

Commentary

JANUARY 2012

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

The Challenge of Lifetime Income Management

Lifetime income management presents challenges at the individual, institutional and national level.

At each of these three levels, the economic challenge is to generate lifetime capital and income and allocate these financial resources efficiently to meet needs at each stage of life. Shakespeare identified seven ages of man in *As you like it*, progressing from infant to old age. In Hinduism, human life comprises four stages or ashramas, from student to professional and family life, followed by a transition to vanaprastha as a phase of retirement or retreat from daily work, leading to the ultimate phase of sannyasa in old age without duties and responsibilities. In most contemporary cultures, the life cycle is divided into three phases: early childhood and student years; productive working years; and the retirement phase at the older ages. The provision of income at the older ages typically involves the integration of inputs from all three of the individual, institutional and national sources. These inputs are sometimes referred to as the "pillars" of the retirement income system. In the United States, for example, potential sources for providing old age income include: social security; employer-sponsored defined benefit pension plans; employer-sponsored defined contribution savings and investment plans; tax-advantaged individual retirement accounts; private personal savings and investments; and home equity conversion through reverse mortgages.

This multi-pillar structure with its several components is difficult to manage in terms of achieving clearly-defined objectives, and is widely seen as failing to achieve satisfactory outcomes. Social Security systems are subject to political pressures to reduce benefits and costs in the guise of imposing fiscal discipline and austerity. Influential institutions expound a philosophy of replacing established

old-age income provision with a system of individual accounts without regard to the adequacy of the outcomes or the risks imposed on individuals by these reforms. Employer sponsors of defined benefit pension plans have frequently reneged on social responsibilities to employees by terminating or freezing these plans so as to reduce expenses and increase profitability. Defined contribution savings and investment plans focus exclusively on the accumulation of account balances without regard to the various contingencies such as disability, death, and old-age and how they do not typically provide adequate income for these contingencies. This piecemeal approach to lifetime income planning is not satisfactory in terms of presenting a cohesive rational structure; it leaves the individual isolated and unprotected to face the risks and uncertainties of longevity, inflation, financial market volatility and instability, as well as other social, economic, demographic and political forces and trends.

Under these circumstances, the individual must either acquire a high level of financial literacy and understanding of complex financial issues or must rely on professional guidance from competent advisors. At the most simplistic level a common question is "how much will I need to retire" and is generally thought of in terms of a fixed amount or lump sum. A more thoughtful approach considers income requirements over time and acknowledges the implications and risks of longevity and inflation. It is inappropriate to consider only average life expectancy and to ignore the risk of surviving beyond the average, perhaps into extreme old age. It is also a serious mistake to ignore the potential effects of inflation where, for example a 3.5% annual rate of inflation reduces purchasing power by 50% over a period of approximately 20 years. Some simple "rules of thumb"

are sometimes suggested for guidance as a target amount for individuals who contemplate retirement, expressed as a multiple of around 200 or 250 times the initial monthly income required.

The challenges to the individual in managing lifetime income, particularly for old age, are daunting and perplexing. Some help may be offered by applying MBO (management by objectives) and MTG (mind the gap) techniques to the problem. It is more practical to think in terms of monthly income requirements rather than in terms of lump sum targets. A planning horizon should be set over a forty or thirty year period from a target date for old age income to commence; monthly income from social security and defined benefit pension plans should be assessed and aggregated; income requirements should be computed for each year with allowance for inflation over the projection period; the gap between these two income streams (required minus actual) should be determined. The MBO process is then to systematically MTG by funding the gap using current and future expected available accumulated account balances from defined contribution savings and investment plans, individual retirement accounts, and personal savings and investments. Two funding mechanisms that are suitable for this purpose are annuities and zero coupon bonds. An annuity will provide protection against the longevity risk and a laddered portfolio of zero coupon bonds can be designed to fill the remaining gap consistent with a target expected rate of inflation.

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