Workshop 2: Extend Your Nest Egg: Planning a Stream of Income in DC Plans

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Separating Out the Planning

The issues are simple:

- How much do I need for retirement?
- How disruptive will my medical costs be?
- How much do I want to leave as a legacy?
- When am I going to die?

This program focuses on “at” retirement. The issues become more “emotionally driven”, so the solutions should be more “advisor driven”.
Retirement Risks vs. Retirement Tools

• Market Risk
  – Risk Tolerant
  – Risk Adverse
• Psychological Risk
• Longevity Risk
• Sequential Risk
  – Investment
  – Spending
• Issuer Risk

• Health Risk
• Inflation Risk
• Interest Rate Risk
• Credit Risk
• Legacy Risk
• Dependent Care Risk
• Unexpected Risks

Retirement Tools

• Chicken Dinners
• Replacement Ratio Tools
• Financial Planning Reports
• Asset Allocation Models
• Annuity Solutions
• Seat of the Pants
Agenda

- No Free Pensions
- Cost of Self-Insuring
  - Pay upfront
  - Pay at the end
- Example
- Coordinating with LTCi and Legacy Planning
- Financial Considerations
- Four Methods
- Considerations
- Spending Rates
- Complex Hybrid Products
- Using the Existing Plan
- Recommendation

There Are No Free Pensions

- The “high costs” of annuities are often shown
  - Low interest environments cause concerns that the annuities are too expensive
  - The forfeiture of money in life annuities to the insurance company on early deaths cause individuals to feel a loss of control
  - Commissions, insurance company profits and anticipated expenses are all built in
  - The press and regulators focus on the fees but not on the benefits
Cost of Self-Insuring

- Systematic Withdrawal Plan (SWP) has it’s own costs for self-insuring
  - Establishing the segmenting approach to have bands of assets
    - Withdraw from cash portion
      - Out of market, so a cost
    - Securing the base amount with low risk investments
      - Low interest and yields (Govt Bonds) so a cost of greater reserves
    - Not protecting the assets can cause the survivor to have a significantly diminished life style
    - Cost of long term care
      - 70% chance of any individual needing care
      - 99.5% chance of at least one of a healthy couple at age 65 needing some form of long term care in their lifetime

Robert and Roberta Retiree

- Robert is  81 years old, and Roberta 14 years younger; age 67
- Has a pension of $60k per year 50% J&S
- Has $400,000 in cash
- Has SS benefits of $25,000 for him $12,500 for Roberta.
- Has a degenerative disease causing him to lose mobility
Who thinks Robert and Roberta are in a good place?

• What are we missing?
• What is the exposure?
• What happens to Roberta when Robert passes?

Cost of Long Term Care

• Robert is going to need long term care shortly
  – In Connecticut the cost is approximately $110,000 per year
  – He is in good health otherwise, so it may last a while
  – If it lasts approximately 4 years, they have no cash
  – The house needs to be fitted for Robert
• If Robert continues to live his income will go towards the cost of care
• Once Robert dies, Roberta has no cash, has his social security survivor benefit of $25,000, loses her spousal benefit of $12,500 and has the pension cut by 50% or $30,000
• Her income drops from $97,500 to $55,000
• She has no cushion if she needs care
Financial Considerations

• Financial Risks in Retirement
• Mitigating the Risks
• The Asset Portion of the Equation
• The Expense Portion of the Equation
• The Income Portion of the Equation
• The Spending Rate: Making it Work
• Solid Foundation with an Upside Opportunity
• Insured vs. Self-Insured Models
• Capital Market Tools.

Risk Management Techniques

• Risk Avoidance or Transference
• Risk Pooling
• Self Insuring or Reserving
• Diversifying
Four Methods of Asset Planning

• Asset Allocation Using Modern Portfolio Theory
  • Risk adjusted for age
    – Example: 100 less age for fixed allocation
  – Segmentation
    • Isolating specific costs/events
    • Banding by frequency and timing
      – 5 yrs bands
      – Asset allocation based upon band
  – Segmentation
    • Series of immediate and deferred annuities
  – Fixed and variable
  – Flooring with Upside Opportunity

Asset Allocation Method

• Differences between risk tolerance vs. risk adverse
• Age dependent asset allocation
  • Similar to Modern Portfolio Theory with adjustments
    – Keeps the equity component prominent
    – Keeps risk tolerance as the core of the method
  – Example
    • 100 less age into fixed
  – Using similar market tools that are used for pre-retirement allocations
    • Stocks, bonds, mutual funds, ETF’s
Segmentation

- Blocks of money for time segments
  - First 5 years of expenses in very secure investments
    - Cash, short term bonds, Certificate of Deposits, 5 year certain annuity
  - Second 5 years
    - Mid-term bonds 5-10 yrs.
    - Allocation of inflation adjusted expenses for the period
  - Third 5 years
    - Longer term bonds, dividend paying stocks, some growth
  - Select and Ultimate
    - Long term bonds, equities, modern portfolio theory for asset allocation

Annuity Banding-Pensionize™

- Variation of Segmentation
  - Separate out the known expenses
  - Determine the present value of the fixed expenses
    - Inflation adjusted
  - Purchase a series of immediate and deferred term annuities
    - Segments that are guaranteed by insurance carriers
    - Use of term certain annuities for first two segments
      - Immediate first 5 years
      - Deferred fixed for second 5 years
    - Deferred fixed annuities
    - Life Annuities with variations
      - Equity Indexed annuities
      - Variable Annuities
      - Provides market exposure with potential floor
  - Longevity annuity for extended insurance
Retirement Sustainability Quotient

• Pensionize Your Nest Egg
  — Calculation that provides you some certainty of not outliving your money
  — Pensionizeyournestegg.com

  — How much money can I spend each year?
  — How many years can I spend it?
  — 100% - good to go, should never outlive your assets
  — 0% - keep working

  — It calculates a Spending rate, a Wealth to Needs calculation is computed. It gives us the probability of ruin.

Retirement Sustainability Quotient

• The greater the percentage of spending needs that is guaranteed (Social Security, pensions, annuities) the higher the RSQ.
• RSQ = (fraction of income that is Pensionized™) x 100% +
• Fraction of Income that is not Pensionized™) x 1 - Portfolio’s Probability of Ruin)%
• Probability of Ruin computed using Stochasitic forecasting
  — Think of it as the probability of running out of money while living
Solid Foundation With an Upside Opportunity

- Building a solid foundation
  - Risk Adverse
- Determine lifestyle needs for the family unit
- Determine sources of income
  - Continued work
  - Hobbies
  - Inheritances
- Determine outside retirement income
  - Social Insurances and pensions
- Determine retirement savings
- Determine your spending rate
- Develop the solid foundation with capital market instruments

Lifestyle Needs of the Family Unit

- Not just the individual.
- What are the overall costs and when do we expect them to occur?
- Have we included an emergency fund?
- Are there dependents that we are assuming will no longer need our support?
- Are there people that we are assuming that will never be our dependent but could be?
Determine the Sources of Income

• Will you continue to work at some level?
• What income can you make?
• Are there Veteran’s benefits available?
• Are there any long forgotten pension benefits?
• Do you have a hobby that makes some income?
• Do any other family members have an income opportunity?
• Are you expecting any inheritances?

Social Insurances

• When do you expect to receive Social Security?
• How much do you expect to receive?
• What will your spouse receive from Social Security and when and how should those benefits be received?
• When should you elect Medicare?
• Will there be any employer coordinated benefits?
Retirement Savings

• What are the sources from which you can draw?
  – IRA’s
  – 403-b’s
  – 401-k’s
  – Pensions
  – Annuities
  – Life insurance policies
  – Collectibles
  – House (reverse mortgage)

Determining the Spending Rate

Lifestyle needs of the family unit
  \[ \text{Minus} \]
Income from working, pensions and Social Ins
  \[ \text{Equals} \]
Amount required from Retirement Savings
  \[ \text{Divide} \]
Amount required from Retirement Savings by total Retirement Savings
  \[ \text{Equals} \]
Spending Rate
Spending Rate

• Using age 65 as our target
  – If our spending rate is less than 3.5% then we are fully funded
  – If our spending rate is in excess of 7% we are underfunded
  – If our spending rate is in between, we are limited

Solid Foundation

• The higher our spending rate the more conservative we need to be
  – Can not take a loss
  – Must immunize against the retirement risks
  – Don’t bet against the house!
  – Need to carefully chose the retirement funding vehicles
Upside Opportunity

• The amount that is left over once we subtract out the present value of the future retirement spending that we will need (inflation adjusted)
• This amount can be invested for the longer duration and can be put into the more volatile markets like the stock market

Insured vs. Self-insured?
That is the Question!

• The balance needs to be understood
• Control and knowledge are the keys
  – Would you go without health insurance, car insurance, home-owners or renters insurance?
• Longevity risk and pooled annuity premiums
• Long Term Care Insurance – Disability Income for Retirees
• Legal expenses to mitigate and loss of control
Capital Market Tools for Securing the Foundation

- Certificates of Deposit
- Government and Agency Bonds
- Corporate Bonds
- Municipal Bonds
- Treasury Inflation Protected Securities
- Fixed Annuities
- Bonus Annuities
- Life Insurance
- Savings Accounts
- Stable Value Funds
- Longevity Risk Premiums

Complex Hybrid Products

- Equity Index Annuities
- Variable Annuities
- Interest Index Annuities
- Multi-Year Guaranteed Annuities

- These products may offer longevity risk protection along with a solid foundation. Each one has particular features associated with the products. Please see your investment professional for information regarding each one.
Using the Existing Plan

• Check vendor services for distributions
• Can pay out of some fixed/guaranteed accounts
• Liquidity is maintained
• Lower costs for assets under management
• Check annuity features

Examples of In-Plan Options

• Managed Account selected with a cost for converting to a longevity guaranty
  – Target Date fund that goes to fixed at or close to retirement
  – A distribution amount normally 3% to 5% is available for life with the option to withdraw
  – Participant selects and pays the cost of the insurance
• Additional Fee for providing the protection
  – Borne by the participant at the participant’s election
• May have portability issues when plan sponsor changes vendors and there are no distributable events
• Some have mitigated the issuer risk by having the annuitization split by a few carriers
• Three illustrations: There may be others and information is general, please see prospectuses before investing or recommending
In Plan Options

• Voya Lifetime Income Protection Program
  – Guaranteed Income for Life diversified by guarantees from multiple insurers
  – Income growth potential from market gains
  – Downside income protection from market losses
• Use of target date funds that allocate between a multi-manager approach and annuity contracts
• Glide path to age 65 based upon a pre-determined approach
  – A lifetime income stream diversified by guarantees from multiple insurers (Voya, Axa Equitable and Nationwide)
  – Begins 17 years prior to portfolio’s target date
  – 5 years prior 100% is allocated to the contracts and factored into the Minimum Guaranteed Withdrawal Base (MGWB)
  – Withdrawal flexibility available but will directly affect MGWB
  – Withdrawal amount not pre-determined
• Please see a Voya representative for fees and availability

In Plan Options

• John Hancock Guaranteed Income for Life
  – Provides for 5% withdrawal option at 65 for single
  – Provides for 4.5% withdrawal option for J&S
  – Establishes a benefit base with additional withdrawal privileges
  – Provides a benefit base that will not decline if the market does.
  – Provides a solution to the longevity risk
  – Has a holding period for five years prior to determining benefit base
  – Non-spousal death benefit
    • Remaining account balance if any (not benefit base)
  – Managed accounts
  – Please see a John Hancock representative for fees and availability
In Plan Options

- Prudential Income Flex Target with Target Date Funds
  - Guaranteed Income for Life
  - Downside Protection for Retirement Income
  - Complete access to market value
- Market Value becomes Income Base on first day and Income Base is the greater of new Market Value or old Income Base determined on the participant’s birthday each year
- Lock-in date is the last measurement date
- Age 65 distribution rates: 5% life only, 4.5% J&S
- Money invested in target date funds
- Please discuss fees and availability with a Prudential representative

Active Management vs. Passive Management

- Broad Market Tools
  - Index Funds
  - Exchange Traded Funds
  - Balanced Funds
  - Asset Allocation/Target Date Funds
  - Asset Managers with Dividend Paying Stocks
  - Asset Managers with Specific Bond Holdings
Exchange Traded Funds

- Passive Management
- Broad Market Approach
- “Black Pool” Trading and “Algorithmic” Trading
- Stop Loss Orders
- Instant Trading vs. Close of Market Trading

Life Insurance as a Tool

- LTCi may be considered a waste of precious money
  - Why pay for something you may not use?
- Life Insurance
  - Guaranteed premium amount
  - Underwriting is normally the same for LI
  - Can pay out cash value tax free up to the Capital costs
  - If not used, death benefit paid out
Recommendation

• It depends!
  – Health
  – Legacy planning
  – Spending habits vs. assets
  – Long term care protection
  – Number of dependents

• Emotional

A Complete Retirement

When you wake up in the morning:
• You have someone to love
• You have someone who loves you
• You have something to do, and
• You have something to look forward to.
Questions