

Have the markets ruined retirement?

Are your clients' nest eggs still large enough to last? They'll need to come to grips with the real effect of changing markets on their individual situations

DIFFERENT YARDSTICKS

Some retirees are fortunate to have their living expenses covered by entitlement sources such as company and state pensions. Others must rely on their own assets. Based on our work in optimising retirement investment outcomes, we've gained an ever-greater appreciation for the challenge of managing portfolios against the risks of unknown longevity, investment volatility, and inflation.

To address this problem, we've created two tests to evaluate the financial condition of clients who have less than three-to-five years until retirement, and those who are already retired. These are the Desired Spending Test and the Minimum Spending Test, both of which are built into the downloadable Client Analyser workbook. Clients with more than three-to-five years until a planned retirement may benefit from similar tests, but since they have more time, they have more flexibility to monitor ongoing market movements without making definitive plans. For them, buy-and-hold is a more acceptable default approach.

IS THE CURRENT PLAN SUSTAINABLE?

The Desired Spending Test helps you filter your book of clients to focus on the ones who need immediate, specific advice to address the market's impact on their retirement status. This test relies on more accessible data and so is the easiest to enter and process for larger numbers of clients. It also represents a tougher hurdle than the Minimum Spending test, which is explained later. The test:

- Assesses your clients' probability of meeting their retirement spending goals based on stated portfolio values and other income sources.
- Categorises an individual client or clients into one of the four zones—Red, Orange, Yellow or Green—based on their probability of success.
- Shows a comparative, sustainable spending level that achieves a Green status (defined as 80% probability of success). While not necessarily the target spending goal, it may help frame discussions with clients whose desired spending goals are significantly higher than this projected sustainable level.

Steps and inputs required for this test:

1. Client Information

Name

Age

Gender/Marital Status

Choices are Single Male, Single Female, and Married (each option has different mortality characteristics).

Retirement Status

Current Portfolio Value

Include liquid investable assets as well as any other assets they likely view as part of their available net worth. The inclusion of less liquid assets, such as home equity, depends on their attitude and overall financial status and your firm's policies about categorising these assets.

Income From Other Sources

Used to calculate the portfolio withdrawal amount required to meet the desired spending level (labelled the Desired Spending Gap). The more income from other sources, the less required from the portfolio.

Desired Spending Goal

The annual spending budget during retirement years, gross of tax. For the test, the portion of this drawn from the portfolio is modelled as an inflation-adjusted annual value.

- The Client Analyser is a simple spreadsheet which captures these inputs and applies them to Monte Carlo simulation calculations using Russell capital market forecasts.

2. Review Outputs

Probability of Success

Based on Monte Carlo simulations, this value shows the probability that your client can sustain his or her Desired Spending Goal during the remaining retirement horizon.

Red Zone

Less than 50% chance

Orange Zone

50% to 65% chance

Yellow Zone

65% to 80% chance

Green Zone

Greater than 80% chance

The colour coded labels associated with these percentage ranges are based on Russell's judgment of what constitutes probabilities of success ranging from prudent to imprudent. No matter how numerically-driven, any tool or process that applies qualitative labels to quantitative measures must ultimately do so using similar methods.

Sustainable Spending Level

Shows the maximum spending level that meets the Green Zone threshold (i.e., one that has 80% probability of success).

Match to Advice Profiles

Using retirement status and colour zone, you can match each client to one of the eight Advice Profiles. Each profile addresses the flexibility and recommended priority of the three main action levers available to retirement investors.

Income Lever

Choose to delay retirement or, once retired, resume full or part-time work depending on their funding status.

Spending Lever

Choose to reduce regular living expenses or to defer or eliminate one-time goals.

Investment Lever

Choose to increase or decrease risk in the investment portfolio.

For clients in trouble, the following Minimum Spending Test can provide additional information about how to manage their retirement income situation.

IS THERE A SAFETY NET?

While there's no secondary market for investors to purchase extra state or company pension income, there is a product with some similar characteristics: An immediate lifetime annuity. This is an insurance product that allows a person to obtain a guaranteed income for the remainder of their life. (Subject to the claims-paying capacity of the issuer, of course, a caveat which shouldn't be taken lightly in our current environment.)

Whether you love or hate them, immediate lifetime annuities contain a great deal of information embedded in their price. This price reflects both pooled investment risk and pooled mortality risk, the very things that are incredibly complicated to individually manage against in retirement.

For clients in poor condition based on the first test, a second test—the **Minimum Spending Test**—evaluates the viability of a minimum spending floor. If a client's desired spending plan doesn't appear to be sustainable, it may help to evaluate against a "worst case" scenario of an essential spending level guaranteed no matter how long the client lives.

This is different from the first test, which is more akin to a typical planning scenario. This second test considers a specific backstop scenario, but requires immediate annuity pricing data.

- Helps clients establish a base level minimum spending floor—an emergency backstop.

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- Evaluates a client's current portfolio value relative to the amount it would take to annuitise if the client needed to establish a guaranteed income floor for life.
 - Categorises clients in Red, Orange, Yellow or Green zones depending on the deficit or surplus of assets they have relative to the cost of funding this emergency backstop.

Steps and inputs required for this test:

1. Discuss and establish a Minimum Spending Floor with the Client

Talk with your client to develop an income level that represents a tolerable, even if less than ideal, essential spending floor. Remember, due to their critical condition as determined by the first step, this process focuses on a fallback position.

It may help to frame this using research that shows typical retirement spending levels ranging from 78% to 88% of pre-retirement income¹. Since this figure represents the typical lifestyle, you could use a lower amount, for example 65% to 75%, to suggest a plan for a more restricted lifestyle.

2. Determine Cost to Annuitise the Minimum Spending Gap

Using annuity pricing data² determine the cost of an immediate lifetime annuity based on the Minimum Spending Gap (i.e., the Minimum Spending Floor minus Income from Other Sources) and your client's characteristics which include:

- Age/Gender
- State of residence
- Single or Joint Payout

Note: Most immediate lifetime annuities aren't adjusted for inflation, so you should consider this when evaluating the results. If you can find information on an inflation-adjusted annuity, then the results of the two tests may be more directly comparable.

3. Review Outputs

Funding Ratio

Measures the relative surplus or deficit of assets compared to the cost to annuitise. The threshold values are set so that a favourable status requires a cushion of assets to account for possible portfolio losses or changing annuity prices that could alter the viability of securing an income floor.

Deficit / Red Zone

Less than 100% of required assets available

Small Surplus / Orange Zone

100% to 120% of required assets available

Moderate Surplus / Yellow Zone

120% to 140% of required assets available

Large Surplus / Green Zone

Greater than 140% of required assets available

As with the colour coded labels from the **Desired Spending Test**, the labels above are based on Russell's judgment of what constitutes funding ratios ranging from prudent to imprudent.

Use this additional information to provide additional context to the Advice Profile determined in the first step. Because these tests determine different spending levels—desired versus minimum—and have different methodologies, they are best used to complement each other.

WHAT'S BEHIND DOOR NUMBER TWO?

The point of this second test is not that every investor who's nervous about the future should annuitise. These products aren't for everyone. After all, while immediate lifetime annuities promise a lot of certainty, their certainty carries a cost — including losing control over assets.

For some retirees, this trade-off may be well worth the price. For the rest, doing the exercise can still give an idea of what a fallback position might look like. Think of it this way: if you're on a game show, and you know what's behind both doors, you'll be more confident about whichever door you choose. And you'll have fewer regrets after making your choice.

The focus here is not specifically on the question of whether to buy or not to buy an annuity, but rather on using the information embedded in the price to help shed more light on a complex situation.

WE'RE ALL THE SAME IN BEING UNIQUE

Now comes the hard part—deciding what these results mean for your clients. At the crux of retirement investment planning is balancing clients' liabilities (the magnitude and duration of their spending) with their assets (their investment portfolio or other assets that could be re-purposed to meet income needs).

The first step in applying this decision-making framework is to segment clients into one of the following categories:

More than three-to-five years until retirement

These clients have a longer investment horizon, and the most flexibility to affect the liability side by delaying retirement as necessary. A sound approach may be to stay the course, provided the current course is based on an appropriate plan. Remain invested, continue saving, and monitor the situation.

Less than three-to-five years until retirement

These clients may have less flexibility over deferring retirement, putting greater emphasis on trimming lifestyle or altering their asset allocation. Base decisions on the status determined by the Desired Spending Test:

Green

Client is likely on track, and can more confidently stay the course with the current plan.

Periodically monitor funding status based on changes to personal circumstances or market changes.

Yellow

Steps to suggest:

1. Delay retirement or consider working part-time.
2. Trim regular spending.
3. Plan to eliminate or delay large expenditures.

Regularly monitor funding status based on changes to client circumstances or market changes.

Orange

Steps to recommend:

1. Delay retirement.
2. Trim regular spending.
3. Plan to eliminate or delay large expenditures.

Closely monitor the impact of market changes and client circumstances and manage expectations about the client's retirement date.

Red

This unfortunate outcome may help serve as a wake-up call to clients willing and able to make drastic changes to their retirement plans.

Steps to *strongly* recommend:

1. Delay retirement as long as possible.
2. When full-time work is no longer possible, plan to work part-time.
3. Plan to significantly reduce spending goals.
4. If any of the above levers are not available, you may consider annuitising* some or all of anticipated income need to lock in a guaranteed income.

Closely monitor the impact of market changes and client circumstances and manage expectations about the client's retirement date.

* With respect to annuitising, consider that this decision is irreversible. If markets take a long time to recover, a decision to annuitise may prove ideal. If markets recover relatively rapidly, annuitising beforehand may produce much lower income than the client could have gained by delaying this decision. Carefully evaluate the benefits and advantages of annuitising with respect to the client's risk tolerance and market potential.

Annuity rates and interest rates, which are a key factor in annuity pricing, change daily. The younger the client, the more interest rate changes affect annuity prices. (This is similar to how interest rates and duration affect a bond's price.)

IN RETIREMENT

Unless the client can go back to work part-time or full-time, the emphasis will be on lifestyle reduction or their asset allocation if resuming full-time or part-time work isn't an option. Base decisions on the status determined by the tests:

Green

Client is likely in a solid financial position and can maintain the current plan with greater confidence.

Periodically monitor funding status based on changes to their circumstances or market changes.

Yellow

Steps to suggest:

1. Reduce regular spending.
2. Eliminate or delay large expenditures.
3. Work part-time to reduce reliance on investments.
4. Consider a more conservative asset allocation in the early retirement phase to reduce risk of future shortfall.
5. If client has little flexibility to work longer or adjust spending, consider annuitising* a portion of anticipated income need to reduce risk of future shortfall.

Closely monitor funding status based on changes to client circumstances or market changes.

Orange

Steps to recommend:

1. Reduce regular spending.
2. Eliminate large expenditures.
3. Return to work full- or part-time to reduce reliance on investments.
4. For the more risk averse, consider annuitising* some or all of anticipated income need to lock in a guaranteed income.

Closely monitor the impact of market changes and client circumstances.

Red

This unfortunate outcome may help serve as a wake-up call to clients willing and able to make drastic changes to their retirement plans.

Steps to strongly recommend:

1. Return to work full-time or part-time to reduce reliance on investments.
2. Reduce regular spending to essentials only.
3. Eliminate large expenditures.
4. Consider annuitising* some or all essentials income. Client has reduced ability to withstand market risk.

Closely monitor the impact of market changes and client circumstances - specifically the effect of additional income if they re-enter the workforce.

Good advice should consider your clients' circumstances and preferences, your analysis, and your ability to communicate and help manage the resulting tradeoffs.

As a financial professional in times like these, your ability to help clients navigate these troubled waters is more valuable and more necessary than it has ever been.

Footnotes

1 See the 2008 Replacement Ratio Study by Aon Consulting.

2 You can access publicly available quotes for annuities by using an Internet search engine to search for "index linked annuities." It is essential the quotes you receive are index (inflation) linked.

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