Planning for a 30-Year Retirement

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–By Helen Modly, CFP, and Sandra Atkins, CPA/PFS

Funding a 30-year retirement will take financial planning prowess as you juggle the effects of inflation, distributions, taxes, asset allocation, and expenditures. Are you up to the task?

George Forman, the boxer-turned-spokesman for portable grills, may have best summed up the retirement conundrum facing baby boomers: “The question isn’t at what age I want to retire; it’s at what income.” The amount you’ll need each year to maintain your desired standard of living is the most critical variable to identify in the retirement planning process. No rule of thumb will suffice.

If you are like many boomers, your spending will not drop significantly at retirement. In the beginning, you’ll be fulfilling the many dreams and desires you postponed during your career and child-rearing years. Later on, the cost of health care will become a significant factor in determining your income needs.

How long will you need it?

Longevity is perhaps the greatest challenge for boomer retirement planning. Most boomers seriously underestimate their life expectancy. Perhaps this is due to a misunderstanding of what mortality age really means. In fact, half the population will outlive their life expectancy.

When the mortality table tells us that a 65-year-old man has a mortality age of 82, it means that half of all men who are 65 today will die before age 82, and the other half will still be alive. The mortality tables also include the entire population, not just those who receive the level of nutrition and health care that you probably enjoy.

Another frequent misunderstanding about mortality age is the statistical increase in mortality age that occurs when calculating joint mortality. A male age 65 has a 50% chance of living to age 82. A female age 65 has a 50% chance of living to 85, but as a couple, they have a 50% chance of one of them living to age 92. In fact, as a couple, they have a 25% chance that one of them will still be alive at age 97. A worker retiring early at age 55 may need to generate more than 50 years of retirement income. This is the basis for the new definition of long-range planning.

The double bite of inflation

The increased longevity that boomers can expect contributes to the serious risk of inflation, which is the long-term tendency for money to lose purchasing power. This has two negative effects on retirement income planning. It increases the future costs of goods and services that retirees must buy, and it potentially erodes the value of their savings and investments set aside to meet those expenses. Even at a modest inflation assumption of 3% annually, the effects of inflation over a half century of retirement could be devastating.

In prior generations, inflation was not such a worry, since retirees were not expected to live much more than five or 10 years past the age of 65. In fact, when the Social Security retirement age of 65 was enacted in 1935, the average mortality age for a man was 64.

The planning process

Explore any and all sources of guaranteed income available when retirement begins. Social Security, pensions, and any other income sources must be quantified as to how much, from what source, and for how long. Pay careful attention to whether benefits index with inflation or continue to a surviving spouse, since survivor planning is an important part of retirement income planning. Develop three cash-flow models — both spouses living, husband dies, wife dies — to identify any gaps in cash flow that need to be addressed by additional savings or insurance.

Next, inventory all assets that will be used to generate retirement income. This is where the traditional financial planning tools are needed to project future values and income streams from various types of assets. Be alert to the differences in taxation during distribution among various types of assets. Retirement accounts will generate less spendable income than investment accounts, because of the taxes due on distributions from retirement plans.

Be cautious about considering your primary residence as an investment asset. You may be thinking of downsizing later, but experience tells us that people are often reluctant to leave a familiar home in their advanced age. Be zip-code flexible when making your retirement plans. Many areas of the country have low to no income tax, and there can be significant differences in the cost of housing and health care.

The risks involved

Health insurance, disability insurance, life insurance, and long-term care insurance should also be evaluated as part of any retirement plan. These policies can be expensive, and some of them may not be necessary if you have significant assets. However, they can provide an important safety net in the absence of such assets, so ask your advisor to review your insurance needs.

If you work in a professional field, litigation is a very real risk to your retirement assets, and professional liability insurance is a must. Divorce is another landmine that can blow up even the best retirement plans, but to date there is no insurance policy available to reduce this risk other than a well-drafted prenuptial agreement.

Asset allocation: Between a rock and a hard place

The double whammy of longevity and inflation creates an asset allocation dilemma for boomers. The old adage of subtracting a person's age from 100 to obtain the optimal percentage of equities just doesn't hold for a five-decade retirement portfolio. Invest too conservatively, and your money may not grow enough to last your lifetime considering the erosion of long-term inflation. Invest too aggressively, and you run the increasing risk of outright capital loss without adding significant years to your plan under average market conditions.

Working with your advisor, determine an appropriate exposure to equities, then design an allocation within those equities to ensure meaningful diversification among asset classes and investment styles. Cash and fixed income will play a larger role in retirement portfolios, since provisions must be made for the orderly withdrawal of assets.

Have your advisor set up regular portfolio transfers to your bank account to enable you to manage your income just as you did when paychecks were funding your expenses. This tends to dampen overspending by imposing some discipline on the withdrawal process. Otherwise the portfolio could easily become an ATM machine.

Setting a realistic withdrawal rate

Most of the evidence seems to point to 4% as being about right for a sustainable withdrawal rate for decades of retirement.

The withdrawal rate is the one variable over which you have the most control — not your mortality, not your health, not your investment returns, not inflation — just your withdrawal rate. You must understand that this is the lever you will need to pull when things don't go as planned. Being realistic about what you can spend and keeping a sufficient contingency reserve fund will ease the pressure that withdrawals put on retirement portfolios.

The challenges facing boomer retirees are significant, but not insurmountable with some realistic and prudent planning. You will need to consider what you own, what you owe, what you will make, and where it will go in order to develop a workable retirement income plan.

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