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Protect Your Nest Egg

THE MISTAKES PEOPLE MAKE WITH THEIR RETIREMENT SAVINGS

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1. Introduction

"We should all be concerned about the future because we will have to spend the rest of our lives there."
Charles Francis Kettering, 1949

The future that will be your destiny will turn most contemporary retirement plans upside down. It reminds me of what John Lennon once said: "Life is what happens to you, while you were making other plans."

Ten years ago when I entered the field of political strategic planning I was doing graduate studies on the work of the French futures scientist Bertrand de Jouvenel. The title of his seminal work "The Art of Conjecture" contended that predicting the future is not a pure science, it is an art. There is a creativity and intuition involved when trying to predict the future. This being said, it does not mean that my endeavor here to predict your retirement future is devoid of science! On the contrary – the only way to project a possible future is to look to the past and identify historical trends.

I have consulted various sources and studies by some of the most prominent financial planners and specialists in the nation, including a study done by the Wall Street Journal[1], as well as well-known planner Michael Stein's book "The Prosperous Retirement: Guide to the new reality."

Based on these studies one can identify six very important ways in which the retirement in the future will differ from retirement in the past, and this is the retirement you all are facing or living: [2]

1. Retirees will live a long and active life in retirement.
2. The extended retirement will be divided into an active and passive phase.
3. The cost of the retirement life-style will be similar to the cost of the pre-retirement life-style.
4. Inflation will increase the need for income by two or three times during retirement.
5. The income sources for this new kind of retirement are different from the sources that were available to earlier retirees.
6. Taxes, estate planning, and insurance have become vital parts of the retirement planning process.

[1] "Cracks in the Nest Egg – A look at the biggest mistakes investors are making with their retirement savings." October 22, 2001. The Wall Street Journal. Dow Jones & Company. I want to credit The Wall Street Journal for the title of my paper. My list of mistakes has some similarities to the article; however, I have reanalyzed the original article. My main thesis has a different emphasis than the article.
[2] As identified by Michael Stein in his book "The Prosperous Retirement: Guide to the new reality."

The mistakes I have identified and which I will discuss are based on this new retirement paradigm.

2. Underestimating life expectancy

"Lord, make me to know mine end, and the measure of my days, what it is; let me know how short-lived I am."
King David of Israel - Psalm 39:5

The biggest mistake people, as well as financial advisors, make with regard to retirement planning is underestimating life expectancy. The other mistakes I identify is the result from this first fundamental mistake.

We all know death is an integral part of life, but few of us deal with that knowledge in a very useful way. The main reason for this is that death is unpredictable. However, with a population the size of the United States one can, over time, identify statistical probabilities.

Life expectancy at birth in 1900 was 49.2 years!! In other words there were more than a 50 percent probability that if you were born in little ole Eugene, Oregon at the turn of the century you would not live to see retirement. Infant mortality was a huge hurdle in those days, so if you just survived your first year your life expectancy jumped to 55.2 years.

According to life expectancy tables from the Department of Labor if you were born in 1950 your life expectancy was 68.07 years. I was born in 1970, and if I were born in the US my life expectancy at birth would have been 70.75 years. In 1993 a person's life expectancy at birth was 75.5; but if you turned 65 in 1993 you were expected to live to 82.3.

If we analyze the increases made in life expectancy, it is short of amazing that more than half of the longevity increase for older Americans occurred in the last 30 years! Moreover, this trend seems to be accelerating.

Over the last 90 years, longevity has increased an average of about half a percent per year. In the last 33 years, the increase averaged close to 1 percent per year. If the trend continues over the next couple of decades the remaining life expectancy of a 65-year-old could increase by about 25 – 30 percent.

This trend of increasing longevity obscures an important aspect of the statistics. If you are retiring at age 65 with a statistical life expectancy of 17 years there is a 50 percent probability that you will live longer than 17 years! In fact, if you investigate the probabilities within these statistics closer, 20 percent of the 65-year-olds will live beyond age 90.

The trend is obvious: life expectancy is not static, it is continually increasing.

There are also ample preliminary indications that we are moving from a surgical and pharmaceutical approach in addressing health problems, to a genetic model which can have a significant impact on your life expectancy.

For most retirees the result of this dramatic increase in life expectancy is they are being caught in the so-called "longevity-gap" regarding their retirement income.

Living longer than expected and planned for means you run out of money. The time between running out of retirement income and your death is the longevity-gap. Your children will refer to it as the "mom-and-dad-are-moving-in-and-they-are-broke" gap!

You might argue social security will provide until you die. Will it, and to what degree? Due to the dramatic increases in life expectancy, and the expected future increases, the US population is aging. The higher the proportion of retirees to active workers in the labor force the more pressure is placed on the solvency of the social security system. Significant changes to this program are inevitable, and it is more likely than not that it will lead to a decrease in benefit provisions.

Due to longevity, and retirees being healthier and more active, investors fail to consider the effects of inflation over an extended retirement period.

3. Failing to consider effects of inflation

"Inflation is not all bad; it has allowed every American family to live in a more expensive neighborhood without moving."
Senator Alan Cranston

It goes without saying, because of the length of time we will spend in retirement inflation will have a greater impact on our savings to fund our lifestyle, than previous generations. We are all acutely aware of the effects of inflation; which is the overall increase in the cost of goods and services over time. Inflation is a tricky concept to understand, and predicting the rate of inflation, especially over the short-term is notoriously difficult. In a capitalist economy inflation is related to the money supply – but even this relationship is controversial. Asking two economists to explain this relationship and inflationary trends they will probably provide you with four different answers. You may recall the quip from President Harry Truman, in which he wished he could find a one-armed economist who then couldn't say "… and on the other hand!"

The exact mechanics of inflation is largely irrelevant to our discussion. I will focus on a few key issues to illustrate what inflation is likely to do to your nest egg over the next few decades.

In 1975 the price of a regular mail stamp was 10c, as opposed to today's 39c. That is inflation. If the prices of the things you will be spending your money on during your retirement increase – you will be faced with two alternatives: to keep your standard of living the same you will need to increase the amount of income generated by your retirement savings each year of your retirement; or, alternatively, if your income remains the same during retirement every year your standard of living will have to decrease until your final years will be characterized by financial pressure while the inevitable effects of old age are starting to take its toll.

In terms of the Consumer Price Index (the tool we use to measure inflation in the US) historical inflation can be calculated as 3.1%. In other words if you go to Albertsons and spend $100 today on a basket of products those exact same products could cost you $103.10 next year this time. Now, don't make the mistake of just adding $3.10 every year! The following year that exact same basket of products at your local Albertsons will cost you $106.30 (in other words $3.20 extra. This is because of the effects of compounding (3.1% on $103.10 and so forth) which have an exponential impact over long periods of time. You might think well that's not too bad! Let's look at a 35 year long retirement.

Let's take a hypothetical couple retiring today at age 65 and needing $2,000 per month in income from their nest egg on-top of social security, to allow them to continue with their current life style. That is $24,000 per year; however, using historical inflation they will need $38,000 per year in 15 years; that is, $3,166 per month when they are 80 years old. How does this picture change when they turn 90? Now they will need $51,000 per year, or $4,250 per month!! More than double the income they started with at the beginning of retirement. Due to compounding, when this couple turns 95 their planner has to ensure their savings can produce $90,000 in income per year. In 35 years $90,000 is the same as $24,000 today.

In our financial planning, and structuring of our clients' investments, we have to choose those investments that will allow our clients' nest eggs to produce this exponentially growing income. The implication of this for the investment choices we make today is critical. You cannot prudently save for retirement if you have not gone through these calculations.

4. Failing to invest for the long-term

"The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelope our future"
Economist John Maynard Keynes, 1936

As I've illustrated so far, most people tend to underestimate their life expectancy, increasing the pressure on their retirement savings to provide an adequate income throughout retirement. Moreover, the pressure on retirement income is exacerbated by inflation eroding the value of their income.

Given these challenges we should plan for the long-term. We should invest with a long-term view. However, when it comes to retirement savings we have experienced many people allow short-term considerations to impact their investment decisions. In numerous cases, though, it is impossible to avoid short-term considerations which lead to a paradoxical dichotomy – which I will expand on later.

Peter Bernstein remarks in his book, *Against the Gods – The remarkable story of risk:* "What is it that distinguishes the thousands of years of history from what we think of as modern times? The answer goes way beyond the progress of science, technology, capitalism, and democracy… The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk."

My aim in this section is to help investors to understand risk. What I'm about to explain may be obvious to most of you. However, to understand investment risk, you need to understand the different types or classes of investments.

When it comes to investments there are essentially two types: loan-type investments and ownership-type investments. Bonds, CD's, Munis, Treasuries etc. are examples of loan-type investments. Stocks, mutual funds, real estate etc. are all ownership-type investments (equity in the stock market). The way most people understand investment risk is they experience the volatility of their investments; the fact that the markets go up and down. Ownership-type investments are prone to more price volatility, as compared to loan-type investments. One can list the types of investments from those with more pronounced volatility to those with virtually no volatility – I call this the vertical risk continuum:

International Stocks/Equity
Small Company Stocks/Equity
Large Company Stocks/Equity
Lower rated Corporate Bonds
High rated Corporate Bonds
US Government Bonds
Short-term Treasuries
CD's
Money Market Funds
Cash in the bank
Cash under your bed

You will observe the loan-type investments at the bottom, and the ownership-type investments at the top. Those investments at the bottom of the pyramid experience the least volatility, and those at the top the most.

There is another component to risk which will reverse this vertical continuum! The second component of risk is the erosion of purchasing power. That is the risk you face from inflation, which I discussed earlier. This second component gets overlooked by many investors who only focus on volatility.

Therefore, investment risk has two different elements, i.e.:

- The potential that when you withdraw income from your savings, you have a lower principal due to fluctuations in the value of your investments.
- The potential that when you withdraw income from your savings <u>in the future</u> the return you received was not adequate to avoid purchasing power erosion.

Most people make the mistake of thinking only of the first component of risk – the decline in the value of their investments due to volatility. This is understandable – we've all seen our investments go down over the last bear market; a number of us had to change plans; we had to work longer and couldn't retire. Volatility is a real and excruciating painful risk. However, we have to be cognizant of the second component of risk – not receiving an adequate return on your investments to prevent purchasing power erosion.

The effects of long term inflation on our retirement income is what I call the risk of purchasing power erosion – your retirement dollars buying less and less over time due to rising prices. Now let me return to our vertical risk continuum. I've made the comment that if you do not have a long-term view your risk continuum might reverse into something like this:

Cash
Fixed Income Investments (Bonds, CD's etc)
Equity Investments (stock market)

Traditionally conservative investments like CD's and bonds now pose the highest risk to you, because of purchasing power erosion. The reason is obvious. These "conservative" investments do not provide sufficient return over time to grow your savings to a sufficient level that will offset purchasing power erosion. In other words, they don't pay you enough interest to protect you against inflation over time, while you're taking an income out of your nest egg.

I will suffice with a simplified example. The 10 year annualized rate of return on treasury bills (as measured by the Merrill Lynch 3-month T-Bill Index) is 3.81 percent; the 10 year annualized rate of return of the Lehman Government Bond Index is 6.14 percent and for the stock market as measured by the Russell 3000

Index the 10 year annualized return is 9.10 percent. (The aforementioned indices where measured on 7/31/2006; and remember treasuries and government bonds are backed by the full faith and credit of the US Government; stocks are not guaranteed and are more volatile.) Let's assume you have $200,000 in retirement savings. If you invest in very "conservative" short-term treasuries (conservative in terms of volatility), your principal amount could grow to be $350,443 after 15 years. If you invest in Government Bonds your principal after 15 years could be $488,896. Lastly, if you invest in the stock market your principal could probably grow to $738,586.[3] It is obvious which type of investment and commensurate return will protect you the best against purchasing power erosion. But we are back to the paradox again – the stock market also has the highest volatility.

What I am explaining here is in essence a catch-22. If you are conservative in terms of not wanting too much volatility then you are being extremely risky in terms of protecting your income later in retirement. If you are prudent and want to protect your income later in life, then you need to invest with more risk in terms of volatility for most of your retirement years, especially before retirement.

This explanation leads directly into the next common mistake people make regarding their retirement savings.

5. **Overestimating how much can be withdrawn from the nest egg**

Clients often ask us how much will it cost to retire? Or, do we have enough money to retire? It is common sense there cannot be a universal answer to this question as the answer is related to each one's peculiar lifestyle and their savings base. Each client that follows our retirement planning process will receive a definitive answer to this question, however.

The strategy implied by my discussion so far, which I hope is becoming obvious, is that people saving for retirement should have a healthy doze of ownership-type investments to sufficiently grow their nest egg to counter inflation during retirement. I now want to provide you with a workable answer to the question "how much will retirement cost?" Stein calculated the answer as $206,372. A 65-year old is likely to need about $206,372 in savings to provide for each $1,000 per month of inflation-adjusted income during retirement. Concomitantly, you need $412,744 in savings for $2,000 of income.

This calculation is based on the following assumptions:

- The retiree will live for 30 years to age 95.
- Inflation will average 4.5% in the future (there are compelling economic arguments for this prediction which I won't go into).

[3] This calculation is a hypothetical example, based on certain historical trends. Remember the past is not indicative of the future. Furthermore, you one cannot invest directly into an index.

- Retirement capital will return 8.5% before-tax (this is an important assumption because it requires a healthy dose of ownership-type investments throughout retirement to attain this return).
- The last assumption is the retiree will consume all retirement savings; there won't be anything left as an inheritance.

Let me illustrate the paradoxes involved in choosing retirement strategies. If you want to retire at 55 and you are "conservative" in terms of volatility, you will overweight on CD's and bonds giving you probably a 6.5 percent return (based on historical trends). Using this investment allocation you will need $349,147 in your nest egg to fund $1,000 of retirement income. If you retire at 65 under these same assumptions you will need $266,636 to produce $1,000. In other words the lower your return, the larger your nest egg needs to be before retirement.

6. Conclusion

In this paper I tried to identify and summarize the four biggest mistakes people tend to make with their retirement savings. These mistakes are the product of a changing retirement paradigm. These mistakes occur because investors have not adapted their investment behavior to the changing retirement behavior. Gone are the days you retire at 65 with your social security and company pension, waiting on visits from the kids and grandkids, and passing away at age 72. Americans are retiring earlier, they are more active, they are healthier, they are living longer and they are spending more. It is imperative that investors' investing behavior adapt to these new trends.

Investors saving for retirement, or retirees' already taking income from their nest eggs will need to avoid the following pitfalls:

- Expect and plan to live a longer and healthier life than your parents and grandparents. Underestimating life-expectancy can lead to severe financial hardships later in life.
- Be prepared for the exponential impact of inflation on your needed income.
- Invest for the long-term, which means investors should not over-emphasize volatility as opposed to the erosion of your nest egg's ability to generate an ever increasing income.
- Be weary of overestimating how much you can withdraw from your nest egg, in other words don't underestimate the cost of your retirement.

Modern western society and the capitalist system provide many Americans with a myriad of opportunities to live fuller and richer lives in retirement; however, many retirees will make some or all of the mistakes listed in this paper. Prudent financial planning can assist many to adapt their investment behavior to the new retirement paradigm.

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