

## **“7 Tips on How to Build a Bulletproof Retirement Income Plan, So You Can Retire Without Fear of Outliving Your Money”**

So you are contemplating retirement after 30 plus years of hard work and saving for your retirement. The thought of retirement bliss and personal accomplishment of finally attaining a goal of no more 10 hour workdays, navigating the treacherous office politics, and relentless mergers and reorganizations being replaced with new opportunities to spend additional family time, travel, play golf, etc. makes you smile. But, as this blissful moment sinks into you, an uneasiness and uncomfortable feeling bubbles up within you about your new uncertain future. A feeling of lack of control, and concerns about how are you going to live, begins to overwhelm you with fear of the future. The thought of retirement bliss is now replaced by real fear of outliving your money. You know others that had unfortunately not saved enough to live on, and recent memories of difficult times including recessions, 9/11, and political tensions has altered best laid retirement plans of others you know. So, you begin to wonder what can be done to make sure that your hard earned retirement assets last, earn enough to stay ahead of inflation, and can survive the inevitable economic and political upheavals with your principal intact, so that you live your retirement with peace of mind and without fear of outliving your money?

Fortunately, today there are now many more ways than ever to build retirement income strategies that can protect your retirement principal in a world of uncertainty and unforeseen events. New ways to generate guaranteed retirement income that you cannot outlive, while still providing the opportunity for you to accumulate more assets with less financial and investment risk, so to provide you the peace of mind you desire during your “golden years”.

Below, are some thoughts you may want to consider:

### ***“7 Tips on How to Build a Bulletproof Retirement Income Plan So You Can Retire Without Fear of Outliving Your Money”:***

- 1) **Foremost in importance is to perform a retirement analysis** to determine the important retirement planning factors such as your estimated retirement expenses factored for inflation, sources of income, retirement assets, so to calculate a target rate of return necessary to be earned on assets to provide a retirement income for you and potentially your spouse’s lifetimes. This can be accomplished using several approaches, but one of the more accepted approaches is performing a Monte Carlo simulation to determine the probability of success using historical expectations for portfolio volatility based upon return over the anticipated retirement period, i.e. 30 years. Other contributing factors including social security estimates, death benefits from insurance based upon life expectancy and other windfall assets can also be factored in the analysis. In addition to the necessity of knowing the required target return to be generated in order to earn enough to pay out income for the duration of retirement, the analysis will reveal other important assumptions that might affect the probability of success, including

estimated income taxes during retirement, additional expenses such as health related expenses, and the impact of selling or not selling illiquid low yielding high dollar assets, such as real estate, collectibles, or a business. The analysis also will allow for “what ifs” to determine the best possible retirement strategy and to modify assumptions to give greater confidence to the success of the retirement plan.

- 2) **Perform a behavioral risk tolerance assessment** - All too often decision making about personal wealth is influenced by emotions and unconscious biases that cause people to make sub-optimal choices. Extensive research has identified several important behavioral factors that can influence investor behavior on gain and loss. Among the most pernicious are those biases that drive people to chase strong investment returns, make them reluctant to rebalance portfolios and cause them to over react to short-term volatility. Investors tend to be highly *loss averse*<sup>1</sup>. Generally, investors favor less short-term volatility at the expense of long-term returns. When faced with the prospect of a certain loss, people were overwhelmingly willing to gamble to avoid it. *Affection for certainty* is a bias that most investors have a disproportionate preference for investments that have no inter-period volatility.<sup>2</sup> For most of us, the pain of a given loss significantly exceeds the pleasure of an equivalent gain. In fact, research on the subject shows that we equate gains and losses in a ratio of about 2:1.<sup>3</sup> An independent study performed over the period from 1984 through 2002 inclusive, found the average mutual fund produced an average return, with dividends reinvested, of 9.6%. During the same period, the average equity mutual fund investor (again, with dividends reinvested) was found to have earned an average annual return of just 2.7%.<sup>4</sup> The only discernible explanation appears to be that investor tolerance for risk affected their ability (behavior) to weather the short-term volatility to realize the long-term rewards. As such, a behavioral risk tolerance assessment will identify attitudes toward short-term risk of loss compared against the desire for long-term gains. Understanding the incongruence between short-term and long-term tolerance for risk can help explain how one might react in volatile markets that could affect long-term retirement plans. Creating a successful retirement investment strategy requires considering one’s possible investment behaviors and risk tolerance in the design and selection of asset classes and investment vehicles to be used.

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<sup>1</sup> Alliance Capital Management, Providing Effective Investment Advice: Insights from Behavioral Finance; Lewis A. Sanders, CEO Alliance Capital Management, June 2005, p. 2.

<sup>2</sup> Ibid, p. 1.

<sup>3</sup> Ibid, p. 2.

<sup>4</sup> The Economist, The Employee Benefit Research Institute - Special Report, July 5, 2003.

- 3) **Avoid investor bias mistakes by using Portfolio Optimization during asset accumulation** – for assets that are not guaranteed and to be invested for other investment objectives besides income i.e. asset accumulation, reducing risk takes on added importance. Again often decision making about personal wealth is influenced by emotions and unconscious biases that cause people to make sub-optimal choices. Investors typically compartmentalize returns (narrow framing at work) and, owing to loss aversion, focus their attention disproportionately on the part of their portfolio that is not performing well. They do this even though they may know that the very point of a diversification is to find assets with no or negative correlations that do well over time but not at the same time. “*Narrow framing*” has the effect of causing many investors to lose faith too quickly in strategies that underperforming because they attribute the failure to a group of bad investments, and not the result of non-correlation, a requirement for risk reduction. Investors see it as funding the losing strategy with the winner, and as such are almost always inclined to do the opposite.<sup>5</sup> “*Trend following*”, is another strong investor bias (today – real estate) that leads to overweighting in performing sectors and underweighting in non-performing sectors which can cause excessive risk and volatility compared to the expected return.<sup>6</sup> Given that most returns mean revert the consequence is that narrow framing, and trend following biases can hurt your chances to make better returns and increase your risk to principal. To ensure your retirement lifestyle, investors should adopt a risk-based investment strategy that protect principals, minimizes risk of loss, and increases risk adjusted investment returns. Because powerful biases like narrow framing and trend following are difficult to control many financial advisors and planners now recommend using “Portfolio Optimization”.<sup>7</sup>

Portfolio Optimization is a systematic portfolio rebalancing process based on Dr. Harry Markowitz's Nobel-prize winning modern portfolio theory. The Portfolio Optimization model calculates the optimal capital weightings for a basket of investments that gives the highest return for the least risk. Today, increasingly financial planners and advisors utilize portfolio optimizers' asset allocation methodologies like Ibbotson Associates to construct the asset allocation of the funds thereby removing innate investor biases from the investment allocation decision to systematically achieve the desired investors return and risk tolerance objective. Some studies indicate that not only will the negative effects of emotional investment bias be minimized, but that your overall portfolio return may be maximized by as much as 2% over time.<sup>8</sup> This is significant in that based upon the Rule of 72, a portfolio will double in 12 years at 6%, and every 9 years at 8%.

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<sup>5</sup> Ibid, p. 3.

<sup>6</sup> Ibid, p. 5.

<sup>7</sup> Markowitz, H., Portfolio Selection: Efficient Diversification of Investments, New York: John Wiley & Sons, (1959).

<sup>8</sup> Alliance Capital Management, op. cit., p. 6

- 4) **Build “income guarantees” as much as possible** – Not many people ever complain about receiving a social security or pension check. Unfortunately, with each passing year fewer Americans can count on the security of a lifetime pension. As of 2003, about 17 million workers were active participants in pension plans, down from more than 22 million in 1988.<sup>9</sup> While a pension is not always guaranteed anymore, more retirement income certainty is better than none. With the average life expectancy extending for many into the 80’s and 90’s, the likelihood of needing a retirement income for 30 years or more is becoming more commonplace. In fact, even if you have a balanced portfolio (60% - Equities, 40% - Fixed Income), studies indicate that you will have only a 63% chance of being able to receive a 5% withdrawal for 30 years and having \$1.00 remaining in your portfolio at the end of your retirement.<sup>10</sup> In a world of uncertainty and longer life expectancies, having some level of guaranteed income for life seems to be a prudent thing to do. Fortunately, today there are more options than ever for investors to seeking “guaranteed options. In addition to the traditional fixed income assets such as savings, CD’s money markets, taxable and non-taxable bonds, and fixed annuities, there are new options to choose from. Today, new variable annuity products offer lifetime benefits income guarantees (including joint lives) without requiring “annuitization”. In addition, some variable annuities provide a rollup annual percentage minimum growth rate during the accumulation phase to determine the “protected value” used to calculate the lifetime income benefit. Depending upon your short and long-term retirement goals, income needs, and risk tolerance, securing some level of “guaranteed retirement income” is increasingly possible.
- 5) **Diversify using low cost investment vehicles and if possible utilize accumulation benefit guarantees** – minimizing investment **costs** on transactions and annual expenses (i.e. mutual funds, ETF’s, stocks, bonds) can significantly increase the long-term performance of a retirement portfolio over the course of a retirement spanning 30 years or more. Selecting low cost no load mutual funds can save valuable fees that can bolster long-term returns. For some assets you may want to consider using variable annuities that provide accumulation benefit guarantees to receive the highest “protected value” during bear markets, recessions, and as a result of unforeseen events (i.e. global terrorism, and 9/11) that can dramatically impact the lifetime income benefit payout potential from your variable annuity no matter what investment sub-account you may being invested in.

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<sup>9</sup> LA Times Business, The Employee Benefit Institute, July 4, 2006, p. C6.

<sup>10</sup> T. Rowe Price, Improving Your Chance for a Quality Retirement – In All Kinds of Weather, December 2005;

- 6) **Review and Monitor** – economies change, your needs change, and money overtime flows to the highest return for the risk. As important as the initial investment is the necessity to have a systematic process for review to account for change. Most investors have less difficulty making a buy decision, but struggle making sell decisions. They also have difficulty with investor bias regarding gain and loss. As such, making sure that a regular review possibly with professional assistance can help clarify the issues and decisions to be made. Utilizing portfolio optimization can reduce the impact of emotional decisions on long-term plans.
  
- 7) **Seek objective financial advice from a professional** – as outlined above there are many factors to consider in building a bulletproof retirement income plan. Personal factors include your investment goals, income needs, risk tolerance and tax situation. However, performing a retirement analysis to determine how much money will be needed to provide a retirement income for life, assessing your behavioral risk tolerance, crafting an investment strategy, evaluating income generation options, understanding taxes, requires training, experience, and objectivity.

As evidenced by much research, working alone without objectivity can subject you to misconceptions and prone you to succumbing to insidious behavioral biases that can sabotage any long range retirement plan, especially in times of market turbulence. Working with an objective preferably fee-based professional can help you design a customized plan suited to your specific goals and needs, and evaluate the plethora of investment strategies and vehicles available to achieve your investment goals. In addition, plans, economies, risks, and investment performance change accordingly over time. Having someone to help monitor and review your investments regularly can help you make the usually difficult decisions to keep your long-term investment plan on track.

The quality of an advisor's services should not only be defined by investment results and cost; as important is how you feel about your wealth along the way. While cost is an often cited reason for not obtaining financial advice, the cost of no financial advice based upon copious research can be extremely expensive considering investor behavioral biases. "In the end, the best portfolio in the world won't save an irrational investor. But a wise advisor – using a behavioral approach to essentially behavioral issues – just might."<sup>11</sup>

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<sup>11</sup>Murray Nick, The New Financial Advisor, February 2005.