

# Rate, Reliance, And Confidence

By **John Florance** - September 1, 2021



## ***Prudent Planners Use The Three M's: Minimize, Minimize And Maximize For Retirement Portfolio Success***

***(Adapted from the author's forthcoming book, "The Biggest Paycheck")***

2020 marked the half-way point of the Baby-Boomer generation's retirement process. The early Boomers began pulling out of the workforce in 2010, and the later ones will continue to begin their retirements for the next 10 to 15 years. The generation before the Boomers, known alternately as Traditionalists, Matures, and "The Greatest," are at the end of their lives on this planet. As a generation, they largely did not have need of retirement income planning. As children of the Great Depression, they spent much of their lives over-saved and underspent. They enjoyed company pensions as a reward for a lifetime of service to their employers and had the backstop of Social Security and Medicare for their later years. The principal role of financial advice for the Traditionalist generation has been risk-mitigated wealth accumulation and legacy planning.

By way of contrast, the Boomers have been under-saved and overspent. The proverbial stable, three-legged stool of retirement income (pension, Social Security, and personal savings) has been reduced to a "mono-pod" of government benefits propped up with whatever meagre assets the retiree can cobble together. Today, fewer than 20 percent of non-government employees have access to company-sponsored defined benefit pensions. These have been replaced since the early 1980s by defined contribution plans and IRAs that provide no guarantees, and place the management, administrative costs, and market risk squarely on the shoulders of the individual. Social Security benefits have become an increasingly uncertain, yet primary source of retirement income for most Americans. Today's financial professional is faced with the challenge of monetizing their clients' accumulated assets to provide both portfolio growth to hedge against inflation and lifestyle-preserving

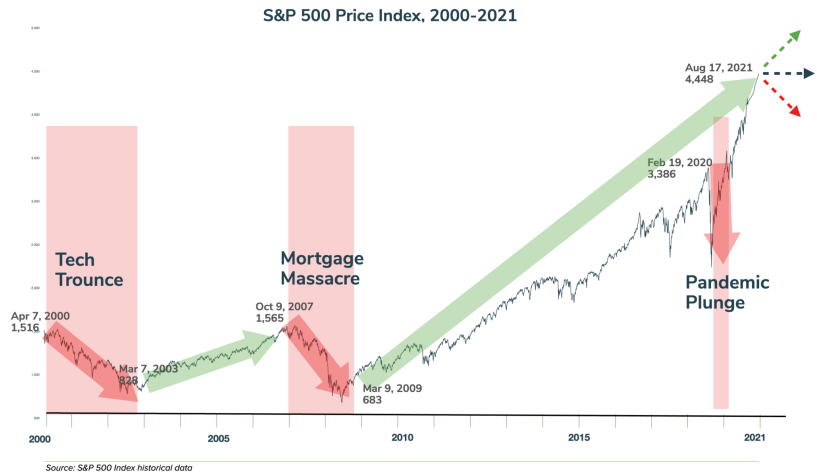
lifetime income that cannot be outlived. The key variable of this challenge is longevity risk. Financial professionals need to engineer income streams for 25, 30, or more years.

**Linked Risks**

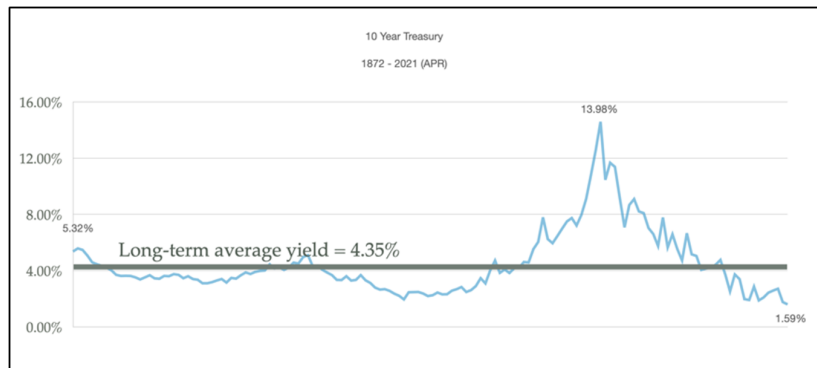
Diagram 1 represents the retirement planner’s conundrum in a nutshell. Longevity risk creates a series of other linked risks: Because we need to plan for 30 years of distributions, inflation now becomes a factor to the retiree. Assuming average inflation of 3.1 percent, a client’s portfolio would need to double-and-a-half simply to maintain purchase price parity over 30 years. The best chance of achieving that kind of growth is through participation in equity markets. However, equity participation subjects the client to market risk and the mathematics of loss. Not only are there the real losses and risks brought on by bear markets, the timing of which can create sequence of return risks, but recovering from those losses subsequently requires growth rates that cannot be relied on potentially exposing the client to portfolio failure. In short, for Baby Boomers in need of retirement income, Longevity Risk leads to Portfolio Failure Risk.



It bears reminding advisors and their clients that we are at an interesting historical crossroads: Equity markets are at all-time highs and continue to be highly volatile amid a global pandemic and world-wide recession.



Where bonds were the traditional safe haven for volatile equities, we can see that the last 40 years of higher-than-normal yield trained a generation of investors to expect more from fixed income than what has been warranted by a broader look at history.



Most pundits would agree that equities today are overpriced and interest rates will likely remain low for some time. This poses a unique set of risks for the retiree, as there is a very real concern about

sequence of return issues if we experience another significant market downturn. Yet, if we turn to the fixed income markets for shelter, we consign our clients to non-sustainable yields and return. Should the Fed decide to raise interest rates, fixed income portfolios face the additional risk of losing value.

If the goal is to give the retiree a higher probability of not running out of money before they run out of life, the prudent planner needs to manage three critical, interrelated ratios:

- Portfolio Withdrawal Rate (PWR)
- Portfolio Reliance Rate (PRR)
- Portfolio Confidence Rate (PCR)

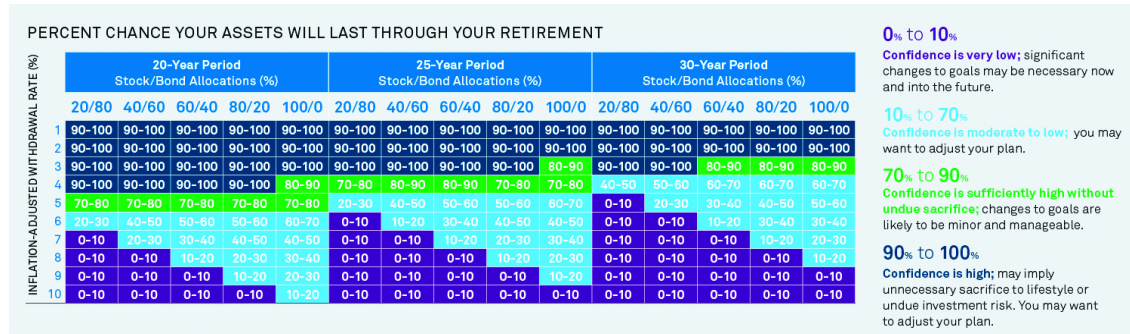
Let's look at each of these in turn.

**Portfolio Withdrawal Rate**—This ratio is the total annual distribution of funds from the portfolio as a percentage of the total value of the portfolio. For example, if a client's total investable assets are \$1 million, an annual withdrawal rate of \$40,000 would translate to a four percent withdrawal rate. The objective should be to minimize this as much as possible. Much has been written about how to structure systematic retirement distributions from investment portfolios. For the past two-plus decades, many advisors have subscribed to some variation of David Bengen's four percent "safe max" rule. The retiree's experience during the Great Recession brought that rule into question. Conventional wisdom suggested that fixed income investments were a safe harbor from equity volatility and generally not correlated, or in the best case, were inversely correlated. However, declining equities and declining fixed income yields placed undue stress on distribution portfolios. So, if four percent isn't a safe withdrawal rate then what is? Dr. Wade Pfau, a researcher and professor at the American College of Financial Services, has in recent years said that a volatile portfolio has no inherent safe withdrawal rate. Other luminaries have revised the safe withdrawal number down to somewhere in the 2.9 to three percent range, based on revised historical market data. One can probably find statistics to argue for both higher and lower ratios than what is currently considered acceptable. Yet we can all agree that ***the lower we can keep the withdrawal rate, the higher the probability of portfolio success***. If we start with a benchmark of four percent, we serve the client well if we can manage to bring that down by any measure possible.

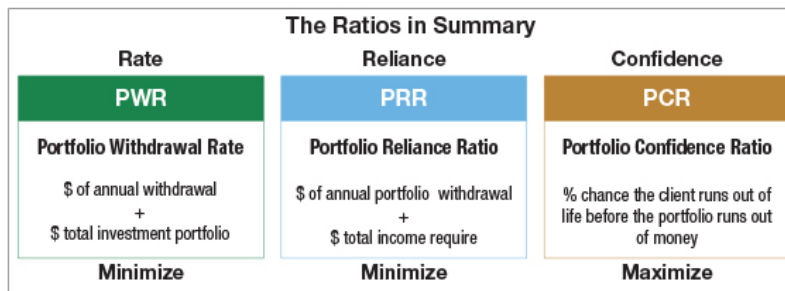
**Portfolio Reliance Rate**—This ratio is defined as the total amount of annual portfolio withdrawals required by a retiree as a percentage of their total retirement income need. For example, a client requires \$60,000 of annual income from all sources. If \$20,000 were to come from, say, Social Security and a small pension, then the remaining \$40,000 would need to come from the portfolio, resulting in a 66.7 percent portfolio reliance rate ( $\$40,000 \div \$60,000$ ). Clearly, the higher the reliance rate, the greater the client's sensitivity to negative market volatility or diminishing fixed income yield, and the greater the sequence of returns risk. ***The less we rely on the invested portfolio for income, the less risk of portfolio failure due to lifetime distributions and sequence of returns risk***. The prudent planner should seek to minimize this ratio.

**Portfolio Confidence Rate**—This is the range of probability of a portfolio's success, given specific stock/bond allocations, lengths of distribution, and portfolio withdrawal rates. The goal here should be to maximize this number: The higher the confidence ratio, the more certain a client will be of maintaining lifetime income goals. Numerous studies have been undertaken to simulate the impact of withdrawals on variously allocated portfolios over differing distribution timeframes. It stands to reason that a 100 percent fixed income portfolio yielding an average of three percent per year has a 100 percent chance of remaining intact in 20 years if the withdrawal rate is kept to one percent per year. Conversely, at the other extreme of the spectrum, a 100 percent equity portfolio earning an inflation-adjusted six percent will certainly be depleted before 30 years if the withdrawal is 10 percent per year. But what about a 70/30, 60/40, or 50/50 allocation? And what if the distribution period is 25 or

30 years? Monte Carlo simulations indicate that a 60/40 portfolio withdrawing inflation-adjusted four percent per year for 25 years has an 80-90 percent probability of success. That is encouraging, but still not "bullet-proof." However, extending the distribution period for five more years reduces the probability of success to 60-70 percent. What advisor feels comfortable telling their client that there's a 30-40 percent chance their retirement plan will fail? The chart below shows probabilistic outcomes for portfolio withdrawal rates of differing portfolios and distribution periods. The prudent planner seeks to maximize their clients' confidence rates.



Source BlackRock



### Putting the ratios to work

Let's take these three ratios and use them together in a set of hypothetical retirement situations to see how they may be applied to improving client outcomes. Just to make certain we're on the same page, we'll over-simplify a retirement scenario. John and Marsha are 65 years old. They have a \$1 million 60/40 stock/bond investment portfolio. They are healthy, they have no debt, and live in their own home. They require \$65,000 annually to sustain their modest lifestyle, which they will withdraw annually from their portfolio. They expect to do this for the next 25 years. \$65,000 withdrawn from the portfolio means a withdrawal rate (PWR) of 6.5 percent. Because they are using the portfolio for all their income, the reliance rate (PRR) is 100 percent. Applying these factors to the Monte Carlo probability chart, shows their confidence ratio (PCR) is probably in the 25 percent range.

Simplistic Scenario	
<b>Portfolio Allocation</b>	
60/40 Stock & Bonds	\$1,000,000
<b>Total Portfolio</b>	<b>\$1,000,000</b>
<b>Sources of Income</b>	
Portfolio distribution	\$65,000
<b>Total Income</b>	<b>\$65,000</b>
<b>Ratios</b>	
PWR	6.50%
PRL	100.00%
PCR	15-30%

Now that we understand how the ratios work together, let's make John and Marsha's scenario a little more realistic. Let's assume that of the \$65,000 income need, \$25,000 of it is coming from their Social Security payments. This simple change of facts alters the ratios considerably. Now, they need only take \$40,000 from the portfolio bringing their PWR down to four percent. The PRR is also reduced to 61.5 percent; still high, but significantly improved. The confidence ratio of a four percent withdrawal for 25 years with a 60/40 portfolio is now around 85 percent, which means they'll probably make it but there's still a decent chance that things could go wrong for them in their later years.

Realistic Scenario	
<b>Portfolio Allocation</b>	
60/40 Stock & Bonds	\$1,000,000
<b>Total Portfolio</b>	<b>\$1,000,000</b>
<b>Sources of Income</b>	
Portfolio distribution	\$40,000
Social Security	\$25,000
<b>Total Income</b>	<b>\$65,000</b>
<b>Ratios</b>	
PWR	4.00%
PRL	61.54%
PCR	65-85%

Perhaps a bit more problematic is what happens when we apply a -30 percent portfolio decline to the more realistic scenario and then recalculate the ratios: The PWR increases to 5.7 percent. The PRR ratio still remains high at 61.5 percent, thus making them more sensitive to market fluctuations, and if the portfolio valuation prevailed for any length of time, the PCR would be reduced to 35 percent, that is to say, a high probability of failure.

The use of an annuity for lifetime income is perhaps the best tool to be able to positively control all three ratios at once. Let's update our scenario: John and Marsha decide to put 30 percent of their investable assets into a deferred annuity with a lifetime income benefit that pays a guaranteed 5.5 percent for both lives starting at age 65. The shifting of this asset away from the volatility of the invested portfolio brings the portfolio value down to \$700,000. The income need remains the same, but now \$16,500 of the requirement comes from the annuity distribution. This means that the portfolio is contributing not \$40,000, but rather \$23,500, or a withdrawal rate of 3.35 percent. Likewise, the portfolio reliance rate is dramatically reduced to 36 percent, and the portfolio confidence rate increases to something in the 90-100 percent range.

Effectively what we have done is shift some of the portfolio risk to a longevity product and spread that risk to an insurance carrier that further spreads the risk across thousands if not millions of people. It should be noted that the annuity is still an asset that is controlled by the clients and advisor, and they have access to the account value and death benefit so long as there is one.

Is it possible to actively manage a portfolio for long term retirement success without the use of annuities or other protection products? Historically, mathematically and mechanically, undoubtedly yes. However, the advisor should bear in mind that while they may be able to operationally deliver long term financial results to a client, as much as 40 percent of the job that advisors perform on clients' behalf is to provide emotional support during times of uncertainty. The use of protection products such as annuities and life insurance not only provide valuable risk mitigation functions, but also help allay fears and insecurities that retirees face in an uncertain and highly volatile world. Off-shoring portfolio risk not only helps create reassurance but binds your clients to you more closely by virtue of the fact that you're addressing their financial needs and their emotional needs.

As the financial professional continues to manage their clients' retirement income plans, it's helpful to remember the Three M's: Minimize, Minimize, and Maximize for retirement portfolio success.



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Market Pull-back Scenario	
Portfolio Allocation	
60/40 Stock & Bonds	\$700,000
<b>Total Portfolio</b>	<b>\$700,000</b>
Sources of Income	
Portfolio distribution	\$40,000
Social Security	\$25,000
<b>Total Income</b>	<b>\$65,000</b>
Ratios	
PWR	5.71%
PRL	61.54%
PCR	40-60%

Annuity Allocation Scenario	
Portfolio Allocation	
60/40 Stock & Bonds	\$700,000
Annuity (GLWB)	\$300,000
<b>Total Portfolio</b>	<b>\$1,000,000</b>
Sources of Income	
Portfolio distribution	\$23,500
Social Security	\$25,000
Annuity (GLWB)	\$16,500
<b>Total Income</b>	<b>\$65,000</b>
Ratios	
PWR	3.36%
PRL	36.15%
PCR	80-100%

services, he had more than 20 years of business development experience in companies from micro-enterprise to some of the world's largest corporations in the high tech and consumer products.

Florance holds Series 6 and 63 securities licenses as well as insurance life, health, and long term care licenses. John received his BA from Wheaton College (IL), and his MBA and Master of International Management degrees from the Thunderbird Graduate School of Global Management. He holds the Certified Fund Specialist designation.

Florance lives in the Milwaukee area with his wife, Karla, of 28 years and their two adult children. John is an avid cyclist, sailor, and rower. He enjoys reading, travel, and playing piano in his free time.

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