PACIFIC LIFE

A PROTECTED APPROACH TO RETIREMENT SPENDING

A White Paper for Pacific Life by Michael Finke, PhD

 This material is educational and intended for an audience with financial services knowledge.

Michael Finke, PhD

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Pacific Life Insurance Company commissioned Michael Finke, PhD, to write this report.
Michael Finke is not affiliated with Pacific Life.

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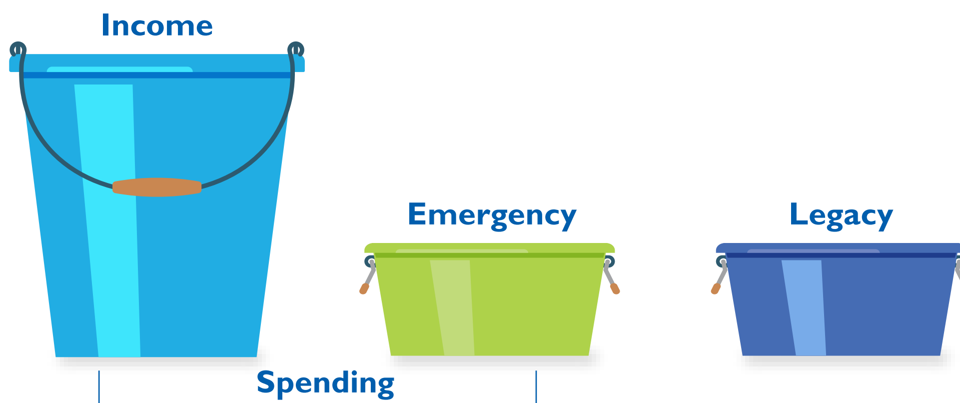
A PROTECTED APPROACH TO RETIREMENT SPENDING

Without a pension, today's retirees must use their own savings to pay for spending in retirement. This white paper provides a simple overview of the retirement income choices faced when using investments to create a lifestyle. The purpose of the research is to help create a goal-based income plan that allows a retiree to get the most out of personal retirement savings.

The Two Fundamental Financial Goals in Retirement

After a lifetime of saving in retirement plans and building wealth for the future, how should retirees begin the process of creating plans to meet their financial goals? The first step is to recognize that there are only two purposes our money can serve in retirement—it can either help us live a better lifestyle, or we can pass a legacy on to others. We can do a better job of meeting each of these two fundamental goals by creating a plan.

Spending goals can be broken into: 1) income and 2) protection against a financial emergency.



How much should a retiree place in each of these boxes? The answer depends on how well one wants to live in retirement. What motivated someone to save in a 401(k) every month? If the primary reason was to afford a dream retirement home, have enough money to eat out with friends without worrying about the bill, or take a cruise in a cabin with an ocean view, then the spending box should be larger. If the goal is to leave a legacy to the next generation, then the legacy box becomes larger and the income box smaller.

How much should a retiree place in each of these boxes? The answer depends on how well one wants to live in retirement.

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TURNING SAVINGS INTO INCOME

Imagine savings as a large loaf of bread. A retiree cuts off a portion of the bread and sets it aside to meet a legacy and emergency-spending goal. The remaining lifestyle loaf needs to be carved so that there is enough to make toast each morning over the course of a month. If the month is 30 days, then you simply divide the loaf into 30 segments.

Retirement income planning isn't as easy. How many slices will there be? If a retiree is 65 years old, will he or she need to make the slices small enough to last to the age of 95? On his or her 90th birthday, will there be a need to cut smaller slices to make sure there won't be a morning without toast? Will there be temptation to cut smaller slices early in the month to avoid running out?

This is the conundrum today's retirees face when deciding how to slice up the spending portion of their retirement savings to pay for a lifestyle. Is the best approach to cut thin slices and spend little each year to avoid the risk of running out? Or is it better to cut roughly equal slices that will last a certain number of years? Is the approach to throw caution to the wind and cut off large slices at the beginning?

What if each retiree could take a tiny piece of each slice and set it aside each year? By setting aside a tiny piece, each retiree could avoid the risk of running out. This is the value of transferring the risk of outliving savings to an insurance company that can collect a small portion of a retiree's savings, set it aside, and use it to help reduce the risk of running out of income if the retiree either lives longer than expected or doesn't get the investment returns planned.

Just as homeowners can sleep better knowing risks are shared through an insurance company, retirees also can live better knowing that they do not have to face the risk of outliving retirement savings. The advantage of using a financial product to fund the spending goal in retirement is that, by sharing the risk of outliving savings with other retirees, a retiree is free to create a more satisfying lifestyle.

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UNKNOWN INVESTMENT RETURNS

An important unknown is the returns retirees will receive from their investments. Investments can be broadly categorized as safer assets (such as bonds) and riskier assets (such as stocks). A sound retirement investment plan will contain a mix of riskier and safer investments.

How should a retiree think about safer investments? Investing in safer investments such as bonds means that each slice of spending will, on average, be thinner because returns on safer investments have historically been lower than returns on riskier investments such as stocks. The average geometric annual return on short-term Treasury bonds between 1926 and 2020 was 3.29%.[1]

Let's assume that a retiree decides to allocate $250,000 to fund lifestyle spending in retirement. If the money is invested in safer bonds that are expected to earn the historical return of 3.2%, each annual slice of spending over 30 years is expected to be $13,238 each year. Of course, if interest rates differ from the historical average, this number could be smaller ($11,162 at 2%) or larger ($16,263 at 5%). After 30 years, the entire retirement savings devoted to fund a lifestyle will have been spent.

Stocks, on the other hand, offer the possibility of larger expected slices of spending each year. Taking risk also means the possibility that the spending slice could be smaller, or that the retiree could run out of savings. The average historical return on large stocks since 1926 is 10.29%. An investor who received 10.29% return on $250,000 of investments could spend $27,163 each year over a 30-year retirement.[1]

The prospect of being able to spend $27,163 using riskier investments rather than $13,238 using safer investments is what motivates retirees to take investment risk with their savings. Who wouldn't want to spend twice as much each year? Unfortunately, taking on investment risk means accepting both good and bad possible outcomes.

No investor has ever earned exactly 10.29% on their stock returns over a 30-year retirement. In fact, if the investor received an average of 7% over the first 15 years and spent $27,164 per year, money would run out just a few months into the 16th year of retirement. Even if stocks rebounded later in retirement, it wouldn't matter because there would be no money left to invest.

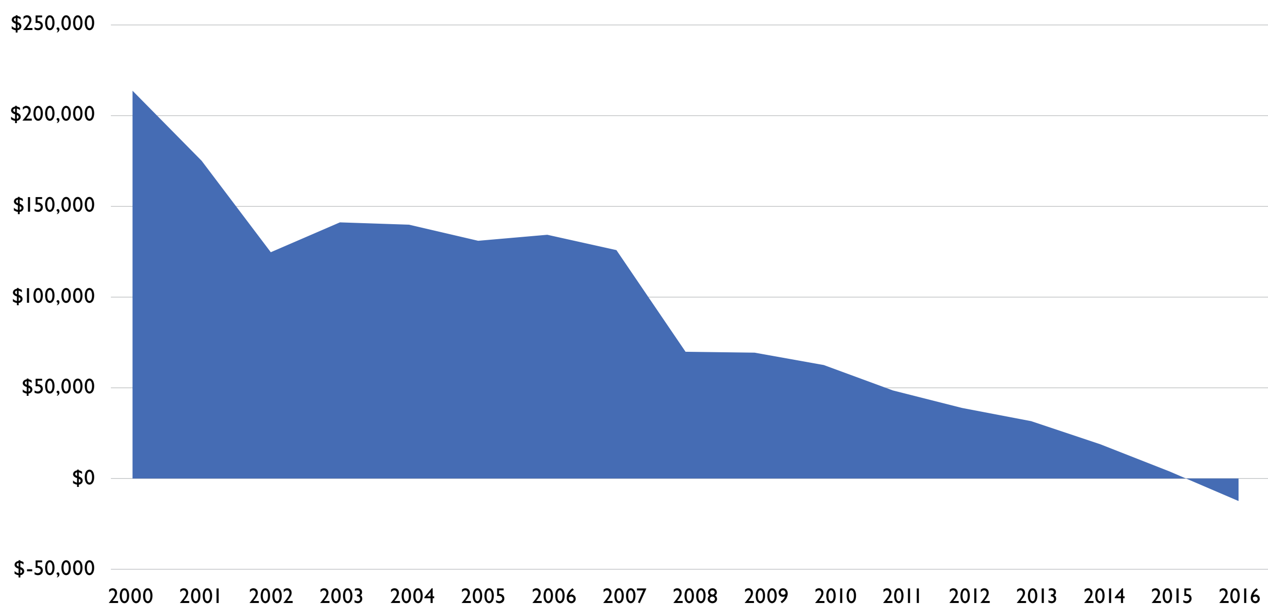
This is an example of a concept known as sequence-of-returns risk. When a retiree withdraws income from investments early in retirement and a portfolio has a negative return, this can have a large and surprising impact on the probability of running out of retirement savings. In other words, a retiree must adjust his or her lifestyle if returns at the beginning of retirement are lower than expected.

When a retiree withdraws income from investments early in retirement and a portfolio has a negative return, this can have a large and surprising impact on the probability of running out of retirement savings.

[1]Ibbotson Associates Stocks, Bonds, Bills, and Inflation® index of 3-month U.S. Treasury Bills 2000–2016.

Consider a worker who retired on December 31, 1999, who decided to invest $250,000 to fund a retirement lifestyle. This person reviews historical returns on stocks and bonds and decides to invest the full $250,000 in stocks in the hopes of living better in retirement. Instead of investing in bonds and only being able to spend about $13,000 per year for 30 years, the optimistic but cautious retiree decides that investing in stocks could lead to spending $15,000 annually. $15,000 is just 6% of the original $250,000 investment.

The following figure illustrates what would have happened if the entire $250,000 were invested in large stocks on January 1, 2000, and $15,000 was withdrawn at the beginning of each year to fund spending.



This example is for illustrative purposes only.
Return Data: Ibbotson Associates SBBI index of large-cap U.S. stocks 2000–2016.

This illustration shows that a retiree can't rely on average returns to fund a lifestyle with riskier investments. Returns will either be higher or lower than the average, and if returns are very low early in retirement, there is a possibility of outliving retirement savings.

Taking significant investment risk means accepting the possibility that a poor sequence of returns will decimate retirement savings. Why should a retiree take such a risk if it would result in running out of money after only 15 years? Most of the time, the rewards from accepting some investment risk are great.

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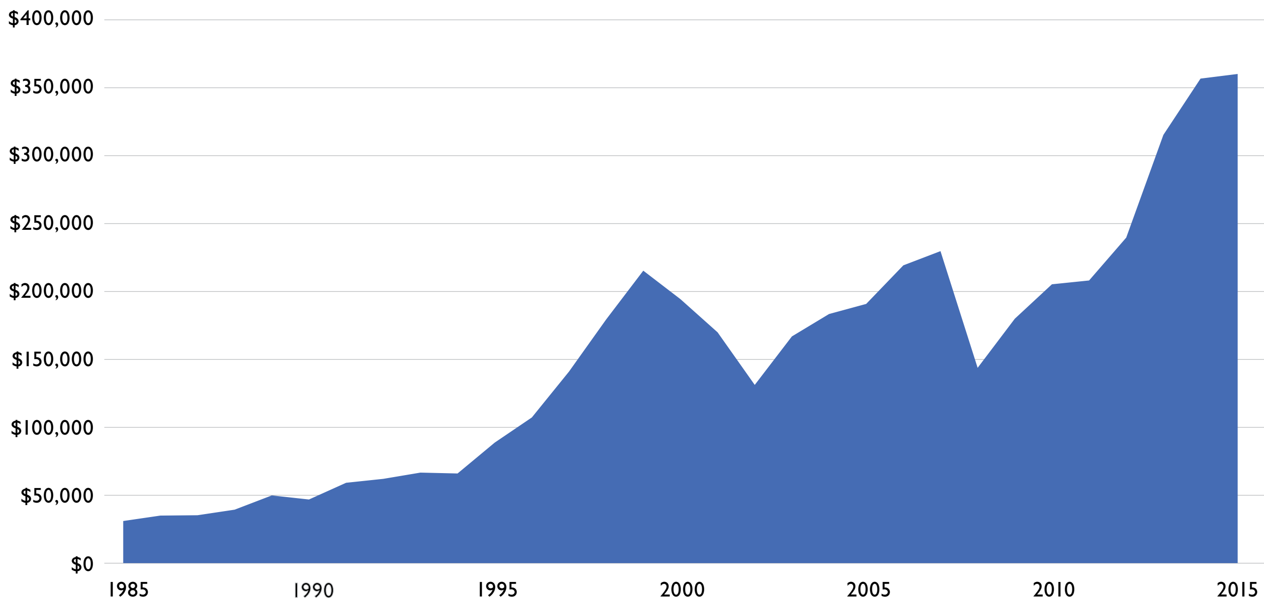
Imagine instead that the worker retired on December 31, 1984, and withdraws the same amount, $15,000 per year, from an initial $250,000 starting in January 1985. This is the exact same initial savings amount, the same 6% initial withdrawal rate, and the same investment in large-cap U.S. stocks. Will the retiree run out after 30 years? The answer may seem obvious since the last 15 years are 2000 through 2015—the same years as the poor sequence above. The actual answer is surprising.



This example is for illustrative purposes only.
Return Data: Ibbotson Associates SBBI index of large-cap U.S. stocks 1985–2015.

By the 30th year of retirement, the investor's balance has grown to $3.6 million. By the end of 2020, this amount would have doubled to $7.2 million even after continuing to withdraw $15,000 each year.

In fact, the retiree could have spent $25,000 each year for 30 years and still had $1.75 million in savings in 2015. This example shows how retirees can benefit from accepting investment risk. Allocating savings to stocks can allow wealth to grow over time resulting in both far higher lifestyle spending and a larger investment balance later in retirement.

When a retiree experiences a favorable sequence of returns, how should this affect spending? Investing in riskier assets means that a retiree must be willing to be more flexible with lifestyle spending. If returns on riskier assets are lower than expected early in retirement, less would need to be withdrawn each year to fund spending. If returns are favorable, retirees can comfortably spend more.

But what is the best approach to spending, especially early in retirement when sequence-of-returns risk is greatest?

BALANCING SAFETY WITH LIFESTYLE

By spending very little, retirees are less likely to run out of money if they live a long time or don't achieve the investment returns they expect. However, spending too little when the money can provide the greatest enjoyment is itself a risk. Retirees who fear spending freely early in retirement will sacrifice the opportunity to benefit from their retirement savings that they so carefully built during working years.

A common approach to spending from retirement savings is the 4% rule developed by financial professional William Bengen[2] in 1994. Bengen's study reviewed historical sequences of returns on U.S. stocks and bonds and found that 4% of an initial portfolio is an amount that would have withstood numerous 30-year historical periods at a 50% to 70% stock allocation. The study was instrumental in providing guidance to retirees who otherwise would have difficulty deciding how much they could conservatively withdraw from investments.

The 4% rule is a guideline for how much retirees should allow themselves to spend each year in retirement. For example, the retiree with $250,000 saved to fund a lifestyle would spend $10,000 the first year of retirement and then increase spending each year by the rate of inflation. For example, if December 31, 1999, was the retirement date, $10,000 would be spent in the year 2000 (4% of $250,000) and spending would gradually increase so that it reaches about $15,350 in 2020, adjusting each year for changes in the consumer price index.

Is this the right lifestyle path for most retirees to take? Should they spend more each year, about the same amount, or slightly less?

It's common to view retirement spending as a steady flow from retirement savings. Strategies such as the 4% rule envision a spending path that is about the same every year. In addition, many financial products designed to allow protected lifetime retirement spending provide a fixed withdrawal percentage from an investment portfolio each year.

Is it reasonable to assume expenses in retirement won't change each year? What happens when a retiree wants to go on a world cruise, pay for a wedding, help a grandchild with college, buy a classic car or a motorhome, or take care of an unexpected health expense? What does spending in retirement actually look like?

> A retiree who fears spending freely early in retirement will sacrifice the opportunity to benefit from their retirement savings that was so carefully built during working years.

[2]Bengen, W. (1994), Determining Withdrawal Rates Using Historical Data, *Journal of Financial Planning,* October, 171–1800.

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UNDERSTANDING SPENDING IN RETIREMENT

To better understand actual spending patterns in retirement among more affluent retirees, I use data from a nationally representative survey of 20,000 retirees conducted by the University of Michigan—the Health and Retirement Study (HRS). The HRS follows retirees over time and contains a subgroup that is asked detailed questions about spending.

A useful way to view spending in retirement is to break expenses into stable spending categories, such as utilities, property taxes, or groceries. These are fixed expenses and generally remain constant or decline gradually (after inflation) throughout retirement. Other categories of expenses such as vacations, vehicles, or gifts are far more variable.

There is a consensus in the academic literature that spending early in retirement is larger than spending later in retirement. In fact, this drop-in spending has its own name—the "retirement consumption puzzle." Recent studies document the gap between how much retirees could safely spend from their savings and how much they actually spend.[3] Among those who could fully fund their pre-retirement lifestyle, spending immediately after retirement was about 5% less then pre-retirement spending and declined to 25% below pre-retirement spending by the 10th year of retirement.[4]

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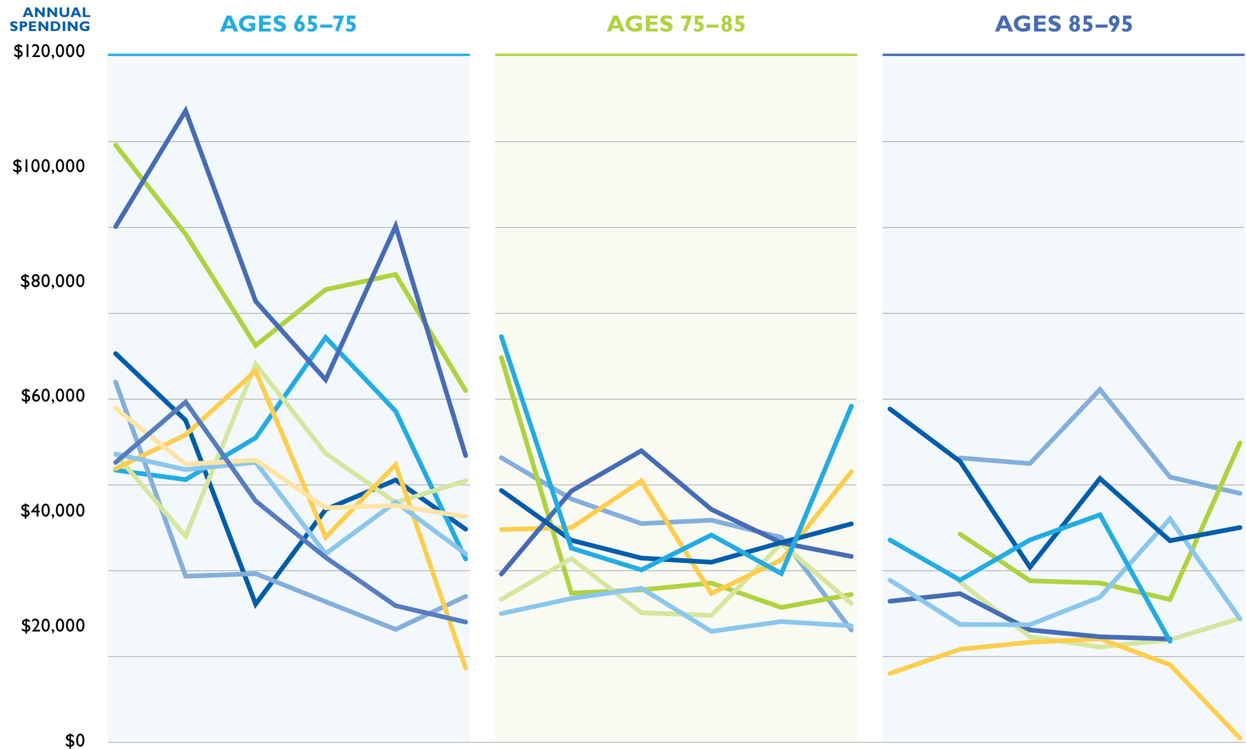
The figure on the next page shows actual spending over time among retirees in the HRS with investable assets between $250,000 and $2 million whose spending data can be tracked for at least 10 consecutive years in retirement. There are three cohorts of individuals—ages 65–75, 75–85, and 85 and up. The 85 and up cohort continues for a maximum of 14 years to show how spending progresses in advanced age. The graph shows the change in actual spending for the same individual for the entire 10-year period, but there are three groups of individuals sorted by age.

[3]Browning, Christopher, Tao Guo, Yuanshan Cheng, and Michael S. Finke. 2016. "Spending in Retirement: Determining the Consumption Gap." *Journal of Financial Planning* 29 (2): 42–53.

[4]Blanchett, David M., and Warren Comier. 2021. "Right-Sizing Retirement: Exploring the Retirement Consumption Gap in Early Retirement." *Journal of Financial Planning* 34 (2): 68–81.

The data shows two general trends. First, spending is not constant. It goes up in some years and down in others. Second, there is a gradual decrease in spending over time in retirement among the three age cohorts. This is consistent with prior research on retiree spending.



Total spending, Health and Retirement Study (2007–2017). Households between $250,000 and $2 million investable assets. Each line represents a retiree from the study.

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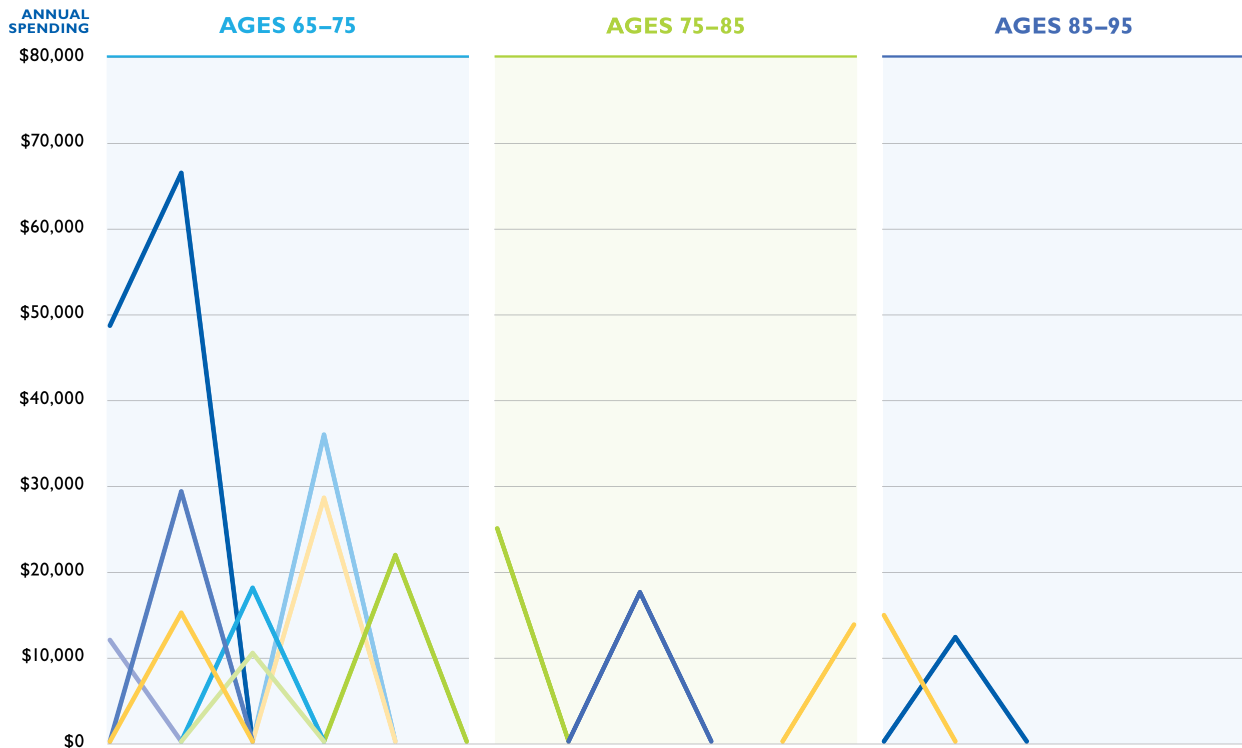
The figure is instructive when developing a spending plan from savings in two ways. First, it shows that spending early in retirement is highest, and for most retirees in their 80s, spending is only modestly higher than the average retiree's income from Social Security benefits.

Second, the figure shows that retirees often choose to spend more in some years than others. While fixed spending categories tend to decline gradually in retirement, variable spending is both higher early in retirement and far more volatile. For example, spending on cars among this group of retirees is very high in some years, nothing in most years, and nonexistent for retirees over the age of 90.



Source: Health and Retirement Study (HRS) Data Products. Center for the Study of Aging. RAND Org.
Health and Retirement Study (2007–2017). Households between $250,000 and $2 million investable assets.
Each line represents a retiree from the study.

A PROTECTED APPROACH TO RETIREMENT SPENDING

To take a deliberate approach to meeting spending goals in retirement, retirees can choose how best to pay for a lifestyle with savings.

Option 1: Invest in safer assets such as bonds to pay for a modest income with little spending risk.

This may sound like the best option for retirees who want to make sure that they won't have to cut back on spending. But even safer investments cannot provide protection against outliving assets.

Why? How many slices of income can a retiree take from $250,000 of savings? Should a retiree cut 30 slices so that his or her money will last to age 95? To answer this question, it is important to understand the science of longevity.

Healthy, higher-income men and women have made significant gains in longevity over recent decades that impact the time horizon of today's retiree. For example, data provided through Opportunity Insights at Harvard University show that higher-income men live 10.8 years longer than lower-income men, and higher-income women live 7.1 years longer than lower-income women, on average. The difference in longevity between higher-income men and women is only 1.9 years, while the difference among lower-income men, and women is 5.6 years.

Why does it matter that higher-income men are living so long in retirement? When men live longer, there is a greater chance that they will outlive their spouses in a married opposite-sex couple. This increases the likelihood that one spouse in a healthy couple will need to fund retirement spending at a given age. The following chart represents the amount of income that a healthy 65-year-old opposite-sex couple can expect to receive from safer investments such as bonds at a 3% rate of return from an initial $250,000 investment to various ages, as well as the probability that one spouse will outlive these payments.

Age of Last Payment	Payment Amount	Probability of Outliving Savings	Spending Percentage of $250,000
90	$14,357	70.5%	5.7%
95	$12,755	40.4%	5.1%
100	$11,635	13.4%	4.7%
105	$10,816	2.1%	4.3%

Probabilities based on joint longevity estimates from the 2012 Society of Actuaries Individual Annuity Mortality Table.
Payment amount is based on an expected 3% bond return.

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While safer assets provide lower investment volatility during retirement, they do not necessarily provide lifestyle stability since the retiree must accept the risk of longevity. How much risk is acceptable? At a 13.4% probability of outliving savings, a retiree can spend 4.7% of his or her initial retirement savings amount each year. If the retiree is only willing to accept a 2.1% chance of outliving savings, he or she can instead spend 4.3% of the initial amount.

All retirees who do not transfer the risk of unknown longevity to an insurance company face this risk of planning for income with an unknown time horizon. Reducing the risk of outliving retirement savings requires spending less, but this also introduces the possibility of "leaving money on the table" by being too cautious. A retiree risks shifting more than planned to the legacy portion of retirement savings by spending too little in order to avoid the risk of living too long.

Option 2: Invest in a balanced portfolio with higher expected returns.

Option 1 invests in safer assets. A retiree can instead invest a portion of retirement savings in riskier assets, such as stocks that have a higher expected return. In Option 2, the retiree places 50% of savings in riskier investments and 50% of savings in safer investments. The benefit of taking risk is the possibility that retirement savings could grow faster over time, allowing greater spending later in retirement and the possibility of a larger legacy value.

Of course, risk also means accepting the possibility of running out of money even earlier in retirement, or more likely having to cut spending back significantly, because of a poor sequence of returns. Accepting the possibility of low or negative returns early in retirement is an unavoidable consequence of taking investment risk.

It is possible to better understand this risk through the use of a statistical simulation model that estimates the paths of thousands of potential retirements using investments whose returns rise and fall randomly. This so-called Monte Carlo analysis tracks spending paths and provides insight into the number of years a riskier investment portfolio will last while funding an annual spending goal.

All retirees who do not transfer the risk of unknown longevity to an insurance company face this risk of planning for income with an unknown time horizon.

The table below shows the failure rate, or the probability of running out of money before a given age in retirement, for a retiree who intends on spending $12,500 per year, or 5% of the initial $250,000 of retirement savings. Recall that in Option 1, spending this same amount would result in running out of money at about age 95, or a 40% chance of running out of money for a healthy couple.

Age of Last Payment	Payment Amount	Probability of Living Beyond Age	Probability of Running Out of Money
90	$12,500	70.5%	8.3%
95	$12,500	40.4%	16.2%
100	$12,500	13.4%	23.4%
105	$12,500	2.1%	30.2%

Monte Carlo analysis assumptions: 10% equity returns and 18% standard deviation, 3% bond returns and 6% standard deviation, 1% investment fees, 50% equity allocation. Mortality assumptions use 2012 SOA annuity table.[5]

Important: The projections or other information generated by the Monte Carlo simulation regarding the likelihood of various investment outcomes are hypothetical in nature, and for illustrative purposes only. This simulation does not reflect actual investments, and is not a guarantee of future results. Monte Carlo is an analytical method used to simulate random returns of uncertain variables to obtain a range of possible outcomes. This simulation is an analysis of the likelihood that you may be able to achieve your stated goals and a tool to identify a range of potential wealth outcomes that could be realized. Results may vary with each use and over time.

By taking investment risk, a retiree has a higher probability of meeting his or her spending goal at a later age than taking no risk at all. Investment risk enables a retiree to achieve a higher expected lifestyle for a potentially longer period of time.

However, investment risk does involve accepting some risk of running out of money in old age. A healthy couple has a 13.4% chance that one spouse will live to age 100 and beyond. In 23.4% of Monte Carlo simulations, a balanced investment portfolio would have been depleted before age 100. Although investment risk increases the possibility that a retiree will have adequate savings to fund later-life spending needs, it does not eliminate the possibility of running out of money early.

Option 3: A protected portfolio approach.

Both Options 1 and 2 involve some risk of running out of money from either living longer than expected or getting lower-than-expected investment returns. Option 1 will provide a more secure level of spending for a defined number of years, but a retiree must weigh a better lifestyle with a higher possibility of outliving savings. Option 2 will, on average, allow a retiree to spend more but does not eliminate the possibility that the retiree will run out of retirement savings if he or she experiences a poor sequence of riskier investment returns in the early years of retirement.

[5]2012 Society of Actuaries (SOA) annuity mortality table.

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Option 3 integrates higher expected spending from stock investments with protection against outliving savings through a lifetime income guarantee. This approach involves working with an insurance company to allow the benefits of living well early in retirement coupled with a guaranteed minimum lifetime income optional benefit, available for an additional cost. This protection is provided by pooling a small percentage of wealth with other retirees to provide a guaranteed[6] minimum amount of spending if savings run out.

There are tradeoffs of risk reduction through a protected portfolio. A retiree must contribute a small percentage of investments each year to provide the lifetime income protection. The insurance company uses these assets to support the income of those retirees who either lived longer than expected or suffered losses in the market. Put simply, the retiree accepts a slightly lower investment wealth early in retirement for the benefit of lifetime income protection that occurs late in retirement.

Just as a homeowner pays an insurance premium to avoid a major loss from an unexpected fire, a retiree can pay a premium to avoid the risk of running out of savings.

Consider a protected portfolio approach using a lifetime income optional benefit to insure against running out of retirement savings. By investing a portion of a portfolio in stocks, each expected slice of spending from retirement savings is larger than if the retiree invested in only safer assets. Taking risk allows an improvement in expected lifestyle.

Using investments that incorporate lifetime income protection allows a retiree to spend a larger slice of retirement savings at the beginning of retirement (when sequence-of-returns risk is largest) than conventional protected portfolio approaches that only allow a lower, fixed spending amount. This more closely aligns with actual spending data, which shows that the amount retirees consume from their retirement savings is volatile as retirees spend more or less on discretionary categories each year. Even though retirees may choose to spend a higher amount to live better early in retirement, they can do so free from the fear that they will no longer be able to receive income if their retirement savings eventually run out.

> Using investments that incorporate lifetime income protection allows a retiree to spend a larger slice of retirement savings at the beginning of retirement (when sequence of return risk is largest).

[6]Guarantees are subject to the claims-paying ability and financial strength of the issuing insurance company.

The following example is for illustrative purposes only and compares what happens in simulated retirements using a protected and an unprotected income approach. The 1,000 simulations assume current expected stock and bond returns according to Blackrock's 15-year capital market assumptions of 2% and 6.9%,[7] respectively, and standard deviation (risk) of 6% and 15% each year.

The retiree invests $250,000 for a portfolio consisting of 50% large stocks and 50% bonds. Investment fees are 1.5% for the unprotected portfolio and 3% for the protected portfolio. Each year, $15,000 of income is withdrawn from investments to fund spending.

Simulation results show the risk of creating income from investments without insurance protection. The figure shows outcomes at the 5th, 25th, and 50th (median) percentiles of investment outcomes in the simulation. The median couple spending $15,000 will run out of retirement savings halfway through their 21st year of retirement at age 86. Less fortunate retirees will run out at age 83 (at the 25th percentile) and age 79 (at the 5th percentile). These same less-fortunate retirees will run out of retirement savings in a protected income portfolio a few years earlier because insurance fees were withdrawn from the account. However, these unfortunate retirees will continue to receive $7,500 of income even if they live to age 100.

Simulation assumptions include 2% return and 6% standard deviation on bonds, 6.9 return and 15% standard deviation on stocks, 1.5% fees on unprotected portfolio and 3% fees on protected portfolio

[7]https://www.blackrock.com/institutions/en-us/insights/charts/capital-market-assumptions

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The trade-off of a protected portfolio is the cost of an insurance premium. The benefit of the protected portfolio is protection against the risk of outliving savings.

The consequence of running out of wealth as a result of market or longevity risk is significant and serious enough that retirees building a spending plan should consider how to face it. Avoiding this risk is only possible by sacrificing lifestyle and spending very little to preserve one's retirement savings. A protected approach allows retirees to potentially live better early in retirement when spending is often the highest. Protection also provides the freedom to spend without the worry that they will regret their choices later in life.

Retirees today are responsible for funding a lifestyle through their own investments. Using a goal-based plan for spending and legacy is a more deliberate approach to getting the most out of savings. Retirees should select an option for turning investments into income that provides the best opportunity for leading a better lifestyle.

Without knowing how long retirement will last, or what returns on investments will be in the future, retirees are presented with risks that could result in either underspending or potentially running out of retirement savings. Safer investments offer less investment risk but cannot eliminate the risk of outliving assets and can result in spending too little. Riskier investments offer the possibility of spending more and building greater wealth, but place retirees at risk of earning a poor sequence of returns and running out of money early in retirement.

CONCLUSION

A protected approach can provide both the possibility of growth and the freedom to spend earlier in retirement knowing that a source of income is protected for life. The value of insurance is protection against risk. Removing risk through the use of investment protection provides a solution for retirees who are focused on maximizing lifestyle without the risk that by living well today, they might ultimately sacrifice spending in the future.

Resources

Pacific Life has the tools and resources to help you and your clients navigate the ins and outs of retirement planning. Contact our Retirement Strategies Group at (800) 722-2333, ext. 3939, send an email to RSG@PacificLife.com, or visit our website at Annuities.PacificLife.com for more information.

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