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Finding a Balance in Retirement Planning
by Craig W. Lemoine, CFP®

Advisors must weigh quantitative recommendations against their clients’ actual behavior.

FINANCIAL PROFESSIONALS ARE CONSTANTLY struggling to manage the dissonance between rational recommendations and the actual behavior of their clients. This dissonance reaches a crescendo as clients retire and age. Advisors face the challenge through planning investment portfolios, planning future spending and setting life expectancies. The rational client maintains an optimal portfolio, spends wisely and passes away according to actuarial tables. Actual clients rarely color in-between the lines.

Rational investors buy when the market is low, hold their positions when times get tough and spend appropriately. Modern portfolio theory (MPT) is the basis for traditional investment philosophy and guides us to buy risk-appropriate, diversified portfolios. MPT encourages investors to seek an optimal combination of lowly correlated assets (domestic and international equities, bonds, cash, real estate, fixed accounts and commodities) that have the greatest risk-adjusted net performance.

MPT encourages investors to attain an optimal portfolio by building a market portfolio of assets that are tangent to an investor’s highest indifference curve and the capital market line. Conservative investors will invest in a higher percentage of risk-free assets, and more ambitious risk takers will lean more towards an optimal risky portfolio. As assets have lower correlations to one another, investors can create less risky portfolios and decrease their overall risk exposure. In layman’s terms, MPT asks us to buy a combination of risk-free and risky assets we are comfortable with and adjust them to stay in line with risk tolerance (see Figure 1).

With investments squared away, a rational client needs to address spending during retirement. The seminal permanent income hypothesis (Milton Friedman, A Theory of Consumption Function, Princeton University Press; nber.org/chapters/c4405.pdf) helps guide rational consumption decisions and provides a background for retirement. Stated simply, consumers tend to adopt the lifestyle of their parents and spend accordingly over their lifetime. For most of us, consumption is constant over a lifetime while income is not (see Figure 2).

Rationally, retirement planning is nothing more than finding a way to consume after our income line drops below a retiree’s consumption line. Ideally, a retiree saved while their income exceeded consumption; and they can utilize their nest egg...
through the remainder of their lifetime. While no uniform theory exists on how to spend down their nest egg, some measure of constraint dominates conversation. Financial advisors engage in conversations and debate if constraining withdrawals to 3 percent, 3.5 percent or 4.0 percent is an appropriate technique. Other advisors recommend practicing withdrawal constraint when viewing how many dollars can be distributed from one asset allocation bucket to another.

Rational clients make consistent distributions over their lifetimes, and if a rational client happens to be a 60-year-old woman she will live to be 84, according to the Social Security Actuarial Life Table (ssa.gov/oact/STATS/table4c6.html). To summarize, rational clients invest optimally while they are working and predictably spend their savings until they die at a point defined in the future. These three assumptions shape traditional thinking about retirement planning and each of them is fundamentally flawed.

CHALLENGES TO INVESTING OPTIMALLY
Clients are rarely invested in an optimally allocated portfolio, and they tend to favor simple and conservative investments. Actual clients sell when the market drops. Losing hurts and our very instinct is to avoid hurt and practice loss aversion (Journal of Behavioral Decision Making, “Loss aversion, diminishing sensitivity, and the effect of experience on repeated decisions,” Erev, I., Ert, E., & Yechiam, E., 2008.). Clients sell after losing because they don’t want to continue pain; they miss out on periods of recovery and gain fear and trepidation. Fear can lead to avoidance of future losses, which may curtail investing in equities or other key components of a diversified portfolio.

Building an optimal portfolio requires access to a universe of investments that have low or negative correlations with one another. This universe extends well beyond traditional stock, bond and insurance options, and outside the comfort zone of many clients and their advisors. Commodities, international exposure, hedge funds, real estate, derivatives and nontraditional investments play a role in achieving optimal diversification. With additional diversification comes increased complexity and higher minimum buy-in thresholds/costs, both of which lead actual clients back to simpler and less diversified solutions. Clients who sell nontraditional asset classes lower their diversification, which increases their overall portfolio risk.

SPENDING
Actual clients have hobbies and emergencies. Either can derail the best of assumptions and retirement plans. Plans are generally structured to emulate a percentage of pre-retirement spending (70 percent is a popular number) or from the ground up, determining a monthly target amount based on client goals. Both mechanisms work well for the first month a client retires. The rational client may continue to spend exactly a target amount. Actual clients will spend dramatically less and dramatically more on a monthly basis. Spending must be structured in a flexible and fulfilling way.

WHEN WE DON’T DIE AT 84
Stagnant life expectancies are troublesome on two fronts. The obvious: outliving a set life expectancy can cause financial hardship. Life expectancy tables are not dormant—they adjust on an annual basis. A 60-year-old woman has a 50 percent chance of living another 23.97 years. When she turns 61 she has a 50 percent chance of living another 23.14 years, and when she turns 70 her life expectancy moves to 86. When she turns 86, there is a 50 percent chance she will be alive at 92. Retirement plans must be built for this contingency. Healthy people in 2012 can live a very long and productive life.

Practicing excessive constraint is equally as troublesome. Clients have accidents, they are diagnosed with cancer and they have heart attacks. If half of 60-year-old women live to 83, half of them die before then. Excessive constraints on retirement spending may prevent clients from enjoying the wealth they built.

Financial professionals must remember that actual clients are never rational. Advisors must find harmony between quantitative recommendations and how clients actually behave. This harmony requires updates, monitoring and regularly engaging the client. When first retiring, monthly check-ins will help stabilize the plan and learn the difference between the actual retiree and rational client who engaged in the retirement planning process.

Retirement modeling requires advisors to assume rates of return, spending and life expectancy. Initial assumptions provide clients with a starting point but are not enough to provide lifelong guidance. Consistent monitoring and updating must take place through retirement to help clients achieve a balance between their retirement plan and actual behavior.