Modern Retirement Theory:
Reaching Client Goals in Every Market

By Jason K. Branning, CFP®, and M. Ray Grubbs, Ph.D.

Not since 1931 have stocks experienced a one-year decline akin to what was experienced last year. 2008 produced the second-worst one-year decline in the market in the last 80 years. The S&P 500 lost 37 percent, forcing many who were on the brink of retirement or in retirement to rethink their risk tolerance, financial plan and possibly their lifestyle. It also challenged some long-accepted assumptions held by financial advisers, such as the buy-and-hold strategy. We do not desire to challenge long-held assumptions by planners, rather to offer a different perspective in applying these assumptions in clients' retirement plans. This new perspective offers an individualized, conceptually sustainable retirement model that we have titled Modern Retirement Theory (MRT).

Retirement is a consumption and preservation phase of life rather than an accumulation phase. MRT encompasses balance-sheet asset management, preservation and utilization strategies at the individual client level. This model views retirement as an absolute, non-negotiable goal rather than a relative one. Additionally, MRT attempts to mitigate income and estate taxes. It is a goal-based strategy that uses a four-pillar asset disbursement structure for meeting client goals.

This theory focuses attention on the individualized nature of financial planning. MRT recommends that an individual financial plan be established on the basis of two facts: longevity and conditions within longevity. These facts are unknowable in individual client terms.

Planners can work around these two concerns to provide retirees peace of mind. Our belief is that clients need to meet their retirement goals in every market environment. Our desire is to help design a strategy and foster discussions of strategies that meet individual client goals in every market.

MRT Versus MPT

One difference between Modern Retirement Theory and Modern Portfolio Theory is the application of asset allocation. MRT seeks to use balance sheet assets versus portfolio assets. Additionally, Modern Portfolio Theory has drawn investors into markets by touting historical long-term average stock returns. This perspective (long-term averages, law of large numbers) may best apply and work only on a group basis (for pension funds, insurance pools, etc.) where there is an institutional time horizon of 30 years or more. Personal finance is not institutional finance; therefore, MRT suggests that historical long-term averages may not apply in individual client scenarios and seeks to offer a sustainable benefit to individuals.

The foundational concerns MRT hopes to address are client longevity and the individual conditions within retirement through balance-sheet asset management. MRT views these issues as individual retirement risks. MRT hopes to mitigate individual retiree risk so that outcomes result in individual retirement security.

Longevity and Conditions Within Longevity

MRT begins with the question of client longevity. Longevity may be analogous to time horizon. Planners use government mortality tables when making assumptions about mortality, yet each person is unique, and living too long or dying too early in retirement has significant financial ramifications to a partner, beneficiaries and an estate.

The second major question MRT asks is: What are the conditions within a client's longevity? What are the specific conditions 10 years before and during retirement? These conditions are defined as market fluctuations, sequence of returns upon retirement, personal health concerns or care-giving for family members. Mitigating the effects of highly consequential negative conditions within retirement will protect the funding of a designated retirement lifestyle.

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Framing a retirement plan around longevity and conditions within longevity requires an integrated financial planning approach. These integrated strategies will mitigate, insure against and diversify these individual and specific risks in each client's unique situation. MRT is more focused on individualized outcome, rather than using group averages.

The MRT standard is that individual retirement goals are absolute and therefore must result in a guaranteed, sustainable lifestyle throughout the retirement phase. To this end, MRT seeks to employ strategies that meet the client's stated objectives in any market climate, mitigate and transfer longevity risk and conditions within longevity risk, are tax efficient, and maximize assets by disbursing the client's balance-sheet assets into four broad categories. Listed in order of priority, these four categories, or funds, are:

- Base Fund
- Contingency Fund
- Discretionary Fund
- Legacy Fund

Base Fund

Asset structuring during retirement must take into account the short recovery period available in the event of negative market returns, since assets must be withdrawn routinely. The core philosophy of this fund is to provide guaranteed income that can be produced in good market conditions or poor market conditions. This income should also adjust for inflation over time and remain in place for a surviving partner. Social Security is viewed as a portion of this guaranteed base. Base income is defined as $B=B1+B2$ where B1 is Social Security and B2 is other income-producing assets.

Preferred Base Fund strategy options offer guaranteed income generated from sources that extend some form of protection and are not subject to market risk. Suggested options include: Social Security, laddered CD interest, laddered fixed annuity income, variable annuities with guaranteed income, defined benefit pension plans, reverse mortgages and Treasury inflation protected securities (TIPS). Alternative income may be generated from income-producing real estate assets or raw land, such as timber and hunting leases.

The potential hazards that must be managed within the Base Fund are primarily inflation and credit risk. Also, using non-qualified assets prior to consuming qualified assets is preferred for tax efficiency. To manage inflation risk, the

income stream should be laddered. To manage credit risk, diversify among annuity companies, government bonds or bank issues up to protected amounts (e.g. FDIC limits, state insurance guarantee fund limits).

Contingency Fund

Mitigating and transferring risk is essential to maintaining a sustainable retirement lifestyle. This fund offers a hedge against the unpredictable, yet highly consequential events[1] that may occur from a personal medical issue, changes in estate laws or with markets.

Planning around market risk in the contingency fund is defined as having assets that are available on short notice and will not suffer market loss even in negative market cycles. The permanent time horizon for the portfolio assets of this fund is the immediate to one-year term. Appropriate tools that may be implemented in this fund are short-term FDIC structured notes, laddered CDs, life insurance for estate planning, market neutral or inverse funds and cash.

Medical risks that individuals may face during retirement may be mitigated by purchasing an appropriate medical supplement along with Medicare. Potentially more devastating to a retiree's savings is a long-term care event. Two possible mitigation solutions for long-term care concerns include:

- Purchasing long-term care insurance, preferably before age 60. Individuals can fully transfer the risk of long-term care to an insurance company if they are insurable, or they can use the coverage to mitigate possible expenses with a reduced daily benefit or specific benefit period. Premiums paid for a long-term care contract may be tax deductible.
- Buying into a continuing care facility as an independent resident. A continuing care facility offers stages of care including independent, assisted living and nursing home care. By choosing a continuing care facility as an independent before the care is needed, the price for the higher stages of care would (in many facilities) be the same as independent care. In this solution, the individual is locking in the maximum out-of-pocket expense for a long-term care event to the effective rent charged for independent living. This solution also offers a

Underlying Premises of Modern Retirement Theory

Modern Retirement Theory (MRT) provides advisers and retirees a new approach to solving individual retirement planning, funding and distribution. MRT defines retirement risk as longevity and the conditions during longevity and conceives methodologies to mitigate, transfer or eliminate retirement risk to the individual. To achieve this, a series of premises support the retirement funding evaluation process and recommendations.

Premise 1: An Absolute Goal

Retirement is an absolute goal, not a relative one. In many ways, retirement has become a modern rite of passage into the golden years—a time to reflect, enjoy and engage life in new ways. But recovering from negative market cycles or health issues may force lifestyle changes on many. MRT is built on the premise that regardless of what occurs in life to an individual retiree, an at-retirement lifestyle will be maintained. Additionally, the absolute goal of a secure, stable and sustainable retirement should be initiated by the retiree and his or her family—the timing of which should not be dependent on market permission.

Premise 2: Individualized and Client Centric

Planning and executing retirement funding should focus on individuals rather than historical data or group statistics. MRT examines the risk to the individual during retirement and offers methods to mitigate, transfer or eliminate these individual risks. The circumstance of every retiree is vastly different, but all share the two risks to retirement identified by MRT.

Premise 3: Outlook Ambiguity—The Future Is Unknowable to the Individual

MRT acknowledges that future events are always unknown to individuals. No one knows in the individual case what market, health or other event may present itself during retirement. MRT attempts to offset individual retiree risk.

Premise 4: Secure, Stable and Sustainable

MRT provides retirement funding that is simultaneously secure, stable and sustainable. Secure retirement funding is guaranteed income. Stable retirement funding is income that is not subject to wide fluctuations unless intentional and initiated by the retiree. Sustainable retirement funding is income that will last for a lifetime or lifetimes and allows for inflationary increases to maintain lifestyles.

Premise 5: Balance Sheet

Retirement funding should utilize an individual's entire balance sheet, not just his or her portfolio. Focusing on all assets will help advisers and retirees better maintain their lifestyle over their retirement years by using other income-producing assets.

Premise 6: Funding Priority

A hierarchical priority of retirement funding can be established to offset retirement risk. MRT addresses the risks to an individual retirement by establishing a priority of funds, each with specific purposes. Depending on the individual retiree's financial situation, some or all of the funds may be implemented.

tax friendly way to pay rent during retirement no matter which level of care is used.

Laws related to the types of events covered in this fund may change overtime, so individuals should seek a legal review of their documents every three to five years. Not only do estate laws change, but there is the potential for estate taxes to be due in a negative market cycle. In this scenario, a life insurance policy can help pay estate taxes rather than the estate being forced to sell depreciated assets. Mitigating the reduction of an estate should be accounted for in retirement planning.

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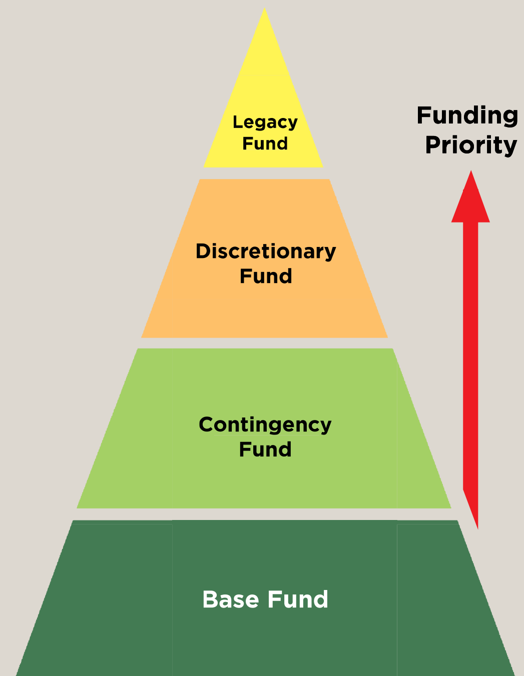
Discretionary Fund

After lifetime income is secure and catastrophic scenarios mitigated, a flexible income fund can be established. The resources of this fund have a time horizon of two to 10 years. We advise setting aside two to five years of expenses in cash or laddered CDs to protect against a normal market cycle and based on risk tolerance. Beyond this cash position, remaining assets in this fund can be invested for a more moderate time horizon. This fund is designed to handle travel expenses, auto purchases and other events that are flexible in need or occurrence.

Appropriate tools may be laddered CDs, laddered FDIC-insured structured notes, cash value from life insurance and TIPS on the more conservative end of the risk spectrum. A slightly more moderate approach to this fund would be to use a conservative investment portfolio or to own dividend-paying preferred stocks.



Legacy Fund

The final MRT set-aside is the legacy fund. These assets are anticipated to be used for inheritance or charitable purposes. They have a time horizon greater than 10 years. These assets will not be used to satisfy any of the prior-mentioned funds. Therefore, this fund may be more aggressively invested. Additionally, this fund may avoid inclusion in the estate through attorney recommended trusts. This fund may include charitable trusts (e.g. CRAT, CLUT), donor-advised funds, a diversified stock and bond portfolio, whole or permanent life insurance or life insurance trusts.

Conclusion

In summary, Modern Retirement Theory proposes a perspective on retirement planning that seeks to meet the individual client's retirement goals under any market condition or life event. The model recognizes potential limits in asset growth in good markets, but stresses balance-sheet asset utilization and preservation over growth. The theory defines success as a sustainable lifestyle throughout the entirety of retirement.

Endnote

1. *The Black Swan: The Impact of the Highly Improbable*, Nassim Nicholas Taleb (New York: Random House, 2007)

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