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Retirement Planning: Focus First on Covering Fixed Expenses

An Interview With Michael S. Falk, CFA, CRC

Article Highlights

- A fixed percentage rate of withdrawal is not necessary if a retiree focuses first on ensuring all of his or her fixed costs are immunized.
- Once all fixed costs are immunized, a retiree could invest more aggressively, since any remaining assets are for wants.
- Longevity annuities can cover longevity risk—the risk of living to 95 or 100—for a relatively inexpensive cost.

Michael Falk is a partner with Focus Consulting Group and the chief strategist on a global hedge fund. His background includes extensive asset allocation research and portfolio development expertise along with a multi-faceted understanding of behavioral finance and retirement issues.
—Charles Rotblut

Charles Rotblut (CR): *You think the focus of retirement planning should be more on liabilities than assets?*

Michael Falk (MF): Yes, and when I say liabilities, it can be taken in two ways. It can be taken as debt owed or as spending. I usually focus more on debt owed because that is what we can refer to as uncontrollable spending. Bills come in and you have to pay them, otherwise there are consequences. In most other spending, you have choices. A simple way to think about it is to ask yourself, do you want filet mignon or do you want hamburger? We have the ability to control our spending to a large extent beyond that of debt. I like to start there from a definitional standpoint.

To the extent that retirees, near-retirees or future retirees can start to think more from this perspective, the whole concept of planning for retirement starts to change. It changes from demonstrably being about the accumulation of assets, building up this big pile of money, to thinking about how best to withdraw. It changes toward, "Why don't we start with deciding what it is we want to do? What are the expenses of that?" We can parse the answers in terms of needs versus wants.

Let's start thinking from the bottom up, how we want to build a lifestyle ("retire to what") versus the top-down view that thinks in terms of what we're trying to replace ("retire from what"). It reframes the dialogue in such a way that it becomes potentially much more constructive. Because now we're talking about what you acknowledge you must have or what you want to have.

During our life, we're busy. We've got jobs, children and friends; do we really think we have good control, knowledge and perspective on our actual spending? I mean, do you have it down to if you had to have cash for everything, what is the average amount of dollars you would have spent per hour per day over the course of the average month? Could you answer that question? Would the answer trouble you greatly if you could get it down to that level?

The challenge here is that we talk about replacement rates. The age-old rule of thumb people talk about is 80% of pre-retirement income, and I have trouble with this. There are a couple pieces of research out there that really support the trouble that I have with this type of a number. What they find is that people at lower socioeconomic or income levels need a higher replacement. They're fully consuming their income just to live. People at much higher socioeconomic levels, people making $100,000, $150,000, $200,000 and higher, their replacement rates can be much lower. I see numbers as low as 50% in research.

If we want to make this even simpler, just think in terms of the number of children you have. Do you have no kids? Do you have four kids? Or do you have somewhere in between? Think about the cost, the expenditure made on behalf of the child throughout their life—it's called the 18- to 20-year time frame—from birth until…hopefully they leave and perhaps you finance college. If you were to take those expenses out of your income or you were to put them back into your income based upon a per-child average cost, well, that would really change the amount of income you need to live your life. It's as simple as thinking about when you retire, assuming at this point the kids are grown and out of the house, that how do we look at a rank-and-file replacement rate without thinking about that really big difference of how many kids do you have? How many children did you raise, and what was the expense per head? And are we factoring that into your replacement rate?

This is why I like to start with the bottom and build up versus the top and replacement rate down. I find it's much more constructive, much easier for people to understand. Plus, at the end of the day, people don't necessarily have to have millions and millions of dollars accumulated to make retirement work.

CR: *This sounds like it's partially a budgeting exercise.*

MF: That's exactly what it is. Not partially, exactly. But you know, it's interesting because I think everybody has a budget and a spending plan. They look at me: "Huh? No, no, no." You have both. Think of your budget as your fixed costs. That can be your debt level: We spent $100 a month on our utilities. We spend $100, $200, whatever amount, a month on our food. That's not necessarily filet mignon. It may be hamburger. Maybe ramen noodles. The point is, think of your budget as your fixed expenses and think of your spending plan for all your wants.

Why do we have to separate the two? Everybody has fixed costs, everybody has wants. Let's acknowledge that. And once you've cared for your budget, if there's still money left over, fantastic. What are your wants? Go enjoy.

CR: *You also advocate that people really look at their costs and decide where they could cut back as well, correct?*

MF: It's a worthwhile exercise for everybody, but I don't like to think about it as cutting back. Start by thinking about what you need first, and then go to what you want second.

I believe it was Albert Einstein who talked about how we should simplify to the extent where we cannot take anything else away. Well, that's a wonderful attitude for your fixed costs. I don't know if that's a great attitude for your spending wants.

CR: *I remember you talked about going down to one car this past June at the Morningstar Investment Conference. I'm presuming this means a person should think about what's acceptable to them in terms of a base level of what they will need in retirement and then plan from there.*

MF: Yes. This is one of the most entertaining parts of this type of dialogue. If you suggest that a married couple who is retired with kids out of the house go down to one car, they look at you like you're from another planet. Let's take a step back without reacting to just think about this. Are you now in charge, completely in charge, of your schedule? Can you not work together? The interesting thing about one car is that it means you're not always together; if one's out doing something, the other one's maybe not.

That separation can also be beneficial from psychological and sociological standpoints. The divorce rate among the 60+ age group over the last 30 years is up on the order of 300%. Now, before I scare people with that number, I'll point out that it's gone from about 1% to 4%. The point is, however, that it's rising as the baby boomers are hitting retirement. Why? The old adage, and this is both serious and facetious, is "for better for worse, for richer or poorer, but not for lunch." When you're retired, it's 24/7 with your significant other. Probably during the course of years or both of your careers, you never spent that amount of time together without children, but rather just the two of you.

The nice thing about one car, versus two cars, is that you can always get another car. You can give it a try for a year or two. When you think about the cost of a car, or the lease payment and taxes and insurance, are you saving $400, $500 a month minimum? This is a big deal for spending purposes. And of course we know a lot of empty-nesters are moving back into cities where they don't need a car as much, they can use public transportation. That's a big part of the budget, if you think about it; it's about $400 a month of spending.

CR: *So you're essentially capitalizing the cost of your retirement and the exercise then reduces what you need in terms of assets.*

MF: Yes, sure it does. So do the math. Let's say a car equals $500 per month—to use easy numbers—$6,000 a year. Even if we just want to follow the 4% withdrawal rule, that's 25 times. Multiply 25 by $6,000 per year and you get an additional $150,000 that you will need in a nest egg for having that car.

CR: *That's a large amount. And you're not a big fan of the 4% withdrawal rule in general?*

MF: I like as it as a reference point. I'm not a fan of plugging it in and saying: This is how we're going to live. If you do this bottom-up build for fixed-expense coverage that I talk about, then the rest is for spending wants. The interesting thing about this is that we're not talking about percentage withdrawals anymore. Because if you had immunized—I use the tagline, "you should immunize your needs before you even try to optimize risky assets for your wants"—there is no withdrawal percentage that is required. Everything else is for wants.

Of course, that's oversimplifying, because you can have a health incident occur and you may not have all of the various medical coverages as well as a long-term care policy, so you do need capital beyond your immunization of needs to the extent that is available.

But we do know that there's a substantial percentage of folks out there

Top Estate Planning Documents to Consider

These are the eight estate planning documents Michael Falk suggests considering or completing to protect yourself and ensure your wishes are carried out. He recommends using a "safe box" to contain these documents that is accessible by your children.

1. A will
2. An inventory/accounting of all assets and relevant data
3. Power of attorney
4. Health care powers of attorney
5. (Likely) An irrevocable trust
6. An "ending wants" policy—what would you like to experience
7. (Potential) An agreement among any children as to who will be the designated helper, and any resultant form(s) of compensation

who receive over 90% of their total retirement income from Social Security. Saving a big nest egg is a lovely concept, but not necessarily realistic for all people. We just have to change our view a little bit on that to be respectful about people as they age and about their capabilities and capacities when they retire. So the 4% withdrawal rule is a nice reference point to kind of measure where you are.

I prefer 25 times, because it's easier math for people than percentages, but if you want to be conservative, let's go with 30 times. Let's go to 35 times. And to frame it differently, at the end of the day, your first hurdle is to cover your fixed expenses, to be able to live your life. Everything else is secondary then. And this changes the math, right? Because now it's not about a withdrawal percentage, it's about whether we've got enough money or we have Social Security, pension benefits, an annuity, or a laddered bond portfolio to cover our fixed expenses.

And now, with the nest egg that we've accumulated, we need to cover all those other potential spending wants or health care types of emergencies. Now it's not about 4%, it's just about being a little bit more diligent. If the market has a good year and you have a lot of stocks, you can spend a little more. If we had a tough year in the market, you spend a lot less or maybe don't spend at all. You're not locking yourself into a liquidation schedule regardless of the performance, and that's okay because you immunized your fixed costs. So you have much more control on how you're going to use your capital to make your life work well.

CR: *How does a retiree factor in the wildcards of medical costs and longevity?*

MF: This is where, to the extent that people like or dislike annuity contracts—I'm not here to tell them that all annuity contracts are worthwhile or good or proper in terms of expenses—they should immunize inexpensively. The reason why is that now we're talking about a lower probability risk, but it's very acute.

If longevity strikes you and you live until 95 or 100, there is substantially higher cost in terms of retirement. Since it's an acute risk, if you can cover it cheaply, which is what insurance is about, why not do so?

And then we're talking about longevity annuities. These are annuities that don't start paying the monthly income until an older age, such as expected mortality or thereabouts. Let's call it age 83 or age 85 for a 65-year-old who's purchasing the contract. It costs maybe 15 cents on the dollar versus a straight deferred annuity contract that begins payments at age 65. It's a great way to cover that acute risk relatively inexpensively.

CR: *What is the ideal time to consider buying one of these types of annuities? I'm guessing you don't want to buy it too early, but obviously if you buy it too late, the costs rise substantially.*

MF: Yes, if you buy it later the cost rises, that's absolutely correct. But it's a marginal increase because payments don't start until you reach the expected point of mortality for your attained age. The costs don't rise as much over time as you might think if you buy at age 48 or 65. But you're also helping to make certain that the organization you bought it from, in this case an insurance company, will be around for the next 50 to 60 years.

One of the things that 2008 taught us is either to diversify the financial institutions that we work with or just understand that not all organizations are going to be around forever and ever. So yes, there's a higher cost, but when you're 40 do you have that lump sum accumulated in which you can make that purchase? You have to counterbalance that, but I think it's a very worthwhile question to ask.

CR: *Also given interest rate risk, is it something where you may want to consider laddering in terms of buying one now, maybe buying one two or three years from now, etc.?*

MF: Absolutely. You lower the interest rate sensitivity of the annuity purchase. The challenge for a lot of people—now we get into behavioral economics—is, will they do it? Will they buy a contract every two years like clockwork, regardless of what interest rates are, regardless of whether the price of the annuity goes up? Five or 10 years down the road are they thinking, "My God, that's more expensive today than it was 10 years ago when I started this, maybe I shouldn't buy this anymore"? You and I might think, well, that's kind of an odd thought knowing what we know, but for the average person, that may be exactly what they're thinking. So does it make sense to create a plan like that, where a person buys it sequentially over time to remove the interest rate sensitivity of the purchase date? Yes, as long as he or she executes on that plan.

CR: *And just to be clear, we're talking about the advanced life deferred annuities, correct?*

MF: Yes, advanced life deferred annuities. ALDA is the acronym that the industry will talk about when you get into details, but when they're marketed a lot of them are referred to as longevity insurance.

CR: *On the other side, you had also mentioned life insurance with a long-term care rider as an almost a somewhat better option than a long-term care insurance policy.*

MF: We just have to be careful of how we define the word 'better.' The challenge with long-term care insurance is, number one, will a company still be around to pay claims? Because we've seen many companies who started 10 or 15 years ago that are no longer in the business of underwriting contracts. Number two, are they going to raise prices over time? This is what I referenced at the Morningstar conference, these contracts often scare the hell out of me. Will they be around? If not, you've spent all that money for no reason. Because this is such a unique type of cost that can arise, the insurance companies don't have a lot of predictability or a lot of evidence to price these correctly, so the other side is that they could raise prices over time. How does that fit into your budget? Because that will be a fixed expense. And if it doesn't fit into your budget and you stop paying it, then you spent all that money and you have no coverage. Whereas a life insurance policy with a long-term care (LTC) rider is a more efficient way of potentially protecting some of those risks, although it's more expensive than "straight" life insurance.

It's difficult for me to define it as specifically better, because if you end up in a long-term care facility for much longer than the average stay of well under five years, then the long-term care insurance could do better than the life insurance with the long-term care rider. Now we're talking about hedging our costs. What is the cost of that LTC policy versus the life policy with a LTC rider? For most people the belief—and we don't have a lot of empirical data on this yet, so we have to be careful—is that the life policy with the long-term care rider will be a better route to go.

There's an additional charge to pay for the long-term care rider, or health rider, if you will. And then you've got the prepayment potential—prepayment meaning they pay you while you're alive an amount for your health care needs instead of the entire death benefit to your heirs; any amounts not prepaid remain as death benefits. Well, if you ultimately need long-term care and you fit within the average stay of less than five years, this very well could take care of your needs for a lot less money than an LTC policy and without the same risks that have, unfortunately, historically arisen with some LTC underwriters.

CR: *If someone were to buy products such as these, figure out what their costs are and immunize them, I'm presuming they would then have the option of being more aggressive in allocating any excess savings.*

MF: They have complete flexibility, and that's one of the very interesting outcomes of this strategy of mine if you immunize your needs before you try to optimize your risky assets. Think of this: Once you have bolstered all of those fixed expenses or forecasted needs in retirement, now everything left over, your residual assets, could be invested very aggressively if you desire but with little worry that such allocations could impair your retirement. Because you've already immunized your fixed expenses. It really changes the nature of what could be called an "appropriate asset allocation" for older people.

It also raises some very interesting questions about some of the ways that products in the industry, like a target date fund product, are positioned. Maybe a target date product could have higher equities when people are 65 for those who've immunized their fixed expenses. But for some people, we might say that is very inappropriate if they're nowhere close to immunizing their fixed needs.

This is one of the reasons that I'm not a fan of target date funds, because people are in very individualized situations when they're entering retirement. To say that there is a one-size-fits-all asset allocation of risky assets—to me, it's silliness. It might work well, but would you want to take the chance that it might not?

CR: *Is there anything else I haven't asked you that you think is important?*

MF: I'll give you a little bit of my thoughts on the value or purpose of retirement. The concept of retirement, and maybe it goes back a little over 100 years, is based upon the premise that older people no longer have any productive capacity left. I think that is incredibly insulting, and it is also very inappropriate in the world today. As we moved away from an agrarian age into an industrial age and into the service or knowledge-based age we're in today, never before have older people had more ability to offer economic value in society. So why do we want to tell these people, force these people, require these people, to leave the economic workforce? I think it's a waste of talent and productivity.

Now, if somebody wants to leave the work force because they have other things they want to do with their life and they can afford to do so, fantastic. Go for it. But to have this date in mind, that when you turn 65ish you are supposed to retire, simply seems wrong today.

I think about the vast numbers of people who when they approach this age in their life they do not have enough money to retire. What are they supposed to think of themselves? Are they a failure? I think this is horrible. I think the premise of retirement is misplaced, I think it is an old premise that we need to lose. I don't think it's good for people. I know it's not good for certain businesses, where they get a brain drain in terms of their employee base. I know it's not good for an economy, because if you don't have a conditional increase in productivity levels that at least offsets the loss in the labor participation, then economic growth shrinks.

We have this concept of retirement

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arbitrage opportunities, help keep the market-determined price of an ETF's shares close to its underlying value.

ETFs and Taxes

Different types of ETFs have different tax treatments.

Investment Company Act ETFs

ETFs registered under the Investment Company Act of 1940 are subject to the same tax rules as mutual funds. To improve their tax efficiency, ETFs commonly employ two mechanisms that also are available to mutual funds: low portfolio turnover and in-kind redemptions. The relative tax efficiency of ETFs and mutual funds depends on the extent to which they use these mechanisms.

- **Low portfolio turnover strategies.** Like index-based mutual funds, index-based ETFs are less likely than actively managed funds to trade securities, thus reducing taxable gains that must be distributed.
- **In-kind redemptions.** ETFs that distribute securities to APs that are redeeming ETF shares can reduce their unrealized gains (also known as tax overhang) by distributing securities that were purchased for less than their current value (so-called low-basis securities). Because these transactions are in-kind, the ETF does not incur any tax when the low-basis securities are distributed.

It is important to note that though these strategies can reduce capital gains distributions to investors while they are holding ETF shares, investors ultimately pay taxes on any capital gains when they sell their ETF shares. Thus these strategies enable tax efficiency through tax deferral, but not tax avoidance.

Physical Commodity ETFs

Physical commodity ETFs are structured and taxed as grantor trusts. Investors in these ETFs are taxed as though they own the underlying assets. That is, investors are primarily taxed when they sell their investment—although there also may be tax consequences if the ETF sells commodities, such as to pay expenses.

Derivatives-Based Commodity ETFs

Derivatives-based commodity ETFs are typically structured as trusts and taxed as partnerships. This carries a number of tax implications, including that investors are taxed annually on so-called mark-to-market gains (even if the assets are not sold), as reported on Internal Revenue Service Form K-1.

Professional tax advisers can help educate investors about the tax implications of investing in ETFs. ▲

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born out of the fact that people were no longer are able to contribute, which of course is untrue today. The cost of retirement is not easily afforded by most people. Retirement may not be good for individuals' health or their relationships with their significant others. It's not necessarily good for business, and it's not good for the economy.

We should think about retiring retirement, at least from the perspective of how we've looked at it historically. Maybe people work until age 70, or they work part-time for a few years in retirement and then gradually retire. They can extend some of their work and their input to society. Surveys of older people say that a lot of people who are working into their so-called retirement years are not working specifically for financial needs. They're doing it for socialization, they're doing for enjoyment, they're doing it for the connection they have with people, they're doing it to stay active and engaged. They're doing it for a whole lot of reasons that have nothing to do with financial preparedness, but that just make good sense otherwise. So I challenge the premise that we should still be thinking about retirement the way that we have done for the last hundred years. I think that is passé and we need to move on to something better for people.

Editor's note: Go to AAII.com to see Falk's thoughts on ruin-contingent life annuities and the Treasury Department's new rules for putting annuities into corporate retirement plans. ▲

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