Retirement Asset Decumulation – a Multifaceted Challenge

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Quote from a Barron's senior Financial Planner

- ***"Decumulation is the most troubling problem in finance today and we're asking each individual to solve it on their own."***
  - We thoroughly agree with this statement!
  - Strange that financial services industry is MIA!
  - We hope to demonstrate today some ***new ideas*** for you to take away & ***improve your "Golden Years!"***

What is Asset Decumulation in Retirement?

- Refers to the tendency for most portfolios to decline over the retirement period
  - ***Consumption > Income & funds growth generated***
- Greatest fear in retirement is ***outspending your life savings +/- any net cash inflows/outflows***
- Literature commonly covers this subject under "***Withdrawal Strategies***"
- Discussion became quantitative in '94 when Bill Bengen found that a "confident" withdrawal (WD) rate for most would be ***4% on a 60/40 balanced portfolio incl COLA***
  - ***Rate recently amended to 4.5%***

How this Talk Came About?

- Many sources provide generic Tips - ***not nearly specific enough!***
- Read article on decumulation by ***Christine Benz*** (Morningstar) & ***Anne Lester*** (JP Morgan Investment Management)
  - Contained some interesting points but ***it missed a lot more than it included***
- Subject is very broad so we won't ***cover every situation***
- ***Almost no writers cover decumulation as an integrated subject***
- ***Far too important not to give it more exposure and try to propose solutions for nascent retirees***

What's Different about Retirement?

- ***Reduced earnings***
- Visible ***spending constraints***
- Heightened sensitivity to ***Investment Losses***
- ***Unknown Longevity periods***
- Exposed to ***spending shocks***
- ***Compounding Inflation rates***
- Declining ***cognitive abilities***
- ***So many more unknowns in this subject domain***

What does picture have to do with decumulation?

What does picture have to do with decumulation?

Chicken has only an interest in retirement but the pig has fully committed

Which one are you?

“Successful & Secure Retirement” –
a reference book by Swedroe & Grogan (2019)

- A great reference book for the entire gamut of Retirement subjects including ***Asset Decumulation***
- ***Swedroe speaking here January 22nd on Factor Investing*** *through the magic of AV*
- Book also speaks to ***Estate planning, HSAs, Factor investing, Elder abuse, et al***
- My copy of book is available to peruse
- Get PPT from our Website ***www.aaiihouston.org***

Swedroe & Grogan Retirement Phases

- **Accumulation Phase**
  - Most of adult life; big pressure to save
- **Black-out Phase** (from retirement to age 70)
  - No salary, no SocSec yet or RMDs - ***Big Transition!***
  - Tax advantage to convert IRAs into Roth's
  - Economic advantage to defer SocSec
- **Spend-down Phase** (at age 70+)
  - Deferral of SocSec expires & RMDs begin
- **Final Spending Phase** (sometime in the 80s)
  - Longevity risk starts to bite as lifespans get longer
- **Legacy Phase**
  - Where we hope to leave something for our heirs

Big switch of some major gears from Accumulation to Decumulation

- We spend ~40 years saving hard for retirement
- Meanwhile, our employers provide 401(k) matching & the IRS allows tax-deferred saving
  - ***This is all about saving & investing aggressively (LT horizon)***
- At retirement, we have to reconfigure what to spend $ on & at what rates
- At age 70, we ***start to pay back*** all those tax deferrals through RMDs & higher tax rates
  - ***This is all about spending & investing wisely (MT horizon)***

WD Rate Strategies- In addition to Bengen

- Proven ***Success model tables*** – Cooley, Hubbard, Walz
- ***JP Morgan Dynamic*** strategy varies with portfolio size & age; also prescribes the sequence of asset types withdrawn
- **Guyton** created rules to preserve capital by adjusting for bad performance periods – "***guardrails***"
- ***IRS Mortality tables*** increase WD rates annually – we ***only reach 4.5% Bengen levels by age 76*** so may be overly conservative
- ***Schiller CAPE ratios*** with10 year ranges - adjusts WD rates annually based on forward/past PE ranges
- ***Guyton*** also created the ***Mid-course Adjustment*** strategy – adjusts WD Rates every 5 years based on performance

What do you think are the major risks are in retirement?

Key Risks in Retirement

- Longevity Risk (***unknown planning horizon***)
  - Macro environment/Market Risk
    - Investment & Interest rate ***volatility***
    - ***Taxation & Regs***
    - ***Sequence of return risks (deemed most important risk!)***
  - ***Inflation*** may be higher than planned
  - Personal Spending
    - ***Health & Long-Term Care***
    - Help less well-off family members
    - Divorce/Fraud/Theft

***Managing Sequence Risk** – Textbook View*

- Sequence risk is the possibility of losing a major % of your family portfolio early in retirement before it has started to grow
  - ***Due to difficulty in recovering from a 30-50% market loss as well as risk of reentering the market too late/too soon***
- Spend conservatively
- Spend flexibly
- Reduce Equity Volatility; same exposure
  - ***Build a lifetime spending floor with annuities or structured settlements***
- Buffer Assets (avoid selling at a loss)

***Managing Sequence Risk** – Targeted Approach*

- Most of this discussion is around making financial plans & diversifying your portfolio
- What is often ***not discussed*** in the literature:
  - ***Reverse mortgages*** on a temporary basis coupled with astute tax planning
  - Systematic ***diversification*** as demonstrated by 7Twelve(R) process by Prof. Israelsen
  - Use of ***Low Correlation*** asset classes
  - Use of ***Alternative Investments*** vs conventional market-based ones

Suggested Approach – Combine Reverse Mortgages, Social Security & Tax Efficiency

- Create significant value by deferring Social Security
  - ***25%*** (ages 62-65); ***32%*** (ages 66-69) **Big numbers!**
- ***Convert Traditional IRAs to Roth's to save major tax outlays***
  - Pay lower taxes for a few years & ***avoid paying absolute taxes starting age 70 for >20 years***
- Fund these two major benefits by ***setting up a RM***
- As a bonus, also get for free ***mitigation of Sequence Risk***
- As a second bonus, can maintain your RM to create a ***lifetime Credit Line up to $1mm***
  - ***Provides huge flexibility to manage unforeseen crises***

Differences - *Pre-Retirement vs Retirement*

"The IRS regs take the gold out of the golden years"

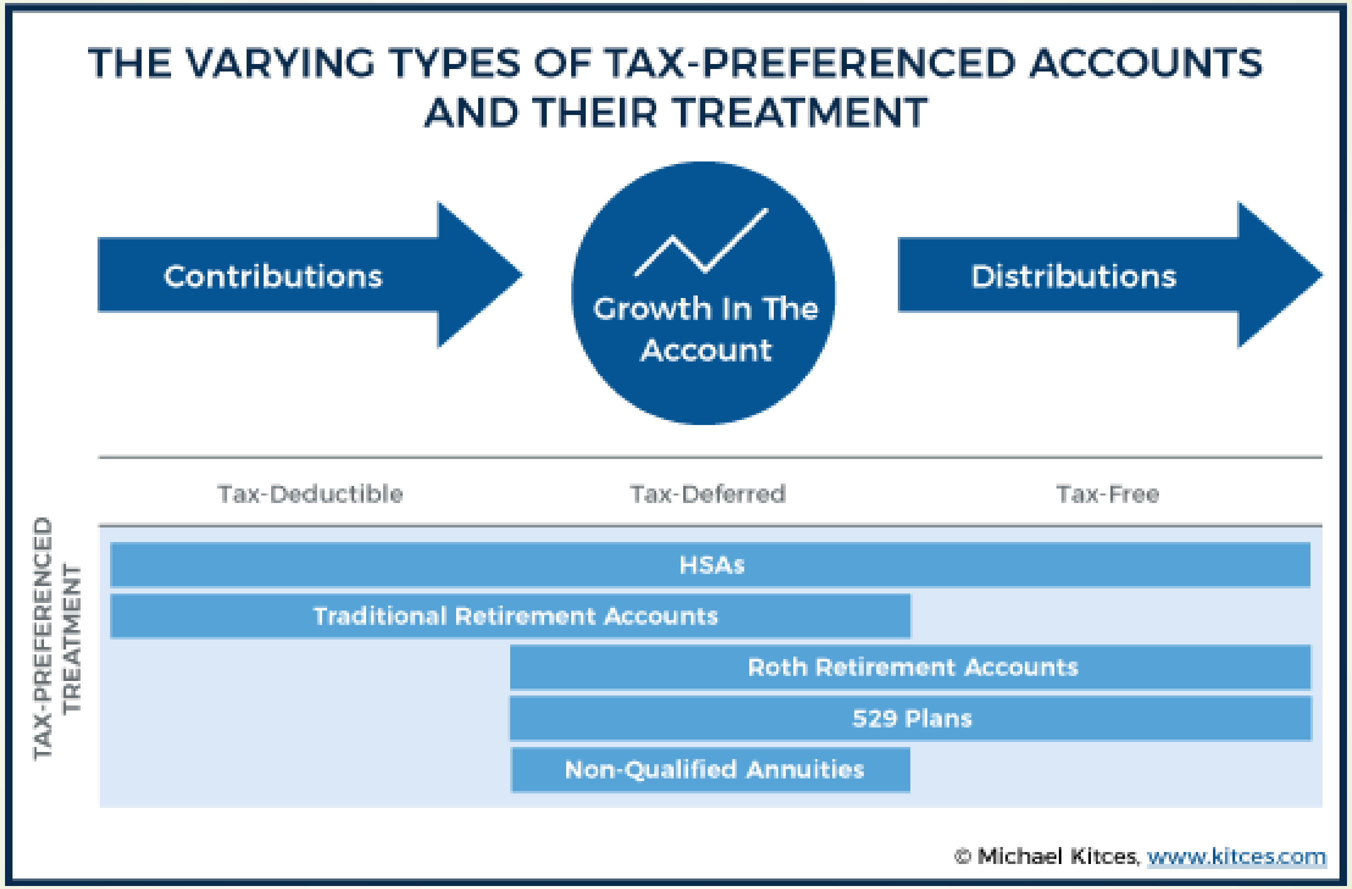
Suggested approach – ***more color***

- SocSec ***deferral pays off quickly***; trend is to ***longer lives***, especially couples
- At age 70, you ***must make mandatory RMDs***
  - ***"Taking the gold out of the Golden years"***
- ***Optimal approach*** is to take RM at age 62, run it up & start paying down over the years to say a $50 balance
- Home Values are ***credited at 1.5% monthly*** & can reach ***$1mm with compounding***
  - Reverse Mortgages currently ***limited to $637k***
  - ***RM interest receives a deduction for income taxes when repaid***
- ***Avoids sequence risk***; also avoids having to guess when to get back into the market
  - Missing a small number of days can represent large % of returns

Reverse Mortgage Realities

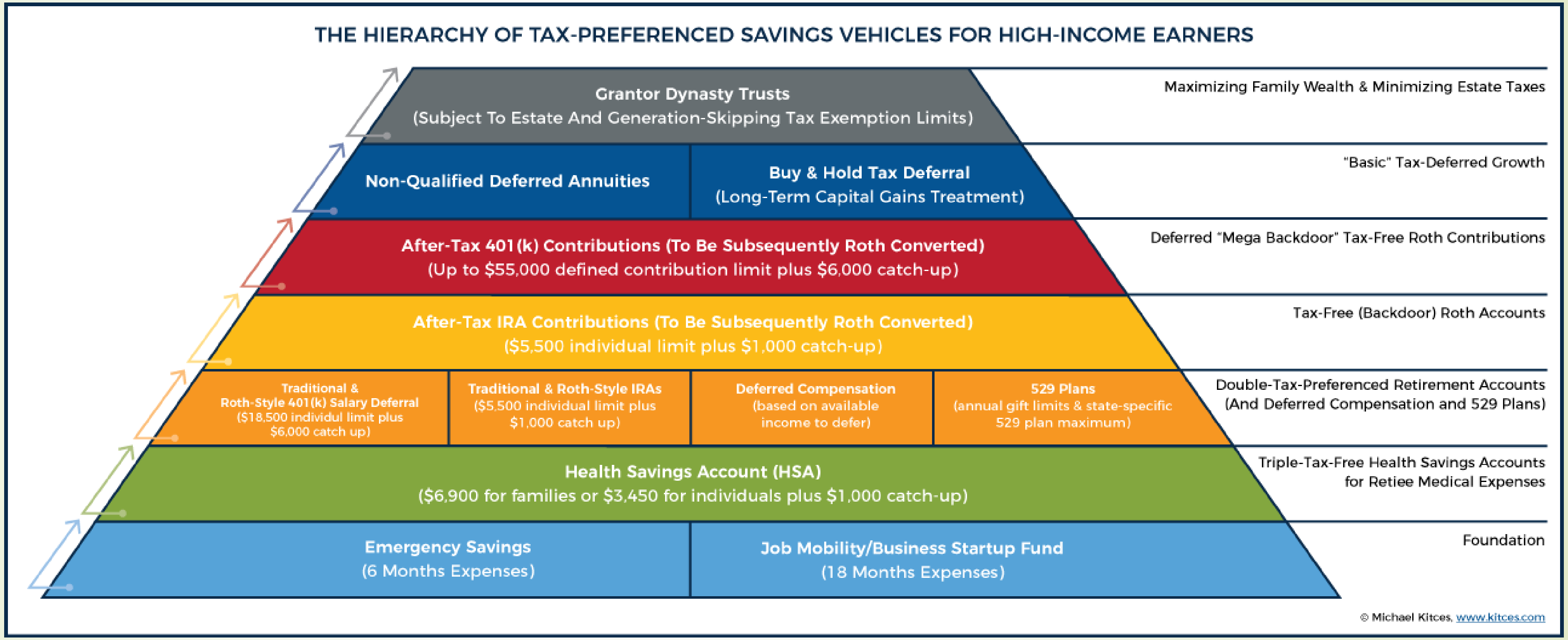
- ***Overhauled by Congress in 2010-13***
  - Historically had ***bad reputations***
  - Set up costs ~$15k; interest ~6.5% on adjustable HECM; less on fixed
  - Pay1.25% insurance as part of rate to protect taxpayers
- **Secured on your primary residence**
  - Must reside there the majority of the year & pay all property taxes
- ***When both spouses pass***: the property value is assessed & offered to heirs at market price less the mortgage balance
  - ***Heirs are free to buy the house or not*** at that price!
- ***Calculus is whether to live off the home equity during life & deprive heirs of a larger inheritance or use RM as a piggy bank***
  - Depends heavily on individual facts & circumstances

Tax Efficiency of Investment Vehicles



These are the main investment vehicles available to lower taxes; Should get educated if unfamiliar.
The vehicles improve from left to right

The search for Tax Efficiency gets complex quickly!



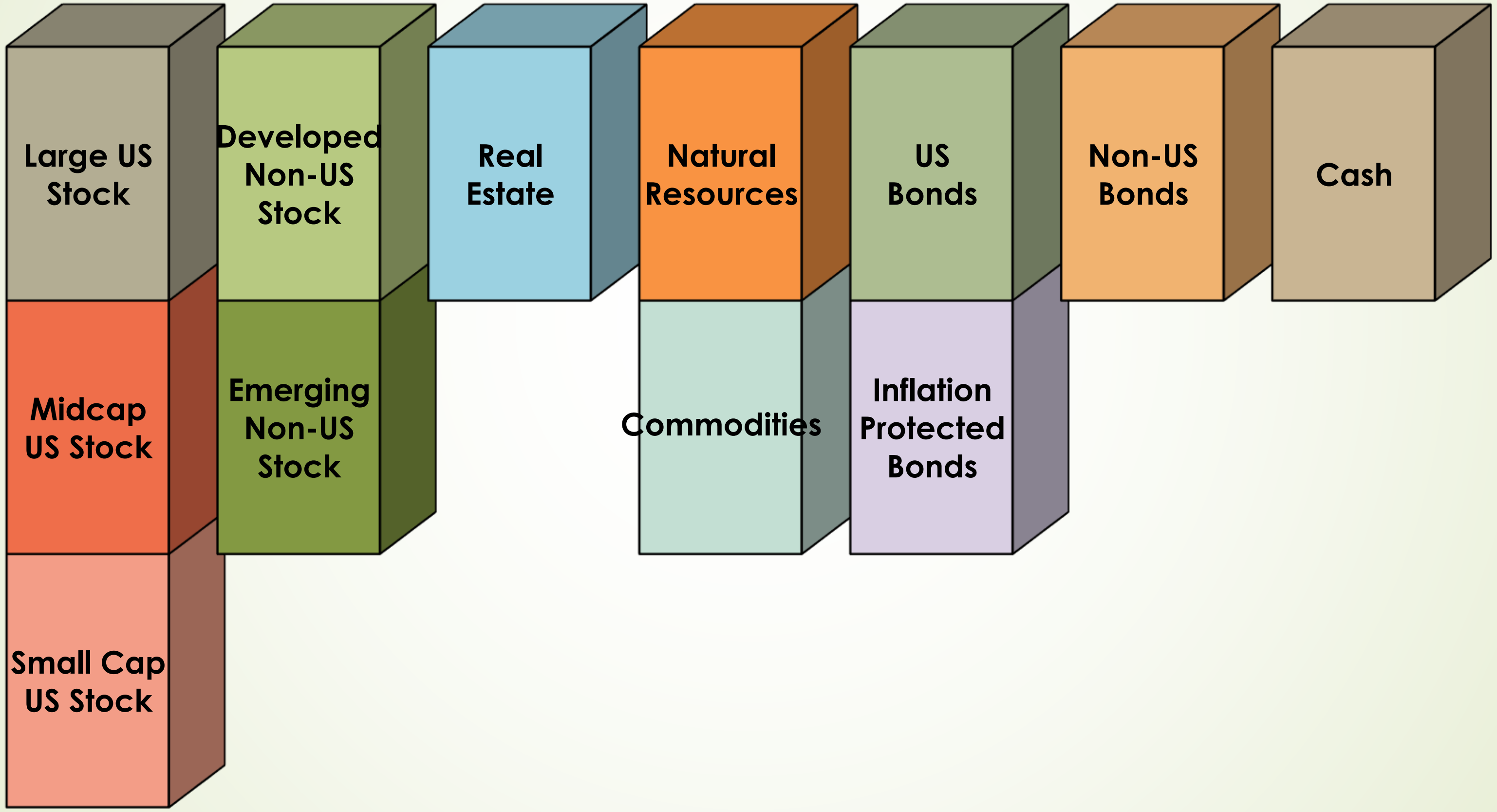
Seek tax advice to take advantage of these vehicles, where beneficial

Systematic Portfolio Diversification

- to mitigate Sequence Risk

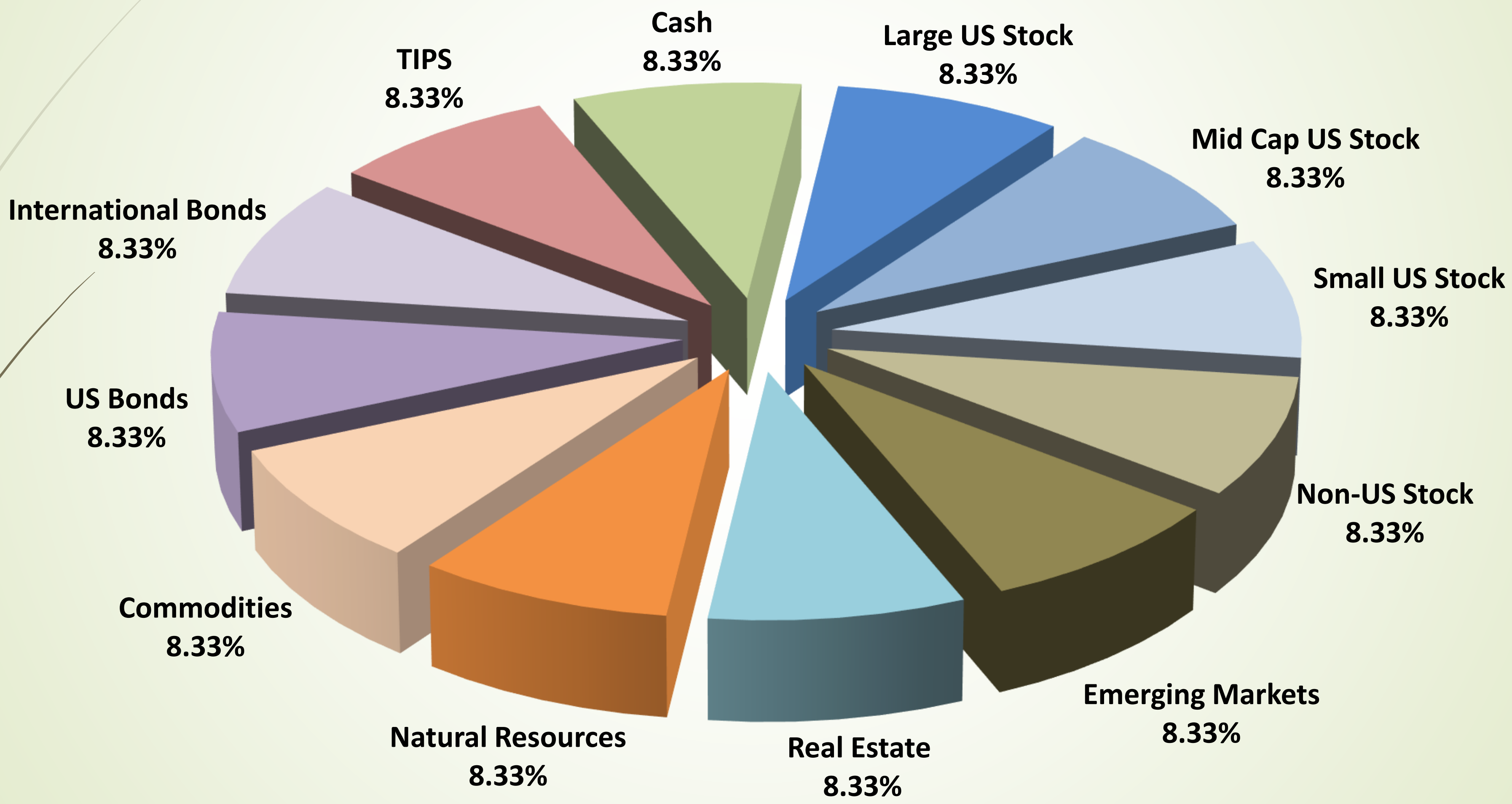
- ***7Twelve(R) process is a good example***, whereby the portfolio is divided into 12 asset classes, monitored, & rebalanced annually
  - ***Trinity funds also very good (GAA);*** available from Cambria Mgt
  - Private 7-Twelve fund ***offered by Millstein Advisors,*** former chapter president
  - ***Since we don't know which will outperform, use all asset classes***
- 7Twelve is ***statistically proven*** to exceed 60/40 & other portfolio structures
- Portfolio is ***widely diversified*** by definition
- Can choose to overweight & underweight asset classes at will
  - Couples with high $ homes & good incoming cash flow ***will need a lot less bond exposure than the standby 60/40 allocation***

7Twelve® Asset Portfolio Structure

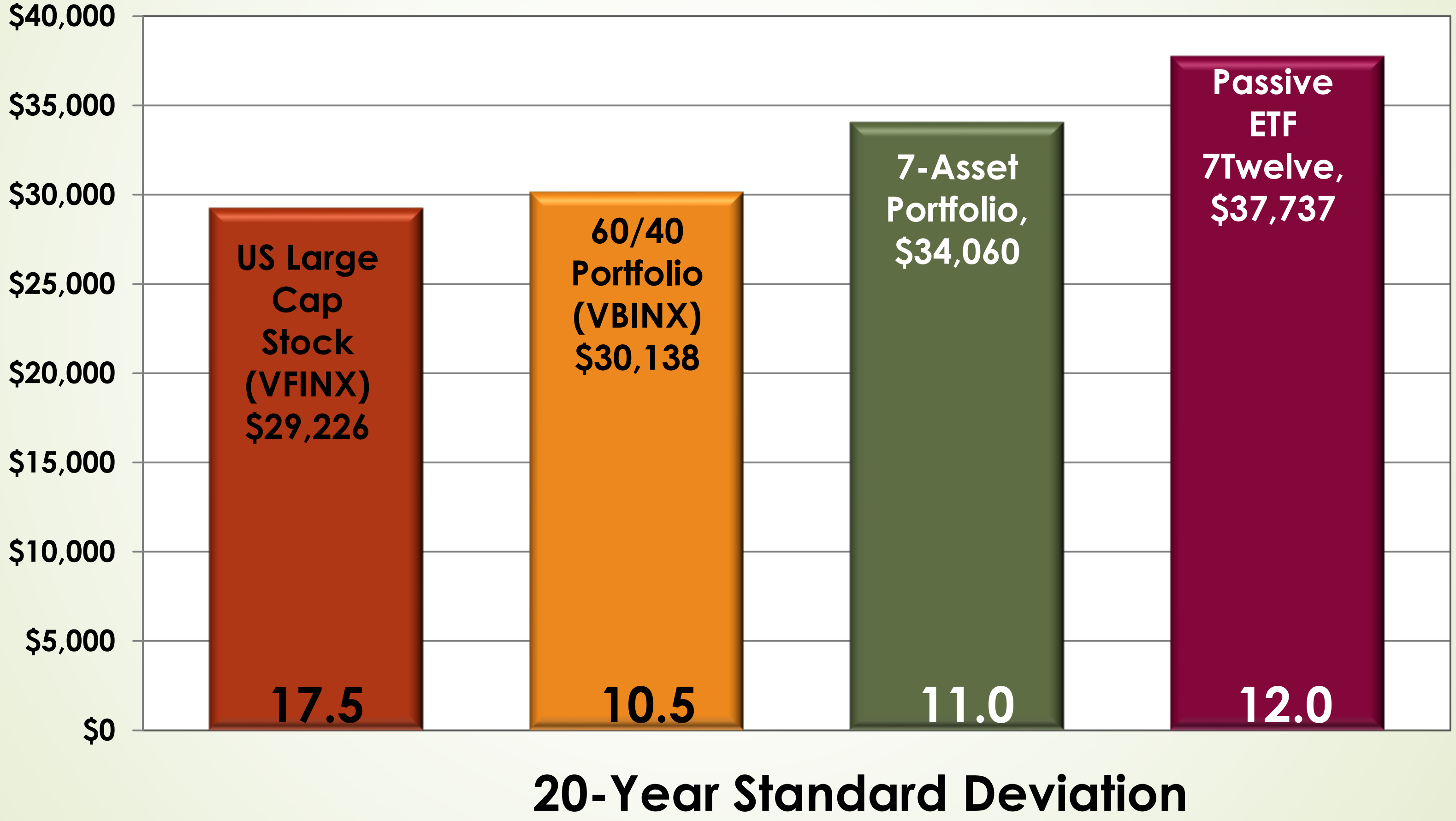


7Twelve®

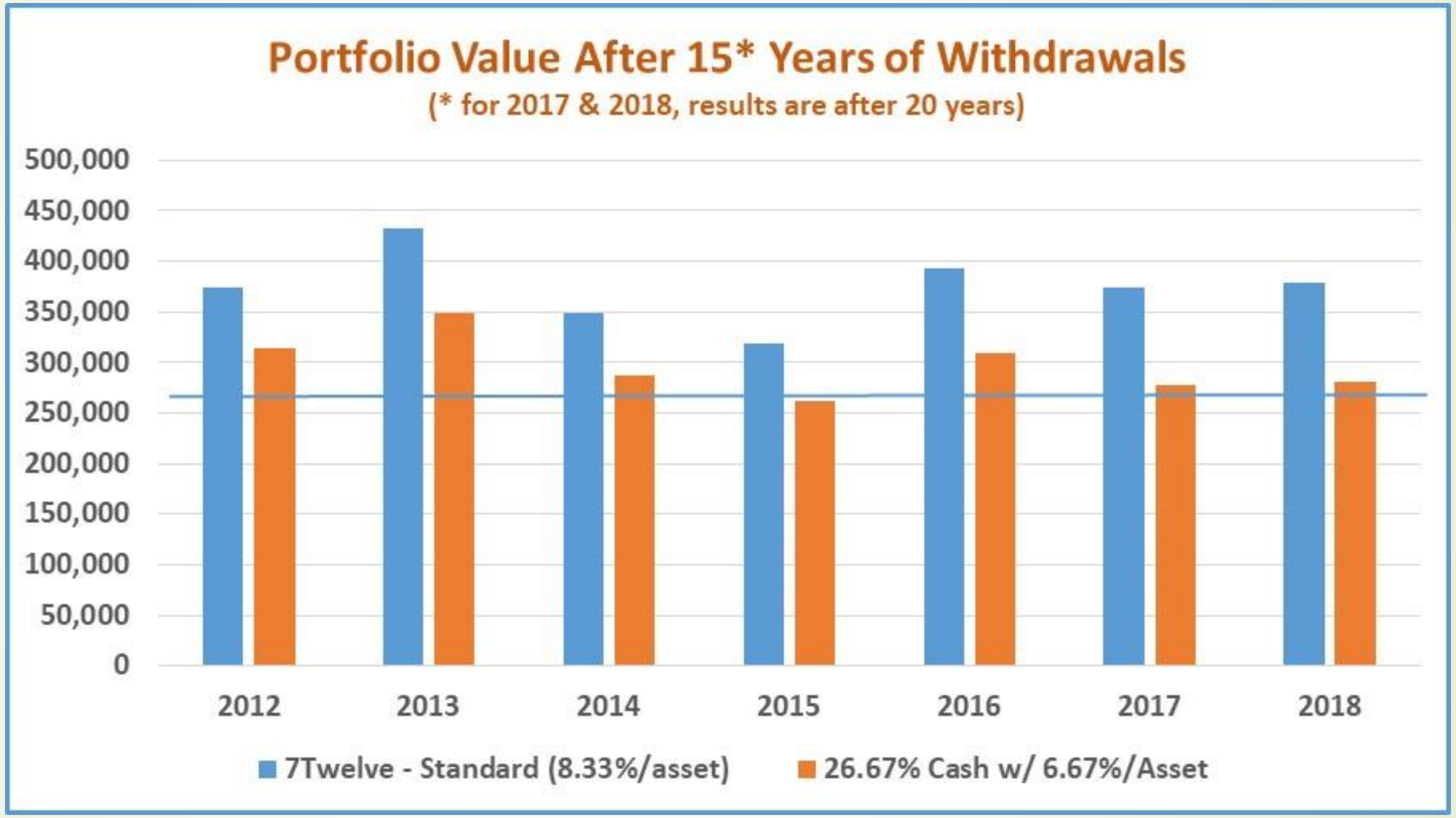
Equally-weighted exposure to 12 asset classes



7Twelve® 20-Year Growth of $10,000
1999-2018



7Twelve® as a Decumulation Vehicle - proven to remain steady



Assumptions:
Begin with $250,000 & withdraw 5% at the end of each year
Give yourself a 3% COLA increase at the end of each year
More conservative case uses 26.67% to cash & equal $ to other 11 asset classes
2012-2016 are for 15 years; 2017 & 2018 are for 20 years

Buy Low, No, or Inverse Correlation Assets

- to mitigate Sequence Risk

- Correlations are the rates of change of the asset wrt the S&P 500
  - Perfect inverse correlation has coefficient of -1 while zero correlation infers no relationship between the asset movements
  - Don't buy assets with high correlations; ***no diversification benefit***
- **Examples** (some covered in 7Twelve):
  - Use several different bond strategies/bond types to diversify
  - ***Life settlement funds; Structured settlements*** (zero correlation)
  - Commodities
  - ***Real Estate/Real Lumber/Real Oil & gas assets***
  - Emerging & Developed market securities
  - Buy ETF funds for diversification vs individual stocks
  - Low Momentum equity/bond funds
  - Dividend Aristocrat ETFs &/or Stock Buyback funds
  - ***Alternative investments*** (see next slide)

Alternative Investments - *to mitigate Sequence Risk*

- They include ***private stocks & bonds, partnership interests in hedge funds, real estate, oil & gas, litigation financing, venture capital funds, medical royalties, etc***
- When markets collapse, correlations tend to migrate towards equity market performance
  - ***Alternative investments should not do that!***
- Since they are private & illiquid, there is ***no "mark to market"*** on a daily basis
- Generally, ***illiquid investments demand higher returns*** to compensate investor's inability to timely cash-out
  - ***They should be more attractive!***
- ***Alternatives have different risk/reward profiles*** than public securities
  - However, they are ***not risk free!***

Another way for Retirees to select Income Strategies comfortable for them

STRATEGIES FOR GENERATING RETIREMENT PAYCHECKS

Approach	Income Focused	Capital Gains Top-Up	Fully-Invested Total Return
Dividends & Interest	Paid As Received	Paid in Cash	Reinvested As Paid
Capital Gains	N/A	Sold Periodically to Replenish (Top-Up) Cash	Liquidated As Needed
Cash	N/A	Accumulates for Distributions	Fully Invested
Common Investments	Bonds, Dividend-Paying Stocks, REITs, MLPs	Balanced Portfolio of Stocks & Bonds	Diversified Growth-Centric Portfolio

All legitimate strategies, depending on needs

Alternatives to avoid Black Swan events

- ***Alternative Lending***
  - Loans for small business, college expenses, student housing, etc
- ***Reinsurance***
  - Act as reinsurer for catastrophic risks
- ***Variance Risk Premium***
  - Arbitrage ST & LT option volatility
- ***Alternative Risk Premium***
  - Long-short equity funds

All funds exhibit negative skewness – more downside protection than upside potential

Retirement Planning I

- ***Must make a Plan yourself***; then solicit one from a trusted financial advisor or a third-party planner for a fee
  - Later, use online plans for ***dynamic monitoring*** e.g. Vanguard
- Make sure all cash flows in/out are considered, especially taxes
  - Tax rates ***will most likely be higher*** than expected after age 70
  - Every $ withdrawn from Traditional IRAs are ***taxed at marginal rates after age 70 (RMD regs)***
- Post-retirement costs tend to rise for a few years with discretionary travel, sports cars, RVs etc but ***begin to reduce considerably after age 75***
  - Typically less active, eat/drink less, & travel less; offset by ***higher medical costs***
  - ***Buy LT Care insurance***; some may self-insure or use hybrid annuity
    - ~68% of people >65 will spend extended periods in LTC facilities

Retirement Planning II

- Fundamental question of ***whether to leave a legacy or not*** could dramatically change impact the Plan feasibility!
- Next "biggie" is ***what market RORs to assume***
  - Planners tend to aim high on this variable; ***market is trending lower***
  - ***After-tax, After-fee returns must be > breakeven net cash outflows***
  - If you can lock in a greater return than your breakeven, ***go for it!***
    - ***Look at Life settlements, Steady growth funds, Low-risk private debt, private stocks, REITs etc***
    - ***Recently placed an 8% 5-Yr private debenture with minimal risk***
- Ensure the planner provides ***Monte Carlo simulations***, portfolio & inflation sensitivities & reasonableness checks back to your Plan
- Also, do your own ***"Back-test"*** by applying weighted 20-25 years stock & bond performance, inflation & tax rates
  - Apply historical data to your portfolio looking forward

<u>Conclusion</u>

If your Plan Feasibility is strong, relax & enjoy life

- But monitor periodically!

Otherwise, keep working the Plan

- Consider ideas presented today as well as lowering costs, adding new income, or applying Leverage!

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