Thinking About Using Assets During Retirement

Anna M. Rappaport

In the first half of 2020, the COVID-19 pandemic changed the week-by-week lives of the vast majority of Americans. In June 2020, several months after the pandemic started, the question is whether it will also change our longer-term thinking about retirement and how to use our assets in retirement. This essay updates a "Perspectives from Anna" column I wrote in 2019 bringing together SOA research and how it influences the use of assets during retirement.

I have been thinking about managing accumulated assets during the post-retirement period for more than 20 years. Over the last few years, I have become more focused on people's financial fragility and emergency funds. As a result of the research and discussions in the Society of Actuaries' Committee on Post-Retirement Needs and Risks, I have gradually changed some of my thinking about the use of annuities and assets during the post-retirement period.

Much of my career was spent as a retirement consultant in a large firm where most of our clients had defined benefit plans. Many of those clients also had defined contribution plans. For those people who had both types of plans, the idea was the defined benefit plans would provide income in addition to Social Security and the defined contribution plans would provide a pool of assets. This worked well for people with long careers under both types of plans, but not so well for many others.

I have always been a strong proponent of lifetime income, longer-term thinking and planning, informed decision-making, and risk management. For many years, I had an expectation that longer-term thinking was a key part of retirement planning and that people could be expected to think about the long term. I thought that annuities would be a very good retirement solution for many people. Focus groups, in-depth interviews and surveys conducted by the Society of Actuaries have changed my thinking about what is realistic for many people.

Some Characteristics of the U.S. Retirement System

Economic security during retirement can come from Social Security, employer plans, personal resources and continued work during retirement.

- Social Security is the largest share of retirement income for many Americans. For some, Social Security is the only source of income.
- Social Security replacement income ratios are higher for lower income earners.
- Social Security claiming age is extremely important. The amount of monthly income is about 75% greater for those who claim at age 70 vs. those who claim at age 62.
- For married couples, the Social Security benefits claimed by the higher earner also affect the benefits of the survivor if the higher earner dies first. This can be extremely important to many widows.
- Many people do not have employer-sponsored benefits. Lower income individuals are less likely to have such benefits.
- Of the people who were employed by employers who offered retirement programs, those with long service did much better than those with sporadic employment. Defined benefit plan benefits are generally better for those people with long service, and defined contribution plan values are generally greater for those people who have long participation in one or more plans.
- Personal savings can be a big part of retirement security, but many people do not have financial assets much beyond the amounts provided through employer-sponsored benefits or their home equity.

What SOA Research Told Us About Retirees

In a series of focus groups and surveys, retirees told the SOA how they thought about retirement planning and income. Some key findings include:

- Many people do not think long-term. It is common for people to plan by looking at their current regular bills and cash flow and try to get them into balance. Many people felt they were OK if they could pay their regular bills over the next couple of years.
- Some people do not do any formal planning.
- Many people prefer to hold on to their assets rather than developing a systematic plan to use them during retirement.
- Many people do not plan for significant unexpected expenses or shocks. They commonly said, "I will deal with it when it happens."
- Even more do not plan for long-term care.
- People are resilient and some are willing to make significant reductions in spending when necessary.
- When we think about the combination of holding on to assets and not doing risk management, the implied plan is that the assets they hold can be used for emergencies if necessary.
- Family is often a huge source of help when help is needed. Help is often hands-on, and it is not clear how people without family manage through some of the challenges that require everyday help. There is little planning for such help.
- When people have a major long-term care event requiring paid care, it can be a huge problem. If they spend down their assets, they may become eligible for Medicaid.

Retirees Are Faced with Big Trade-Offs

Retirees who want to use their assets systematically in retirement are faced with many options and important and complex trade-offs.

- Using assets gradually over time by systematically withdrawing from an asset account provides the retiree the flexibility to change their mind later. It preserves liquidity for the remaining balance. However, investment and longevity risk remain with the retiree. Investment downturns at the wrong time can create major problems for a retiree.
- Buying a life annuity transfers the investment and longevity risk to an insurance company, but without flexibility. The decision is irrevocable and there is no liquidity.
- There are also options that combine these two strategies and blend some liquidity and some guarantees. For example, while a pure life annuity has no return of capital on death, some annuities have limited return of capital on death, based on their provisions. Combinations of strategies can be used.
- There is another trade-off between spending and doing more now vs. saving for later. I often remember that it is important to "do it while you can." If retirement plans include physically ambitious activities, it is important to remember that abilities often change. And couples never know how long both will be capable (or even there) to pursue their interests.

Analyzing the Trade-Offs

Understanding what is involved in the trade-offs of asset use is complex and the analysis is not easy. The challenges are even greater when one realizes that there are many different income options available. In partnership with the Stanford Center on Longevity, the Society of Actuaries sponsored several projects on different forms of lifetime income and a framework for analysis and measurement of the trade-offs. The analysis used a form of "efficient frontier" particularly focused on the payout period. In my view, anyone who wants to compare income options and understand the pros, cons and trade-offs should look at this work. The reports were authored by Steve Vernon, Wade Pfau, and Joe Tomlinson and can be found at https://www.soa.org/research/topics/research-post-retirement-needs-and-risks/#income. Some of this work is also summarized in the 2018 *Securing Future Retirements Essay Collection*, https://www.soa.org/essays-monographs/2018-securing-future-retirements/.

The first report sets up a framework for using income options in defined contribution plans. One of the reports focuses on the analysis of income options that are suitable for use in a 401(k) or other employer-sponsored defined contribution plan. Another of the reports focuses on options that are suitable for individuals including the use of reverse mortgages. One of the reports focuses on the legal framework which could be used by plan sponsors to incorporate income options into defaults. A fifth report focuses on the use of a strategy that combines late claiming of Social Security with Required Minimum Distributions. That strategy provides for accumulating and using a transition fund to help the individual defer Social Security until they reach the maximum Social Security claiming age. The authors demonstrate why they believe this type of option would be a suitable default option in an employer-sponsored plan and I agree with them. They also provide indications of how to use the option as a starting point and to tailor it to individual needs. Actuaries interested in retirement income planning should study this work and see how it fits in.

I believe that there is a lot of personal preference involved in these trade-offs and that a scientific answer, such as those provided by the papers, is helpful, but it is still up to the individuals to choose what works best for their personal situation.

The Risks and the Early Stages of the SOA Research

The SOA research started about twenty years ago with the identification of post-retirement risks, and the construction of a risk chart titled "Managing Post-Retirement Risks."[1] In 2020, the SOA published the fourth edition of the risk chart. Some risks can be protected against by insurance and/or financial products, but others cannot. The complexity of the risks and methods of protecting against them may serve as a barrier to formal risk management. The cost of risk protection is also a barrier. The financial products may cover one or more risks but most likely, not all risks.

Another of the earlier stages of the SOA research focused on the assets held by middle-income people both nearing and in retirement. That work, "Segmenting the Middle Market", used data from the Federal government's Survey of Consumer Finances. The important findings from that survey were that for the mass middle income population, the value of non-financial assets, primarily housing, was substantially greater than the value of financial assets. The results of that study raised major questions about what retirement income options are feasible for the mass middle-income population. For many of them, there were not significant financial assets that could be invested and spent down. For me, this work changed my outlook, so that whenever we thought about a retirement financial topic, it was important to ask where housing fit into the discussion.

---

[1] Managing Post-Retirement Risks was written before the COVID-19 pandemic, but all of the same risks continue. For information on how COVID-19 is linked to retirement risks, see the SOA report "Impact of COVID-19 on Retirement Risks" https://www.soa.org/resources/research-reports/2020/covid-19-retirement-risk/.

Putting This Together – Where Am I Today?

Successful management of the post-retirement period remains an important topic. These are some things that I think are important:

- There is a lot of value to having a longer-term plan, but many people fail to do this. Employers and the media should stress the value of having a longer-term plan.
- For middle-income Americans, Social Security is a vital part of their retirement income, and it will be the sole source of income for some of them.
- Late claiming of Social Security is often an advantageous strategy. It is important that everyone evaluate their options, and not just make a choice. In the evaluation, don't forget to consider tax issues, to use your actual earnings history if you are near retirement, and for couples, remember that the evaluation needs to focus on both people.
- People with mortgages should explore the possibility of paying them off before they retire. Better tools would help people blend this into the decision-making process at this life stage. Paying off the mortgage reduces regular monthly expenses, but consideration must still be given to property taxes, homeowner's insurance and repairs and maintenance costs.
- Everyone needs easily accessible emergency funds. Many people have not thought about unexpected expenses and how to provide for them. COVID-19 reinforced the importance of emergency funds.
- People who do not have adequate retirement income to retire at their planned retirement, often age 65, and manage as they wish, may have a variety of strategies available to them. Working longer is a strategy available to most of them, and more needs to be done to help individuals and encourage employers to support better job options. Reducing expenses is another strategy. These are the best bets for people who reach retirement age without enough assets. Saving early is important.
- For people with defined benefit plans, these plans serve as an additional source of guaranteed income beyond Social Security. If they offer a variety of payout options, care is needed in the decision about the payout option. The SOA offers a decision brief to help with this.
- For people without defined benefit plans but with assets, there are a variety of options: Delaying Social Security to age 70 and then withdrawing the Required Minimum Distribution (RMD) at age 72 will be satisfactory for many people.
- For those who want income in excess of the RMD and who have assets, there are a variety of options for generating income and major trade-offs involved in the choice. I hope that the work done by Steve Vernon and jointly sponsored by the SOA and the Stanford Center on Longevity will lead to the development of new user-friendly tools and easier default options to help people make these choices efficiently.
- The work from Steve Vernon demonstrates that a thoughtful systematic withdrawal plan from assets that are significantly invested in stocks can produce higher lifetime income than an annuity most of the time, but not always. And we can't predict in advance when "not always" happens. This is why the research suggests people are better off with a diverse portfolio of retirement income.
- One of the newer forms of annuities is a deferred annuity starting payments at a high age, such as age 85. This increases income at age 85 and supports a broader range of choices earlier in retirement. These products have had limited market acceptance to date.
- Having a plan for long-term care financing is important, whether it includes long-term care insurance or not. Those who do not have insurance need more savings to pay for expenses as they are incurred. COVID-19 will likely cause many people to think about care options more carefully as they do long-term planning. The SOA has a decision brief to help people think about long-term care financing.
- It is important not to forget about health insurance. Medicare is a big part of the picture after age 65, but there are still ongoing decisions that are needed. The SOA has a decision brief to help

people think about their choices. COVID-19 may change the health care decision process going forward.

- For people with significant housing equity and not a lot of financial assets, a reverse mortgage might help. It also may help to sell the house and downsize to a less expensive house. More people may be using multi-generational households in the future.
- As we think about these issues, we need to remember that many people are not planning for the longer term. A big challenge for actuaries and retirement planners is understanding what people actually do and how they think. The solutions that are offered need to include options for those people who do not plan for the longer term.
- I value guaranteed lifetime income highly, but I recognize that people are in many different situations and that the choices they make will not always focus on guaranteed income. People with larger amounts of assets may also not focus specifically on annual income. They may rather think more about the progression of the assets if they spend what they want. Trying to hold on to assets is a popular strategy that has worked out well for many people. It gives them some flexibility to deal with a variety of risks.
- We all need to work to help people plan effectively for the post-retirement period and develop strategies to fill in the gaps when it looks like they will not have enough lifetime income.

Anna M. Rappaport, FSA, MAAA, is president of Anna Rappaport Consulting. She can be reached at anna.rappaport@gmail.com.