Divide and Conquer

How dividing retirement into distinct segments can ease the planning process

“Getting older is no problem. You just have to live long enough.”

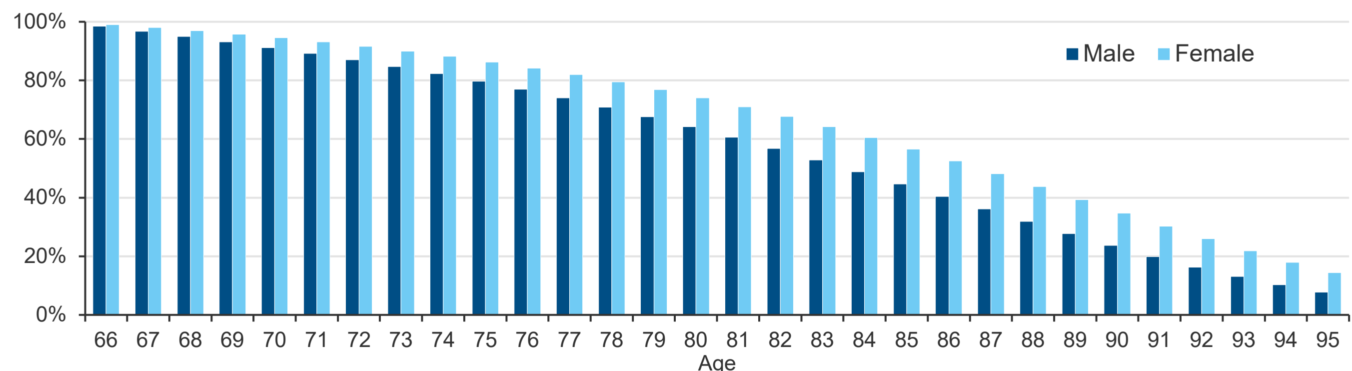
— Groucho Marx

As people continue to live longer than any generation has seen, the idea of retirement presents new challenges when planning for the future. The greatest of these challenges is the unpredictability driven by 1) the general effects of aging and 2) how long their retirement will last. To help mitigate this unpredictability when planning for retirement, we take a “divide and conquer approach”: we divide the retirement planning into two distinct phases - early retirement and later retirement. Although retirement age can vary depending on when retirement begins, for this paper we will assume an age 65 at retirement. We propose that the early phase is finite, encompassing the first 20 years, which may be dominated by relative certainty and the likelihood of more precise planning. The later phase comprises the post-20 years into retirement and can be expected to present more of the unknowns.

Planning is different than execution

In his 1998 book, *The Prosperous Retirement: Guide to the New Reality*, Michael Stein views retirement in three phases: the Go-Go, Slow-Go and No-Go years. These phases divide retirement according to activity level with the Go-Go years being very active, the Slow-Go years showing the signs of aging and the No-Go years dominated by the impact of advanced aging. These descriptions are very helpful in discussing the practical stages of retirement but fall short when planning for them. When will physical and mental decline begin? When will a retiree’s scope of activity become limited to their neighborhood or eventually their house? And ultimately, how long will one’s retirement last? While it would be hugely beneficial from a financial standpoint to have the answers to any (if not all) of these questions, the reality is that we cannot predict what the future will hold. The best we can do is *plan* for what *may* come.

Figure 1: Probability of reaching various ages from age 65



Source: Social Security Administration, 2019

Life-expectancy trends

For planning purposes, it is important to impose order on the uncertainty of retirement length. This begins with understanding life expectancy trends. On the previous page, Figure 1 illustrates the probability that males and females who live to 65 will survive to ages beyond 65. For example, it shows that, on average, once an individual reaches age 65, there is a roughly 50% chance of living to age 85 (more specifically, 45% chance for males and 57% chance for females). Of those who do live to 85, there is a 17% chance for males and 26% chance for females to live to age 95. For those females who live to 95, statistics show that they will have a 3% chance of living to age 105.[1]

Quality vs. quantity

There are two key things we can learn from these numbers. The first lesson is that, in today's society, both men and women have a reasonable chance of living to approximately age 85. The second lesson is that an ever-increasing number of retirees will live even longer into retirement. This creates a conundrum. Some retirees will realistically only need to cover 20 years or less of spending in retirement; however, they *must be prepared* to cover 40 or more years of retirement spending. As a result, retirees are faced with two tough financial choices – either spend as if you only need 20 years of income and risk being left resource constrained longer-term or spend significantly less in the early "Go-Go" phase, anticipating a 40-year retirement, and potentially miss enjoying a large portion of their hard-earned retirement savings at a time they are healthy enough to enjoy it.

Planning ahead

Planning now for later is important. As we age, our ability to process new information and make decisions – so-called "fluid abilities" – exhibit a marked decrease beginning around age 55.[2] This fluid ability is precisely the type of processing involved in making financial decisions. Retirement Solutions, therefore, must accommodate the real possibility of one cognitively slowing down the older one gets.

The answer to planning

We believe the answer to the retirement planning conundrum is a two-part division of retirement. The first phase, Early Retirement, covers the first 20 years through which most retirees, statistically, will generally survive. As Figure 1 reminds us, on average 80% of retirees will survive for the first 20 years of retirement (78% for men and 85% for females, assuming an age 65 for retirement). Because of this relatively high degree of certainty in this finite timeframe, we can better plan for this first phase of retirement. The second phase, Late Retirement, covers the remainder of retirement: a period of uncertain length. To address every retiree's uncertain length of retirement, retirees need an approach that allows as much retirement as possible to benefit from certainty, while at the same time carefully plan for the time period with the most uncertainty. By separating retirement into two distinct phases, we allow the specific planning for each phase to carry its own set of financial goals and objectives.

Early Retirement

We propose that the first phase is a finite, 20-year, fixed period that allows for an efficient use of savings, capital building and systematic drawdowns over the entire period. We believe that the best approach to providing consistent income for this period is to use a drawdown strategy with a fixed 20-year horizon – where the income levels adjust regularly to ensure the impact of market movements can be distributed evenly over the entire period. Simultaneously, the assets are managed in a way that also aims to protect the wealth from downside market turns while also setting aside assets for the second phase of retirement including unexpected emergencies.

Late Retirement

Using Figure 1, LGIM America calculates that on average less than a fifth of retirement wealth (20% for women and 16% for men) is spent in late retirement; however, for those who survive to age 85 it is more like a quarter (27% for women and 25% for men). Planning for later retirement has become a requirement, as more individuals are surviving longer into retirement. Statistically, those retirees who survive to age 85 will continue a life expectancy for about five more years (age 91 for women and age 90 for men). Those who survive to ages 90 or 91 will statistically enjoy an additional three to four years (age 94 for women and age 93 for men). These statistics present a paradox: the longer we live, the longer we are *expected* to live. In our view, the financial planning for this paradox requires one of two solutions.

The first planning solution is to develop a drawdown strategy that steadily decreases income levels as individuals age and in response to adverse market movements. In contrast to the type of drawdown strategy discussed for early retirement, such a strategy might display the unavoidable tendency to continually drawdown income. This happens to be a familiar strategy that can be easy to employ, as this is precisely the type of strategy followed by the Required Minimum Distribution (RMD) governmental rules. In fact, RMD rates are calculated based on life expectancy tables such as Figure 1

1 Source: Actuarial Life Table, Social Security Administration, 2019 https://www.ssa.gov/oact/STATS/table4c6.html
2 Murman DL. The impact of age on cognition. *Seminars in Hearing.* 2015;36(3):111–121.

The second solution, which we believe is a more efficient way to financially plan for the Late Retirement phase, is to use an annuity, such as a deferred life annuity, which is purchased before or at retirement and begins paying out (continuing income distribution) once Early Retirement Phase has ended (after the first 20-year period). With this solution, individuals can potentially mitigate the "risk" of surviving long into retirement more comfortably by taking advantage of the mortality pooling an annuity offers. Consider the following highly-stylized example: Only about 2% of retirees will survive to 100. Therefore, it follows that for every dollar an individual using a non-annuity drawdown solution would have to set aside to provide for income at age 100 (should they live so long), a retiree using an annuity would only need to set aside two cents (due to the 50 to 1 or 2% of 100 scaling due to mortality pooling).

Moving away from the theoretical to the practical, annuities can also carry disadvantages, both in terms of costs (such as lower potential investment growth or direct fees) and lack of flexibility/liquidity. Most annuities involve surrendering the wealth to the annuity provider. Ultimately, the choice between these two types of solutions is one of personal preference and circumstances. However, we believe for an in-plan default solution, the liquidity and flexibility benefit of a drawdown-based solution is a significant advantage over the traditional long-term annuities.

When planning for retirement, we believe the divide and conquer approach makes financially planning a bit easier and more approachable. Our strategy divides the intractable open-ended retirement puzzle into two more manageable, finite pieces, while helping conquer the fear retirees face of the unpredictability of how long retirement assets need to last.

We want to help

We believe dividing retirement into manageable phases allows the implementation of retirement income solutions that more effectively meet the evolving needs of today's retirees. We have solutions to help address these evolving needs. For more information about this thought paper or LGIM America's retirement capabilities, please contact Jimmy Veneruso at Inquiry.DefinedContribution@lgima.com.

About LGIM America

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