

Winds of Change

By Somnath Basu
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A convergence of major medical and social trends will forever change the face of retirement planning and raise its importance in the pantheon of employee benefits. Chief among them: longer life expectancy, advances in medicine, healthier lifestyles and years of abysmally low savings rates. Employers, service providers and financial advisors who want to plot a more accurate and thoughtful course for retirement planning need an approach that takes these trends into consideration.

The key to this new approach is age banding, based on the premise that individuals undergo lifestyle changes during retirement that last for finite, or age-banded, time periods. Consider the early retirement years. During this phase, people tend to spend more time and money on leisure activities than they do in their later retirement years, when healthcare expenses are more likely to dominate.

The costs associated with these periods change at rates that differ from the basic inflation rate. While the basic inflation rate is about 3%, the U.S. Census Bureau notes that recreation costs rose at a 7.14% annual pace through most of the 1990s. Healthcare costs also increased much faster than the basic inflation rate. Since the traditional model bundles all costs (including leisure, healthcare, housing and food) and extrapolates at the basic rate, it tends to underestimate retirement expenses. The traditional model's static approach to retirement can have dangerous implications, since it may lead to underfunded retirement plans, especially in the later years.

The age-banded model offers a more accurate portrayal of retirement expenses and an algorithm to calculate the income-replacement ratio, as well as greater flexibility in managing risk. It also allows easier incorporation of long-term-care insurance (LTCI). As a result, age banding can significantly reduce retirement funding needs.

A Flawed Model

There are five inherent weaknesses in the traditional approach to retirement planning. They are:

- The assumption that all living expenses will increase at the overall rate of inflation as measured by the Consumer Price Index (CPI);
- Bundling expenses together and not changing their percentages;
- Estimating expenses as a fixed percentage (replacement ratio) of preretirement costs;
- Investing in low-return assets; and
- Failing to consider contingencies such as LTCI benefits.

Estimating how much income a client will need hinges on income just prior to retirement. That income is adjusted downward by 10% to 35% to reflect what's needed to maintain the client's standard of living after accounting for reductions in taxes and other work-related expenses that will cease. Unfortunately, there's no objective way to estimate this income-replacement ratio. Aggressive financial planners use large ratios and conservative planners use smaller ones.

Funding the Bands

The age-banded model assumes that an individual typically lives about 30 years in retirement (age 65 to 95) and experiences a lifestyle change every 10 years, at 65, 75 and 85. Both the retirement period and the width of the age bands can be changed to fit each retiree. Using these bands as a guide, the planner would group retirement costs into taxes, living expenses, healthcare and leisure, calculating the appropriate rate of inflation for each category. Expenses are extrapolated through 30 years; the current value of postretirement expenses is calculated at an amount deemed sufficient to finance each age band. Indeed, age banding considers each time period as a separate retirement portfolio. The clients can help provide the numbers by describing their current lifestyle and how they expect it to change.

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. So, a couple who are both age 60 and five years from retirement could seek higher rates of return for longer-term investment portfolios that would more than mitigate the effects of rising healthcare costs.

These marginally higher risks allow for a decrease in the portfolios' funding requirements compared with a traditional plan. The couple's funds could be reduced by more than 16% using the age-banded approach. In the case of a 35-year-old woman, overall contributions could be reduced by 42%, as I showed in my article, "Age Banding: A Model for Retirement Needs" in the May 2005 issue of the *Journal of Financial Counseling and Planning*.

One caveat: Clients may be reticent to buy equities when markets are underperforming. Planners will need to explain clearly why such investments may be beneficial in the long run and assure the client that the risk will be managed. The results will be well worth the effort: The peace of mind associated with knowing that retirement expenses are portrayed accurately and that risks may be managed flexibly. Most important, the clients will enjoy more comfortable lives when their working years are over.

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