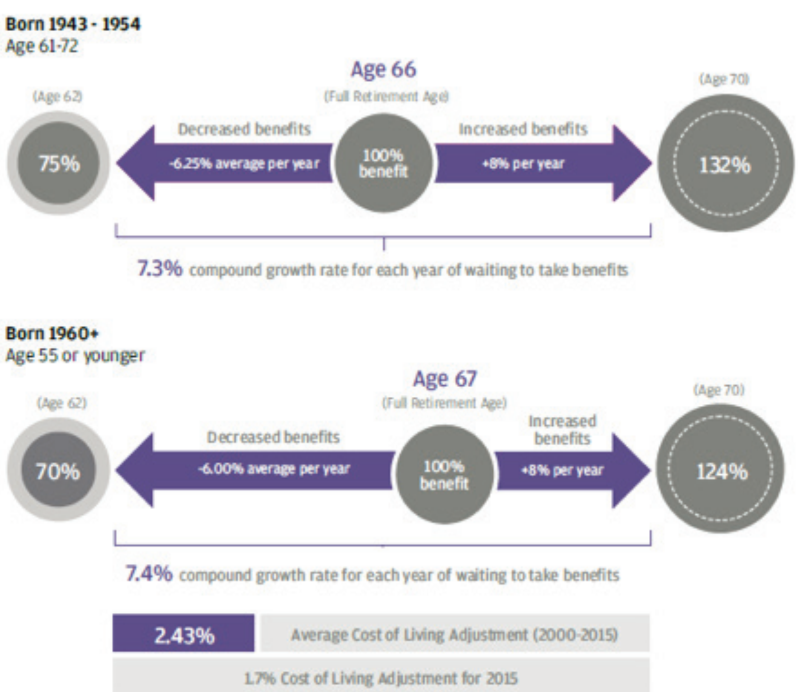
Source: J.P. Morgan Asset Management; Employee Benefit Research Institute (EBRI), data as of December 31, 2014. SelectQuote data as of December 31, 2014; Consumer Expenditure Survey data 1984-2014; Kaiser Family Foundation "Medicare Part D in its Ninth Year: The 2014 Marketplace and Key Trends, 2006-2014." J.P. Morgan analysis.

For those with greater healthcare needs, a larger reserve will be required to cover the added costs or they will be forced to reduce their discretionary expenditures. Advances in medical technology and delivery may stem the rising tide of costs, but the demographic pressure of the retiring baby boom generation may more than offset such benefits. We suggest hoping for the best but planning for the worst.

6. Social Security

Social Security is a governmental income benefit that can be claimed at different ages assuming you have worked long enough to qualify for benefits. Your earnings record determines your benefit amount at your 'full retirement age' (previously 65, but now between 66 and 67 years of age depending on the year you were born). The system is designed as a 'pay as you go' system, meaning the funds collected now are used to fund current distributions rather than being set aside in a trust account for the future. Therefore, if you only collect benefits for a short period of time, there is nothing for your heirs to inherit.

The Social Security Administration allows participants to claim their benefits early (age 62) but at a reduced level. They also allow you to defer receiving payments beyond full retirement age until up to age 70 to receive a higher benefit. The graph below illustrates the decrease in benefits (-6% per year) for claiming early versus the increase in benefits (+8% per year) for delaying your claim.



Source: J.P. Morgan Asset Management, Social Security Administration, For illustrative purposes only. For 1955 - 1960, two months are added to the Full Retirement Age each year.

The right time to claim Social Security will depend on your life expectancy. The cost benefit analysis* of when to claim Social Security suggests that if you die prior to age 84, claiming at age 62 is the best option, but living beyond age 86 makes claiming at age 70 best. It is important to note that if you wait until age 70 to collect benefits, you will likely need to fill your spending gap by drawing down your portfolio, which could otherwise be left to your heirs.

Social Security also provides spousal benefits for those that have an insufficient earning history to claim on their own work record. A spouse has the benefit of receiving the greater of his or her own retirement benefit or one-half of his or her spouse's benefit. This applies to ex-spouses as well, provided that the marriage lasted at least 10 years and the claiming ex-spouse remains unmarried. Spousal benefits are reduced if taken before the spouse's full retirement age but there is no credit for delaying benefits beyond full retirement age.

For married couples, there are many strategies for claiming Social Security benefits. A few factors to consider include amount and timing of spousal benefit, differences in retirement dates, and whether there is a meaningful age difference between spouses. The most effective strategy for a couple is highly dependent on their specific situation, nevertheless, it is important to understand the tradeoffs of receiving benefits early versus delaying benefits, as well as maximizing the benefit available to you and your spouse.

*Breakeven calculated using the Social Security Administration calculator for beginning values at each age. Assumes maximum benefits are received for individuals turning 62 and 1 month, 66 and 70 in 2015 and assumes the benefit will increase each year based on the Social Security Administration 2014 Trustee's Report "intermediate" estimates (starting at 1.7% in 2015 and gradually rising to 2.7% in 2020). Monthly amounts without the cost of living adjustments (not shown on the chart) are: $2,014 at age 62; $2,713 at age 66; and $3,606 at age 70.
Source: J.P. Morgan Asset Management.

7. Long Term Care

Long term care insurance (LTC) is an insurance policy designed to hedge against the risk of an extended nursing care stay that could meaningfully deplete your assets. Generally for a policy to provide coverage, an individual must require assistance with two or more of the six activities of daily living, or ADLs (eating, bathing, dressing, toileting, transferring and caring for incontinence). Underwriting standards and policy terms vary by insurance company but a policy should include the following elements: a specified benefit period, a waiting period before benefits begin, a maximum benefit pool, and an inflation rider. The average time for nursing care is approximately three years, so a LTC policy ought to cover at least this period of time.

Premiums for LTC policies have been on the rise due to demographic pressures, higher usage rates, cost of care for cognitive impairment, and lower cancellation rates. Considering whether to obtain such coverage depends on your available assets (the ability to self-insure) and also requires assessing the tradeoffs between the policy costs (i.e. the premiums) versus the probability of needing such care.

8. Income Tax Planning

You might assume that your income tax bill would go down in retirement because you will be no longer earning income, but that is not always the case. Taxes are dependent on individual circumstances and the particulars of a complex tax code, so we defer to your accountant as to the best way to manage your tax exposure. Nevertheless, it is important to know what is taxed as ordinary income versus what is taxed at a lower rate. Distributions from retirement accounts (e.g. 401(k)s, 403(b)s, IRAs, etc.), pensions, short-term capital gains (gains from the sale of an asset held for 1 year or less), interest income and non-qualified dividends are taxed using ordinary income tax rates. Conversely, long-term capital gains (gains from the sale of an asset held for more than 1 year) and qualified dividends benefit from a preferred, lower tax rate.

With most retirement accounts, contributions receive a tax deduction and assets benefit from deferred gains/income tax during the accumulation phase, but, upon withdrawal (as early as 59 ½ but required at age 70 ½), the full amount withdrawn is taxed using ordinary income tax rates. Additionally, distributions from retirement accounts prior to age 59 ½ are generally subject to a 10% penalty on top of the tax liability.

Since retirement plan distributions are fully taxable, it is important to maintain some balance between retirement plan assets and those held outside of such plans for more tax planning flexibility. If the majority of your portfolio is in a tax deferred retirement account, taxes will become a large, fixed expense in your retirement budget. Work with your accountant to ensure you are planning accordingly as generalizations do not apply here.

9. Portfolio Construction

Conventional wisdom states that you should shift your portfolio as retirement draws near so that your cash and bond allocation account for the majority of your portfolio. With retirement often lasting 20-30 years, inflation increases the cost of food, energy and healthcare, significantly impacting quality of life. While cash and bonds provide short-term stability, they do little to protect you from inflation. Stocks, while offering little stability in the short-term, are better suited to hedge against the longer term inflation risk since stocks often provide growth of principal and growth of dividend income.

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In retirement, it is important to adjust your asset allocation according to your financial needs rather than your age. We advise having sufficient cash and short-term bonds to fund short-term needs (0-2 years) and intermediate-term bonds to cover intermediate-term needs (3-7 years). Long-term assets, such as stocks and real estate, are better suited to fund longer term cash needs (beyond 7 years). While there are no guarantees, seven years should be sufficient time to allow the stock market to go through its short-term cycles. Approaching your allocation in this way creates a unique portfolio, more appropriate for meeting your retirement needs than subscribing to general rules of thumb.

10. Emotional Investing

History and studies repeatedly prove that it pays to stay invested in the market, the disciplined investor benefiting from long-term growth potential. When it comes to investing, oftentimes we are our own worst enemy. As emotional creatures, humans are often driven by fear and greed when making investment decisions, particularly at market peaks and troughs.

The 2015 Dalbar study* on investor behavior shows that over the past twenty years the average equity fund investor underperformed the S&P 500 by over 4% per year. While some of this is explained by the average fund trailing the market, most of the difference is explained by investors buying at too high a price during market peaks (out of greed) or selling too low during troughs (due to fear).

Consider $1 invested in 1970 in the MSCI World Index with no changes made to the investment. Keep in mind that during this 44-year time period, there were significant painful events – the oil embargo and stagflation of the 70's, income tax rate increases and Black Monday in the 80's, the dot com stock crash, 9/11 terrorist attacks, the banking crisis of 2008 and the downgrade of U.S. credit rating. Despite all these events, that dollar would be worth $45. The lesson here is that markets bounce back after troubling times. Exiting the market when scared and moving to cash only to re-enter once you feel better often leaves you at a disadvantage; it is unlikely that you will feel better until recovery is well under way and values are higher than when you sold. It is far better to develop and adhere to a sound investment strategy based on your needs through a properly constructed portfolio (as explained in item #9) than try to outsmart everyone else.

*http://www.advisorperspectives.com/commentaries/20150408-streettalk-live-dalbar-why-investors-suck-and-tips-for-advisors

Conclusion

We could dedicate an entire newsletter to each of the items discussed and still not give it full and proper consideration. Our objective is to bring to light many of the important issues for individuals to consider while planning for their own retirement. There is no one size fits all approach to retirement planning, so it is imperative that you evaluate your particular circumstances and objectives when deciding how to address each of these issues.

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