RETIREMENT

Developing a Retirement Income Plan

by David A. Littell, JD, ChFC®, CFP®

> Steps necessary to create a comprehensive retirement income plan for your clients

As retirement income planning is a relatively new discipline, one concern is that advisors may not have a clear process for developing a plan. Here are 10 steps for developing a robust retirement income plan that addresses the client's income needs, the various risks that clients face in retirement, and legal and tax issues that impact the plan.

> Recognize there are tax strategies that can improve a client's financial situation, such as using appropriate tax-advantaged vehicles for saving for retirement...

STEP 1: EVALUATE THE CLIENT'S CURRENT SITUATION

Building a retirement income plan for the future requires a complete understanding of the client right now. That holds true if the client is still working and is in the planning stage or if you start working with the client at or after retirement. This process involves reviewing quantitative data, such as current financial statements. The cash flow statement shows both current income and spending habits. Looking at the client's current situation provides some clear hints about future spending patterns. It also tells us whether the client's reported retirement goals seem realistic based on current patterns. For example, when the client reports a retirement income need of only 60 percent of pre-retirement spending, a review of current expenses may clearly show that this will be quite difficult to accomplish. We also learn a lot by analyzing a statement of net worth, as it will identify long-term debts as well as assets that may be available to meet retirement needs.

The evaluation process also includes a qualitative fact-finding process. Fact finders and conversations can reveal information about the client's current financial challenges and concerns—what keeps them up at night. Appropriate questions about their experiences with financial professionals might help you understand what they are looking for from you, and personal information about their family, activities and organizations they support begin to give you a picture of what is important to your clients.

STEP 2: IDENTIFY AND PRIORITIZE RETIREMENT GOALS

Determine the client's retirement goals and objectives. This may sound easy but it really isn't. Some clients may know what their lives will look like in retirement, but many will not. They may need help envisioning what their future might look like. There are many new tools to help people think through what they may want to spend their time doing in retirement, and what legacy they might want to leave after they are gone. The

David A. Littell, JD, ChFC®, CFP®

David is the Joseph E. Boettner Chair in Research and Co-Director of The New York Life Center for Retirement Income at The American College.

david.littell@TheAmericanCollege.edu

For many retirees, expenses in the later years of retirement actually decrease as activity levels and abilities decline.

harder job may be helping clients consider what issues arise in the later years of retirement, for example, addressing the possibilities of needing long-term care, providing for a spouse after death or simply living longer than expected. Discussing the potential risks faced in retirement (discussed in Step 8) is one way to help the client picture some of the contingencies they are likely to face.

STEP 3: ESTIMATE RETIREMENT INCOME NEEDS

Estimate the income needs required to support the retirement objectives. Combined with information about current expenses we can begin to flesh out projected retirement expenses. We can divide expenses based on whether they are essential or discretionary. Discretionary could mean the budget could be a little lower if necessary (making your own coffee vs. going to the local café) or items you could do without entirely (a trip to Europe). This distinction is important as income solutions for basic expenses may be different than for discretionary ones. The other issue is that expenses do not stay constant over retirement. The idea that we identify expenses for the first year and then increase them throughout retirement for inflation can provide an inaccurate picture and possible over estimate of expenses. For many retirees, expenses in the later years of retirement actually decrease as activity levels and abilities decline. Sophisticated retirement software can address categories of expenses, allowing periodic increases or decreases over time, as well as allowing for specific inflation rates appropriate for that type of expense.

STEP 4: IDENTIFY SOURCES OF INCOME AND ASSETS AVAILABLE TO GENERATE RETIREMENT INCOME

The obvious sources of retirement income are Social Security benefits and employer-sponsored defined benefit plans. These benefits will depend on when work stops, when benefits begin and the form of payment selected. However, there can be many other sources as well. Executives may have supplemental nonqualified employer-sponsored benefits. Some may have income from rental property or renting out part of their home, income from selling a business or other streams of income—often the case for those that are paid based on commission. Part-time employment can be another important source of income in retirement, although historically more people indicate that they will continue to work than actually do. As with expenses, a good software program can consider the duration and amount of each stream of income.

Similar to the process of an inventory of income sources, with assets it is appropriate to ask questions to make sure that we identify less obvious sources, such as cash value life insurance, home equity and collectibles. Some people with vacation homes may plan to move into that home in retirement and sell their primary residence. The list of those assets, however, should be limited to those likely to be used to generate retirement income. Figuring how to address home equity, for example, can be tricky. The plan may be to stay in the family home as long as possible, but home equity tapped through a reverse mortgage could be considered an emergency fund to address long-term care needs, health care expenses or costly home repairs.

STEP 5: MAKE A PRELIMINARY CALCULATION OF THE CLIENT'S PREPAREDNESS FOR RETIREMENT

Make a preliminary calculation of whether current income sources and income generated from available assets will be sufficient to meet the client's estimated need throughout retirement. Many software tools and worksheets are available for making these determinations—and they can generate a wide range of results depending on what the software is modeling and the assumptions used about rate of return, longevity, inflation, etc. With regard to the first issue, the advisor must understand what the program is illustrating. For example, Monte Carlo probability analysis has become quite common, but neither the advisor nor the client may fully understand what the results mean and how they were derived. With regard to assumptions, these need to be reasonable and appropriate for each specific client.

STEP 6: DEVELOP STRATEGIES FOR ADDRESSING A RETIREMENT INCOME SHORTFALL

After doing the mathematical calculations, it may become obvious that the client is not financially prepared to meet his or her retirement objectives. At this point, the focus of the plan turns to identifying strategies that may eliminate the shortfall. This may mean saving more, getting better performance out of the portfolio, working full-time longer or working part-time in retirement. It can also mean deciding to live on less. Telling a client that they are not prepared to meet their goals can be a difficult conversation. On the other hand, solving the problems before or during early retirement is much less painful than discovering the problem later. Solving financial problems when you are 90 is almost impossible, but there are still options when you are 60 or 65.

STEP 7: CONSIDER LEGAL AND TAX ISSUES THAT CAN DERAIL THE PLAN

Recognize that there are tax strategies that can improve a client's financial situation, such as using appropriate tax-advantaged vehicles for saving for retirement and choosing the appropriate order of withdrawals once the client is in the decumulation phase. Tax issues can also undermine a plan. For example, failing to satisfy the required minimum distribution rules from qualified plans and IRAs can result in a 50 percent excise tax. Some of the legal issues that need to be addressed include planning for the possibility that a client will not be able to make financial or health-care decisions, and putting the appropriate estate-planning tools to use to meet legacy objectives—whether those are to protect a spouse, leaving assets to other heirs or meeting charitable goals.

STEP 8: CONSIDER RETIREMENT CONTINGENCIES (RISKS) IN DEVELOPING ALTERNATIVE SOLUTIONS

As we start formulating strategies for addressing a shortfall or for converting assets into income, it is important to stress test the plan. The current plan (or future recommendations) must address the various risks and contingencies that will be faced

A successful advisor will be an important part of their clients' lives.

in retirement. For example, how does the plan address the possibility that the client will live longer than expected, that the market will have a sustained down period in the first few years of retirement, or a spouse dies at an early age? Before offering retirement income solutions, thinking through how the solutions will address these and many other retirement risks is critical. The advisor should be familiar with a full range of options for addressing each risk.

STEP 9: DETERMINE AN APPROPRIATE STRATEGY FOR CONVERTING ASSETS INTO INCOME

With all of this legwork done, and assuming that income sources are insufficient to meet income needs, we're now in the position of having to convert financial assets into income. Some think that this step is what retirement income planning is all about, but a successful plan requires a comprehensive analysis to come up with appropriate strategies for a particular client. For example, converting a 401(k) account into a life annuity may be an excellent solution for the client with little other guaranteed lifetime income but not for someone with a significant pension benefit. Plus, increasing lifetime income isn't entirely about converting assets to income. It can also be figuring ways to maximize Social Security benefits, using a reverse mortgage to tap home equity or making better tax decisions to increase after-tax income. Another option for solving cash flow needs is reducing expenses instead of increasing income.

Once we've clearly established the need to generate income from financial assets, we must choose the appropriate way of framing the issue. Some advisors look to create an income floor for essential expenses, in which case the product solutions for meeting the income floor may be different than for discretionary expenses and legacy goals. Others start with the question of how much they can afford to withdraw from the portfolio each year and still make the money last, in which case some type of systematic withdrawal strategy seems more appropriate. An advisor working in this area should be familiar with the different ways of framing the issue and be able to pick solutions that best fit their specific client.

STEP 10: INTEGRATE ALL CONSIDERATIONS —PRESENT ALTERNATIVES AND AGREE ON A PLAN

Clearly, there are trade-offs in addressing possible concerns and solutions in a retirement income plan. Clients will have to make some difficult choices. For example, strategies that improve income security in retirement may have a negative effect on wealth accumulation for legacy goals.

Clients may not fully understand the issues until they see several alternatives, so a back-and-forth process should be expected. Getting to a final plan clearly requires some give and take, and the planning may go through a number of rounds before a final plan is agreed upon.

These steps have laid out how to develop the content of the retirement income plan. We haven't focused on the timeline and action steps that the financial planning process can provide, as well. The steps discussed provide a logical way of proceeding, starting with clarifying the scope of the engagement with the client all the way to developing an implementation program and monitoring the plan. Important to mention is that implementation may involve a team of professionals, including an estate planning lawyer, tax advisor and others.

Once a plan has been proposed, approved and implemented, it may be almost time to circle around and start the process all over again. Possibly no other type of financial planning will hit more road bumps along the way. There may be a big dip in the market, the client spends too much, inflation suddenly increases, or a grandparent takes on financial responsibility for adult children or grandchildren. Each of these changes affects the plan, and regular contact is required to evaluate and revise that plan. Retirement income planning can be rewarding work; you are really helping your client invent and navigate a new life stage. It's challenging as it requires a process, a wide range of knowledge, and the tools to help design and implement the plan. A successful advisor will be an important part of their clients' lives.

If you are interested in learning more about the steps in the process of retirement income planning, you may want to consider The American College's new course, HS 353, Retirement Income, Process, Strategies and Solutions. This is the first course in the new Retirement Income Certified Professional (RICP™) designation offered by The College.

Of keen interest to those involved in helping clients prepare for retirement, HS 353 identifies at least 28 of the risks that can affect a retirement income plan.