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DC Perspectives

Making retirement "Golden" again – Part 1

With over 10,000 Americans retiring each day, ensuring one's Golden Years are indeed golden is a critically important matter for millions of Americans, as well as the Plan CIOs who oversee trillions in retiree assets. While there's a lot of investment information on the lead-up to retirement, there can never be too much knowledge to help ensure retirees don't outlast their money. In this two-part article we will first look at the *retirement income* landscape and ways to build a better retirement mousetrap. In Part 2, we will look at decumulation best practices in order to maximize one's withdrawal rate.

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When people think of retirement, most prefer the images conveyed in marketing ads; lavish sailboat excursions, country-side bike rides, or sitting on a porch with one's trusted golden retriever. **Unfortunately, the stark reality is that most Americans are not adequately prepared for retirement.**

In a recent Schroders retirement survey among 1,004 investors age 45 and above, we found that nearly half (42%) classify themselves as being "concerned" or "very concerned" about outliving their assets once they've reached retirement, and 35% of those already retired being "concerned" or "very concerned" about outliving their money. In addition, we found that the majority (60%) of respondents claim that their primary investment objective in retirement is "steady income generation." And while Social Security benefits would help check that box, the same survey found that 67% also believe Social Security will not be enough.

The building blocks of retirement income success

Some readers may be thinking "*ok, I have retirement assets, now what do I do?*" To properly frame the topic, on the next page we outline the main retirement income options. After all, there's a wide range to consider:

The dream...

...and the reality for many retirees

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1. **Annuities:** These are financial contracts whereby you purchase a specific level of income for a stated term, or for life (for a fee). One type is an Immediate annuity, whereby in exchange for a lump-sum payment, an insurance company is providing you guaranteed income for life. The drawback is these cannot be revoked once purchased. However, there has been a lot of innovation in the types of annuities now available that seek to strike a different balance between the level of income, variability in that income, and the ability to access capital once the annuity has been purchased. Therefore, there is a lot to consider and we recommend retirees should do their homework to understand rather than figure out the right type that meets their specific needs.
2. **Bonds:** Bonds are a widely used income instrument and can be used in a number of different ways. Retiree investors can purchase individual bonds (usually investment-grade) which distribute periodic coupons. There are strategies called bond ladders, whereby a series of bonds with varying maturities are purchased upon (or nearing) retirement. Cash flows are derived both from fixed coupon payments as well as the proceeds of the bonds as they reach maturity. There is, of course, an entire universe of bond mutual funds. For investors concerned about inflation in retirement, there are Treasury Inflation-Protected Securities (or TIPS). These are government-issued bonds that, unlike other bonds, the principal is adjusted up (or down) based on the current rate of inflation.
3. **Real Estate:** Physical rental properties can provide a stable source of income, but much like home ownership there's high costs and operational factors to consider. On the other hand, there are Real Estate Investment Trusts (or REITS) and Master Limited Partnerships (or MLPs) which are publicly traded companies that offer the high current income benefits of real estate or infrastructure ownership but with less risk compared to physical ownership.
4. **Equity income:** For those with higher risk tolerance and/or longer time horizons, investments in equities (or equity Funds) enable income to be generated from dividends, while maintaining potential for growth should equity markets perform well. For those that seek to target higher income from their equity portfolio, covered call option strategies may be appealing. An investor would write (or sell) a call option on the equities which they already own to generate income via premiums derived from the sale of the call options. However, the investor will give up equity returns beyond a certain level and may still experience losses if equity markets fall, so implementing such a strategy should be carefully weighed.
5. **Retirement Income Funds:** One of the more popular options, these are essentially multi-asset portfolios that invest in a range of income-producing instruments, combined with some growth-oriented assets. Somewhat of a new DC investment vehicle are Post-Retirement income funds whereby upon reaching a specific retirement age, the assets within the portfolio are reinvested into income-generating assets. Investors simply stay invested within the plan and draw down their accounts. Many DC platforms are in the early stages of evaluating and making these post-retirement options available.

Of course, there's Social Security benefits and for many Americans this reflects their only source of retirement income. Retirees can begin taking the benefits at age 62, however it's suggested to hold off for as long as possible claiming your benefits (to after age 66, or even age 70). The higher level of benefits for deferring can be considerable, versus collecting at age 62.

Time to SoRT things out

We've identified our retirement building blocks, now how to we organize them? One way to address this challenge is through a framework we call Sequence of Retirement Things (SoRT). Much like how the term "Internet of Things" refers to the convergence of all things Tech within a given system, SoRT helps us organize the convergence of retirement components so that they work together.

For many Americans, target-date funds (TDFs) take the guesswork out of retirement planning. Or, so one thought. The reality is that many TDFs – even those with "through retirement" provisions – still carry significant equity market risk in the few years before, and after, reaching the target date. So, let us dive into our SoRT framework:

1. **Land the approach (toward 59 ½):** Anyone retiring in 2020 is unfortunately familiar with what is referred to as sequence-of-returns risk[1]. And simple rule-of-thumb "systematic withdrawal" strategies like the "4% rule" can be thrown out the window if you encounter a sharp market decline like we did in March. Managing sequence risk is both an art and a science (and part nerve, sometimes) and we do not suggest market timing; but rather having market "awareness". If you are nearing, or are in, retirement during a volatile period, be careful not to quickly "run for the hills" into safety assets. Locking in loses won't help your future income needs. And on the contrary, in a bull market, consider any re-allocations carefully so that you can maximize as much growth potential, while staying diversified. We feel that this is where some TDFs may not offer participants enough "dynamism" to adequately transition to a post-retirement portfolio – a topic for Fiduciaries which we explore in "Turning off auto-pilot". For plan participants, evaluate all of

1 Sequence-of-returns risk, also called sequence risk, refers to the impact that the order in which one's investment returns, while making redemptions (or deposits), will have on capital over time. For retirees, the risk is that steep market fluctuations in the few years before and/or after retirement may not be offset since they are no longer contributing new capital nor have the longer time horizons as in the accumulation phase.

your plan's options, stay diversified, and, if necessary, consider adjusting your time horizons for retirement if possible during turbulent times.

2. **Have an Income plan**, not an allocation plan: When it comes to retirement income within a SoRT framework, don't think of it as *asset-allocation*, but rather, think of it as *income-allocation*. Start by assessing what your specific retirement spending needs will be over a certain time period and construct an income-generating portfolio that can best meet those needs for the stages of your retirement life – this is sometimes called "bucketing". At the end of the "bucket" time period, re-assess what your future income needs will be and based on how much you may have drawn down, and what your future income potential may look like.

   For those who are fortunate to have either a **State/Public or corporate-sponsored defined benefit (DB) pension plan**, this is an obvious retirement income plus. Millions of people rely on DB pensions – many as their sole income source until Social Security benefits kick in. For those in this camp, we would still encourage you to think about the entirety of your retirement assets – including decumulation strategies – and seek to diversify your retirement income within the context of the SoRT framework.

3. **Taxes**, the only certainty in retirement planning: We'll keep this article somewhat light by skipping the first true certainty in life and focus on taxes because many folks don't even realize that there are a variety of tax consequences on retirement assets. Tying together the last two points, under the SoRT framework, retirees should guide the receipt of income and the depletion of investments based on tax efficiency. The best ways to preserve one's wealth is to pay as little in taxes as legally possible. For example, using municipal bonds rather than corporate investment-grade bonds may increase your overall after-tax income (even with reaching a lower tax bracket in retirement). Keep in mind that to the extent annuities, as well as Social Security benefits, are utilized, each may have tax consequences, and much of the distributions would be taxed at a retiree's current ordinary income levels. REITs also have special tax consequences. So carefully consider taxes as part of a retirement plan.

Conclusion

In closing, we encourage savers of all ages to take the time to SoRT out their retirement objectives – and for Plan CIOs, this could be a moment of reflection. Remember, while you can't control certain things like the weather, or the markets, or inflation, you can control how you allocate, spend, and receive your retirement capital. With the right plan, you can elect to sail off into the sunset, start that new business at age 65, or any number of "Golden Years" marketing cliques.

In Part 2, we will explore the art of decumulation, sequencing and withdrawal rates in greater detail.

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