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The Art of Managing Retirement Assumptions

By Elaine Floyd, CFP®

A retirement plan is built on a set of assumptions that can't be validated until it's too late. One key to successful retirement planning is carefully setting assumptions and revising them often.

Retirement calculators make it so easy. Pick a retirement date. Estimate your living expenses in retirement and choose an inflation rate. Figure out a rate of return for your investments. Guess how long you think you'll live. Put these assumptions into the calculator, and it will tell you just how much you need to have at retirement in order to receive the income stream you desire.

The problem is your assumptions could be off. And if they're off by just a little, they could skew the result by a significant amount over your remaining life. Consider this:

- The difference between a 5% and a 6% return on a $1 million portfolio over 30 years is more than $1.5 million ($4,467,744 vs. $6,022,575).
- If you have annual living expenses of $60,000 now, in 30 years you'll need an annual income of $147,410 if inflation averages 3%, but just $109,272 if it averages 2%—a difference of over $38,000 in just one year.
- If a portfolio withdrawal rate is set to last to age 90 and you make it to your 91st birthday, the plan failed.

You can't do retirement projections without making some assumptions. But most of the self-help tools out there make assumption-setting seem too easy. Some even have default settings, which imply that the metric in question—a 3% inflation rate, for example—is what any reasonable person would choose. To change it would be to go against the conventional wisdom, a scary proposition for anyone who isn't even sure what the inflation rate is based on.

According to a research report by LIMRA and the Society of Actuaries, major gaps exist in the public's understanding of retirement preparation.

For example, people often:

- **Underestimate retirement spending.** Most people have not tried to estimate how much money they will need for retirement. Those who have calculated this amount often underestimate what they will need to maintain their pre-retirement lifestyle in retirement.
- **Don't plan for contingencies.** Many workers will retire before they expect to because of disability, job loss, or the need to care for a spouse, parents, or other family members.
- **Underestimate health care.** Many people underestimate their chances of needing longterm care.
- **Take the cash.** Although people find guaranteed lifetime income attractive, they usually choose to receive retirement plan benefits in a lump sum, failing to recognize the difficulty of self-insuring longevity.
- **Fail to explore investment options.** Many workers misunderstand investment returns and how investment vehicles work.
- **Underestimate income.** Workers misunderstand what their primary sources of income will be in retirement, and may be disappointed when trying to live on the income available to them.
- **Don't seek help.** A significant number of retirees and pre-retirees do not seek help, yet they indicate a strong desire to work with a qualified professional.

Here are some things you can do to get ready for retirement:

- **Establish initial assumptions that are as accurate as possible.** This requires considerable knowledge and judgment—the opposite of "pick a number." Get some help.
- **Revise the assumptions going forward to keep the plan on track.** As new information comes in and the plan plays out, the original assumptions may need to be changed and the plan revised accordingly.
- **Get help.** Professionals are experienced in setting assumptions and can help you set reasonable assumptions for your particular plan.

Consider the following issues when discussing assumptions with your financial professional.

REASONABLENESS OF THE ASSUMPTION

This is one of the main challenges for people doing retirement planning on their own: they simply don't know what is reasonable, especially when it comes to financial matters. Is it reasonable to expect a consistent annual 6% rate of return over the next 30 years? Is a 3% inflation rate realistic if the mortgage is paid off and the bulk of your spending in retirement is on food, energy, travel, and health care? Are tax rates likely to go up, down, or stay the same?

POTENTIAL CONSEQUENCES IF YOU'RE WRONG

Some assumptions carry such drastic consequences if they are wrong that it influences how the assumption is set to begin with. Outliving one's life expectancy is just about the worst, because by the time you find it out, it's too late to do anything about it. This is why most professionals recommend a life expectancy of 90 to 100 years rather than the average life expectancy past which half of all people will live. Underestimating health care needs can be another disastrous assumption.

THE INTERPLAY OF MULTIPLE ASSUMPTIONS

Some assumptions impact one another. For example, retirement age and life expectancy determine how many years you have left to save and how long the portfolio must last in retirement. By extending one, you shorten the other, and vice versa.

Two other assumptions that impact one another are estimated expenses and life expectancy: the longer the withdrawal period, the less annual income you may receive, and vice versa—unless you adjust something else, such as the expected rate of return. The permutations are endless and may be one reason people get bogged down with retirement planning.

A NATURAL SHIFT IN ASSUMPTIONS AS THE PLAN AGES

Complicating retirement planning further, but potentially increasing its accuracy, is the idea that one set of assumptions may apply in the beginning, while another set may apply when you reach certain milestones.

To begin with, it seems that the overall inflation rate for older Americans is higher than for the general population. The CPI-E, an experimental inflation index for Americans 62 years of age or older, show that prices for the things older Americans spend money on—primarily health care and leisure—are rising by more than the general inflation rate.

In addition, older Americans generally vary their spending throughout retirement. Two mistakes many retirement plans make, says Dr. Somnath Basu, program director of financial planning at the California Lutheran University, are assuming that all living expenses will increase at the overall rate of inflation as measured by the CPI, and bundling expenses together over a person's retirement.

Basu created an age-banded model that assumes an individual will experience a lifestyle change every 10 years—at 65, 75, and 85—causing a change in the mix of leisure, health care, and ordinary living expenses.

Since the inflation rate for each area of spending will vary, each age band will have its own set of projected expenses. Typically, for example, the travel budget (and the inflation rate applied to travel expenses) declines when people enter their 80s. However, this is offset by an increase in health care expenses, which may carry a different inflation expectation.

When planning your retirement, visualize your life all the way through and establish appropriate assumptions for each phase, including a final phase that may require several years of living assistance or nursing care.

COLLABORATE WITH YOUR FINANCIAL PROFESSIONAL

You and your financial professional each have information and insights that can increase the accuracy of assumptions. Your professional's understanding of the markets and the economy, his experience with clients who are already retired, and his number crunching ability can give you a professional advantage over web-based retirement calculators designed for individuals to use on their own.

At the same time, you have information that may influence the assumptions that should be used. For example, you may decide to shorten or extend the life expectancy assumption based on what you know about your particular family history, health status, and lifestyle.

Another important factor is your willingness to revise your goals if one or more of the major retirement risks should threaten to play out. Ask yourself if you would be willing to work longer (or go back to work if already retired) or lower your standard of living in order to either save more now or reduce expenses in retirement. The less willing you are to revise your goals, the more conservative the assumptions need to be.

Elaine Floyd, CFP® is Director of Retirement and Life Planning for Horsesmouth, LLC, where she helps people understand the practical and technical aspects of retirement income planning.