

Innovations in Retirement Income Planning

Software can give you the edge to stay ahead of your financial services competitor.

By Wade D. Pfau, Ph.D., CFA®

To stay competitive in the 21st century, advisors will need access to planning software that incorporates the latest validated findings from ongoing research in the financial planning field — while also automating processes to help make advisors as efficient and effective as possible when serving their clients.

In this regard, I have enjoyed the opportunity to serve as the director of retirement research for inStream Solutions, a cloud-based proactive planning software for advisors based in Alexandria, Virginia. Some of the ways this cloud-based software scales an advisor's practice includes:

- Integration of client data from a variety of sources, which reduces the need for manual data entry
- Nightly re-running of client plans coupled by daily alerts if the plan falls outside a pre-set range, so advisors are able to easily and automatically stay on top of their clients' constantly evolving situations
- Crowd-sourcing of best practices from users to provide better indicators about what is and isn't working in practice

As an academic at The American College, it is important to make sure that the research we do has useful applications for the financial services industry. As advisors are increasingly recognizing the need to treat retirement income planning as distinct from wealth maximization, a growing body of research is expanding our understanding of the retirement income problem. Advances in retirement income planning include a growing use of the funded ratio concept, more sophisticated distribution management techniques and the use of "safe savings rates" to calibrate one's financial plan with respect to retirement goals.



FUNDED RATIO

Funded ratio analysis allows advisors and clients to see a snapshot at a given point in time about whether the assets on the household balance sheet (including human and social capital as well as financial capital) are sufficient to cover the client's lifetime liabilities. This approach brings institutional pension fund management to the household level, and it has been popularized by the Retirement Income Industry Association. Based on the trajectory of cash flows related to a lifetime of income and expenses discounted at an appropriate rate, advisors can immediately determine their client's funded ratio. This provides instant knowledge about whether the lifetime financial plan, as determined from a specific point in time, is overfunded, underfunded or looks to be on track.

Though today's funded ratio is calculated without use of Monte Carlo simulations, the funded ratio can also be projected forward with Monte Carlo simulations to supply a ten-year



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look ahead. This provides a distribution of funded ratios for the client. Clients who are currently overfunded, but who are using more aggressive investment portfolios, will experience a greater dispersion in outcomes and a higher probability of seeing their funded status move from over to underfunded. This aspect of the funded ratio analysis can alert advisors and clients to the possibility that in overfunded states it may be appropriate to lock in gains and reduce the likelihood of witnessing that unfortunate transformation to an underfunded status through portfolio losses. This helps a client more effectively see both the downside and upside potential when considering guaranteed income sources and volatility investment portfolios.

DISTRIBUTION MANAGEMENT

Distribution management can be used to answer two basic questions for clients: (1) For those who've planned a budget, what is the sustainability for the plan? (2) For those without a budget, what is the most that can be spent on a sustainable basis?

Distribution management must also move beyond simply assuming clients will spend a constant inflation-adjusted amount from their portfolios. Early research by William Bengen, Jonathan Guyton and others illustrated that, for those who are willing to build flexibility into their plans to reduce spending if the markets perform poorly, it is possible to begin retirement with a higher withdrawal rate.

Any cutting-edge software should incorporate various rules advisors can use to frame retirement income strategies with their clients. These involve determining when inflation adjustments for spending are appropriate, how to set bounds on what percentage of remaining assets still imply a sustainable strategy

and the impact of incorporating constraints on spending fluctuations through the use of hard-dollar ceilings and floors on spending.



SAFE SAVINGS RATES

Related to the distribution management strategy, clients in the pre-retirement phase may wish to determine what savings rate should be used to have a high chance to meet one's retirement spending goal. This matter can be addressed through an investigation of the "safe savings rate" for a client, related to research I published in the *Journal of Financial Planning* in 2011. This research subsequently won the Montgomery-Warschauer Award from the journal editors for that year.

The safe savings rate approach is more sophisticated than traditional methods of assuming an asset return and a savings rate needed to target a wealth accumulation level that allows the retirement spending goal to be met using a "safe withdrawal rate."

When holding a portfolio of volatile financial assets, it is very difficult to know whether one is on track to meet a wealth accumulation target because the

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returns experienced in the final years before retirement have a disproportionate impact on the final wealth accumulation. This is the case whenever households contribute new savings throughout their careers. The point is lost in static analyses that assume a fixed rate of return compounded to investments over time.

A safe savings rate removes the need to worry about achieving a wealth accumulation target that will correspond to a safe withdrawal rate because it considers the planning problem as an integrated whole for both pre- and post-retirement. Conceptually, a safe savings rate works as an inverse of the maximum distribution module in post-retirement, helping clients to know whether they are on track to meet their goals.

These recent research innovations can be put to the test more effectively as financial planning software evolves. In a sense, the software will provide a laboratory to allow for refinements and improvements with retirement income strategies. I'm very excited to be a part of the effort. ■■