Six Retirement Blind Spots and How to Fix Them

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Presentation Overview

- Why I'm passionate about simplifying retirement portfolio planning
- Key blind spots that retirees can miss as they create their plans, including:
  - Retirement date risk
  - Sequence-of-return risk
  - Low-yield risk
  - Inflation risk
  - Health care, long-term care risk
  - Longevity risk
- How retirees can mitigate those risks with portfolio and financial planning

5 Key Reasons Why I'm Passionate about Simplifying Retirement Portfolio Planning

Reason 1: People make investing more complicated than it ought to be. ("The Financial Complexity Complex.")

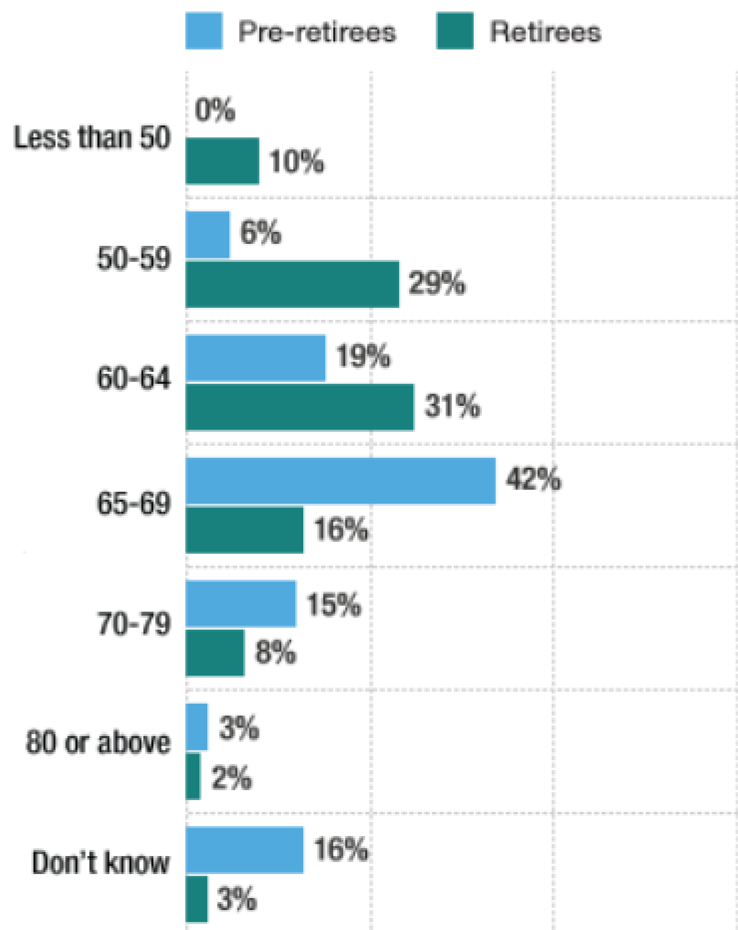
Reason 2: Retirement decumulation is inherently MUCH more complicated than retirement accumulation.

Reason 3: Behavioral issues further "complexify" retirement planning and lead to behavioral traps—e.g., investing for current income, not total return.

Reason 4: Retirees are the ultimate "just-in-time" learners.

Reason 5: DIY investors need to protect their plans against the possibility of cognitive decline

Pre-Retirees: At What Age Do You Expect to Retire?
Retirees: At What Age Did You Retire?



Survey: NPR, The Robert Wood Johnson Foundation, Harvard School of Public Health

Retirement Date Risk: Why It Matters

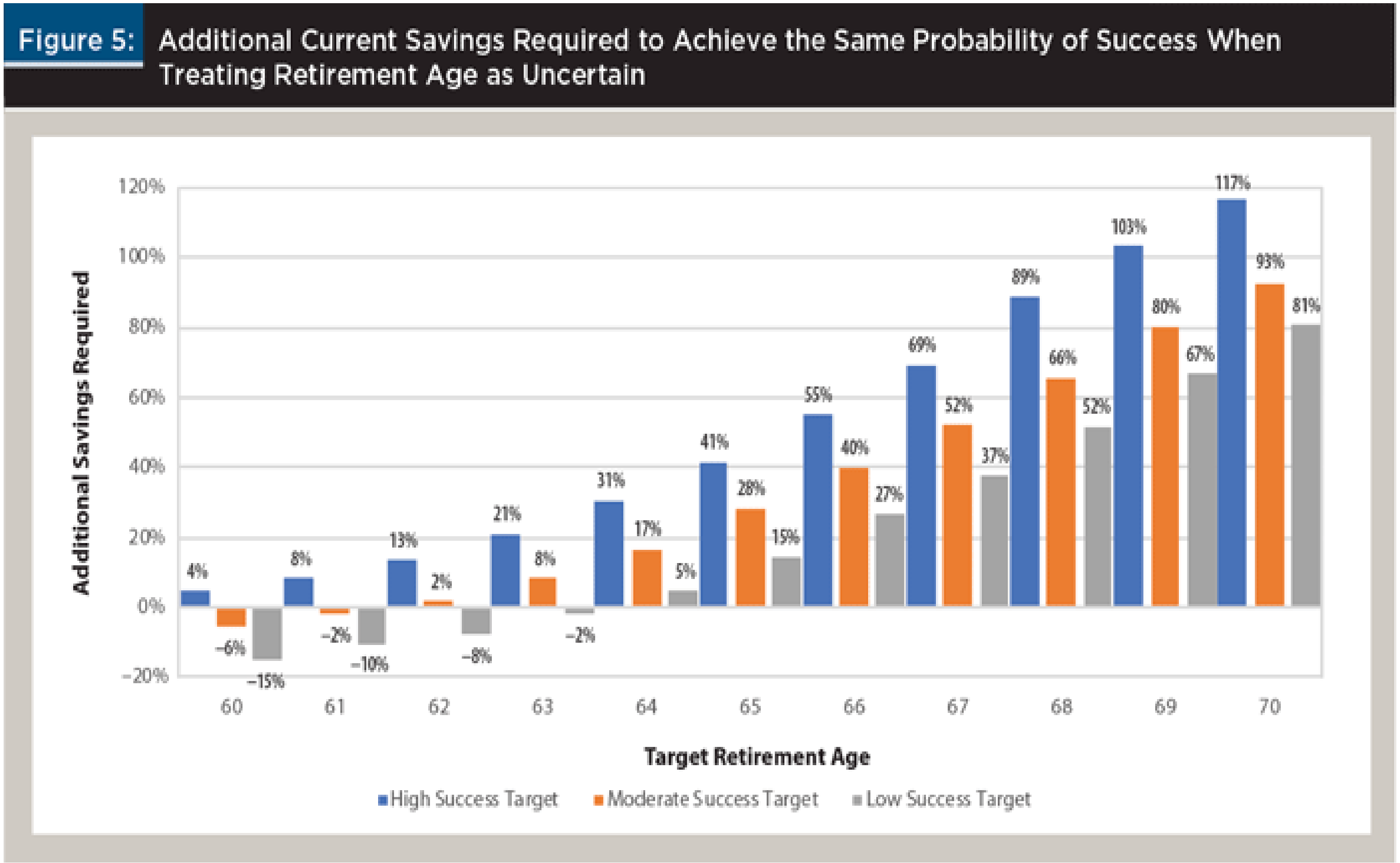
- Working longer isn't always a possibility due to factors such as:
  - Unexpected job loss/difficulty replacing a job
  - Difficulty doing a job that entails physical exertion
  - Health issues: Own, spouse's, parent's

- Risks for the viability of a retiree's income replacement following early retirement include:
  - No opportunity to make additional portfolio contributions
  - Fewer years for portfolio assets to compound prior to drawdown
  - Withdrawals over a time horizon that's greater than 25-30 years have to be very modest (<4% of initial balance) to ensure a high probability of sustainability
  - May reduce ability to benefit from delayed Social Security filing (past full retirement age)

Retirement Date Risk: How to Mitigate It

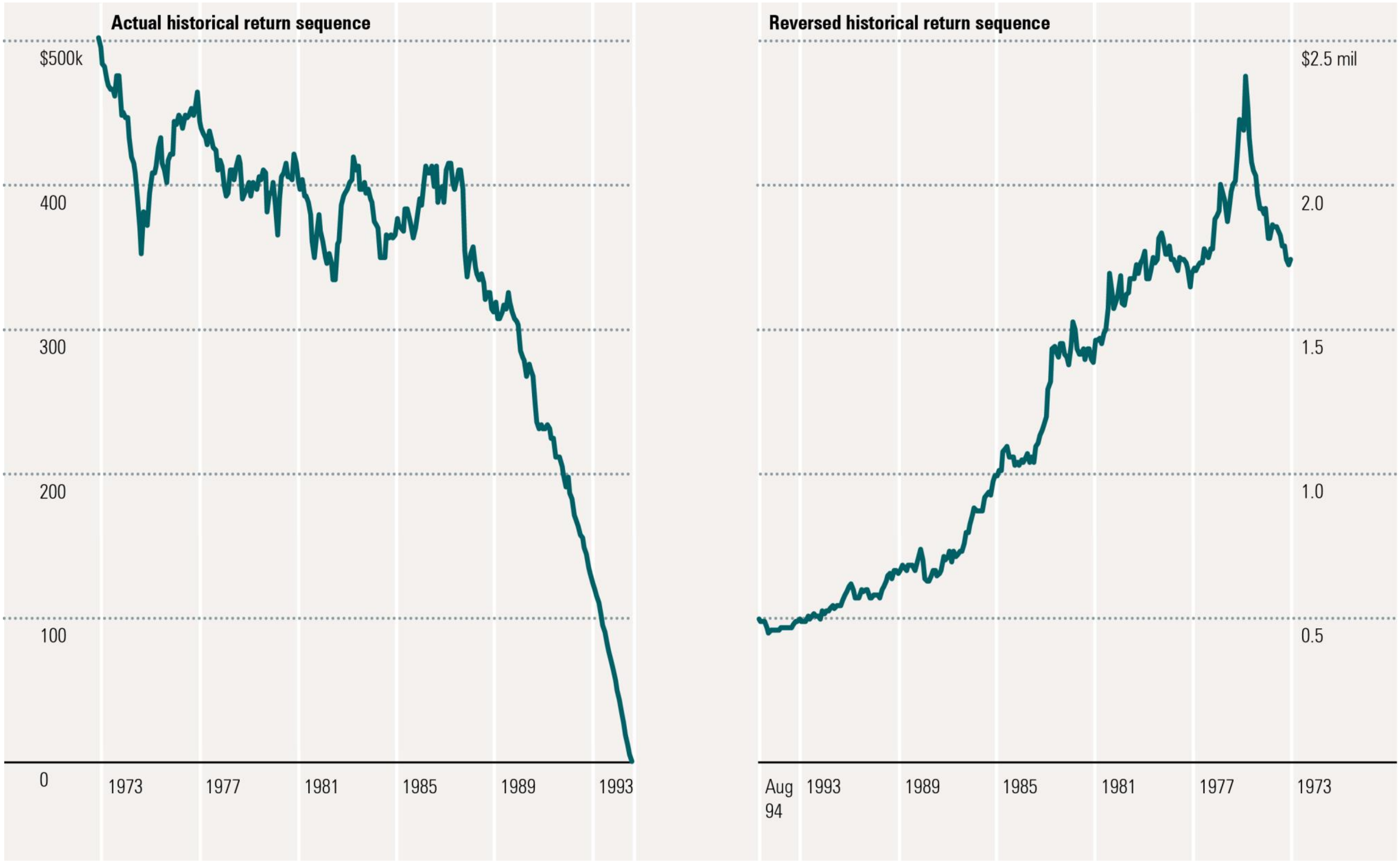
- Nurture human capital over age 50 with additional training, staying current on technological developments, etc.
- Consider "backup" work plan in case of unplanned early retirement ("encore career")
- Save more while working!
- Insurance planning
  - Health care if need to retire prior to age 65
  - Disability for self
  - Long-term care (esp. for married couples)

Retirement Date Uncertainty Calls for a Higher Savings Rate While Working



Survey: David Blanchett, Journal of Financial Planning

A Tale of Two Retirements



Sequence of Return Risk: Why It Matters

- Sequencing risk refers to the order in which your investment returns occur
  - Ideal sequence of return risk: Poor returns in accumulation (buy low) followed by strong returns in early years of retirement (sell high)
  - Negative sequence of return risk: Strong returns in accumulation (buy high) followed by weak returns in early years of retirement (sell low)
- Negative return sequencing affects one of two things (or both):
  - Retiree reduces withdrawals/standard of living to reduce risk of running out of money later in life
  - Retiree doesn’t reduce withdrawals and runs out of money later in life

Could New Retirees Be Heading into a 'Bad Sequence'?

Shiller PE Ratio

Chart | Table | FAQ   Share

Current Shiller PE Ratio: 30.56 +0.18 (0.58%)

10:45 AM EST, Thu Nov 7

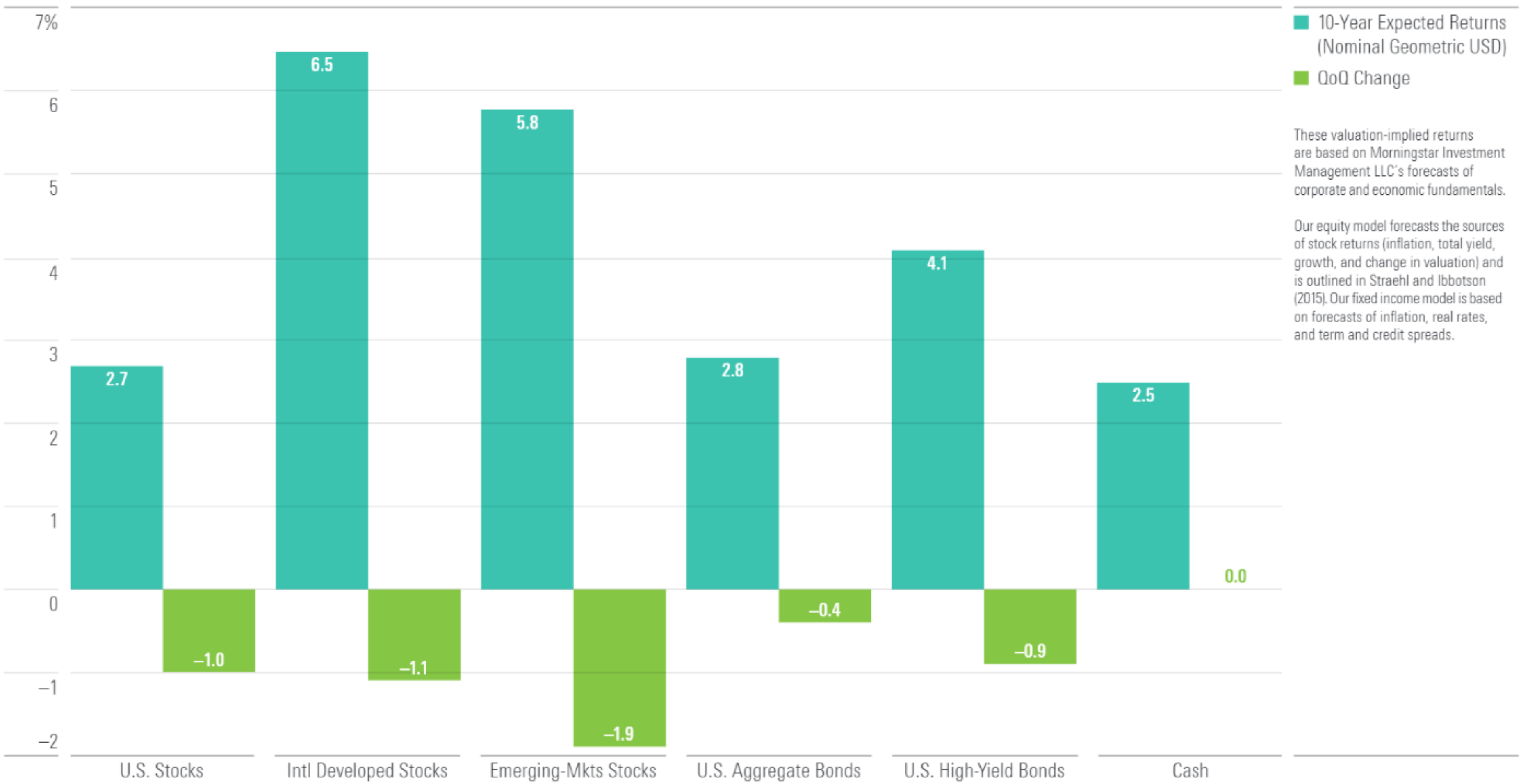
Mean:	16.66	
Median:	15.76	
Min:	4.78	(Dec 1920)
Max:	44.19	(Dec 1999)

Fairly High Valuations = Muted Returns for U.S Stocks and Bonds

International Developed Stocks Expected to Outperform

Our valuation models indicate that international developed stocks will outperform both emerging markets and U.S. stocks over the next 10 years. Investment-grade bonds only offer a small return advantage over USD cash given low starting yields. The first quarter's strong returns significantly lowered the future expected returns for all asset classes except cash.

10-Year Valuation-Implied Returns



These valuation-implied returns are based on Morningstar Investment Management LLC's forecasts of corporate and economic fundamentals.

Our equity model forecasts the sources of stock returns (inflation, total yield, growth, and change in valuation) and is outlined in Straehl and Ibbotson (2015). Our fixed income model is based on forecasts of inflation, real rates, and term and credit spreads.

Source: Morningstar Markets Observer

Outside Experts Largely Corroborate Morningstar's Pessimism

BlackRock (June 2019)

- 6% nominal returns for U.S. large caps over next 10 years
- 2% returns for bonds

JP Morgan (October 2019)

- 5.6% nominal returns for U.S. stocks over next 10-15 years
- 3.4% nominal returns for U.S. investment grade corporates

Research Affiliates (November 2019)

- 0.5% real returns for U.S. large caps over next 10 years
- -0.6% real returns for Bloomberg Barclays Aggregate over next 10 years

- Two key levers to combat sequencing risk
  - Reduce portfolio withdrawals in weak market environments
    - Employ a fixed (and low) withdrawal on an ongoing basis (e.g., 3%)
    - Employ a “ratcheting” strategy to tie portfolio withdrawals into portfolio returns (Jonathan Guyton “guardrails” strategy)
  - Maintain enough in safer assets to ensure that withdrawals don’t come from falling/depreciated assets (“bucket approach”)
    - Withdrawals won’t *necessarily* come from safe assets, but they can if stocks drop

Bucket Approach Provides Bulwark Against Sequencing Risk

Bucket 1

For: Years 1 and 2

Holds: Cash

Goal: Fund Near-Term Living Expenses

Bucket 2

For: Years 3-10

Holds: Bonds, Balanced Funds

Goal: Income production, stability, inflation protection, modest growth

Bucket 3

For: Years 11 and beyond

Holds: Stock

Goal: Growth

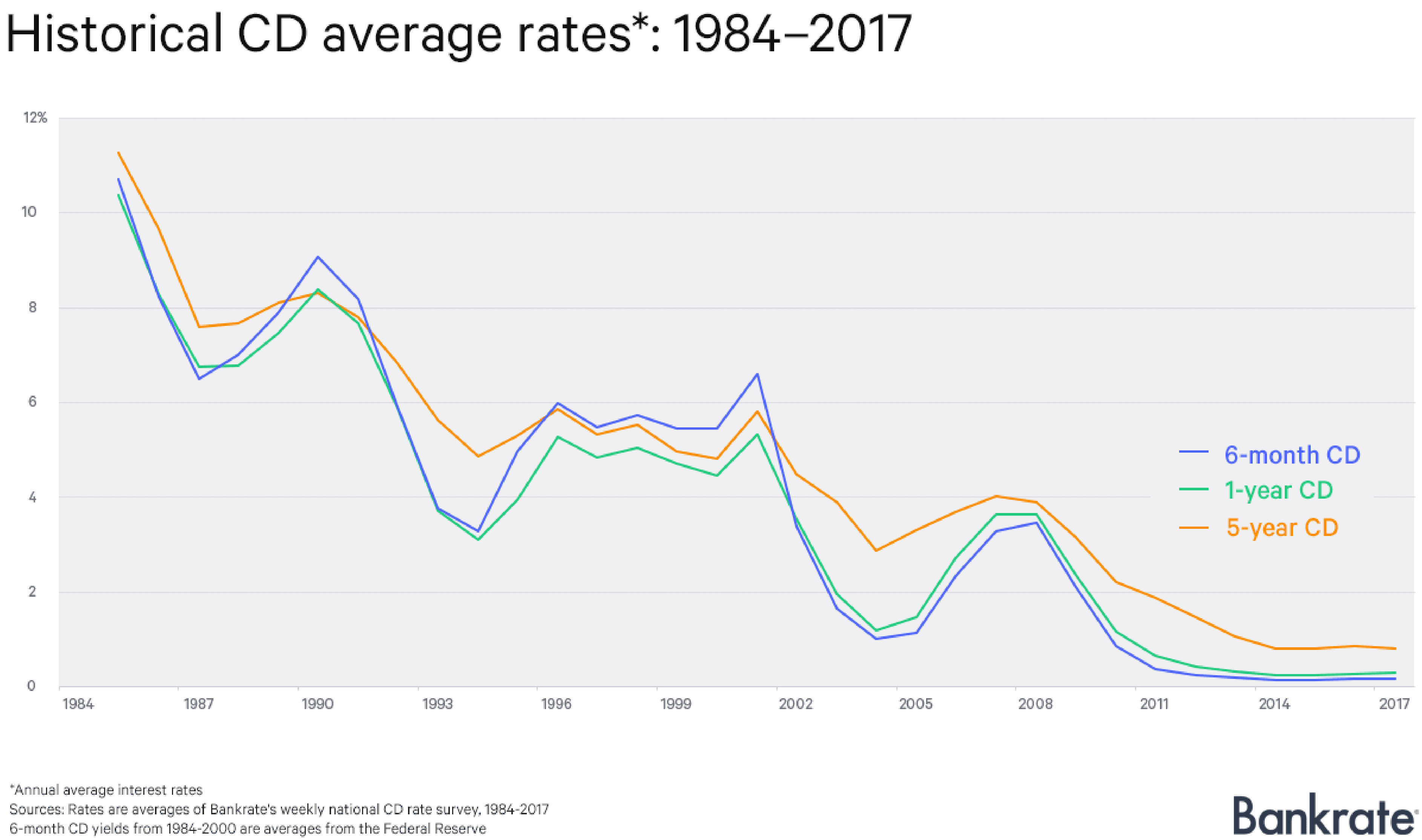
Sample In-Retirement Bucket Portfolios: ETF
Retirees Spending $60,000/Year from Portfolio

Bucket 1: Liquidity Portfolio for Years 1 and 2: $120,000
$120,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $480,000
$100,000 in Vanguard Short-Term Bond ETF BSV
$150,000 in Vanguard Short-Term Inflation-Protected Securities VTIP
$230,000 in iShares Core US Bond Market IUSB

Bucket 3: Growth Portfolio for Years 11 and Beyond: $900,000
$350,000 in Vanguard Dividend Appreciation VIG
$225,000 in Vanguard Total Stock Market Index VTI
$250,000 in Vanguard FTSE All-World ex-US VEU
$75,000 in Vanguard High-Yield Corporate VWEHX

Heard About the 'War on Savers'?



Very Low Yield Environment Risk: Why It Matters

- Many retirees aim to subsist on whatever income distributions their portfolios kick off
- When yields decline, income-centric retirees are left with one of two choices
  - Subsist on less income
  - Venture into higher-yielding/higher-risk bonds in search of a higher payout
    - Longer-duration bonds
    - Lower-quality bonds
- Bond yields have historically been a good predictor of bond returns over the next decade
  - Current long-term Treasury yield: 2.15% (October 8, 2019)

‘Livable’ Yields Come at a Price

High-Yield Bonds
Current Yield: ~ 5%-7%
2008 Return: -24%

Emerging Markets Bond
Current Yield: ~6%-7%
2008 Return: -18%

Bank Loan
Current Yield: ~3%-4%
2008 Return: -17%

Multisector Bond Fund
Current Yield: ~3%-4%
2008 Return: -15%

Negative Yield Environment Risk: How to Mitigate It

- Rather than using income alone to supply living expenses, use:
  - Pure rebalancing to source needed cash flows/prune appreciated securities
    - Pros: Most rational; rebalancing allows you to take risk out of the portfolio by selling appreciated components
    - Cons: There won’t always be something to sell (maintain cash ‘bucket’ for lean periods)
  - Hybrid: Spend current income (but don’t stretch for it), use rebalancing cash flows to supply additional living expenses
    - Pros: Appeals to retirees’ desire to have a baseline level of current income distributions
    - Cons: Combination won’t always deliver needed cash flow; maintain liquid reserves in case

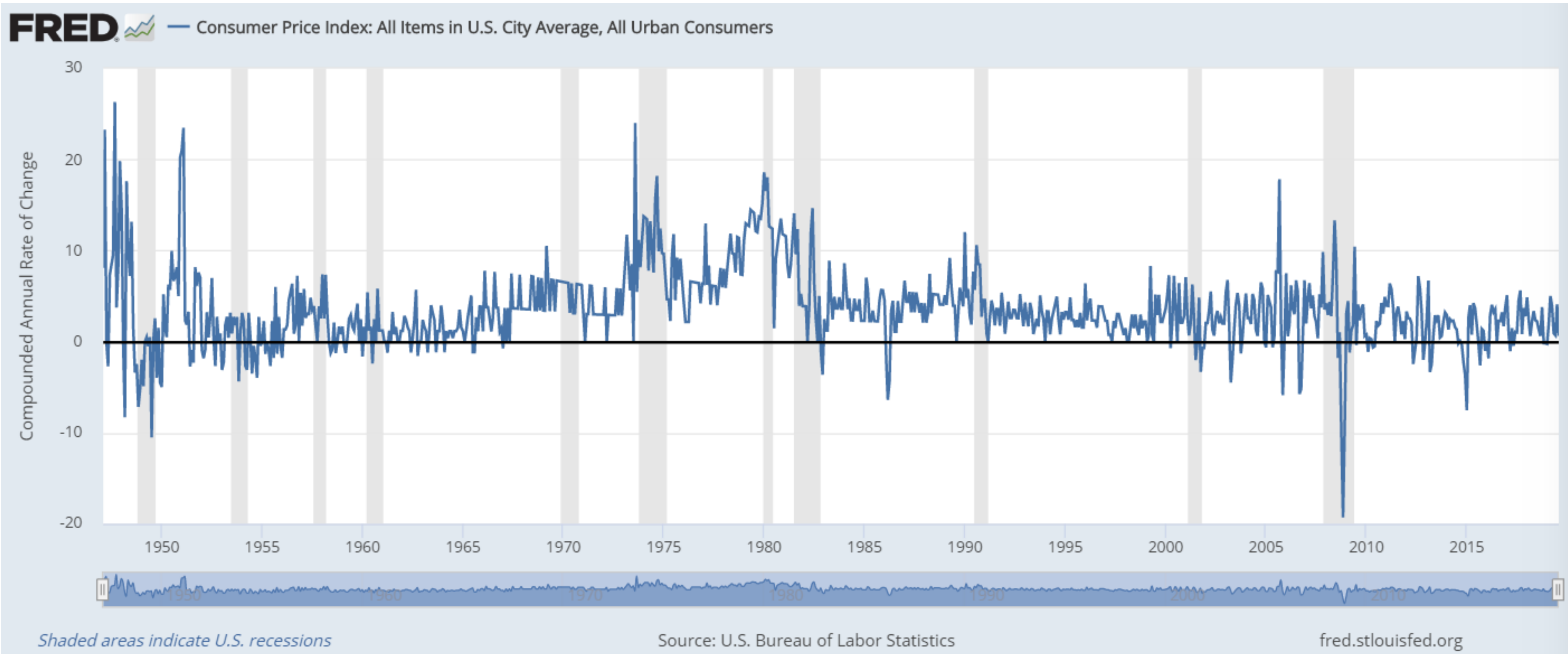
How Retirees Can Source Cash Flows without Stretching for Yield

- Example of the opportunistic approach in action
  - Retiree needs $40,000 in cash flow from $1 million portfolio to re-fill bucket 1 in 2017
  - 60% S&P 500/40% bond portfolio yields $21,500 in 2017
  - Portfolio also has capital return of $118,680 in 2017
  - Retiree’s $40,000 cash flow distribution comes from:
    - $21,500 in income
    - $19,500 from capital return
    - Retiree reinvests remaining $99,180 of capital return or steers it to cash to cover next year’s living expenses

But Some Years Won't Be That Good

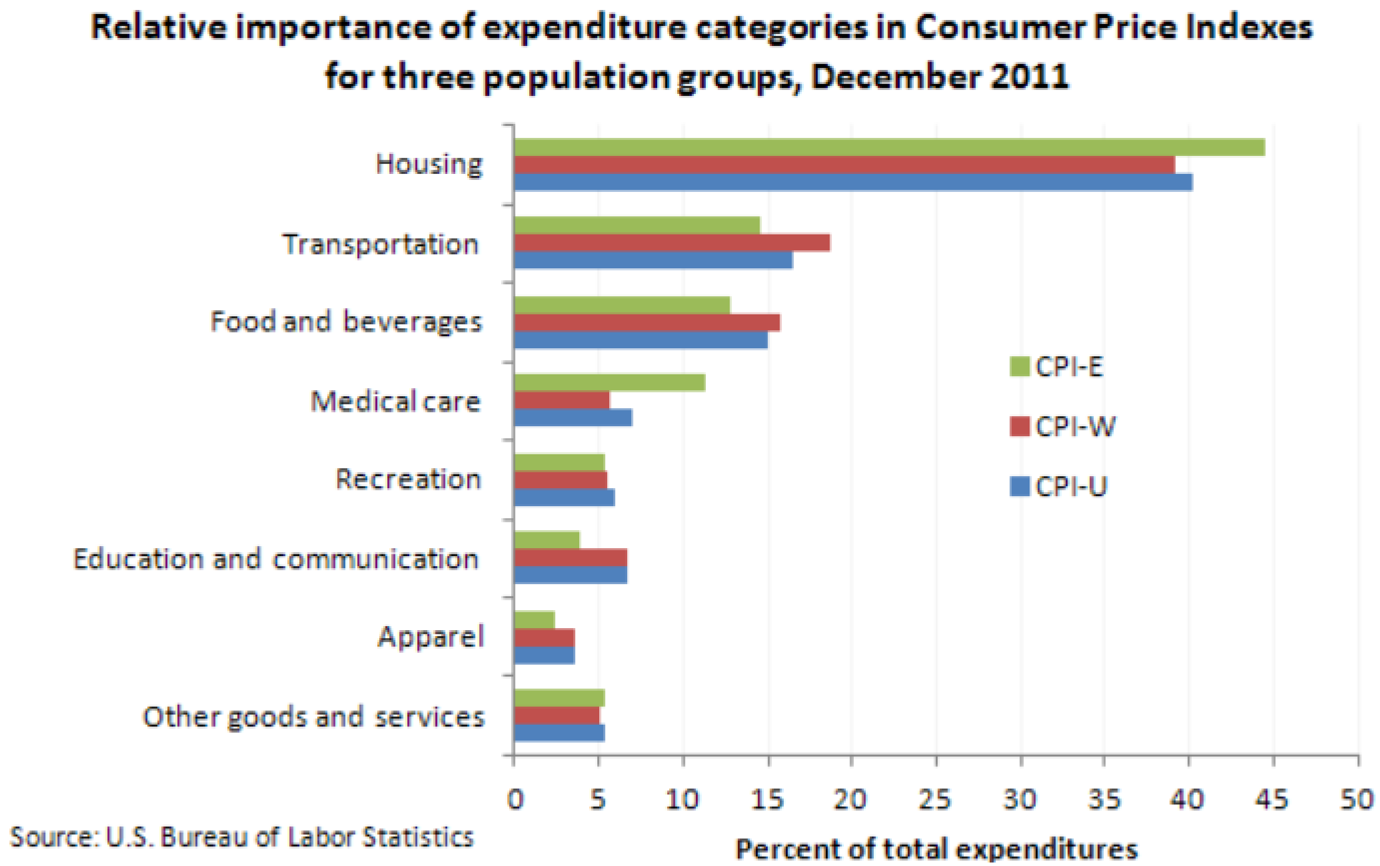
- In 2018:
  - S&P 500 return: -4.38%
  - Bloomberg Barclays Aggregate Index return: 0.01%
  - Holding two years' worth of portfolio withdrawals in cash helps guard against years in which neither stocks nor bonds provide rebalancing opportunities
  - Holding short-term bonds serves as next-line reserves in case cash is depleted and income insufficient/rebalancing opportunities aren't there

Inflation Is Benign…Or Is It?



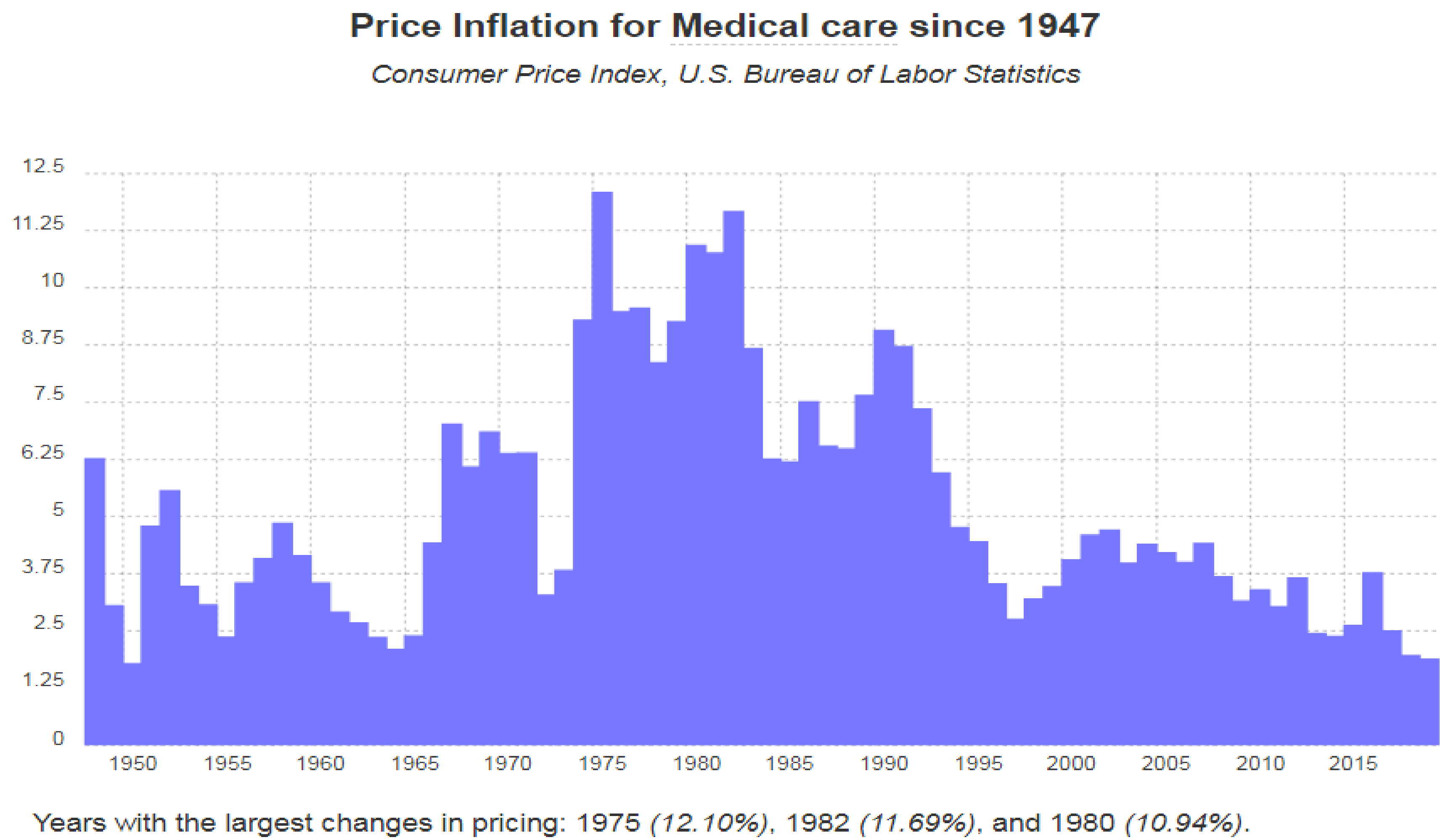
Source: St. Louis Fed

Older Adults Spend More on Categories with Higher Inflation



CPI-E measures consumption for older adults; older adults spend differently than the general population.

Medical Care Inflation: A 3.42% Annual Rate Between 2000-2010



Higher spending on health-care tends to drive a higher inflation rate for older adults.

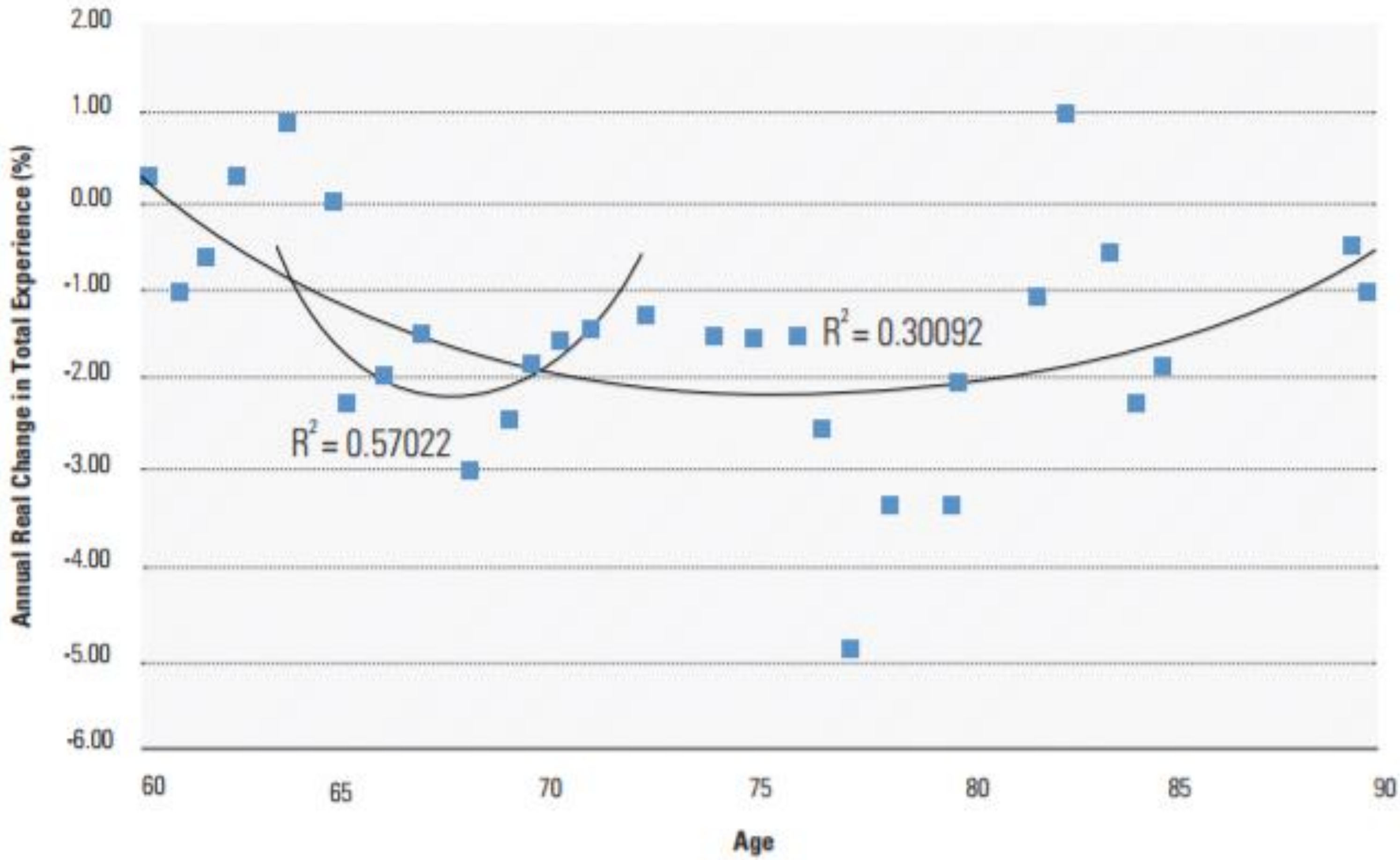
Inflation Risk: Why It Matters

- g Inflation is a factor for all of us, but it's especially negative for retirees because:
  - / The portion of their portfolios that they're withdrawing is not automatically inflation-adjusted (in contrast with our paychecks and Social Security)
  - / Inflation is the natural enemy of anything with a fixed payout:
    - – Nominal (non-inflation-adjusted) bonds
    - – Fixed annuities
  - / More conservative portfolios have lower return potential, so inflation takes a bigger bite in percentage terms

Inflation Risk: How to Mitigate It

- At the portfolio level, consider:
  - Treasury Inflation-Protected Securities, I-Bonds
  - Stocks: Best long-run shot at beating inflation
  - Niche categories: Bank-loans, high-yield, REITs (recognize interest-rate sensitivity)
- At the plan level, consider
  - Delaying Social Security: Enhanced return is also inflation-adjusted
  - Adding inflation protection if purchasing long-term care insurance, annuities

Who's Smiling Now?



Source: David Blanchett, Morningstar

Health Care Cost Risk: Why It Matters

- The average married couple will need $280,000 in aftertax dollars to cover their in-retirement health care costs, per Fidelity
- Retiree health-care costs include the following:
  - Medicare premiums (Part B, D)
  - Supplemental insurance policy premiums, copays, deductible
  - Pharmaceutical costs
- Remember: Those insurance costs are not brand-new; most retirees had them subtracted from their paychecks prior to retirement

Retirees' Health-Care Costs Vary Widely Based on Health, Geography, Income

Figure 7. The range of annual health care costs for a 65-year-old woman, 2018

	Income below $85,000						Income above $160,000					
Health risk	Low	Medium	High	Low	Medium	High	Low	Medium	High	Low	Medium	High
Geography, cost of living	Low	Medium	High	Low	Medium	High	Low	Medium	High	Low	Medium	High
Supplemental coverage	**None**	**None**	**None**	**Plan F**	**Plan F**	**Plan F**	**None**	**None**	**None**	**Plan F**	**Plan F**	**Plan F**
Median	$3,300	$3,900	$7,700	$4,700	$5,200	$6,900	$7,800	$8,300	$12,100	$9,200	$9,600	$11,300
10th percentile	$3,000	$3,200	$3,500	$4,700	$4,900	$5,500	$7,400	$7,600	$7,900	$9,100	$9,300	$10,000
25th percentile	$3,100	$3,400	$4,700	$4,700	$5,000	$5,900	$7,600	$7,800	$9,100	$9,100	$9,400	$10,400
75th percentile	$3,700	$4,900	$13,500	$4,800	$5,600	$8,700	$8,100	$9,300	$18,000	$9,200	$10,000	$13,100
90th percentile	$4,200	$6,600	$21,800	$4,800	$6,000	$11,000	$8,700	$11,000	$26,200	$9,300	$10,500	$15,500
10th-90th percentile range	**$1,200**	**$3,400**	**$18,300**	**$100**	**$1,100**	**$5,500**	**$1,300**	**$3,400**	**$18,300**	**$200**	**$1,200**	**$5,500**

Annual health care costs for a 65-year-old woman, 2018

Lower ⟷ Higher

Source: Vanguard

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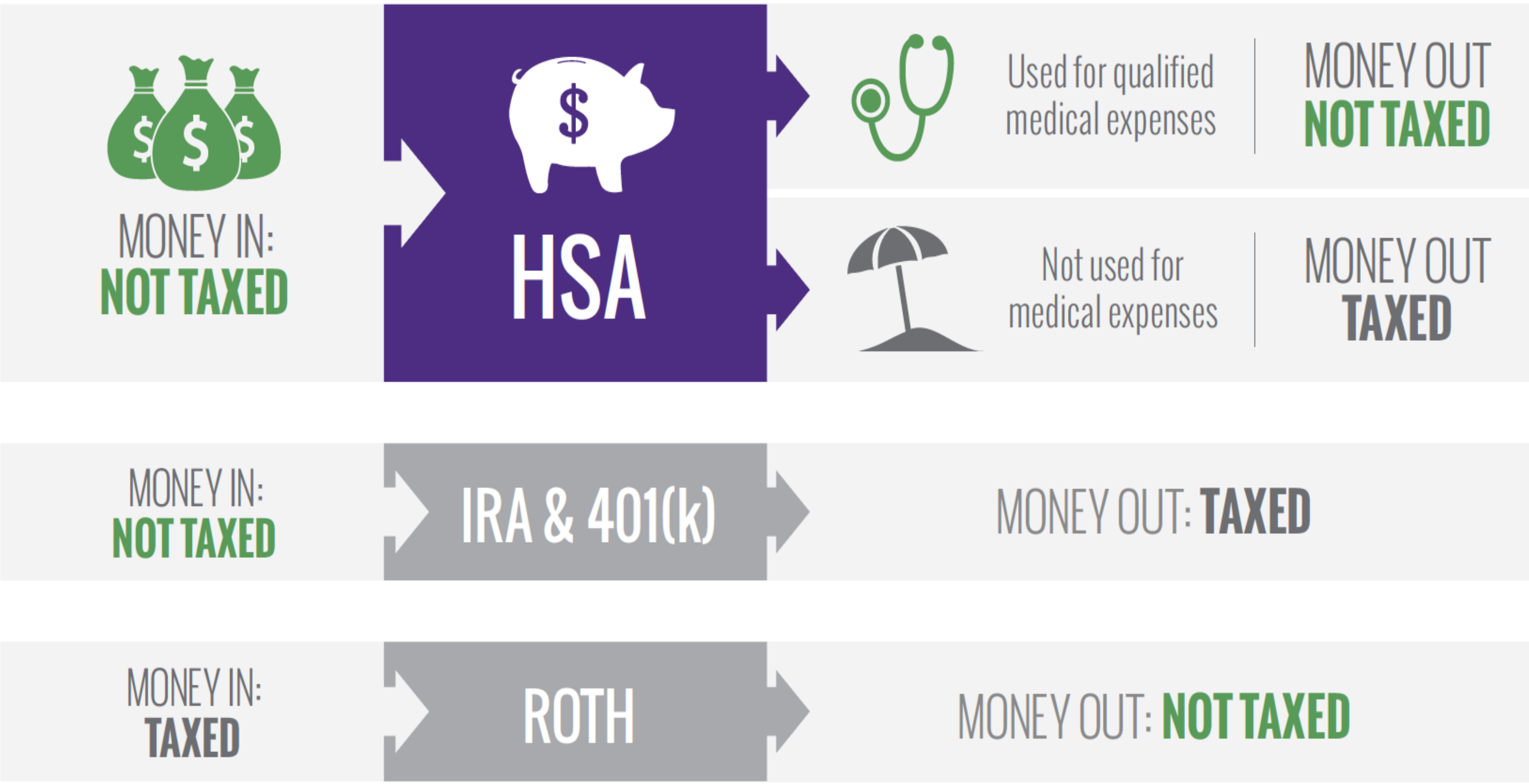
Health Care Cost Risk: How to Mitigate It

- Portfolio plan should factor in possibility of higher health-care costs in retirement
  - Customize cost forecast factoring in any chronic health conditions, geography, income level
  - Factor in likelihood that health-care costs will increase later in life
- Portfolio plan should also factor in risk of high out-of-pocket costs in early retirement, pre-Medicare years
- Proper insurance is essential: Medicare Parts B and D, supplemental insurance policy
- During accumulation years, take advantage of tax-sheltered ways to save for health-care expenses, especially health savings accounts

A Closer Look at Health Savings Accounts (HSAs)



Source: HealthEquity.

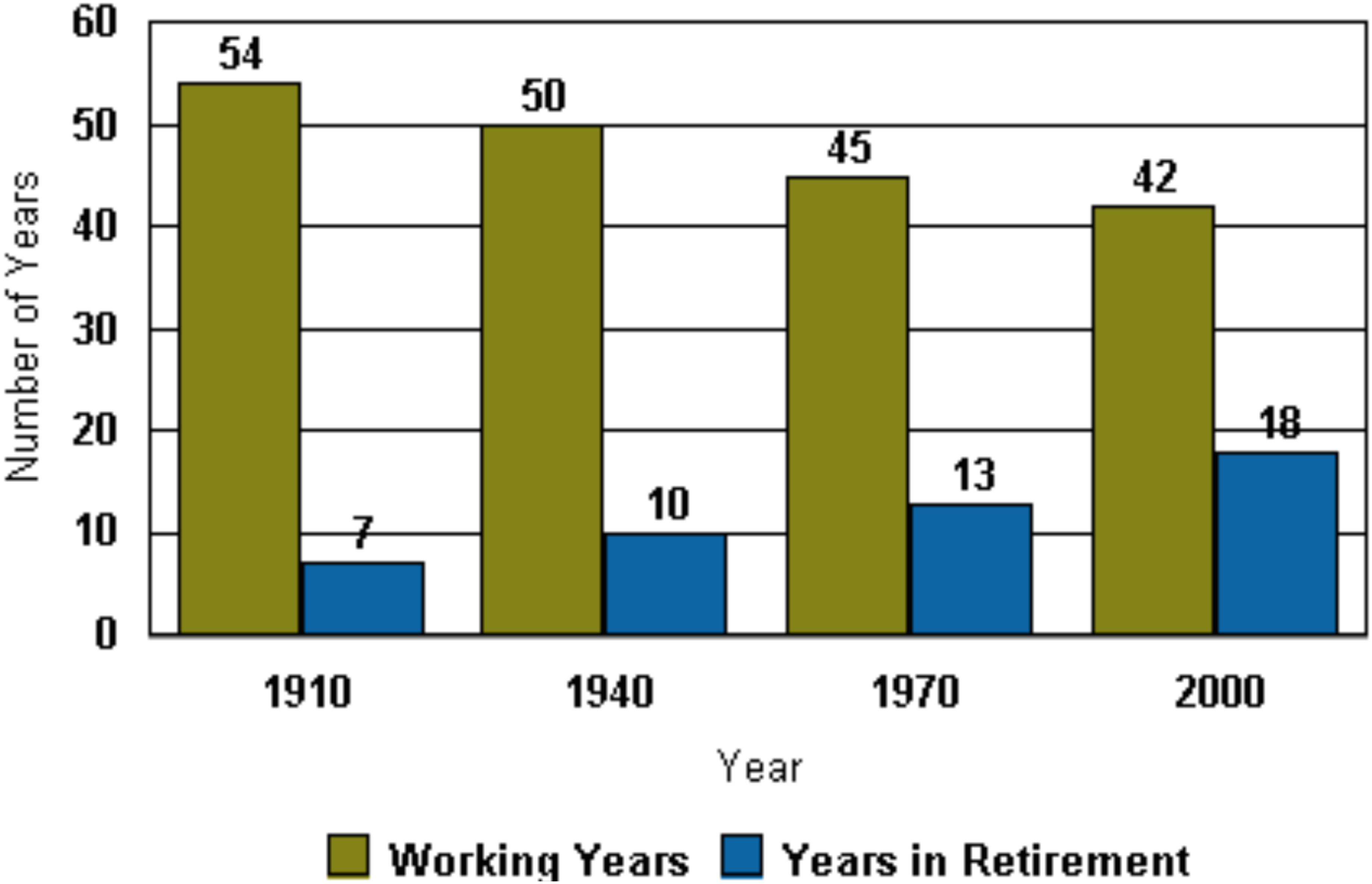
Long-Term Care Cost Risk: Why It Matters

- Long-term care is non-medical care for people who are unable to complete activities of daily living (bathing, dressing, etc.)
- This type of care is not covered by Medicare (unless it happens to arise in connection with a qualifying hospital stay—”rehab”)
- An extended long-term care need can loot a portfolio
  - $102,200: Average nursing home cost, private room, 2019 (Genworth)
  - Costs vary dramatically by geography (Annual nursing home cost, private room, NYC: $161,148)
  - Women tend to require paid long-term care more often than men
  - Average length of stay: ~2.5 years

Long-Term Care Risk: How to Mitigate It (Real Headline: No Good Answers)

- Purchase insurance
  - Premiums have increased substantially over past decade
  - Many insurers out of the business altogether (125 insurers offering standalone LTC policies in 2000; 15 today)
- Purchase a hybrid long-term care/annuity or hybrid long-term care/life insurance policy
  - Policies have supplanted traditional long-term care insurance
  - However, more opaque, harder to comparison-shop
  - Don't offer guarantees of higher payouts if yields increase in the future
- Self-fund using portfolio assets and/or home equity
- Rely on government resources
  - Can create risks for "well" spouse
  - Will limit care choices

This Is a Good News Story, Right?



Longevity Risk: Why It Matters

- 19 years: Average life expectancy: 65-year-old male
- 21 years: Average life expectancy, 65-year-old female
- 31%: Odds that one member of a 65-year-old couple will live to age 95
- Higher incomes correlated with longer life expectancies (better access to health care, access to better health care)
- Meanwhile, % of population with pensions (lifetime income) has declined
  - 67% unionized private sector workers covered by pensions (2013)
  - 78% of public sector workers covered
  - **13%** of non-unionized private-sector workers covered

Longevity Risk: How to Mitigate It at the Portfolio Level

- To help ensure portfolio's sustainability (and in turn, ability to deliver cash flow) over a very long life, consider:
  - Maintain a conservative withdrawal rate (<4% if time horizon is longer than 25-30 years)
  - Reinvest a portion of required minimum distributions if bulk of portfolio is in tax-deferred account
  - Hold healthy allocation (at least 50%) in stocks, diversified by style, size, geography

Longevity Risk: How to Mitigate It at the Plan Level

- Maximize non-portfolio sources of lifetime income, such as:
  - Social security maximization: Waiting longer not always the right answer, but can help enhance lifetime, survivors' benefits
  - Pension maximization: Annuity option often the better bet for retirees concerned about
  - Annuities: To annuitize or not?
    - Can be complex, costly, often sold, not bought
    - Income annuities, immediate and deferred, tend to be less complicated, less expensive
    - Quality longevity annuity contracts (QLACs) are also an option

Questions? Comments?

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