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Living | Lifestyle | Emergency | Legacy

A building block framework for lasting retirement income

KEY TAKEAWAYS

01 Investing for retirement income requires an understanding of each client's unique objectives.

02 Using a "building blocks" framework, advisors can help guide conversations on spending needs in retirement.

03 This framework can help build portfolios that balance living, lifestyle, emergency and legacy goals against the fear of outliving one's assets.

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Many advisors have spent the better part of their careers helping clients accumulate assets. Now an increasing number of Americans are fast approaching retirement — and conversations are changing. How much retirement income will I need? How much spending will my nest egg support? And most importantly, will I outlive my assets? Making the mental switch from saving to spending assets isn't easy nor is managing a nest egg to support multiple retirement objectives over a lifespan. The value of advice has perhaps never been greater.

But first, advisors need to have an understanding of what retirement looks like for each client, including how much they may want to spend — or not spend — and how much income variability they can handle along the way. This paper will discuss a framework designed to do just that: facilitate the types of in-depth conversations needed to form the foundation of an objectives-based retirement income plan.

A research-based framework

In order to better understand how retirees save and perceive their retirement assets, Capital Group conducted in-depth qualitative interviews and surveyed 800 retirees and near retirees.* The resulting analysis found that many retirees think about their assets as one lump sum. Nevertheless, there is also a significant cohort of investors who think of their assets in separate buckets, or "building blocks," to serve specific needs aligned with their personal retirement objectives. Generally, these were: unplanned emergencies (84%), basic living expenses (79%), discretionary expenses (79%) and leaving a legacy (72%).

We believe that this framework of four distinct categories, or building blocks, can be a valuable tool to help guide conversations between advisors and clients. Such an approach can have the positive effect of helping retirees adopt a mental accounting framework for their assets — making it easier for them to understand, quantify and prioritize their retirement spending and legacy objectives. The conversation starts by asking clients these four questions:

* Retirement Income Product Development Research Findings, Aeffect (for Capital Group), 2015.

1. Living – What are your essential expenses?

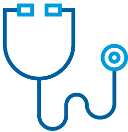
Living expenses typically include day-to-day necessities such as food, housing, transportation and health care. While an investor may have some flexibility with these types of expenses over time, many investors will seek to have an objective of 100% confidence in meeting these expenses.

- It is important to review investors' sources of income available to meet their retirement income needs and to help determine if income is secure enough to be sustained in all environments.

2. Lifestyle – What are your optional expenses?

The lifestyle block includes discretionary spending – the spending you can live without if necessary such as travel, spending on grandchildren, dining out and entertainment. What constitutes a lifestyle expense will vary from retiree to retiree, as will their comfort level with variations in income and spending as their lifestyle evolves over retirement.

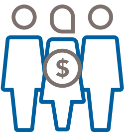
- When it comes to lifestyle spending, investors can cut back or live without these expenses if necessary in order to meet their basic expenses. For that reason, a lower level of confidence in meeting their lifestyle expenses, such as 75%, might be an acceptable objective for many investors.



3. Emergency – Do you have a cash cushion?

A well-funded and liquid emergency fund can provide retirees with more confidence that they can weather unexpected market, health or household shocks. Having adequate emergency savings put aside can provide retirees greater flexibility so they don't have to liquidate other assets when unforeseen expenses arise.

- Just how much emergency savings to proactively put aside will vary for each investor. Emergency fund assets that are held in cash or more readily liquid assets can be used as a contingency when needed.



4. Legacy – Do you plan to pass on your wealth?

An important objective for many investors might be to leave a legacy by setting aside money to help with things like their grandchildren's education, charitable donations and leaving something for descendants. Many others simply plan to leave behind "whatever is left." Identifying a retiree's legacy goals upfront can help inform both where assets are located and retirement income spending decisions. Legacy goals can and often do change over time, so it's important to revisit this goal throughout retirement.

- A total portfolio approach to living, lifestyle and legacy goals may be most efficient, where assets are invested in portfolios designed to balance income, growth and capital preservation objectives.

Harry and June

Retiring couple:
65 years old – in good health

Income	
Social Security	$28,000
Retirement portfolio	**solution needed**

Assets	
Emergency savings	$45,000
Retirement assets	$1,000,000
House	$500,000

Annual spending	
Living expenses	$40,800
Lifestyle expenses	$27,200

This hypothetical illustration is shown for illustrative purposes only, is not indicative of any specific investment and does not reflect the impact of fees, expenses, or taxes that may be owed.

CASE STUDY

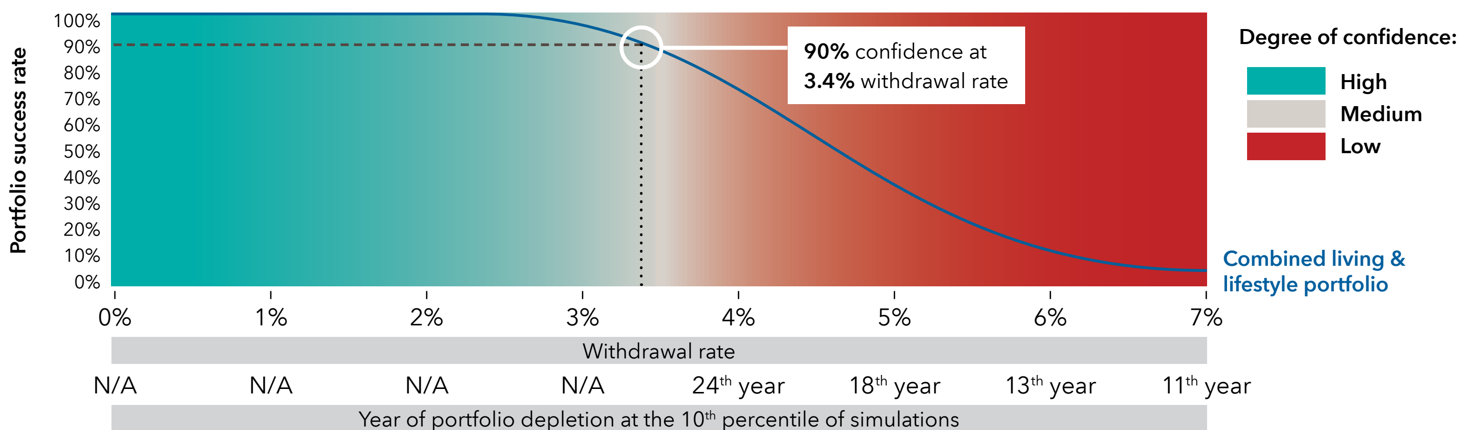
Putting the building blocks into action

In this case study, we discuss a hypothetical example of putting the building blocks framework to work – one that helps identify an optimal withdrawal rate from the couple's retirement portfolio assets designed to support more than one income objective. When sitting down with their advisor, Harry and June employed the four building blocks framework to engage in a deep discussion concerning their spending goals and available resources and came to the following conclusions:

- Their annual basic living expenses are $40,800. They would like to set an objective to achieve 100% confidence in meeting these essential living expenses over their lives.
- They desire $27,200 annually for spending on their lifestyle expenses in retirement. Since they have more flexibility achieving this spending goal, they agree that a 75% confidence objective is acceptable given that the portfolio needs to balance income, growth and asset preservation.
- They have cash savings of $45,000 in their emergency fund if needed for any unforeseen expenses.
- They would like to leave a legacy for their children, which would include the family home valued at $500,000.
- Their $1,000,000 portfolio would need to generate $40,000 ($68,000 less $28,000 from Social Security) annually to cover both their living expenses and desired lifestyle spending – a 4% withdrawal rate.

To stress-test this single 4% withdrawal rate to confidently support both living and lifestyle expenses, their advisor looked at a Monte Carlo simulation, which uses a large number of scenarios based on a set of market assumptions. Since Henry and June were most concerned with the risks to their retirement income plan, the simulation focused on the lowest 10th percentile of possible scenarios. Here we see that a 4% withdrawal rate may be too ambitious. With the proposed split between living and lifestyle, combined for a weighted success rate of 90%, the simulation shows a 3.4% withdrawal or less would provide them more confidence in sustaining their spending needs. The analysis suggests that Harry and June may need to discuss with their advisor the trade-offs and implications of decreasing their spending objectives, delaying retirement, portfolio adjustments, as well as exploring opportunities to increase their level of protected income to improve their overall confidence in retirement.

EXHIBIT 1:
Retirement income confidence chart (30-year time horizon)



Source: Annuities in Portfolio Construction, Capital Group, 2018. Chart is for illustrative purposes only.
Note: Taxes and fees not considered in this assumption.

Building retirement confidence — one client at a time.

Given the many unknowns of retirement, a building blocks framework may help investors better define their retirement income needs. With insights gleaned from this framework and the benefit of professional advice, investors should be able to invest in portfolios that align with their personalized goals and objectives as they navigate through retirement. For advisors, that means creating portfolios designed to help clients pursue overall income security, meet their essential living expenses no matter how long they live, and invest for a high degree of confidence so that desired lifestyle and legacy goals can be pursued.

A Monte Carlo simulation was used to calculate a potential range of outcomes and probabilities shown on page 4. A Monte Carlo simulation is a statistical technique that provides a range of potential outcomes using a large number of scenarios based on a set of market assumptions. The results of the simulation are highly dependent on the market assumptions used and there can be no assurance that these market assumptions will prove to be accurate. Accordingly, actual results may vary significantly from the simulation results presented. Median values represent the 50th percentile. This simulation is provided for informational purposes only and is not intended to provide any assurance of actual results.

The following assumptions were used in the Monte Carlo simulation:

The investor withdraws a fixed percentage of the initial portfolio value each year for up to 30 years. The initial withdrawal amount is increased by 2.0% each year.

The hypothetical portfolio is composed of 60%/40% S&P 500 Index/Bloomberg Barclays U.S. Aggregate Index. 60%/40% S&P 500 Index/Bloomberg Barclays U.S. Aggregate Index blends the S&P 500 with the Bloomberg Barclays U.S. Aggregate Index by weighting their cumulative total returns at 60% and 40%, respectively. This assumes the blend is rebalanced monthly. The market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

For the first 10 years of the simulation, assumed hypothetical returns for the S&P 500 Index were 3.75% with a standard deviation of 15.00%; assumed hypothetical returns for the Bloomberg Barclays U.S. Aggregate Index were 3.25% with a standard deviation of 4.00%.

After the 10th year of the simulation, assumed hypothetical returns for the S&P 500 Index were 7.50% with a standard deviation of 15.00%; assumed hypothetical returns for the Bloomberg Barclays U.S. Aggregate Index were 4.20% with a standard deviation of 4.00%.

The portfolio success rate shown in Exhibit 1 is the percentage of simulations where the hypothetical portfolio sustained the applicable withdrawal percentage each year for 30 years (inclusive of a 2.0% annual increase). While we believe the calculations to be reliable, we cannot guarantee their accuracy. Simulation results may vary.

The assumptions for the characteristics (return, volatility and correlation) of the hypothetical portfolio represent the opinions of a small number of macro-focused analysts based on their individual research and should not be interpreted as the view of Capital Group as a whole. As CG employs the multiple manager system, the views of other individual analysts and portfolio managers may differ from those presented here. All market forecasts are subject to a wide margin of error, including our own.

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