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Retirement Planning

Marking milestones

Age-banded approach a more accurate portrayal of retirement planning

BY SOMNATH BASU, PH.D.

A convergence of mega trends will forever change retirement planning and raise its importance in the pantheon of employee benefits. Chief among them: longer life expectancy, medical advances, healthier lifestyles and mounting concern about years of abysmally low savings rates.

What this means in practical terms for future retirees is that employers, service providers and financial advisers must plot a more accurate and thoughtful course to planning for retirement that pursues an “age-banded” approach — understanding that individuals undergo various lifestyle changes during retirement that last for finite, or age-banded, periods.

For example, people spend more time and money on leisurely activities early on in retirement, while health care needs dominate the latter years. Further, costs associated with these lifestyles also change at different inflation rates than basic inflation.

While the basic inflation rate is about 3%, the U.S. Census Bureau noted that annual recreation costs increased at 7.14% throughout most of the 1990s. Health care costs also increased by much higher rates than the basic rate. Since the current retirement planning model bundles all costs — leisure, health care and basic living — and extrapolates at the basic rate, it tends to underestimate retirement expenses. The traditional model’s static approach to retirement can have dangerous implications, including underfunded retirement plans, especially those earmarked for the critical years.

By contrast, the age-banded model provides a more accurate portrayal of retirement expenses and an algorithm to calculate the income-replacement ratio, as well as smaller resource requirements and greater flexibility in managing risk.

It also allows easier incorporation of long-term care insurance and significantly reduces funding needs. In fact, the savings needs of a husband and wife who are both age 60 and presumably five years away from retirement are reduced by more than 16%, and contributions for a 35-year-old single woman are reduced by 42% compared with previous approaches.

A flawed model

There are five inherent weaknesses to the traditional approach to retirement planning, specifically the traditional approach:

1. Assumes all living expenses will increase at the overall rate of inflation, as measured by the consumer price index.
2. Bundles all expenses together without allowances for lifecycle changes.
3. Estimates those expenses as a fixed percentage (replacement ratio) of preretirement costs.
4. Invests in low-return assets.
5. Fails to consider contingencies such as LTCI, which can significantly affect the amount savings required to secure retirement.

When financial planners estimate how much income a client needs in retirement, the calculation hinges on their income just prior to retirement. Preretirement income is adjusted downward by 10% to 35%, reflecting the income necessary to maintain one's standard of living and incorporates reductions in taxes and other work-related expenses that cease upon retirement. Unfortunately, there's no objective way to estimate the replacement ratio.

Using the 30-year retirement window

Under the age-banded model, an individual typically lives about 30 years in retirement (age 65 to 95) and experiences a lifestyle change every 10 years at age 65, 75 and 85. Of course, both the retirement period and the width of the age bands are arbitrary but can be subjectively changed to fit each retiree as closely as possible.

In addition, a number of steps are taken to produce a clearer picture of retirement costs by categorizing them based on taxes, living expenses, health care and leisure, as well as calculating anticipated expenses using the appropriate rate of inflation for each category, which is adjusted to reflect postretirement lifestyle changes.

Those expenses are extrapolated through 30 years of retirement and the present value of post-retirement expenses are calculated at an amount deemed sufficient to finance the three following decades (each age band). Instead of discounting these values to the year of retirement (the traditional model), age-banding considers them to be three retirement portfolios that require funding. Since the portfolio required to fund expenses from age 86 to 95 is 20 years behind the first band (age 66 to 75), investors can seek marginally higher rates of return to reflect the longer terms. Contributions toward these amounts now can be calculated. For example, a 60-year-old couple can seek higher rates of return for longer-term investment portfolios which more than mitigate the effects of escalating health care costs. For the 35-year-old single woman, since the funds required for these three portfolios are 30, 40 and 50 years away she should be willing to take on more risk since she has ample time to manage the portfolio risk.

Expenses for the age-banded method become considerably higher at the latter stages of retirement, which is desirable since the overfunding coincides with an age at which one cannot afford to be out of money. The higher estimate of the age band comes from higher inflation rates for health care and the incorporation of lifestyle changes that imply accelerated costs such as increased leisure spending upon retirement and higher health care costs in the latter years.

Thus, these higher costs are not only more realistic but incorporate the dynamics of a retired life. Incredible as it might seem, the ability to assume a marginally higher risk leads to a decrease in savings requirements, compared to the traditional model.

Financial planners need to keep in mind, though, that clients may be reticent to buy equities when markets are underperforming. Therefore, clear explanations are required regarding why it may still be beneficial for the long run and that risk will be managed on an ongoing basis. But the results will be well worth the effort in assuring that tomorrow's retirees are able to live more comfortably. It's a small price to pay for the peace of mind associated with knowing

retirement expenses will be portrayed more accurately and plan participants will be afforded greater flexibility in managing risk. —**E.B.N.**

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