Baby Boomers and Retirement Planning Strategy

Generating Retirement Income to Meet Expenditures

IRI

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About the Insured Retirement Institute:

The Insured Retirement Institute (IRI) is the leading association for the retirement income industry. IRI proudly leads a national consumer coalition of more than 30 organizations, and is the only association that represents the entire supply chain of insured retirement strategies. IRI members are the major insurers, asset managers, broker-dealers/distributors, and 150,000 financial professionals. As a not-for-profit organization, IRI provides an objective forum for communication and education, and advocates for the sustainable retirement solutions Americans need to help achieve a secure and dignified retirement. Learn more at www.irionline.org.

OVERVIEW

IRI's fifth annual report on the Baby Boomer generation, "Boomer Expectations for Retirement 2015," revealed a generational cohort with expectations for retirement that are at odds with their level of preparedness and projected expenses over what will be, for many, far more years in retirement than any generation in history. The majority of Baby Boomers have inadequate savings, no pension other than Social Security, and limited opportunity to make catch-up contributions to bolster their savings. This state of affairs leaves millions facing difficult choices, and those who are not yet retired and who do not take steps now to improve their outlooks will be forced to make significant compromises in their standard of living to avoid seeking help from family, friends, or other assistance programs. Adjusting saving habits and developing a strategic plan, including optimizing when and where to retire, can mean the difference between dignity and poverty at advanced ages.

KEY OBSERVATIONS

- Four in 10 Baby Boomers have no retirement savings.[1]
- 69 percent of Boomers have no defined benefit pension plan.[2]
- Of Boomers who do have retirement savings, 59 percent have saved less than $250,000 and 37 percent have saved less than $100,000.[3]
- Nearly half of Boomers with any retirement savings at all earn $75,000 per year or less.[4]
- A 65-year-old male in good health has a 50 percent chance of living to age 87 and a 25 percent chance of living to age 93, and a 65-year-old female to age 89 or 95, respectively.[5]
- A 65-year-old male retiring today would need more than $1 million of investable assets, in addition to the income provided by Social Security, to safely generate sustainable income sufficient to meet national average projected expenditures through at least age 95.
- Retiring at age 70 instead of age 65 can reduce needed retirement savings to approximately $720,000, and moving to an area of the country with a lower cost of living can further decrease that amount.
- A 50-year-old saver who makes the maximum current "catch-up" contributions of $6,000 per year to a 401(k) until age 70 will add more than $239,000 to retirement savings at a 5.5 percent average annual rate of return.
- Individuals can work to close the "income gap" – the difference between projected expenditures and potential income from retirement savings – by retiring in less expense areas of the country and reducing or eliminating major expense categories, such as housing and transportation.

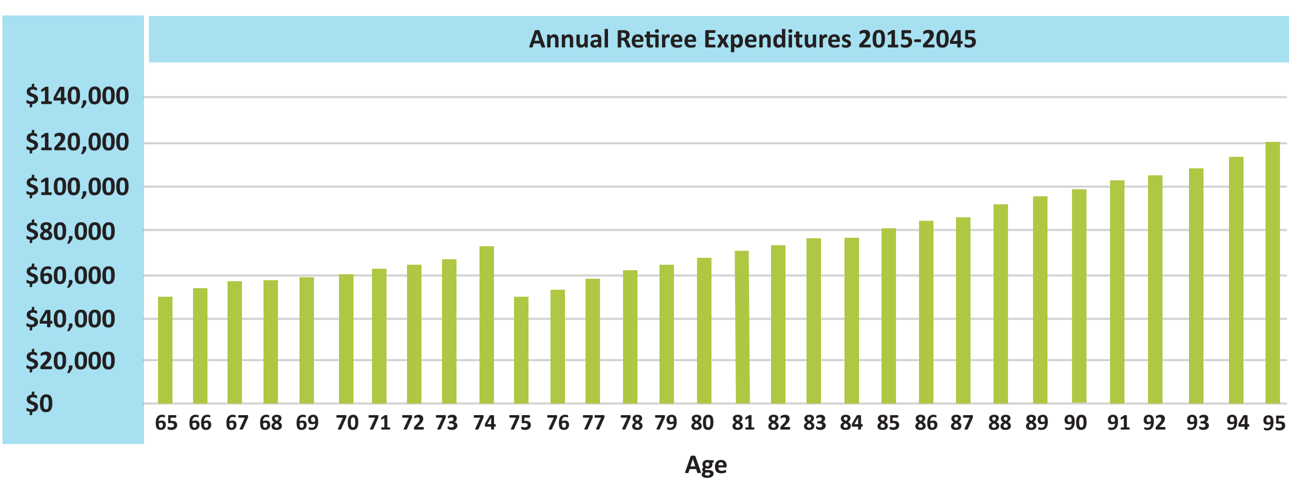
EXPENSES IN RETIREMENT

Often the retirement security challenge in the United States is framed in terms of how little Americans are saving, and how unprepared they are for the reality that steadily increasing lifespans mean retirement may last as long, or longer, than their time in the workforce. And this is certainly a valid, and important, lens to look through when gauging Americans' retirement preparedness. But what does being under-saved and unprepared really mean in terms of the decisions many retirees and near-retirees will have to make?

The Bureau of Labor Statistics (BLS) compiles annual survey data on consumer expenditures by age and category of expense. A comparison between average expenditures by retiree age group between 1984 and 2013 offers insight into the changes in expenses a Baby Boomer may expect to experience over the course of a 30-year retirement.

	Annual Consumer Expenditure Comparison					
	Ages 65 to 74			Ages 75 and up		
Expenditure Category	**1984**	**2013**	**Annualized Increase**	**1984**	**2013**	**Annualized Increase**
All	**$15,842**	**$46,757**	**3.80%**	**$11,122**	**$34,382**	**3.97%**
Food	**$2,578**	**$6,020**	**2.97%**	**$1,741**	**$1,741**	**3.04%**
Housing	**$4,901**	**$15,639**	**4.08%**	**$4,006**	**$12,314**	**3.95%**
Apparel and Services	**$4,901**	**$15,639**	**4.08%**	**$4,006**	**$12,314**	**3.95%**
Transportation	**$2,997**	**$7,972**	**3.43%**	**$1,413**	**$5,149**	**4.56%**
Health Care	**$1,485**	**$5,188**	**4.41%**	**$1,504**	**$4,910**	**4.16%**
Entertainment	**$595**	**$2,488**	**5.06%**	**$372**	**$1,422**	**4.73%**
All Other	**$2,404**	**$8,228**	**4.33%**	**$1,655**	**$5,675**	**4.34%**

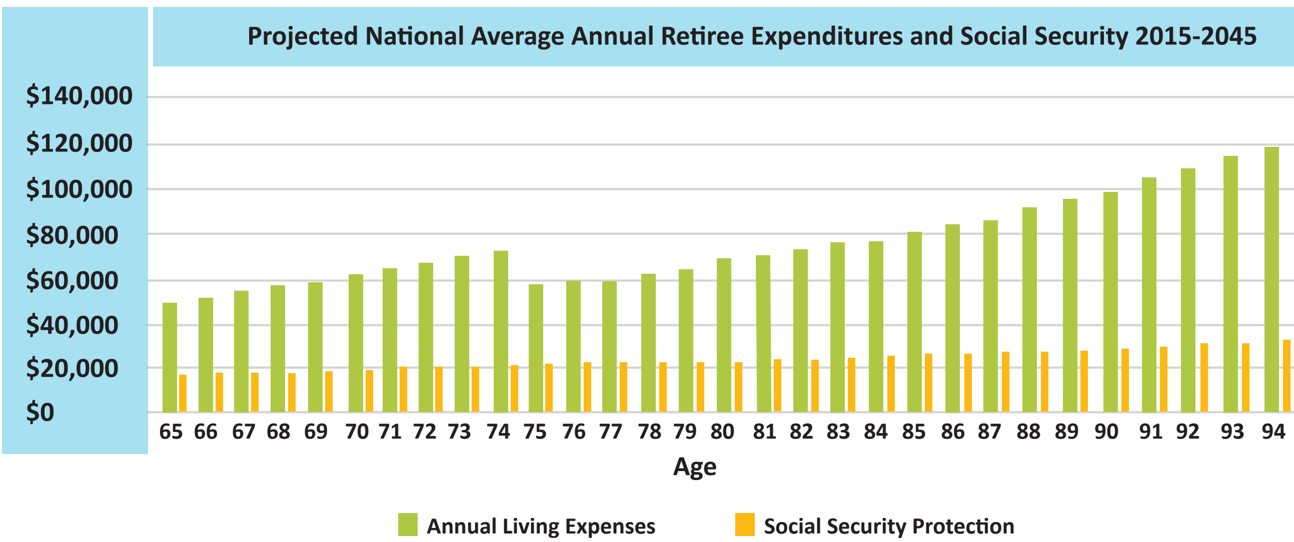
As the table shows, during the 30-year period between 1984 and 2013, average annual consumer expenditures for Americans ages 65 to 74 increased by 3.80 percent annually, and for those ages 75 and up by 3.97 percent annually. Certain individual categories of expenditures, notably health care, increased by significantly more. In comparison, the Consumer Price Index for All Urban Consumers (CPI-U) inflation for the same period was 2.82 percent[7], revealing that actual expenditure increases outpaced the general rate of consumer inflation by almost a full percentage point. If we project expenditures 30 years into the future, then, an average American retiring now, at age 65, would be faced with a retirement expense trajectory resembling the following chart.



Certainly an individual's expenditures will not drop dramatically coincident with the 75th birthday, but the analysis provides data rooted in empirical measurement that we can use to put Americans' savings, and potential to generate income, in perspective relative to expected expenditures.

INCOME IN RETIREMENT

In 2015 more than 42 million Americans were receiving Social Security retirement benefits, with an average monthly payment of $1,355, or $16,260 per year, and from 1984 to 2015 annual cost of living adjustments to Social Security retirement benefits averaged 2.79 percent annually.[8] Assuming the same average increase extending into the future and overlaying Social Security on an expenditure graph, Social Security will eventually rise to almost $40,000 a year under these assumptions. This is the "income gap" that many Americans will face in retirement – an income gap that most will need to close using their retirement plans and personal savings.



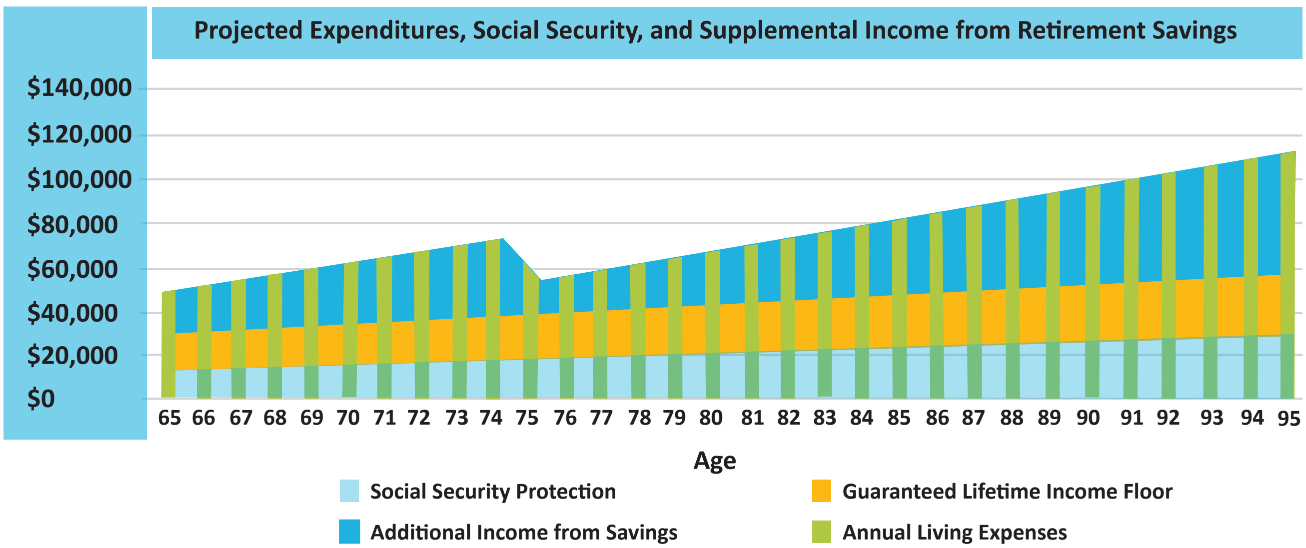
Age	Projected Annual and Cumulative National Average Living Expenses & Social Security Income					
	Annual Expenditures	Annual Social Security	Annual Income Gap	Cumulative Expenditures	Cumulative Social Security	Cumulative Income Gap
65	($50,378)	$16,260	($34,188)	($50,378)	$16,260	($34,118)
75	($54,856)	$21,411	($33,446)	($654,121)	$206,021	($448,100)
85	($80,96)	$28,193	($52,774)	($1,337,928)	$455,891	($882,037)
95	($119,506)	$37,123	($82,382)	($2,347,214)	$784,912	($1,562,302)

What would be required for an individual to generate the income needed to fully close the gap between Social Security and average retiree expenditures? For the purpose of analysis we'll use the following assumptions:

- Approximately half of the initial additional income needed is generated by immediate annuities, which provide pre-tax income of $25,000 annually, beginning at age 65 and increasing at 2 percent per year to help offset the impact of inflation on purchasing power[9].

- The remaining income is generated by withdrawals from a diversified portfolio of investments with an annual assumed after-tax rate of return of 5.5 percent.[10]
- Withdrawals begin at 3 percent of the portfolio value and rise as the increase in expenditures outpaces the increases in annuity payments and the return on invested assets.
- Social Security payments, annuity payments, and portfolio withdrawals are taxed at 28 percent based on current rules regarding the taxation of Social Security payments, qualified plan withdrawals, and Required Minimum Distributions.

Adding the additional income from retirement savings to the graph shows the gap between projected expenditures and Social Security fully closed.



Age	Projected Annual and Cumulative National Average Living Expenses & Social Security Income							
	Annual Expenditures	Annual Social Security	Annual SPA+ SWiP	Annual Income Gap	Cumulative Expenditures	Cumulative Social Security	Cumulative SPA+ SWiP	Cumulative Income Gap
65	($50,378)	$13,984	$36,394	$0	$50,378	($13,984)	($36,394)	$0
75	($54,856)	$18,413	$36,443	$0	$654,121	($177,178)	($476,943)	$0
85	($80,967)	$24,246	$56,721	$0	$1,337,928	($392,066)	($945,862)	$0
95	($119,506)	$31,926	$87,580	$0	$2,347,214	($675,024)	($1,672,190)	$0

Using the combination of a Single Premium Immediate Annuity (SPIA) and a Systematic Withdrawal Plan (SWiP) from a diversified portfolio of investments, a plan is created to close the gap between expenditures and Social Security income. However, this is where the trouble lies: to close that gap, a healthy male retiring at age 65 would need retirement savings of $1,038,295. First, $461,232 to purchase a SPIA paying $25,000 per year, increasing 2 percent per year. Increasing payments are relatively costly: a SPIA without 2 percent increases would cost $379,966, but would make it more difficult for a retiree to adjust to the erosive effects of inflation on purchasing power throughout what may be a 30- or 40-year retirement.[11]

To supplement Social Security and annuity income, the $577,063 remaining after the SPIA purchase is used in this example to provide income through withdrawals until age 95, sufficient to cover remaining projected expenditures and leave a balance of $100,000. The remaining balance of $100,000 is arbitrary but has a dual purpose, both helping to ensure that savings are not completely exhausted, and as a cushion in the event that investment returns are lower than projected or even negative in some years. Unfortunately, IRI research shows that the average Baby Boomer falls far short of this level of savings, with four in 10 Boomers stating they have no retirement savings, and of those with retirement savings 59 percent have saved less than $250,000 and 37 percent have saved less than $100,000.[12] If we extrapolate from these numbers to the national level, that is about 44 million Boomers with little or no retirement savings, and another 19 million with a retirement nest egg inadequate to close the gap between Social Security and average expected expenditures.[13]

CLOSING THE INCOME GAP

Fortunately there are steps Boomers can take to help close the income gap.

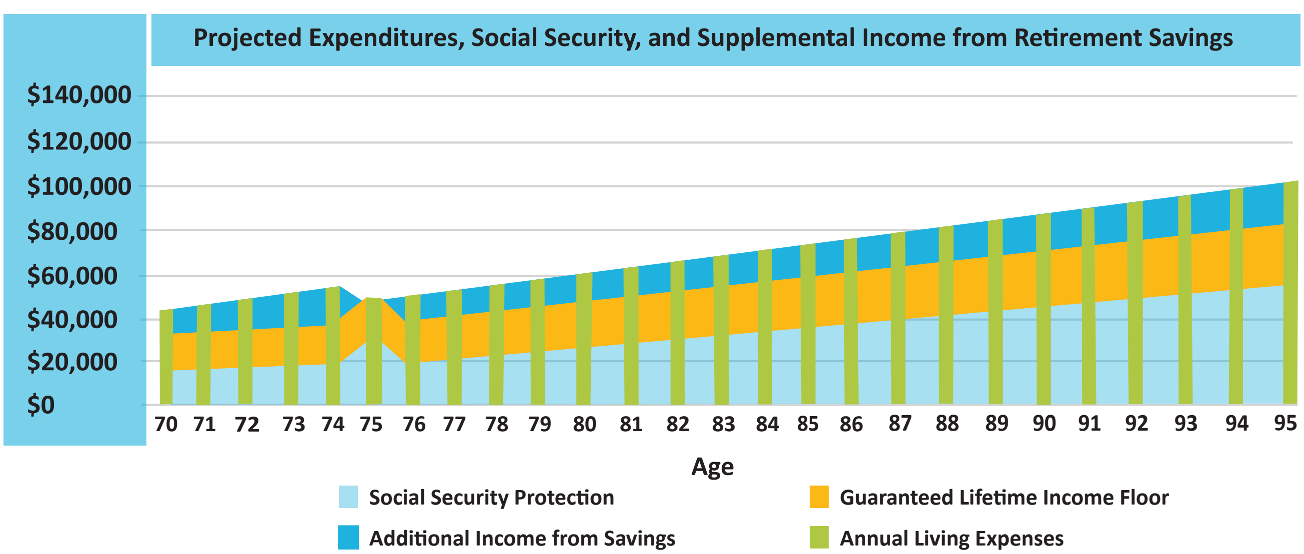
- **Plan to delay retirement until age 70.** This could produce multiple benefits including:
    - Social Security payments are 132 percent more than the payment received if benefits start at age 66.
    - Lifetime annuity income is less expensive. The $25,000 annual payment, increasing at 2 percent per year, used in the above example would cost $389,504 at age 70, or $71,728 less.[14]
    - Regardless of life span, there are five fewer years when savings are required to produce income and five more years to build up retirement savings.
- **Increase contributions to retirement savings.** Those age 50 and older can contribute up to an additional $6,000 per year to workplace retirement plans.[15] Even assuming current contribution limits do not increase, if these "catch up" contributions are made from age 50 to 70 and realize an average 5.5% pre-tax investment return, they will add over $239,000 to retirement savings.
- **Plan to retire, or move to, an area with lower expenses, particularly in expense categories that are meaningful given personal circumstances.** The composite cost of living index for Harlingen, Texas, is 82.8, meaning it costs approximately 83 percent of the national average to live in Harlingen. By contract, the index for Manhattan, N.Y., is 216.7, or more than double the national average! If health care costs are a particular concern, the health cost index for Dothan, Alabama is 81.7, versus Fairbanks, Alaska, with the highest health care costs and an index value of 144.9.[16]
- **Maintain the best health possible**. While living healthy could mean a longer lifespan, it also could mean a lower consumption of medical care on an annual basis. Cessation of unhealthy habits, such as smoking, and maintaining a healthy diet and regular exercise may lower the risk of needing chronic care, and therefore lower annual expenses for health care. A healthy lifestyle also may have the added benefit of providing a higher quality of life in retirement.

THE IMPACT OF PLANNING AND STRATEGIC DECISONS

Using the abovementioned hypothetical Baby Boomer example and applying these retirement income and expense management tactics can illustrate how these steps can help close the income gap. For the purpose of this illustration, we will take a look at a hypothetical 55-year-old male Boomer named Ryan.

- Ryan is planning his retirement. For simplicity we'll assume Ryan is not married and has no heirs. Ryan earns an annual salary of $75,000 per year, and contributes 3 percent of his salary, plus a 3 percent company match, to his 401(k). He has $100,000 saved for retirement. This is the situation that many near retirees face, as nearly half of Boomers with any retirement savings earn $75,000 a year or less and about six in 10 have saved less than $250,000.[17]
- Ryan decides he can increase his total 401(k) contribution to 18% of his salary, including his current deferral of 3 percent plus a 3 percent company match. Deferring 15% of his income may be difficult, but is critical for ensuring he has sufficient income in retirement.
- Having heard about the low cost of living, Ryan plans to move to Harlingen, Texas, when he retires at age 70, reducing his expected expenditures during retirement. His expenditure of $50,264 in the first year of retirement is derived from lower expected expenses in Harlingen, adjusted for five years of inflation.
- Ryan plans to purchase a life annuity to ensure he has a guaranteed source of income, in addition to Social Security, to fund a portion of his retirement needs. And he plans to use systematic withdrawals from his retirement savings to cover the remainder of his expected expenditures.

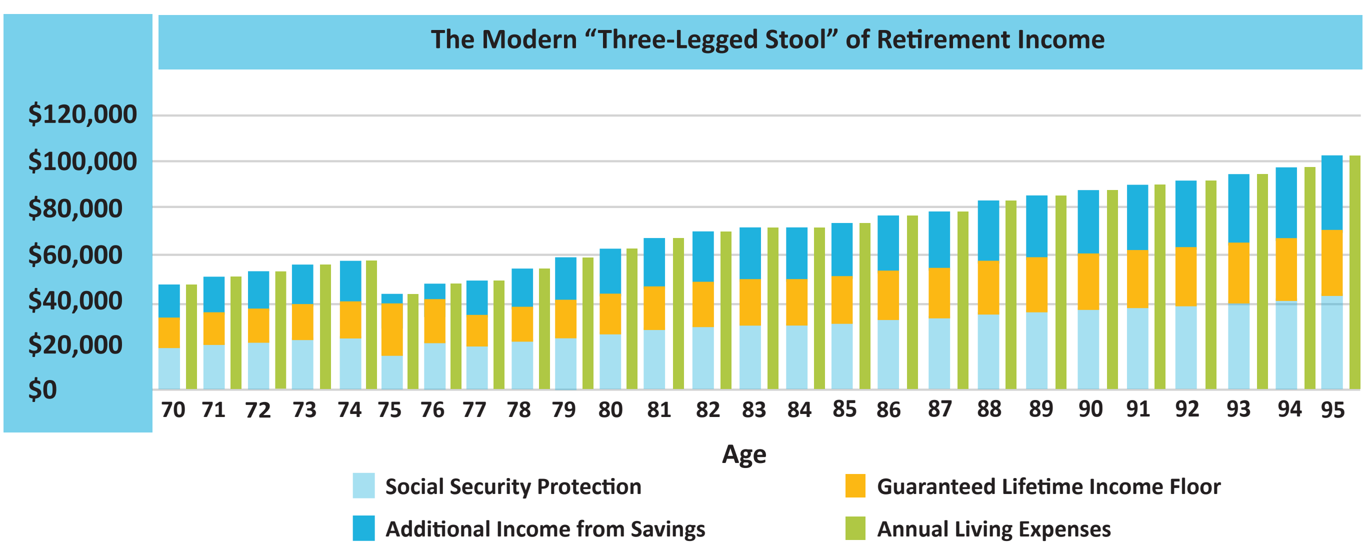
When we project income and expenditures for Ryan based on the above assumptions, annual expenditures start higher due to a later retirement date and the use of nominal dollars in the analysis. But the combination of working longer to maximize Social Security, which reduces the cost of guaranteed lifetime income and the amount of expected portfolio withdrawals (which also reduces tax on Social Security), saving more, and reducing costs by moving to a less expensive area of the country brings the income potential of Ryan's savings in line with his expected retirement expenditures.



Age	Projected Annual and Cumulative Harlingen, Texas Living Expenses & Social Security Income							
	Annual Expenditures	Annual Social Security	Annual SPA+ SWiP	Annual Income Gap	Cumulative Expenditures	Cumulative Social Security	Cumulative SPA+ SWiP	Cumulative Income Gap
70	($50,264)	$21,181	$29,083	$0	$50,264	($21,181)	($29,083)	$0
75	($45,421)	$28,262	$17,159	$0	$316,582	($140,244)	($176,338)	$0
85	($67,041)	$32,004	$35,036	$0	$882,775	($423,897)	($458,878)	$0
95	($98,951)	$42,142	$56,808	$0	$1,718,463	($797,401)	($921,062)	$0

Historically many Americans planning for retirement at Ryan's age have had a "three-legged stool" of retirement income protection: Social Security, a traditional pension, and some degree of retirement savings to provide supplemental income, cash for emergencies, and to leave a legacy. Today, however, much more of the onus of securing income in retirement falls to the individual. The number of private pension plans in the United States fell from a peak of 175,145 in 1983 to 43,601 in 2012.[18] For most individuals, the only source for guaranteed lifetime income, other than Social Security, is individually purchased annuities. Fortunately, with some additional saving and a sound strategy, individuals can replicate the three-legged stool using annuities to replace the traditional pension component and build a guaranteed lifetime income floor to ensure they have sufficient income to last throughout their retirement years.

By increasing his 401(k) contributions from age 55 until he retires at age 70, Ryan is able to grow his 401(k) balance to about $640,000. He purchases a SPIA generating $20,000 a year in retirement income, with a 2 percent annual increase, which costs him $311,566 versus the $368,942 it would cost at age 65, a savings of more than $57,000.[19] Using his remaining portfolio balance of $331,096, again assuming average annual returns of 5.5 percent, he can supplement his income annuity and Social Security income with systematic withdrawals and still have about $100,000 remaining at age 95. Ryan has now created his own "three-legged stool" of retirement income, matched to his expected retirement expenditures.



Saving more and lowering expenses are intuitive steps toward achieving a dignified and well-funded retirement. Less intuitive, but quite important, are the tax implications of reducing expenses that contribute to the success of this example. By reducing the amount of income that is drawn from a portfolio of investments, Ryan's Social Security benefits are not taxed to the extent they would be if he needed to generate higher income from his investable assets.

In planning for retirement income it is critical to use realistic expectations regarding investment returns, and to be cautious in how much is withdrawn from investable assets. An analysis of anticipated retirement expenditures is useful for creating a plan, but many life events could occur that would require an adjustment to the plan, such as adverse health events, greater than anticipated inflation, or even excessive spending on discretionary items, such as travel. Periodic review and annual check-ups, with the help of a financial professional, are critical for staying on track and ensuring resources aren't exhausted. The value added by this process is reinforced by several IRI surveys, which show that nine in 10 Boomers who plan for retirement with the help of a financial professional say they are better prepared for retirement as a result of their advisor's help.

While the above strategy is effective, it may not be realistic for Ryan to save more given his income level and current financial obligations, to delay his retirement until age 70, or to relocate to a less expensive area. Or, he may be at retirement and not have the opportunity to bolster his savings, in which case this type of analysis would still provide him the information he needs to make adjustments to his plan, and there are a number of other options he can consider to help him fund his retirement:

- If Ryan owns his home and intends to sell it when he moves, he can downsize and add the net gain to his investable assets.
- Housing itself is a highly variable expense that was 33 percent of the average 65-year-old retiree's expenditures in 2013.[20] To bring expenditures in line with potential income, Ryan may need to consider a smaller residence when relocating.
- He may be able to reduce or eliminate some expenditures. For example, in 2013 transportation was 17 percent of the average 65-year-old American's budget.[21] Living in an area with access to mass transit may significantly reduce this expense.

Given the variability of expenditure growth rates over time, making the right decisions at the point of retirement is critical when aligning potential income with expected expenses. Large budget items like housing, transportation and health care expenses may increase faster than the general rate of inflation and have an outsize effect on the spending power of an individual in retirement.

THE TOOLS

The above analyses assume the use of SPIAs and balanced mutual funds to produce income in retirement. While useful tools, they are certainly not the only financial instruments available that can help produce income, and manage risk, in retirement. While the SPIA provides 6.42 percent income yield ($20,000 per year / $311,566 investment), growing at 2 percent per year, it comes at the price of giving up control of the amount used to purchase it. Variable annuity lifetime withdrawal benefits at age 70 are typically in the range of 4.5 - 4.75 percent income yield, and the consumer retains control of the account value. The account value of the variable annuity is not guaranteed, but the floor level of income is guaranteed for life by the insurance company. Inflation adjustment is not automatic with a variable annuity, but payments may increase if investment gains reset the lifetime withdrawal amount to a higher level. Similar features are offered on Fixed Indexed Annuities, which also offer principal guarantees. On the mutual fund side, outcome-oriented strategies designed, but not guaranteed, to protect against various risks such as market volatility, inflation, and rising interest rates can also be used to both generate income and manage uncertainty. A financial professional can help educate and guide the retiree and near-retiree in using these products and strategies in concert with each other to create, and maintain, an optimal retirement income portfolio.

CONCLUSION

Statistically, the retirement realities facing many Boomers are grim. Put simply, they face a dangerous combination of being under-saved and long-lived. Those at the point of retirement with no savings and who are unable or unwilling to delay retirement are in the worst position, and will need to take the most drastic steps to reduce expenditures by moving to less expensive areas, downsizing, and eliminating, if possible, high-cost budget items such as transportation. With no savings at all, however, making ends meet it will be difficult if not impossible without support from family, friends, or other assistance programs. Those with time left to build savings can take steps to increase their savings as much as possible, delay retirement to maximize Social Security and reduce the cost of lifetime income, and work on reducing anticipated expenditures by carefully planning both the timing and location of their retirement. The more retirement savings an individual Boomer can accumulate, the more flexibility he or she will have in choosing when, where, and how to experience retirement.

SOURCES

[1] "Boomer Expectations for Retirement 2015," IRI, March 2015

[2] "Boomer Expectations," IRI

[3] "Boomer Expectations," IRI

[4] "Boomer Expectations," IRI

[5] Society of Actuaries 2012 Individual Annuitant Mortality Tables

[6] 2013 Combined Expenditure, Share, and Standard Error Tables, Bureau of Labor Statistics (BLS)

[7] CPI Inflation Calculator, Bureau of Labor Statistics

[8] Social Security Administration

[9] True inflation protection, i.e. annuity payments tied to CPI-U, is not commonly available

[10] 5.5% represents is the median between annualized Investor Returns and broad market index returns for a 60/40 bond/equity portfolio as reported in Dalbar's 20th Annual Quantitative Analysis of Investor Behavior 2014

[11] Fidelity Investments: Guaranteed Income Estimator

[12] "Boomer Expectations," IRI

[13] U.S. Census Bureau

[14] Fidelity Guaranteed Income Estimator

[15] Publication 571, U.S. Department of the Treasury Internal Revenue Service (IRS)

[16] Missouri Economic Research and Information Center

[17] "Boomer Expectations," IRI

[18] Pension Benefit Guaranty Corporation

[19] Fidelity Guaranteed Income Estimator

[20] 2013 Expenditure Tables, BLS

[21] 2013 Expenditure Tables, BLS

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