

Retirement Planning: Your Largest Liability in the Making

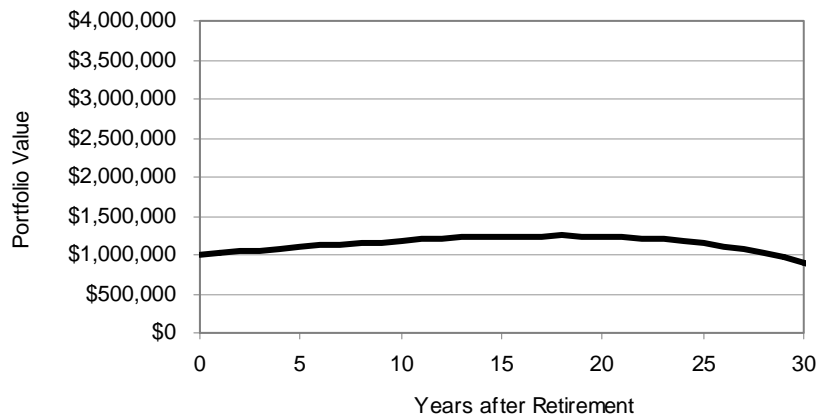
By Jim Otar

Last time I spoke to a group of financial professionals about advanced retirement planning, I asked a simple question: “When you design a retirement plan for your clients, what portfolio growth rate do you assume?” Answers ranged from 7% to 11%. When I asked why these numbers, most responses had something to do with “average historic growth rates”.

I changed my career from engineering to financial planning over ten years ago. The following ritual amazes me as much now as it did ten years ago: An advisor assumes an “average” portfolio growth rate and an “average” inflation, plugs these numbers into a retirement calculator and call this process “designing a retirement plan”.

Imagine a civil engineer saying, “The average wind speed in Miami is 6 mph. Therefore, I will design this building in Miami for a wind load of 6 mph”. This engineer would be fired on the spot for incompetence! What happens to that building when a hurricane hits?

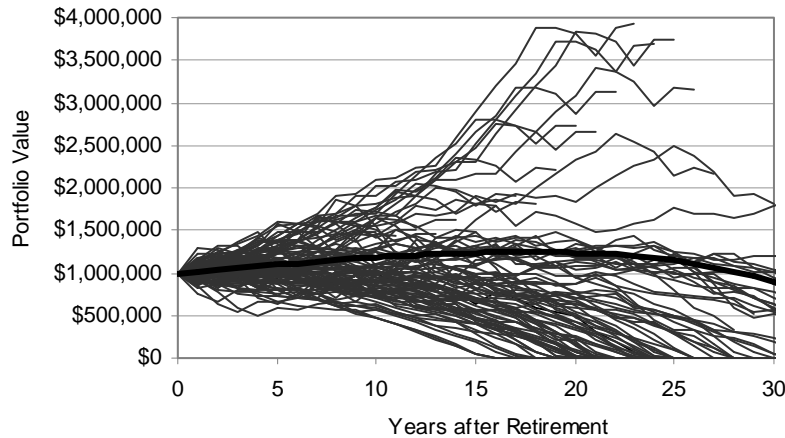
Moving from civil engineering back to retirement planning, here is a typical example: Steve, 65, is retiring this year. His retirement savings are \$1 million. He needs \$60,000 income each year from this portfolio, indexed to inflation. He assumes 8% “average” portfolio growth rate and 3% “average” inflation. Here is his asset projection using a standard retirement calculator:



According to our friendly retirement calculator and our conservative assumptions, after 30 years, Steve’s portfolio is supposed to have about \$900,000. Wonderful, isn’t it?

Well, how about a reality check? Let’s assume Steve’s asset allocation is 40% equities and 60% fixed income. His equity portfolio outperforms the index (DJIA) by 2% annually. I plug in these numbers into my retirement calculator, which is based on pure

market history. Each thin line shows the portfolio value if Steve were to start his retirement in any one of the years since 1900:



Here is the reality: Unlike the projection of the standard retirement calculator, the probability of depleting his portfolio by 30th year was 72%. In only 7 out of 75 years, the portfolio value exceeded the value projected by the standard retirement calculator at the 30th year. Why the discrepancy? Please refer to my last article, “Time Value of Fluctuations”, January 2006 issue.

Design Growth Rate:

When I prepare a retirement plan, I look at historic outcomes and then use the bottom decile. Bottom decile is the line where only 10% of portfolios did worse. In other words, the bottom decile indicates 90% survival. This is an acceptable “design growth rate” for me. If things don’t go well for the client, it gives me sufficient time to buy a life annuity and that may save the day for the client (and for me).

The table below depicts the design growth rates based on market history since 1900. They have been calculated using 3% inflation. If you are using a standard retirement calculator, enter 3% for the “assumed” inflation. Then enter the design growth rate from the table as your “assumed” portfolio growth. The resulting asset projection will then illustrate a 90% survival rate. Keep in mind; these figures apply only to individual distribution portfolios. Don’t use these figures for accumulation portfolios or pooled funds (pensions); they are entirely different.

	Initial Withdrawal Rate (IWR)			
	2%	4%	6%	8%
Design Growth Rate	5.8%	5.2%	4.0%	2.4%

By following this methodology, not only do you design robust retirement plans but you are also bulletproofing your practice, as your clients cannot blame you for using unrealistic growth rates.

You may want to review your clients' existing retirement plans. What "average" growth rate did you assume? If you notice a shortfall, make sure your client knows about life annuities. Don't let your clients' retirement dreams turn into retirement nightmares.

Editor's Note: Feel free to download Otar's retirement calculator that is based on market history.

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