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Develop Business/Financial Planning

Export Client Retirement Risk

By Jim Otar, CMT, CFP
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Asset allocation can't help clients who haven't saved enough for retirement. At best they have a 78% chance of outliving their money in a traditional 40/60 asset mix. Instead, export the risk with a variable annuity with guaranteed withdrawal benefits. They'll be protected from the market and enjoy a retirement paycheck for life.

Say you have a client, 60 years old, planning to retire in five years. His portfolio is worth $500,000. You want to know what the best strategy is for creating $31,250 in annual income until at least age 95.

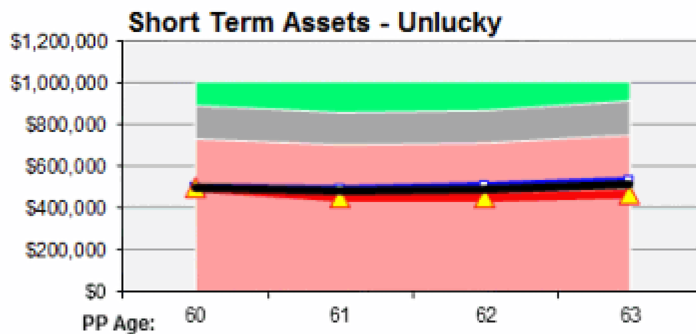
Choice 1: Regular investment portfolio

When we talk about an investment portfolio, most of us think about asset allocation. After all, we have been brainwashed by the financial industry that "asset allocation contributes to over 90% of a portfolio's success!"

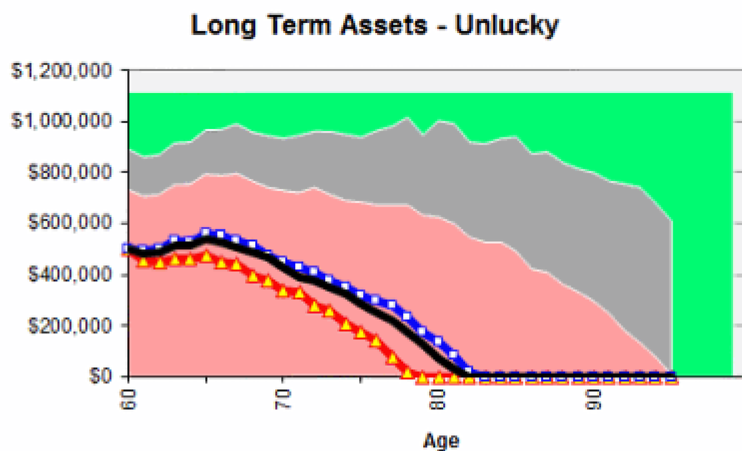
Instead, I use my retirement calculator that is based on "aftcasting" for the answer. Aftcasting—as opposed to forecasting—is a method for analyzing retirement outcomes. It is based on actual market history. It includes the actual historical equity performance, inflation and interest rate data, as well as the actual historical sequencing of this entire data set, unlike simulators or economic scenario generators.

In this case, I look at asset allocations of 30/70, 40/60, and 70/30 to see how they might affect my client's retirement picture. Figure 1, below, shows the effect of various equity allocations in the short and long term.

Figure 1: Comparing Retirement Portfolios



Equity:				
30%	$500,000	$493,393	$503,691	$534,934
40%	$500,000	$481,742	$487,142	$513,139
70%	$500,000	$452,543	$447,658	$464,506



Source: Jim Otar

The green area on the chart shows where my client can have lifelong income from the asset sufficiency point of view. The gray area shows where the client can perhaps make it, provided that he is lucky. The reddish area shows where my client has no hope of achieving his retirement income objective unless he makes significant changes to his expectations.

The blue, black, and red lines show the aftcast of the bottom decile of all outcomes since 1900 (which I call "unlucky") for 30/70, 40/60, and 70/30 asset mixes, respectively. In this particular case, all of my client's aftcasts—regardless of what asset mix I use—are in the red zone.

So, here is my conclusion: it makes no damn difference what asset mix I suggest, or what the client wants; he is deep in the red zone. Even in the long term, the larger the equity content, the sooner he runs out of income, because of the effects of reverse dollar cost averaging and sequence of returns.

My aftcast shows that his probability of going broke is 32% at age 85, 62% at age 90, and 78% at age 95 for a 40/60 asset mix. Not a good plan, is it?

Choice 2: Variable annuity

Here is a better alternative. Put this money into a variable annuity with guaranteed minimum withdrawal benefits (GMWB) or guaranteed minimum income benefits (GMIB), i.e., export the market and longevity risks to an insurance company.

Many plans will give a 5% or a 6% annual increase in the guaranteed withdrawal/income base, regardless of what the markets do, until he starts withdrawing at age 65. That means the amount that your retirement paycheck is based on will grow to $625,000 over the next five years, no matter what. The starting income—based on a 5% payout—will be $31,250 for life. Some plans even double this pay if one spouse needs long-term care.

One of the best benefits is, when markets rebound between now and retirement, your client's paycheck will be larger—for life. How much larger will depend on the type of reset that the insurer offers. Even after his withdrawals start, a rebounding market might mean a pay increase.

Do yourself a favor. Get off the roller coaster. Asset allocation contributes to the success of a distribution portfolio much less than you think. Export the risk!

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