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Strategy Compilation for a Successful Retirement Income Plan

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Abstract: *A balancing act must take place when selecting retirement income strategies. Planners must find the proper equilibrium that will effectively negate a variety of postretirement risks while leaving the client with enough assets to maximize his or her standard of living. Finding the right combination of products, strategies, and investments (strategy compilation) can enhance the client's chances for both a secure retirement and the greatest possible spending power. The puzzle needs to fit together without any holes and with as little overlap as possible. One facet of strategy compilation centers on testing combinations of strategies to discern the most cost-effective way to handle a risk. Another facet of strategy compilation is finding efficiencies by allowing one or more strategies to serve as a hedge against multiple risks. This facet does not shut down all risks. It does, however, address the age-old financial planning conundrum of allocating limited resources to multiple priorities by allowing clients to find trade-offs with which they are willing to live.*

Let's start with the premise that clients want their retirement income plans both to manage retirement risks (see Table 1 for a partial list of risks) and to provide as much income as possible for annual spending. Let's also stipulate that many times these two goals are at cross-purposes. In other words, one problem with managing retirement risks is that the strategies used to address risks often come at the expense of limiting the amount of retirement income the client can draw down for their annual budget. Spend retirement assets on long-term care insurance (LTCI) and Medigap insurance to address long-term care and health care expense risk and the client will not have that money to spend on everything from groceries to visiting the grandchildren. However, ignore those two risks and the client will almost certainly fall into poverty should he or she get dementia or suffer from a serious illness. What's worse is that the surviving spouse could be left destitute for the rest of his or her retirement after the spouse with the serious illness dies. It is the age-old financial planning conundrum of allocating limited resources to multiple priorities.

TABLE 1		
Selected Risks to Retirement Security		
Risk	**Definition**	**Issue**
1. Longevity Risk	Living longer than expected and consequently running out of assets to convert into income. The planning horizon for retirement is indefinite and unknowable, so a client who underestimates the required length of time will deplete his/her resources too quickly and lack the necessary resources to fund retirement income after a certain age.	Planners should note, however, that overestimating life expectancy in the retirement income plan will compel the client to parcel out resources in an inefficient and oftentimes standard-of-living altering manner.
2. Portfolio	Depletion of retirement assets	Choosing a withdrawal rate that is

Failure Risk (also called Excess Withdrawal Risk)	throughout retirement may lead to a shortfall of needed resources in the later stages of retirement. Choosing to draw down assets too quickly will cause the premature exhaustion of needed resources.	too low, however, will lower the client's standard of living unnecessarily. Clients are not solely seeking safety; they are looking for permissible withdrawals that are both safe and that maximize their standard of living.
3. Investment Risk	Poor investment choices and black swan market events can lead to capital loss or less-than-planned-for investment returns. Clients also may suffer from other related risks including market risk, which is the risk from events that cause all security prices to fall; or asset allocation risk, which is the risk of not adequately diversifying investments. Any reduction in the client's portfolio can lead to inadequate resources to fund retirement income.	Too conservative an investment approach can make a secure retirement impossible. Too aggressive an investment approach can also undermine retirement security.
4. Sequence of Return Risk	The variations of sequences of actual events beginning with different time periods may adversely impact the client's ability to count on his/her asset pool to provide the needed amount of income. If the client retires right before or after his/her investments fall sharply due to a black swan market event, then the pool of resources may prove to be insufficient for retirement. In other words, the client won't be able to sufficiently recover from the unfortunate timing. Consequently planners might suggest that the client continue employment or go back to work after a down market.	This solution may not be tenable since continued work or “unretirement” may be out of the client's control.
5. Reinvestment Risk	There is a chance that as higher-yielding fixed income investments mature, the client may need to reinvest that principal and possibly interest payments into a lower-yield fixed income investment. If your client is relying on returns from investments, then any drop in expected yield may have an adverse impact on his/her standard of living.	A portfolio without some fixed-income investments may not allow the client to properly convert assets into retirement income and it may not be properly balanced.

6. Liquidity Risk	The inability to have assets available to support cash flow needs. Cash flow planning is an essential part of proper retirement income planning. This not only means planning for budgeted expenses but also means being prepared to have the resources needed to pay for and combat unanticipated or emergency needs. A client who ties up too much money will lack the ability to account for the dynamic nature of retirement.	Failing to tie up assets in products that serve other purposes may undermine many viable strategies and enhance other risks.
7. Inflation Risk (also called Purchasing Power Risk)	Increases in the price of goods and services will impede the ability to maintain the desired standard of living. Compounding inflation works against a client in a manner similar to the way compounding interest works for a client. For example, three percent annual inflation for a client who retires at age 62 will mean that costs will nearly double for the client by the time he/she turns 86.	Underestimating inflation in the retirement income plan will cause a decline in the client's spending power. However, overestimating inflation in the retirement income plan (and consequently spending less) will lower the client's standard of living throughout retirement.
8. Long-Term Care Risk	Dementia or other mental or physical limitations may restrict a client from performing the activities of daily living and require an outlay of significant resources for custodial and/or medical care. The need to provide health and custodial care in retirement is unknowable and potentially economically devastating. Studies by the Employee Benefit Research Institute (EBRI) have tagged long-term care risk as being the most substantial factor in the lack of financial preparedness for retirement.4 Clients who do not prepare for, or who suffer from, this risk can expect to spend significantly more during retirement than clients who do not suffer from, or are prepared for, long-term care issues.	Using too many assets to account for this contingency may undermine the client's standard of living.
9. Health Care Expense Risk	Costs exceeding Medicare coverage based on an increased need for care and/or rising health care prices may impede the ability to maintain the desired standard of living. The need	Determining the amount of coverage is crucial. Too little coverage exposes the client to disaster. Too much coverage uses resources that could be better

	for resources for health care is unknowable and potentially economically devastating. Underinsured clients often-times will spend significantly more during retirement than clients with proper insurance protection.	used to mitigate other risks or enhance the client's standard of living.
10. Loss-of-Spouse Risk	In addition to the emotional and psychological consequences of losing a spouse and consequently having to live alone, there are financial and planning hardships that may arise when one spouse predeceases another.	Resources spent to protect the second spouse to die could be used to help both spouses while they are alive. In addition, clients can never be certain how best to utilize the “protection resources” because they cannot be certain which spouse will die first.
11. Forced Retirement Risk	Stopping work prematurely based on health concerns, company downsizing, caregiving responsibilities, job satisfaction erosion, or other reasons prior to the planned-upon retirement date. The client who needs to retire earlier than anticipated will often have inadequate retirement resources especially if the client cannot reenter the work-force (sometimes called reemployment risk).	Optimally clients would choose their retirement date based in part on having saved enough resources to sustain them throughout the period ahead. However, much like the squirrel that got caught short from storing enough acorns by an early winter, clients must find a way to ration inadequate resources.
12. Public Policy Change Risk	An unanticipated transition in government programs that were embedded in the planning process including, but not limited to, significant tax increases, elimination of relied-upon tax benefits, and/or minimization or elimination of government programs such as Medicare, Medicaid, Social Security, and others. Any change from the expected events on which planning relied can undercut the client's retirement stability.	Clients cannot plan for all contingencies. But certain changes like higher taxes or means testing can be anticipated. The problem is devoting resources to these contingencies may undercut the retirement standard of living.
13. Unexpected Financial Responsibility Risk	Acquiring additional unanticipated expenses including but not limited to the need to support children and/or grandchildren financially may derail a client's retirement income plan.	The opportunity exists here to avoid this problem by turning away from this responsibility. Since most parents probably won't accept turning children and grandchildren away, it may be a question of reserving resources to deal with this contingency. Once again, the

		opportunity cost issue arises. Resources used for this contingency cannot be used for other purposes.
14. Legacy Risk	The inability to meet the philanthropic and bequest goals that are set. Retirement planning does not operate in a vacuum. Estate goals can be compromised if the client does not properly approach retirement income planning.	Clients need to balance between their standard of living today and their legacy. Too much legacy may lead to too much sacrifice during the retirement period and vice versa.

The solution, of course, is that a balancing act must take place when selecting retirement income strategies. (See Table 2 for a partial list of strategies.) Making tradeoffs in retirement income planning, like balancing the trade-off between risk and reward in investment planning, should be standard practice in the industry. The planner and the client must assess each unique client situation and cobble together a plan that weighs risks in the most cost-efficient manner possible. Put another way, there are many facets to managing retirement income; however, there is none more essential than striking the proper equilibrium when choosing strategies that will effectively negate the variety of risks that a client will encounter while leaving the client with enough assets to continue his or her standard of living. The right combination of products, strategies, and investments can maximize the client's chances for a secure retirement. Conversely, overkill in the plan that overaddresses one risk, while ignoring or exacerbating others, may lead to the type of disproportion that can ultimately undermine an effective retirement income plan. By way of analogy, investment planners practice the now common convention of proper asset diversification. Retirement income planners must practice a first cousin to this, the new art of strategy compilation (a subset of which includes product diversification).

The goal of strategy compilation is to weave together complementary strategies to draw down retirement assets and cope with retirement risks while leaving the client with as much cash flow as possible. The retirement planning challenge is to balance maximizing retirement income while providing adequate risk management. An additional concern is for planners to seek out efficiencies wherever possible. It is not just a question of choosing strategies; it is the issue of adapting those strategies to work in concert with one another. The puzzle needs to fit together without any holes and with as little overlap as possible. For this reason a planner who uses strategy compilation will do the following:

- Step 1—Identify the client's goals and priorities.
- Step 2—Decide on a decumulation strategy to create an income stream for retirement.
- Step 3—Identify the retirement risks the client is facing. (Table 1 provides a start, but is not intended to be comprehensive.)
- Step 4—Address each risk with a strategy or strategies. (In the end the planner must identify how he/she has “checked off” each risk.)
- Step 5—Adapt and integrate the strategies to solve the risks while maintaining as much spending income for the client as possible by running the numbers for multiple scenarios. (In the end the planner must demonstrate that he/she minimized the expenditures that were used to account for the risks.)

The Two New Attributes of Strategy Compilation

We believe it is safe to assume that most planners are currently performing steps one through four. (It would be worrisome to think that planners are ignoring risks!) For this reason let's focus on step five, the heart of strategy compilation. One facet of strategy compilation's step five involves bonding multiple strategies so that the weld is stronger than the original metal. To illustrate this point with an overly simplistic example, take the "four percent systematic withdrawal strategy." In an attempt to provide a portfolio that will not fail under any circumstances for a 30-year retirement period, some planners suggest that clients limit withdrawals to four percent of the initial portfolio value and add a cost-of-living adjustment each year to maintain purchasing power.[1] Assuming the client does not live longer than 30 years, research has shown that based on historical performance his/her portfolio will not fail, even if the Great Depression repeats itself. Problem solved; the planner has substantially eliminated longevity risk! However, research has shown that 96 percent of the time clients will end up with the same value they had in their portfolios when retirement started as they do when they die.[2] This may be acceptable for some high-net-worth clients, but it doesn't work for the vast majority of clients who are trying to squeeze each dollar of retirement assets in order to maintain their pre-retirement standard of living.

Enter strategy compilation. Here is how it might work. The client could first adapt the four percent systematic withdrawal strategy by using a five to six percent withdrawal rate, as long as he or she changes the amount withdrawn to reflect market conditions.[3] He/She could even go higher than 6 percent if the horizon is shortened from, for example, 30 years to 25 years, and purchase an advanced life delayed annuity (typically called an ALDA and also called longevity insurance) that kicks in when the 25 years is over. Additionally the planner could recommend the client delay claiming Social Security to age 70 to maximize income in later retirement. The combination of first adapting the strategy, then adding product diversification with an ALDA, and also adding the delayed Social Security claiming strategy has the simultaneous potential to better address longevity risk and to increase assets available for spending. Planners who run the numbers may find this a cheaper way to cover risk. In any case, the key to strategy compilation is for planners to seek cost efficiency by running the numbers while adapting and integrating multiple strategies. Assuming the math works out (and our point is not that the math will always work, but that the planner needs to run the numbers using various scenarios), the planner might have both increased the Social Security annuity and gone from a 5.5 percent withdrawal rate (e.g., $55,000 in the first year with a $1 million portfolio) to a 6.5 percent withdrawal rate (e.g., $65,000 in the first year with a $1 million portfolio), while at the same time checking off longevity risk from the list of things the client needs to be worried about. The tradeoff was that some assets were depleted in the early years of retirement to wait for Social Security benefits and there was a willingness to lower spending when market conditions warranted it.

This simple example shows how multiple and adaptive strategies may combine to enhance the dual goals of minimizing risk and maximizing income. It also illustrates the other facet of strategy compilation—it finds efficiencies by allowing trade-offs with which the client is willing to live. Another simple example can further demonstrate this second side of strategy compilation. Assume the client is concerned with the following risks: longevity risk, portfolio failure risk, liquidity risk, inflation risk, unexpected financial responsibility risk, and legacy risk (see Table 1 for explanations of these risks). The combined strategies of creating a separate portfolio (rainy day fund) and having a reverse mortgage line of credit reserved for these possibilities may provide an effective hedge against these varied scenarios. Should each and every risk happen to an extreme measure the client will not be sufficiently protected. However, these two lifeboats (the rainy day fund and the reverse mortgage) may be a cost-efficient alternative to overprotecting each risk separately. It's all about balance and deciding the trade-offs with which the client is willing to live.

In order to aid consumers and planners in weighing the trade-offs involved when a strategy is suggested as a way to mitigate or eliminate specific retirement risks, we first identify in list form a variety of the most common and troublesome retirement risks (Table 1). We then identify in list form a variety of the most common retirement strategies (Table 2). Lists are used in both these circumstances in order to truncate essential background information that is necessary for any strategy compilation analysis. Readers who are less experienced with the topic can find additional information in Appendix 1: An Abbreviated Literature Survey of Risks and Solutions. A final section of this paper will provide a deeper look at the five strategies that were raised in the examples above. This will enable the planner to gauge some of the core trade-offs involved with these strategies.

Identifying Retirement Risks

The primary focus of retirement income planning is to develop a plan of action that will help the client to maintain the highest possible standard of living throughout the retirement period. Any obstacle to that goal can be deemed a retirement risk. And each retirement risk must be addressed in order for the retirement income plan to be successful. Each risk, however, requires a balancing act. Table 1 briefly identifies the most common and important retirement risks and the premier balancing issue that arises with each risk.

Identifying Retirement Strategies

There are more potential strategies, products, and alternatives to create a retirement income plan than could possibly be dealt with in a single article. Listed below are brief descriptions of some central strategies. We will leave an analysis of the key balancing issues for the five previously mentioned strategies (using systematic withdrawals, deferring claiming Social Security, creating a separate portfolio, acquiring a reverse mortgage line of credit, and purchasing an ALDA) to the final section of the paper.

TABLE 2	
Selected Retirement Income Strategies	
1. Use the Systematic Withdrawal Strategy for Converting Assets into Income	This strategy focuses on creating guidelines for appropriate withdrawals from the client's portfolio. Some planners use safe withdrawal rate guidelines so that the portfolio will last for a specified time (e.g., 30 years) under all investment conditions. Other planners consider an optimal withdrawal rate that takes into consideration risk tolerance (the trade-off between spending more and the risk being future reductions in spending). There are several different variations on this strategy. In one popular method clients take an initial withdrawal from the portfolio at retirement (e.g., 4 percent of $1,000,000, or $40,000 in the first year) and then adjust the $40,000 each subsequent year for inflation regardless of the current value of the portfolio. Under another popular method, clients take an initial withdrawal of the portfolio at retirement (e.g., 5 percent of $1,000,000, or $50,000 in the first year) and then adjust the $50,000 each subsequent year for inflation regardless of the current value of the portfolio.

	However, if the portfolio value is more or less than a specified value, clients will then make adjustments to the percentage withdrawn accordingly.
2 . Use the Bucket Strategy for Converting Assets into Income	This strategy focuses on breaking the portfolio into a series of age bands, which have their own specific time horizons and spending goals. It is common to choose three 10-year time segments representing the 30 years of retirement. The assets needed for the short-term horizon are invested to be drawn down in the earliest time segment. They may be invested in laddered bonds, they may use an immunization strategy, or they may use some other liquid or cash position. The goal is to provide specified streams of income, for specified budgets, at specified times. The assets needed for later time periods (the second and third buckets) are invested for growth. Both investment and product allocations can be different depending on the corresponding bucket.
3 . Use the Flooring Strategy for Converting Assets into Income	Under the flooring approach (also known as the essential versus discretionary approach) the focus is to distinguish between essential and nonessential retirement income needs and create an investment strategy to address both. A portion of the portfolio is put into guaranteed or low-risk products or ladder strategies to create a “floor” for the client to meet day-to-day living expenses like food and rent. Once the “floor” is set, the remainder of the portfolio is managed to meet discretionary spending goals.
4 . Defer Claiming Social Security to Create Larger Amounts of Income for the Later Years of Retirement and Additional Spousal Security	Clients can claim Social Security benefits as early as age 62 and should claim no later than age 70. For a client retiring today, claiming at 62 means the client will receive 75 percent of his/her primary insurance amount. Claiming at full retirement age (66 for current retirees) means the client will receive 100 percent of his/her primary insurance amount. Claiming at 70 means the client will receive 132 percent of his/her primary insurance amount. In addition to receiving approximately a 7 to 8 percent increase in benefits for every year they delay, married clients are also increasing the survivor benefit amount that may be claimed by the surviving spouse if they delay claiming Social Security.
5 . Delay Retirement as Long as Possible or See if Formal or Informal Phased Retirement Is Possible to Grow Assets and Decrease Overall Retirement Expenditures	Planners should consider recommending postponing retirement when possible. For example, a two-year delay in starting retirement means two fewer years of assets needed for retirement income, stockpiling more money for retirement, and increased Social Security benefits. In addition, reemployment through phased

	retirement or otherwise may give the client the extra income needed to have sufficient assets for retirement.
6 . Create a “Rainy Day” Fund To Be Used for Contingent Risks (Events That May or May Not Happen)	The client could set aside assets (the family home, rental property, a stock portfolio, etc.) that could remain untouched until needed for one contingency or another.
7 . Acquire a Reverse Mortgage to Garner Extra Income or Manage Portfolio Reduction	A reverse mortgage is a loan against an individual's home that does not require repayment as long as the client lives in the home (paid when the owner sells the home or dies). One recently discovered use of this resource advocates using the home equity line of credit to allow cash flow in down market years and avoid having the client sell off stocks that have declined in value.[5]
8 . Prepay to Lower Retirement Expenses	By prepaying for a funeral, or paying off mortgages and other loans, the client will lower or eliminate expenses in retirement.
9 . Choose to Reside in a Continuing Care Retirement Community (CCRC) to Enable a More Structured Retirement Lifestyle and Cope with Health Care Issues	CCRCs provide a variety of levels of living experiences ranging from independent living in a private structure (house or apartment) to assisted living, to nursing home care. In so-called Type A/Extensive Care facilities, assisted living and nursing home care are pre-paid parts of the care continuum.
10 . Use Advance Directives to Direct Health Care Expenditures	Many health care costs are associated with end-of-life medical issues. Clients can gain a measure of control over these costs by having advance directives such as a durable power of attorney for health care and/or a living will.
11 . Use Laddered Bonds to Convert Assets into Income	Within an investment portfolio, it is possible to structure the bond holdings to enhance the ability of the portfolio to support the client. A bond ladder is one in which the portfolio is invested in bonds whose maturities are spread evenly across a selected time horizon. The income from the matured bonds is used for the annual living expenses of the client.
12 . Invest in Inflation-Protected Securities to Maintain Purchasing Power	Investing in inflation-protected securities, like Treasury Inflation Protected Securities (TIPS), can provide inflation protection for that part of the portfolio.
13 . Purchase Immediate Annuities to Handle Longevity Risk	Immediate annuities pay income for a lifetime and are an insurance solution to the insurance problem of longevity risk (just like life insurance is an insurance solution to dying prematurely). A balance with other portfolio investments is desired. Too much in an immediate annuity will leave the client with insufficient assets for liquidity and if the annuity does not contain a cost-of-living adjustment will expose the client to inflation risk. Too little in an immediate annuity will

	expose the client to longevity risk.
14 . Purchase an ALDA (also called Longevity Insurance) to Handle Longevity Risk	ALDAs guarantee a lifetime income but do not start paying benefits until an advanced age. An ALDA is a tax-deferred annuity, which is used specifically to provide protection against longevity risk and portfolio failure risk. ALDAs provide the greatest amount of longevity insurance per dollar spent (they are the most effective way to purchase longevity insurance) because they are analogous to having a very high deductible which would lower insurance premiums.
15 . Purchase a Deferred Variable Annuity Using a Guaranteed Living Benefit Rider to Lock in a Stream of Retirement Income and Protect against Downside Risk	Guaranteed minimum living benefit riders allow a client to pull out a benefit from a variable deferred annuity equal to a percentage of the initial premium. At the time for the money to come out of the contract, the client will receive specified payments even if the underlying market for the annuity has dropped. A deferred variable annuity creates downside protection by providing guaranteed income.
16 . Purchase Long-Term Care Insurance to Cope with Dementia or the Loss of the Ability to Perform Activities of Daily Living	Long-term care insurance is one of several private financing methods to cover the cost of long-term care. A long-term care insurance contract gives the client options about where to get his/her care (nursing home, assisted living, or home health care) and who will provide the care. Long-term care insurance benefits are triggered if a client is unable to perform two or more activities of daily living and the need for help is expected to last 90 days or more, or if the client is cognitively impaired.
17 . Purchase a Medicare Supplement Policy (also Known as Medigap Coverage) to Control Medical Expenditures	Medigap insurance is a tool that can be used to address the inadequacies of the Medicare program. It helps to eliminate the risks of uncontrollable health care bills by converting them into a predictable and affordable series of insurance payments.
18 . Invest at Least 50 Percent of the Portfolio in Equities to Make Money Work Effectively, to Create Greater Amounts of Income, and to Protect against Inflation	Research has consistently shown that large portfolios of stocks always provide substantially higher returns over long time periods than do large portfolios of bonds, and that the bonds substantially outperform cash over long time periods. Equity allocations on the order of 50 percent to 75 percent have a much better chance of lasting for the lifetime of the retiree than portfolios with lesser allocations. Even a 70-year-old client is investing part of his or her retirement funds for use when he or she is 90 or 95. The 20-to-25-year time horizon is best served by equity investments.
19 . Diversify the Portfolio and Use Age-Appropriate Investments to Conform to Time-Honored	Finance research is replete with warnings about having an adequately diversified portfolio and using age-appropriate investments. The marriage of these two

Investment Strategies	ideas has spawned target-date funds and other portfolio strategies.
20 . Identify Ways to Maximize Tax Savings on Retirement Investments and Withdrawals to Increase Net Retirement Income	One way to squeeze out extra retirement outcome is to find creative ways to take qualified plan withdrawals that will help to minimize the tax burden. A second way is to maximize tax efficiencies while saving for retirement. Planners can use the Federal Tax Code to effectively extend portfolio longevity and to create a larger amount of retirement savings.
21 . Meet Bequest and Charitable Giving Goals to Satisfy the Client's Need to Provide for Others	There are a variety of strategies available that can both provide for retirement income and yet preserve resources for future generations and/or charitable intentions.

The Core Trade-Offs with Selected Strategies

Strategy compilation cannot be accomplished without a deeper appreciation of the risks that a strategy is trying to address. It is important to note that while helping with some risks, a given strategy may exacerbate other risks. In our final section we present a brief sketch of the five strategies that were broached in the examples given at the outset of the paper in an attempt to illustrate the depth of thinking that accompanies an analysis of each strategy (let alone the combination of strategies) when using the strategy compilation approach to retirement income planning.

Strategy: Use Systematic Withdrawals

The systematic withdrawal strategy using a safe withdrawal rate was essentially created to combat longevity risk and portfolio failure risk. As long as the client parcels out income according to the predetermined schedule embedded in the strategy, he/she hopes to ensure that his/her portfolio lasts for the prescribed time period which presumably accounts for life expectancy. In addition, this strategy addresses liquidity risk (because assets remain available as opposed to locked up in, for example, an annuity) and legacy risk (since often a substantial legacy is available at death). The strategy does not solve any investment risk issues, since the money remains “in the market” and it may curtail the client's standard of living since it is based around a worst-case scenario.

Strategy: Purchase an ALDA

An ALDA can be used to create a stream of income for the latter part of retirement. This strategy helps to mitigate longevity risk (a monthly check will be forthcoming as long as the client lives), excess withdrawal risk (using assets to purchase an ALDA means that those assets won't be prematurely or recklessly spent), inflation risk (if the ALDA was targeted to offset inflation's impact on the later years of retirement), and investment risk (the use of an ALDA shifts the investment risk for the funds used to purchase the annuity from the client to the insurer).

However, the ALDA hurts by potentially increasing liquidity risk (the use of an ALDA means assets are consumed to pay for the annuity and consuming those assets might impede the client from having the funds needed for major expenses in retirement), bequest opportunity risk (an ALDA takes away the client's ability to leave those assets to his or her heirs), and upside investment potential risk (on the money used to pay for the ALDA).

Strategy: Defer Claiming Social Security

In addition to mitigating longevity risk, by providing greater income at older ages because larger monthly Social Security checks are paid as long as the client lives, the delay in claiming Social Security helps to mitigate the following risks:

- Excess withdrawal risk, by “forcing clients” to use assets to pay for legitimate retirement expenses while they wait for increased Social Security benefits. Using assets to pay for the increased annuity value of Social Security means that those assets won't be prematurely or recklessly spent.
- Inflation risk, because deferred claiming of Social Security benefits means that Social Security cost-of-living adjustments will compound on a larger monthly benefit providing greater maintenance of purchasing power.
- Loss-of-spouse risk, because deferred claiming of Social Security benefits could result in a larger survivor benefit for a widow or widower.
- Investment risk, because deferred claiming of Social Security benefits achieves the purpose of using assets to increase the annuity value of Social Security, which effectively transfers the investment risk on those assets from the client to the government. Also note that it is difficult to get a higher rate of return than can be obtained from delaying Social Security receipt.

However, delaying Social Security exacerbates liquidity risk, because deferred claiming of Social Security benefits will mean that assets may be consumed to pay for expenses while the client waits for larger Social Security checks. Consuming those assets might impede the client from having the funds needed for major expenses in retirement. It also increases exposure to public policy risk, because deferred claiming of Social Security benefits might result in the client losing the opportunity to get benefits which are taken away (e.g., by means testing), or missing the opportunity to be grandfathered into an existing system that is more beneficial to the client. It also affects investment returns, because this strategy takes funds out of the investment portfolio that are used to “purchase” a greater annuity from Social Security. Those same funds could have been privately invested to yield a greater rate of return than was possible from choosing to “spend” the funds in this manner.

Strategy: Rainy Day Fund

Creating a separate portfolio that is reserved for a variety of purposes helps to potentially minimize the following risks:

- Longevity risk—a portfolio separate from the assets and income used for the retirement income plan can be reserved to be used if the client has an unusual life expectancy.
- Excess withdrawal risk—a portfolio separate from the assets and income used for the retirement income plan means that those assets won't be spent prematurely.
- Long-term care risk—a portfolio separate from the assets and income used for the retirement income plan can be reserved to be used if the client has additional expenses for long-term care.
- Health care expense risk—a portfolio separate from the assets and income used for the retirement income plan can be reserved to be used if the client has uninsured health care expenses.

- Liquidity risk—a portfolio separate from the assets and income used for the retirement income plan will allow the client to maintain liquidity.
- Unexpected financial responsibility risk—a portfolio separate from the assets and income used for the retirement income plan can be reserved to be used if the client endures the unexpected expenses throughout the course of retirement.
- Loss-of-spouse risk—a portfolio separate from the assets and income used for the retirement income plan can be reserved to be used if the client loses his/her spouse.

However, the rainy day fund hurts by potentially exacerbating investment risk because keeping a separate portfolio creates the extra risk of investing that portfolio. It also restricts the client from maximizing spending because he or she is holding assets in reserve. This strategy is also a self-funded approach to addressing the risks, and there is no guarantee that the fund is sufficient to meet all of the risks.

Strategy: Reverse Mortgage Line of Credit

A reverse mortgage home equity line of credit can be used to minimize longevity risk because a reverse mortgage can be used if the client has an unusual life expectancy. It also can be used to combat inflation risk because a reverse mortgage can be used if the client needs to augment his income to maintain his purchasing power. It is commonly used to cope with long-term care risk or health care expense risk because a reverse mortgage can be used if the client has additional expenses for long-term care or health care expenses. However this strategy may upset the opportunity to leave the house to heirs (bequest risk) and it may be insufficient to cope with the risks it addresses.

Conclusion

Strategy compilation creates an additional level of responsibility for planners. It combines problem analysis with holistic planning to form a more professional plan. It is not just about choosing strategies and eliminating risks. It is about assessing how strategies, products, and investments relate to and balance each other. It is about eliminating redundancies to avoid double counting (risk overkill). It is about hedging the client's options in the most desirable manner based on his/her goals. It is making sure that the chosen solutions do not work at cross-purposes. It is about running the numbers for a variety of combinations to seek efficiencies that will result in optimizing the retirement standard of living. The energy devoted to putting together a retirement income plan that involves the use of strategy compilation and product diversification helps to ensure that the client's plan reflects state-of-the-art thinking and it will help to build additional trust and respect in the client-planner relationship.

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(1) The so-called 4 percent rule stems from the research of William Bengen. William P. Bengen, "Determining Withdrawal Rates Using Historical Data." *Journal of Financial Planning,* January 1994: 14-24. There have been many follow-up articles written by the author and others. According to a study by the Financial Planning Association, "Financial Adviser Retirement Income Planning Experiences, Strategies, and Recommendations" (December 2011), about 75 percent of advisors "frequently use" or "always use" the systematic withdrawal approach.

(2) See the Nerd's Eye View blogs of Michael Kitces and videos about this concept featuring Michael Kitces at New York Life Center for Retirement Income Web site at The American College http://www.theamerican college.edu/retirement-income-center.

(3) See Johnathan T. Guyton, "Decision Rules and Portfolio Management for Retirees: Is the Initial Withdrawal Rate Too Safe?" *Journal of Financial Planning,* October 2004: 54-62 and his follow-up article, "Decision Rules and Maximum Initial Withdrawal Rates." *Journal of Financial Planning,* March 2006: 48-58 for a discussion of how to adjust the initial withdrawal rate if the client is willing to cut spending based on specified conditions. Planners should note that these adjustments can still be considered a "safe" withdrawal rate (successful 100% of the time) and they can go even higher if they are willing to take on some risk of failure.

(4) See the Annual Retirement Confidence Survey authored by Dr. Jack VanDerhei of the Employee Benefit Research Institute (EBRI). Also listen to Dr. VanDerhei talk about the extent to which long-term care risk affects retirement security at the New York Life Center for Retirement Income Web site at The American Collegehttp://www.theamericancollege.edu/retirement-income-center.

(5) John Salter, Shaun Pfeiffer, and Harold Evensky, "Standby Reverse Mortgages: A Risk Management Tool for Retirement Distributions." *Journal of Financial Planning,* August 2012:40-48.

APPENDIX 1

An Abbreviated Literature Survey of Risks and Solutions

Risks

Rappaport, Anna "Deeper Dive into Post-Retirement Risk: Important Research about Retirement."

Presentation for the Actuarial Society of Greater New York, November 2011.

Society of Actuaries, "Managing Post-Retirement Risks: A Guide to Retirement Planning." October 2011.

Society of Actuaries, “The Phases of Retirement and Planning for the Unexpected.” A 2007 Risks and Processes of Retirement Survey Report.

Withdrawal Strategies

Ameriprise Financial, Lifetime Retirement Income: Responding to the Challenge, 2011.

Bengen, William P. “Determining Withdrawal Rates Using Historical Data.” Journal of Financial Planning, January 1994: 14-24.

Financial Planning Association, Financial Adviser Retirement Income Planning Experiences, Strategies, and Recommendations Whitepaper, December 2011.

Guyton, Johnathan T. “Decision Rules and Portfolio Management for Retirees: Is the Initial Withdrawal Rate Too Safe?” Journal of Financial Planning, October 2004: 54-62.

Guyton, Johnathan T and Klinger William J.“Decision Rules and Maximum Initial Withdrawal Rates.” Journal of Financial Planning, March 2006: 48-58.

Insured Retirement Institute (IRI) “Building Your Future: Strategies and Products for Retirement Income Planning.” 2011.

Principal Life Insurance Company “Income Distribution: Comparing a Bucket Strategy and a Systematic Withdrawal Strategy.” 2012.