Retirement Planning for the Middle Class: Holistic Strategies Will Be Essential

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Abstract: *The traditional retirement will be out of reach for most middle-class baby boomers. The financial resources won't be there if current trends continue regarding personal saving and employer-sponsored retirement programs. The middle class will need to change their goals from the traditional retirement, defined as "not working," to a "rest-of-life" that is fulfilling, healthy, and financially secure. To achieve these goals, working Americans will need to adopt lifestyle solutions that complement financial solutions.*

Financial professionals can help their clients make the most effective choices regarding financial solutions. Analyzing the realistic limits of financial solutions helps identify when nonfinancial solutions are needed.

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Introduction

The prevailing model for happiness and fulfillment in a person's 60s and later is the traditional retirement, defined as "not working." The traditional solution to enable not working is to accumulate sufficient financial resources through a combination of personal saving, employer-sponsored benefits and Social Security. These three resources have been called the "three-legged stool" that supports retirement.

However, all three legs of the stool are under stress in today's environment and may not be sufficient to support the traditional retirement for many people:

- Personal saving is at an all-time low.
- Employers have been reducing or eliminating traditional defined-benefit and retiree medical plans.
- Social Security has long-term financial difficulties, and some experts predict that benefit cutbacks are likely.

Two other possible financial resources have been mentioned in the popular press—home equity and inheritances. For some people, these may help; a realistic assessment is necessary instead of relying on blind hope that these will make up for potential shortfalls.

However, if all of the above are insufficient for financial security in retirement, the inevitable solution will be some combination of 1) working in retirement to make ends meet, 2) postponing retirement, 3) reducing living expenses before retirement to enable higher saving for retirement, and 4) reducing living expenses during retirement.

Continued work is now called the "fourth leg" of the retirement stool.

Any of the above solutions may be viewed as unpleasant or undesirable, but they should be assessed against the new goals espoused in the abstract. Will they jeopardize life fulfillment, health and financial security?

First, this article summarizes the current state of financial resources available to the middle class to substantiate opening statements in the abstract and introduction. Next, it summarizes the change in goals necessary to respond to the new environment. Finally, it describes 10 steps to meet these new goals.

The statistics quoted in this article on the level of financial resources available to the middle class were prepared before the significant declines in the stock market in late 2008 and declines in real estate values in 2007 and 2008. These declines only reinforce the need for strategies presented in this article. See the appendix for more thoughts on the effect of the recent financial meltdown.

For the middle class, there is no "magic bullet" that will solve their retirement challenges. It is unlikely that employers and Social Security will spend more money to improve the situation; if anything, future reductions in benefits are more likely. A holistic approach is needed that integrates finances with lifestyle and makes the most effective use of available resources. Effective solutions need to be reliable and simple to understand and execute; most won't have access to more sophisticated financial products and services that are available to affluent people. Financial professionals will often find that the challenges are more behavioral than technical in nature, and explaining difficult concepts to clients in a simple way is critical. The solutions suggested in this article keep this in mind.

TABLE 1

Reported Retirement Savings

Prevalence	Retirement Savings
28%	Less than $10,000
23%	$10,000 to $99,000
18%	$100,000 to $249,999
23%	$250,000 and over

TABLE 2

Average 401(k) Balances in 2006 by Age and Tenure

Age Group	Tenure (Years) <2	2-5	5-10	10-20	20-30	30+
50s	$17,854	$32,532	$54,491	$99,794	$174,272	$167,806
60s	$20,076	$31,914	$51,268	$93,636	$157,069	$190,593

Many in the middle class may not have sufficient assets to generate significant estate planning needs or tax issues, so these topics won't be covered here. This article focuses on providing sufficient income in retirement years to cover living expenses at the level necessary to support a happy and fulfilling life.

Current State of Financial Resources Available to the Middle Class

A considerable amount of research points to two significant trends: 1) currently available financial resources are not sufficient to support a traditional retirement for large numbers in the middle class; and 2) many people have misperceptions about the amount of money that is needed for a traditional retirement and how to manage financial resources to last a lifetime. This section briefly reviews this research, which supports statements in the abstract and introduction of this article.

Following is a brief summary of employer-sponsored benefit plans that shows that large numbers of American workers are not covered by a retirement plan at work.

1. According to the Employee Benefit Research Institute (EBRI),[1] only 49% of all workers age 55 to 64 participate in an employer-sponsored retirement plan. Presumably the remainder of workers must accumulate funds on their own.
2. For reasons to be discussed later, a defined-benefit plan, which provides a guaranteed lifetime income, is one of the best ways for the middle class to achieve financial security in retirement. Yet according to the Center for Retirement Research, only 39% of workers in private-sector employment are covered by such plans.[2]
3. In 2002, 13% of private-sector employers offered retiree health benefits to pre-65 retirees, down from 22% in 1997. Thirteen percent of private sector-employers offered retiree health coverage to Medicare-eligible retirees (age 65 and older), down from 20% in 1997.[3] By 2008, these percentages have certainly dropped further.

Actually, the situation is worse than is portrayed by these statistics. Many workers do not stay at their employers for the 15 to 30 years that are needed to generate significant lifetime pensions, or for the 10 to 15 years that might be needed to satisfy eligibility conditions for retiree health benefits.

Next, let's look at the financial resources available to working Americans. EBRI's 2008 Retirement Confidence Survey[4] surveyed 1,000 individuals age 25 and over. Respondents age 55 and over reported their amounts of retirement savings, as shown in Table 1.

The amounts in Table 1 are self-reported but are consistent with other surveys. For example, EBRI Issue Brief No. 308[5] reports the average 401(k) balances in 2006 from a database of 20 million 401(k) participants (Table 2).

The average balances reported in this study understate the problem, since these balances are more than twice the median balances (50% of participants have balances below the median, 50% above). Average or median balances reported by several surveys, using various demographic groupings, all indicate account balances that are far below the amounts necessary to generate sufficient retirement incomes.

Married couples tend to have the best statistics regarding retirement savings, followed by single men, with single women predominating at the bottom. Single and widowed women need particular attention, as large percentages of them face poverty in their retirement years.

The retirement savings reported in Table 1 don't include home equity or retirement income earned under traditional defined-benefit plans. This shouldn't give much hope, as shown by statistics from EBRI on defined-benefit plan participation. Recent declines in housing values point to the danger of relying on home equity for funding retirement. However, it is instructive to look at the total amount of wealth available to the middle class. Table 3 shows the wealth holdings of the typical household approaching retirement (mean of the middle 10% of households headed by an individual aged 55-64).[6]

Reviewing Table 3 provides a few conclusions:

1. Liquid assets will probably be insufficient to generate significant amounts of retirement income, as demonstrated below.
2. Home equity represents a large portion of total wealth, and many will be tempted to use home equity to generate income in retirement.
3. For those who have defined-benefit retirement income, smart choices will be necessary to maximize the security generated by those benefits.

How much lifetime annual retirement income will the retirement savings in Table 1 generate? Analyses by financial planners and actuaries suggest annual withdrawal rates of 4% or 5% of retirement savings if they must last for life and generate income that increases for inflation. Table 4 applies a 5% withdrawal rate to the amounts of retirement savings reported in Table 1 to illustrate estimates of the resulting annual retirement income.

For most Americans, these amounts won't fund a traditional retirement, even when Social Security income is considered.

But will Americans be prudent in drawing down their retirement savings? The 2008 MetLife Retirement Income IQ Test[7] surveyed 1,216 people aged 56 to 65 on the safe withdrawal percentage, with the following results: a) 31% say withdrawing 4% of retirement savings per year is safe, b) 26% say 7% is safe, c) 29% say 10% is safe, and d) 14% say 15% is safe.

How safe are these strategies? The author applied Monte Carlo techniques to the above withdrawal percentages to estimate the odds of ruin, defined as outliving retirement savings. A portfolio balanced between equities

TABLE 3

Wealth Holdings of Typical Household Approaching Retirement

Source of Wealth	**Amount**
Financial assets	$42,014
Defined contribution retirement	45,244
Subtotal liquid assets	**$87,258**
Primary house	$125,208
Business assets	10,370
Defined benefit retirement	96,705
Other nonfinancial assets	26,402
Subtotal nonliquid assets	**$258,685**
Total assets excluding Social Security	**$345,943**

Source: Center for Retirement Research calculations from 2004 *Survey of Consumer Finances,* conducted by the U.S. Board of Governors of the Federal Reserve System.

TABLE 4

Estimated Annual Income Generated by Retirement Savings

Prevalence	**Retirement Savings**	**Resulting Annual Income with 5% Drawdown**
28%	Less than $10,000	Less than $500
23%	$10,000 to $99,999	$500 to $4,999
18%	$100,000 to $249,999	$5,000 to $12,499
23%	$250,000 and over	$12,500 and over

and bonds was assumed. Only a 4% withdrawal rate has acceptable odds of ruin—about one 1 of 13 for a 65-year-old man with a 62-year-old spouse. Less than one-third of the MetLife survey respondents say this rate is safe. With a 7% withdrawal rate, the odds of outliving retirement savings are a little worse than 1 out of 2—equal to or worse than the flip of a coin; pretty bad odds for such an unpleasant outcome. Almost half of the MetLife respondents are considering a withdrawal rate of 10% or more; with this rate, the odds of outliving retirement savings are very high, ranging from 4 out of 5 to virtual certainty. All of these odds get worse for retirement ages below 65, or if the individual consistently experiences net investment returns that are much less than historical averages.

But what are current retirees actually doing? According to the Fourth Annual Retirement Survey from Wachovia Bank,[8] 28% of current retirees are withdrawing 10% or more from their retirement savings every year. Most likely, these retirees will run out of money in their mid-70s at a time when it could be difficult to return to work.

The role of financial planners is to give their clients a realistic picture of the amounts of annual income that their resources will generate. This helps their clients determine if retirement is feasible, and if not, how long they should work and how much money they should save.

New Goals

It may be more realistic for the middle class to strive for life fulfillment, health, and financial security, instead of a traditional retirement. This may include continued work and/or reduced material living standards. Financial security can be defined simply as maintaining the following relationship over a lifetime:

Income > Living Expenses

Many retirement planners use the replacement ratio method for setting retirement income targets. Typical goals have been 80% to 90% of preretirement pay, although lately higher goals have been advocated to account for higher spending for medical expenses. The underlying assumption is that the retiree should have the same amount of disposable income during retirement as before. This goal focuses just on the "income" part of the above formula and ignores living expenses, which can change substantially after retirement and can vary due to individual circumstances.

A more robust strategy focuses on both sides of the above formula—maximizing income and minimizing expenses. Risk is then defined as unacceptable income reductions and/or expense increases. Specifically, risks on the income side include outliving financial resources, below-expected investment returns, and inefficient choices regarding Social Security and employer-sponsored plans. Risks on the expense side include inflation, catastrophic medical expenses, and unsustainable expenses for long-term care. Risks on both sides of the formula include fraud and inability to manage financial resources due to deteriorating mental or physical health.

Nontraditional or alternative lifestyle solutions should be considered to enhance and complement financial solutions. All solutions should be considered in light of lifestyle risks in retirement years, which include poor health, loneliness, stress, and unhappiness.

The connection of poor health to financial risks is fairly straightforward—it can result in increases to living expenses. In addition, it may prevent continued work if wages are needed to make ends meet. However, recent research[9] supports the notion that loneliness, stress, and unhappiness can be significant contributors to chronic illness, also leading to higher medical expenses. In addition, if the new goal includes life fulfillment, members of the middle class may want to consider the amount of income that is needed to meet this goal. What activities and purchases support life fulfillment, and what can be eliminated?

Thus, a robust strategy for financial security in retirement years addresses life fulfillment, health, and financial security, and these goals influence each other. Next, 10 steps are explored to meet these new goals.

Step One: Do a Realistic Assessment of Circumstances and Resources

The EBRI 2008 "Retirement Confidence Survey"[10] reports that roughly half of Americans do any form of retirement needs assessment, where the amount of income that will be generated from various sources is estimated and compared to expected living expenses. For many in the middle class, there may not be much margin between income and living expenses, so having accurate estimates of each is essential to understanding when partial or full retirement is realistic.

It is relatively straightforward to obtain estimates of lifetime income from Social Security, under various retirement ages. A statement with benefit estimates is mailed once per year, and Social Security's Web site has online calculators. It's the same with most employer-sponsored defined-benefit plans; many offer online calculators, and if these aren't available, benefit estimates can be obtained with a request to the plan administrator or the employer's human resources department. It should also be relatively straightforward to use online calculators to estimate living expenses and how they might change during retirement due to inflation and changes in spending habits.

The more difficult situation is estimating income from retirement saving accounts. The goal is to generate a lifetime income that increases for inflation. To estimate such a lifetime income, assumptions regarding investment returns and expected longevity are necessary. The best method is to use retirement planning software. A quick method that most people can understand is to use conventional wisdom on safe drawdown percentages (covered in Step Seven). Many analysts and financial planners use 4% or 5% as safe percentages to apply to retirement savings to estimate annual income. These can be flipped to estimate the amount of assets needed to generate a specific amount of retirement income. If the individual estimates the amount of annual income that is needed to supplement Social Security and pension benefits, then multiplying this amount by 20 or 25 results in rough estimates of the amount of retirement savings needed to generate that income.

If an individual wants to tap home equity to fund retirement income, then a realistic estimate of the amount of income that can be generated is necessary. This is described further in Step Nine. It's the same with inheritances; estimates of the potential amounts are necessary, considering estate taxes and the portion going to siblings and others. In most cases, these resources will help, but they won't be sufficient to fund a traditional retirement.

Another aspect of assessing circumstances is estimating how long an individual or the last survivor of a couple might live, considering family history and lifestyle. This provides an idea of how long financial resources might need to last. One problem is planning to make financial resources last for periods equal to life expectancies; these are averages, and just planning for life expectancies has an expected failure rate of 50%. Safer approaches are to plan for the top quartile of life expectancies or to add 5-10 years to life expectancies.

Many people in their 60s may find that they could live another 25 to 30 years or more. Living exclusively on financial resources for this long can take a staggering amount of money, beyond the reach of most in the middle class. It may not make sense to "not work" in the early part of a person's retirement years if he or she is still able to work and earn wages. Several online calculators can help with estimating expected longevity; some include suggestions for improving the results through lifestyle changes, helping with Step Two below.

The processes of picking a retirement age and projecting income and expenses are often iterative, meaning that if projected income falls short of projected expenses, individuals will need to change their retirement age and/or reduce living standards and recalculate the projections. They will need to use some combination of delaying retirement, saving more, working part time, or reducing living expenses to make retirement feasible.

The financial professional's role in this step is to be the catalyst to complete all the necessary planning steps. This can range from providing reminders to stay on task, to identifying useful planning tools and online calculators, helping when clients don't understand potentially confusing software, determining when retirement is feasible and how much should be saved, and discussing viable lifestyle solutions.

Step Two: Stay Healthy

A substantial amount of research[11] suggests that healthy lifestyle choices can reduce the odds by 50% or more of contracting the chronic, expensive, debilitating diseases of later years, including conditions that may require long-term care expenses. Such diseases include heart disease, cancer, diabetes, osteoporosis, dementia, and Alzheimer's. The lifestyle choices associated with this reduction in health risk are easy to express, harder to adopt:

- Healthy diet
- Exercise
- Stress management
- Cessation of smoking or other substance abuse

Adopting these steps should be the first line of defense against high medical and long-term care expenses. The "downside" is that a person's lifespan might be extended to age 90, 95 or even 100, adding stress to financial resources. This should be taken into account when assessing and deploying financial resources; how long might they need to last, given an individual's lifestyle and family history?

One study[12] estimates that a couple aged 65 would need about $225,000 to pay for out-of-pocket medical expenses over their lifetimes, after considering the amounts paid by Medicare. This estimate does not include long-term care expenses or dental expenses, which make the situation worse. However, of the $225,000 amount, only about $67,500 would be spent on premiums for Medicare. The remainder, $157,500, is spent on Medicare copayments, deductibles, and coinsurance—only when people get sick. This helps quantify the financial advantage of staying healthy.

Step Three: Protect against Catastrophic Health Risks

Every retiree needs realistic strategies to address the risks of high expenses for both medical and long-term care expenses. These risks must be addressed separately, since Medicare and most medical insurance policies do not pay for long-term care expenses. Another difference is that it is theoretically possible for family and friends who are not medical professionals to provide long-term care services but not medical services.

Since a healthy lifestyle as advocated in Step Two does not eliminate the odds of expensive illnesses, retirees still need a strategy to pay for medical services when they are necessary. People retiring before eligibility for Medicare at age 65 have limited choices. First, they should assess whether they are eligible for employer-provided retiree medical insurance, which is increasingly rare, or as a codependent under a spouse's plan. If not, the next possibility is to purchase individual insurance, which may not be feasible due to either high premiums or preexisting conditions. After a retiree attains age 65, the situation gets better. Medicare significantly reduces premiums for individual insurance, and insurance cannot be denied due to preexisting conditions. The lack of available or affordable medical insurance before age 65 can be a deciding factor in determining whether a person can retire. Continued work until age 65 may be necessary to obtain medical insurance; one refinement may be to use COBRA coverage as a bridge for up to 18 months until Medicare eligibility at age 65.

The potentially ruinous costs of long-term care are fairly well known to the financial planning community, but not among average citizens. Many people are unaware that Medicare does not cover these costs, which can range from $30,000 per year to $80,000 or more. The first line of defense is a healthy lifestyle, as advocated in Step Two. Again, this lifestyle doesn't eliminate the odds, so retirees need strategies to pay for these expenses when they are necessary.

Long-term care insurance is one good way to address this risk, although less than 10% of people buy this coverage. If insurance isn't purchased, people should realize that they are self-insuring. Most people in the middle class will not have the financial resources to pay directly for a sustained period in a nursing home. In this case, individuals should consider whether it is realistic to rely on family members who are close by and have the time and ability to provide these services. If not, then it's necessary to investigate if it is realistic to rely on community services or government-sponsored programs for the poor, which typically require exhausting assets and have facilities and services that may be considered undesirable.

One potential strategy is to use home equity as a reserve to pay for long-term care expenses if and when they occur, either by selling the house to realize the gain, or by obtaining a reverse mortgage. This requires abstaining from tapping home equity to fund retirement income for ordinary living expenses.

Education is one final but necessary strategy. People should learn about alternative medical treatments when care is needed, less-expensive alternatives for delivering long-term care, and various provisions in medical and long-term care insurance policies. There is tremendous variation in the costs of all these items and their ability to meet an individual's needs.

The financial planner's role here is to raise awareness of the issues for both medical and long-term care expenses, which are often overlooked by many in the middle class, and then to be persistent to make sure that realistic solutions are adopted.

Step Four: Work as Long as Possible

For reasons cited previously, many people may need to work in their later years to cover their living expenses. While this may seem like an undesirable result, there are advantages:

- The employer may provide medical insurance and/or 401(k) and retirement plans.

- Research suggests that working in later years may enhance health and longevity.[13]
- Working allows people to plug into a social network. This can help with the lifestyle risks of boredom and loneliness, which have their health consequences (see Step Two).

Delaying commencement of lifetime Social Security and pension benefits will increase the annual income, and delaying drawdown of retirement savings gives them additional time to grow. Thus, an important part of the planning process is to project the potential increase in retirement income for different retirement ages to determine how long continued work may be needed.

Many people may be unable or unwilling to continue their current employment situation, for a variety of reasons, including burnout, boredom, or physical disability. Many possibilities exist for addressing these issues. First, working full time may not be necessary. Individuals may only need to generate sufficient wages to supplement other sources of income in order to meet living expenses. Saving for retirement from current wages may not be necessary if all that's needed is to buy time while existing benefits and retirement savings grow (see Steps Five, Six, and Seven). Second, individuals can take new directions in work, either continuing in their current field but with reduced or flexible schedules, or branching out to new fields. They may be able to convert a hobby or personal interest into income-producing activities. This can extend their working lifetimes, which may be needed for the financial reasons cited in this article. They can view continued work as a temporary "bridge" until they draw on financial resources, or it can be viewed as a new career.

One feature to consider is the Social Security earnings test, which has the potential to reduce Social Security benefits if recipients are working. One outcome of the Social Security earnings test is that if an individual has substantial employment income before Social Security's full retirement age (FRA), it doesn't make sense to start Social Security benefits. See Step Five for details on the earnings test and the FRA.

Step Five: Make Social Security Income as Large as Possible

Most Americans won't have substantial lifetime incomes from traditional pension plans, for the reasons cited previously. In this case, Social Security income may be the only guaranteed lifetime income they will receive, unless they buy an annuity from an insurance company. Maximizing Social Security benefits will be a good strategy for many people, for the following reasons:

- Social Security benefits have unique advantages: benefits are increased for inflation, and for many people, income taxes on the benefits are reduced or eliminated.
- Managing retirement savings to last for a lifetime is a challenge, as discussed in Step Seven. Maximizing guaranteed lifetime incomes will be a good strategy for many people in the middle class.

Social Security benefits are maximized when the retiree delays commencement of benefits; delaying to age 70 results in the maximum increase. Age 62 is the earliest possible age at which benefits can start. Delaying commencement until age 66 increases the annual income by approximately 35% over commencement at age 62, while delaying commencement until age 70 increases the annual income by approximately 80%.

However, statistics show that the majority of Social Security recipients don't follow this strategy; almost three-fourths start benefits before the FRA, and a little more than half elect commencement at age 62, the earliest possible age with the smallest amount of income.[14]

An individual's life expectancy should be considered when assessing the strategy to delay benefits commencement. Table 5 estimates lifetime Social Security income, given different commencement ages.

Table 5 shows data for a person born in 1950 who earned $50,000 per year in 2008, and always earned this amount adjusted for changes in average wages. It shows that if a person lives until age 70 and dies, starting benefits at age 62 was the best choice. If a person lives until age 80 and then dies, starting benefits at age 66 was the best choice. If a person lives until age 90, starting benefits at age 70 was the best choice. This is a simplified example that ignores the time value of money; however, reflecting this wouldn't significantly change the outcomes because Social Security benefits are increased for inflation.

Table 5 also assumes the person works until the benefits commencement age. The conclusions wouldn't change significantly for other scenarios, such as working until the FRA but delaying commencement of benefits until age 70. The reason is that most of the increase in income associated with delaying benefit commencement is due to Social Security's delayed retirement credits, which increase the income by 8% for each year of delay after the FRA. Such scenarios can be modeled using updated calculators on the Social Security Web site.

Most "break-even" analyses show that for a person considering commencement at age 62 versus ages 66 or 70, the break-even ages are in the late 70s or early 80s. This is one reason that estimating life expectancies is an important part of the planning process. Many people will have life expectancies well into their 80s, so delaying benefits as long as possible would be a smart strategy.

If an individual delays Social Security benefits, it may be necessary to continue to work until benefits start. One consideration when deciding the benefits commencement date is the Social Security earnings test, which has the potential to reduce Social Security benefits if they are being paid before an individual's FRA. For example, in 2008, an individual can earn up to $13,560 per year in wages with no impact on the Social Security benefit. Any employment income above this threshold reduces Social Security income by $1 for every $2 of employment income. Investment earnings and pensions do not count toward the threshold, only wages and self-employment income count. An individual's FRA depends on the year of birth, and ranges from age 66 to 67. Once an individual attains the FRA, an unlimited amount of wages can be earned without reducing Social Security benefits.

Step Six: Make Employer-Sponsored Pensions as Large as Possible

Most people won't have substantial lifetime income from an employer-sponsored defined-benefit plan; those who do are fortunate to have an income that is guaranteed for life. A good strategy is to maximize the annual retirement income. This is possible through one or more of the following strategies:

- Working longer—Most plans use years of service when calculating the annual income, so working longer will increase benefits.
- Maximize covered wages—Many plans use salaries or wages to compute benefits, sometimes in the last few years before retirement. All such plans use base salary, but other forms of compensation may or may not be included. Examples of the latter include overtime, bonuses, and shift differentials. It pays to know the types of compensation that are counted in order to maximize the covered wages, if this is within the individual's control.
- Delay commencement of benefits—Most plans have a normal retirement age at which unreduced benefits are paid, typically age 65 but sometimes younger. Most likely, the retirement income will be subject to an early retirement reduction if it commences before the normal retirement age. Usually a participant can leave employment but defer commencement of benefits to avoid or minimize the reduction in benefits for early retirement.

Many plans offer a lump sum payment that is actuarially equivalent to the lifetime retirement income, also called an annuity. When this option is offered, election rates are quite high, as the resulting lump sums can seem very attractive. Participants should be urged to carefully consider the annuity. Electing a lump sum requires participants to manage this sum to last for the rest of their lives; however, this is a difficult challenge, as described in Step Seven regarding drawing down retirement savings.

When does the lifetime annuity make sense?

- If the participant or the spouse is in good health and maximizing lifetime retirement income is important. Lump sums are based on average life expectancies, so if the participant or the spouse lives longer than average, the annuity might result in higher total lifetime income.
- If participants are unsure of their investing abilities, particularly when they get to their 80s or 90s. One advantage of an annuity is that it's user-friendly. The check comes automatically in the mail or is deposited electronically. The participants don't need to invest the money and be subject to market volatility or unscrupulous or incompetent advisors.

When does a lump sum make sense?

TABLE 5

Lifetime Social Security Income Depends on Commencement Age and Longevity

Start Social Security at Age	62 (earliest)	66 (FRA)	70 (latest)
Initial annual income	$13,560	$18,480	$25,200
Live to 70, total lifetime income	$108,480	$73,920	$0
Live to 80, total lifetime income	$244,080	$258,720	$252,000
Live to 90, total lifetime income	$379,680	$443,520	$504,000

- If both the participant *and* the spouse are in poor health and might live less than their average life expectancies.
- If, for the rest of the lives of the participant and spouse, they can invest successfully and live on prudent withdrawals from the lump sum—2% to 5% per year as discussed in Step Seven.
- If the participant has a purposeful strategy to live on just the interest and dividends and leave the principal to children or charities upon death (this may not be necessary if there are other substantial assets to leave in the estate).
- If the lump sum can be used to buy an immediate annuity from a highly rated insurance company, where the monthly income is substantially higher than the amount payable from the pension plan.

For those who have substantial benefits from a defined-benefit plan, these benefits will be one of their most significant assets, so smart choices are essential. The role of the financial planner is to help the participant understand the implications of his or her choices.

Step Seven: Be Prudent When Withdrawing Retirement Savings

For many people in the middle class, a primary source of retirement income will be withdrawals from savings of any type, whether from a 401(k) plan, 403(b) plan, 457 plan, traditional or Roth IRA, or just an account that has no special tax features. The primary goals are to manage withdrawals so that retirees do not outlive their savings and provide increases for inflation.

The concern is that many retirees may think that their retirement savings is a lot of money, so they spend it freely without a strategy to make it last for 20 years or more in retirement. A good strategy is to consider retirement savings as a generator of a monthly paycheck. Then, spend no more than this paycheck. Most people live paycheck-to-paycheck while they are working, so maintaining this financial discipline in retirement is familiar and desirable. To determine the amount of the monthly retirement paycheck, one of the three methods described below minimizes the chance of ruin (outliving assets).

Method 1: Spend Just the Investment Income

Spending just interest and dividends virtually guarantees that retirees won't outlive their assets. With a portfolio balanced between stocks and bonds, annual income can range from 2% to 4% of invested assets, depending on the specific asset allocation and the portfolio's emphasis on income-producing stocks. Portfolios with investment income rates higher than 4% usually are significantly invested in bonds, which leads to a concern about inflation.

This method works if the investment income is enough to cover living expenses. Also, it's the best method if leaving money to children or charities is important. Of the three methods discussed in this section, this method has the highest chance of lasting for life and protecting against inflation. However, it produces the lowest amount of retirement income, compared to the next two methods.

This method has two other advantages:

1. There is less concern about market value fluctuations, as long as the interest and dividend stream is safe (which is an important goal that deserves attention). This can provide some peace of mind during times of market volatility.
2. In case of an emergency, retirees can tap into principal.

Method 2: Spend Principal Cautiously

Withdraw income and principal in a way that minimizes the likelihood of outliving principal. One rule of thumb is to calculate 4% of the retirement savings balance at the beginning of each year; divide by 12 to determine the monthly paycheck. This technique provides automatic adjustments for subsequent fluctuations in the value of the portfolio; if the portfolio appreciates, then the 4% factor is applied to an increased balance, resulting in larger withdrawals in dollar amounts. The reverse is true if the portfolio decreases; withdrawals are reduced in dollar amounts if the portfolio depreciates. A variation of this method applies the 4% withdrawal factor to the portfolio in the first year, and increases the dollar amount of withdrawal in each subsequent year by 3% for inflation. Regardless of the specific application of this method, reducing withdrawals when the market is down reduces the probability of outliving assets. People in their mid- to late 60s or 70s may be able to increase the withdrawal percentage to 5%. Some online calculators estimate the odds of ruin with various withdrawal strategies.

This method is designed to withstand the worst scenario—a significant drop in the value of investments early in retirement. If this scenario happens, the goal of this method is to maintain sufficient assets when the market bounces back. If people withdraw too much principal just before a market downturn, there might not be enough invested assets to recover. Hurricane Katrina and other disasters have taught the wisdom of utilizing strategies to survive the worst case. If the worst case doesn't happen and the portfolio appreciates, then retirees can enjoy future increases in their retirement income when they apply the 4% or 5% rate to a higher asset value.

This method works if retirees need more income than provided by just interest and dividends, and if leaving money to children or charities isn't as important as maximizing retirement income. Retirees also have the flexibility to tap into principal if an emergency arises.

Method 3: Buy an Immediate Annuity

These shouldn't be confused with deferred annuities, which are investment vehicles that can have high expenses. With an immediate annuity, retirees give a lump sum of money to an insurance company, and they promise to pay a monthly income for life. Usually the monthly income is a fixed amount. However, with some annuities, the monthly pension is increased at a specified rate. For married couples, income can be continued throughout the life of either spouse. Attention should be paid to the safety rating of the insurance company; it's safest to use companies with one of the four highest ratings from S&P or Moody's.

If the monthly income is fixed, there is no inflation protection. For this reason, it may be desirable to apply just a portion of the retirement savings to an annuity, from one-third to one-half. Then, the remainder of the portfolio is invested in stocks and other assets that provide inflation protection.

An annuity typically has two disadvantages compared to the first two methods: money won't be left to children or charities, and there is no reserve if an emergency arises. However, an annuity has one significant advantage—no management is needed, which might help for elderly retirees who become less able to manage their investments.

Most people are familiar with investment diversification where investments are spread across different types of assets and securities. An important refinement to this concept is income diversification, where two or more methods of generating retirement income are used. This balances the advantages and disadvantages of each method.

For example, it may not be desirable to invest all retirement savings in an immediate annuity, since there may be nothing for emergency reserves and no protection against inflation. Instead, deploy just a portion of the portfolio to an annuity, and use one of the first two withdrawal methods for the balance of the portfolio.

The appropriate withdrawal method can change as people age. For example, in the "early" retirement years, through the late 60s or early 70s, it may be prudent to use the first method—live on investment income. Part-time work may be needed to provide enough income while the retiree is still able. With this strategy, retirees would wait until their 70s or later to begin drawing principal and/or buy an annuity. This might coincide with when they stop working altogether.

Here is one final important detail. For investments in a 401(k), 403(b), or 457 plan, or a traditional IRA, attention must be paid to the minimum distribution rules during the owner's lifetime (Roth IRAs aren't subject to these rules). Upon attaining age 70½, the IRS requires minimum withdrawals, or significant penalties may apply. This doesn't require that the money be spent; retirees can always withdraw the money and put it in a taxable investment account.

Managing financial resources to last for a lifetime is a daunting challenge. Retirees may want to withdraw amounts that are more than prudent to meet current living expenses, placing pressure on financial planners to produce results that please their clients. The role of the planner is to help his or her clients make informed decisions and be aware of the features and risks of different methods to manage and spend retirement savings.

Step Eight: Adopt Simple, Effective Investment Strategies

People in the middle class may not have sufficient assets to attract professional portfolio managers, and they may not have access to investment products and services that are available to more affluent people. It will be necessary to utilize investment strategies that are easy to execute, don't have requirements for constant monitoring, have low transaction expenses, and satisfy reasonable expectations for favorable investment returns. Examples include:

- No-load mutual funds that allocate between various investment classes such as balanced funds, asset allocation funds, and/or target retirement date funds. Such funds may use passive investing through index funds.

- Immediate annuities from well-rated insurance companies for lifetime income.

Financial professionals can help individuals select mutual funds and then check back periodically to make sure they are still meeting investment goals.

An important and related financial management strategy is to have one to three years' worth of living expenses covered by the combination of anticipated income from Social Security, pensions and annuities, and in safe investments such as bank CDs, Treasuries, or other short-term instruments. This enables individuals to ride out market downturns, thus avoiding liquidation of long-term stock and bond investments at the wrong time.

Step Nine: Be Thoughtful about Tapping Home Equity

As indicated previously, home equity comprises a significant portion of the total wealth of the middle class. If financial assets are insufficient to support retirement, creative use of home equity may be necessary. Possibilities include:

- Sell the house and move to a less expensive home, converting the net gain after taxes and transaction costs into financial assets that can generate retirement income.
- Rent the house and move into a smaller house that has a lower monthly rent or mortgage payment.
- Stay in the house and rent out a room or two (also may help with loneliness).
- Stay in the house and take out a reverse mortgage. However, this could reduce or eliminate home equity as a possible contingency strategy for long-term care expenses, as noted in Step Three.

Reverse mortgages need to be shopped carefully for the best possible return and lowest expenses, as there is a large variation in product offerings. One strategy views a reverse mortgage as part of a contingency plan: delay buying a reverse mortgage until absolutely necessary, when other assets have been depleted or to cover high nursing home expenses.

Monthly housing expenses can be one of the largest items in a retiree's budget; even if the mortgage has been paid off, the forgone investment income on the equity can be high. Creative use of home equity may be essential. Sharing a home with other people, particularly retirees, can be an effective way to share living expenses and address lifestyle risks such as loneliness, boredom, and poor health.

Step Ten: Adjust Living Expenses to Match Income

Retirees must be more careful with living expenditures than workers, who can rely on future wages to pay for current expenditures (a problem created by credit card debt). When a retiree has stopped working altogether, existing financial resources are the sole source of funding for current and future expenditures. Therefore, retirees must be mindful to balance lifelong living expenses with lifetime income. They need a long-term view that preserves financial resources, to avoid needing to adopt drastic measures late in life when assets have been depleted.

Like all other steps in this article, this could be the subject of entire articles and books. Here are some considerations:

- Retirees should consider buying only what is necessary for living expenses and what truly makes them happy. For this latter item, people in their later years tend to value relationships more than things, and they can be quite happy on a reduced material standard of living.
- Retirees can spread the cost of large ticket items such as cars and houses by sharing among friends and family. Sharing housing represents a special opportunity, as it can reduce living expenses and help with loneliness and boredom.
- Retirees can utilize one of their most significant assets—time. Time to shop for the best buys, time to make their own repairs, time to make or swap instead of buy.

Many people planning their retirement face a profound choice—continue their current material standard of living and continue working, or reduce or stop working but with a lower material standard of living. Which will help them best meet the new goal of a life that is fulfilling, healthy and financially secure?

Conclusion

To summarize the themes in this article, financial professionals can play a critical role in helping those in the middle class prepare for their retirement years. Financial professionals can help analyze the realistic limits of traditional financial solutions and discuss holistic strategies that integrate financial and lifestyle solutions. Because the challenges may be more behavioral than technical, their role might evolve from financial planning to life coach.

The middle class may not have sufficient assets for an ongoing relationship with financial professionals;

instead, they may need to work with financial professionals at critical events, such as deciding when to retire, during the year or two immediately preceding or following retirement, or at the death of a spouse. Financial professionals should consider simple, reliable solutions that don't need constant monitoring but instead can work for a few years between periodic "checkups."

Given that there are millions of baby boomers with a lot of anxiety about retirement, financial professionals can do well for themselves and do well for society by helping the middle class achieve life fulfillment, health, and financial security in their retirement years. ■

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Steve has produced one DVD (*The Quest: For Long Life, Health and Prosperity*) and published two books [*Live Long & Prosper! Invest in Your Happiness, Health and Wealth for Retirement and Beyond* (John Wiley & Sons, 2005), and *Don't Work Forever! Simple Steps Baby Boomers Must Take To Ever Retire* (John Wiley & Sons, 1995)], all of which address retirement issues facing the middle class. He may be reached at steve.vernon@restoflife.com or visit his Web site, www.restoflife.com, for more information and articles.

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(2) "Frequently Requested Data, Private Workers with Pension Coverage," Center for Retirement Research at Boston College, www.crr.bc.edu.
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(7) 2008 MetLife Retirement Income IQ Test.
(8) "Fourth Annual Retirement Survey" from Wachovia Bank.
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(12) Fidelity Investments, March 5, 2008 news release.
(13) For a summary of the research, see Steve Vernon, *Live Long & Prosper! Invest in Your Happiness, Health and Wealth for Retirement and Beyond,* Chapter 2 (Hoboken, NJ: John Wiley & Sons, 2005).
(14) "Annual Statistical Supplement to the Social Security Bulletin," 2007, including Table 6B1.

APPENDIX: THE FINANCIAL MELTDOWN EMPHASIZES THE NEED FOR HOLISTIC STRATEGIES

Most of the strategies described in this article are designed to help individuals withstand a "Katrina-like" financial event such as the significant market volatility in late 2008. Examples of such strategies include

- working as long as possible
- living just on dividends and interest income
- being prudent with withdrawals of principal from retirement savings (particularly during market declines early in retirement)
- diversifying income sources by maximizing Social Security and pensions and/or purchasing immediate annuities
- covering one to three years' worth of living expenses to avoid liquidating long-term stock and bond investments in market downturns
- staying healthy and sharp so that individuals can act during such crises

The main thoughts to add here are psychological and emotional strategies. Financial planners are now more likely to get their clients to pay attention to financial planning matters. Clients are more willing to "do the right thing" with their finances since the consequences of not doing the right thing have been vividly illustrated on a national and global scale.

People will most likely be retired for periods of 20 to 30 years. During the last 21 years, there have been four financial crises (the 1987 crash, the S&L debacle of the early '90s, the tech bubble, and now the meltdown of 2008). People with long memories might include the significant market decline in 1974-75. These events demonstrate that it's likely there will be future financial crises during an individual's retirement, and arranging one's finances to withstand such crises is a very good idea. When preparing projections to determine if retirement is feasible, barely making the numbers work with "most likely" assumptions is not very prudent; planning for a substantial cushion that can withstand a significant market downturn is a better idea. Scenario planning is one way to do this; how do the projections look if we build in assumptions regarding a financial crisis? Financial planners and their clients now have a memorable example of the wisdom of these strategies, and planners can feel justified in bringing these to the attention of their clients.