Time to Ditch the Three-Legged Stool Analogy for Retirement and Replace it with a Two Pictures Analogy: a Mailbox and a Piggy Bank

By Barry Kozak

At a very basic level, financing retirement is not much different than financing life. Strip away all of the verbiage we retirement professionals insert into the conversation, and it truly simplifies to a predictable stream of income and the spend down of the individual’s retirement nest-egg. Regardless of other motives that we each bring to the table, if the goal is to educate as many people as possible about preparing for and then paying for retirement, then public policy should dictate we replace the proverbial “three-legged stool of retirement,” which might have suited us well for eighty years, with a down and dirty question: “what income source in retirement will replace your salary while working.”

Under this approach, the client, who is presumably still working and starting to think about retirement, is asked this question: “right now, your salary dictates your lifestyle, so when you stop working and retire, how much guaranteed income will you need to maintain your lifestyle?” To this author, this is the only logical starting point. Individuals, regardless of socioeconomic status or educational level, should understand this conversation, and if they start to realize that they will not have enough income, and not enough savings to purchase additional layers of income, then they basically have two choices: continue working later than planned, or downsize expectations of lifestyle. If we are actually having a live conversation with Baby Boomer clients, and advising and counselling them, then this would be the appropriate time to quote Messrs. Richards and Jagger – “You can't always get what you want, But if you try sometimes, well you just might find, You get what you need.” Once an individual figures out ways to ensure a proper stream on income during retirement, then every other asset owned by that individual will simply, by default, be called his or her “nest-egg,” which will be liquidated to cover unbudgeted and non-recurring expenses, and any balance will be their legacy to family, friends, and charities.

So, after understanding salary-replacement, possibly without ever hearing the word “annuity,” now individuals can begin to envision some of the recurring retirement expenses for which they can draft a budget. They will soon realize that expenses during retirement might be less than expenses while working, which justifies the historical emphasis by actuaries on pension replacement rates and the coordination with Social Security benefits, but they will realize that they will need in the range of 75% to 90% of their current net take home pay. Again, a great starting point because they are not passively listening to financial planners and attorneys talking over them, but are actively engaged in a conversation that they fully understand.

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Most of the following costs are controllable, and can be reduced to appropriate levels with proper planning and time horizons. However, since out-of-pocket health care costs of Medicare, other than fixed monthly premiums and annual deductibles, are usually uncontrollable, they should be paid from the “nest-egg,” and not budgeted from the income stream. Typical expenses to consider (whether monthly, quarterly, biannually, or annually) include:

- For each home (primary, secondary, or vacation)—mortgage or rental payments, property taxes, utilities, cable and phone bills, homeowners insurance, community assessment dues, alarm systems, landscaping and cleaning services, and, other planned and expected maintenance costs;
- Federal and income taxes;
- State and local income taxes, sales taxes, renewal and licensing fees, and other required remittances;
- Credit card and other personal debt obligation payments;
- Automobile—maintenance and tune ups, insurance, and fees for parking passes, city stickers, and disability vehicle placards;
- Insurance premiums—life insurance, long-term care insurance, homeowners or rental insurance, and health insurance;
- Food, clothing, and general personal upkeep; and
- All other discretionary expenses that can be budgeted ahead of time – vacations, hobbies, gifts, charitable contributions, dues for clubs and other organizations, securing professional services such as house keepers, barbers, attorneys and accountants, and general entertainment.

Here is where the individual who is planning for retirement should think of an image of a mailbox. A statement like “every month you are still alive, go to your mailbox and there will be a number of checks from different sources that, in the aggregate, will cover that month’s budgeted expenses.” Once this information is absorbed, then we can add the complications of cost of living, joint life protection, and all other risks that we, as professionals, can help our clients to mitigate.

All other expenses that are unique, unbudgetable, unpredictable, or, dare we say, unnecessary, should be paid from the spend-down of the nest-egg. This means that as long as the income stream is ample to pay all of the above budgetable expenses, there should be no strategy for the strategic liquidation of the nest egg (such as the 4% per year rule); rather, it should simply be ad hoc distributions as needed. Typical expenses to consider (whether periodic, random, or contingent upon other events) include:

- Unexpected medical emergencies and other out-of-pocket health care expenses;
- retrofitting expenses in the home due to a disability and moving expenses if the current home cannot be retrofitted;
- assistance to a family member who is out of work, has a new baby, gets married, moves, goes to college, or other pleasant or emergency needs; and
- large donations to charities or for funding of a legacy.

As can be seen from this short list, the spend-down of the endowment could, and should, be used for some happy, pleasurable, and positive expenses that were not budgeted, as well as expenses associated with emergencies. Here is where the individual who is planning for retirement should think of an image of a piggy bank. A statement like “every time you need extra money, dip into
the piggy bank; however, every dollar remaining at your death will be your legacy passed along to your family, friends and charities.”

Okay, so now the individual planning for retirement sees that the most important aspect of retirement is the fixed income portion, and can develop a realistic budget, then we, as counselors and advisors, can explain sources of income, and if that is not enough, then the priority of nest-egg assets that should be converted into some form of income in advance of retirement. Most individuals are entitled to an annuity in the form of Old Age benefits or Survivor benefits from Social Security, and although the monthly benefit depends on his or her compensation history and the number of quarters payroll taxes were contributed, each individual can choose a larger (actuarially equivalent, but don’t use those words in front of your client) dollar amount by postponing the starting date. As to the employer retirement plans, if they have accrued benefits in a defined benefit plan, then a discussion about opting for an annuity in lieu of a lump sum is very appropriate; or, if they have an account in a defined contribution plan, then a discussion of taking the lump sum and converting it into an annuity stream (especially if the plan sponsor has adopted a Qualified Longevity Annuity Contract option) is very appropriate. Other general sources of annuities or income streams in retirement include (this is not an exhaustive list): annuities and similar financial products from private insurance companies; corporate or municipal bonds that pay interest at specific points in time for a stated term; stocks that pay cash dividends; rental income; royalties; alimony and other family support payments; installment payments from damages awarded through lawsuits or settlements; sales of personal assets or businesses through an installment sale; certain long term care insurance policies that provide monthly income to cover costs for assistance with Activities of Daily Living; financial assistance from a governmental welfare program (Supplemental Security Income, Medicaid being called upon to pay the out-of-pocket costs associated with Medicare, Supplemental Nutrition Assistance Program, housing support, … ); reverse mortgages with an income stream; and, grantor trusts with an income stream (including charitable trusts).

This part of the conversation can end with a discussion of all other property owned by the individual that, by default, is part of the nest-egg. A lump sum distribution from an employer-sponsored retirement plan can be rolled over into an IRA or deposited into some other form of savings or investment account (but the client must, at this point, also be taught about income tax issues with distributions, and instructed on Required Minimum Distributions, which can upset any planned decumulation and spend-down phase). Other general sources of discretionary income in retirement include (this is not an exhaustive list): withdrawals from bank accounts or investment accounts (but there might be fees for trades and premature liquidation); reverse mortgages or home equity loans that provide withdrawals as needed or a source of credit; grantor trusts with a discretionary distribution option; monetary awards from litigation; gambling winnings; the sale of property, a business, or other personal assets; the return of principal after the term of a corporate or municipal bond has expired; distributions from previously-established Health Savings Accounts; financial gifts and support from family and friends; financial gifts and support from charities, societies, or other organizations; and, loans from, or viatical agreements against, life insurance policies.

So, with a building block approach to education, the individual planning for retirement first envisions a mailbox, thinks about how fixed income during retirement will be the direct
substitute for compensation while working, develops a budget with expected fixed living expenses, compares the realistic income stream with the expected budget, and then determines if there will be enough checks in the mailbox to pay his or her bills – if there are, great, but if not, then he or she needs to determine if there are any assets within the nest-egg that can be converted into the missing part of the required income stream, or if he or she realistically can continue working beyond the anticipated retirement age, or if he or she must now make plans to downsize the expected lifestyle in retirement to match the actual income stream.

Now, let’s determine which actors should be providing this education and information about financial literacy and planning for retirement. Public policy suggests that Congress should enact a law that requires a joint publication prepared and updated annually by the various federal agencies that can provide basic information about retirement, ageing, end-of-life, estate and legacy issues, and links to their respective websites with more comprehensive information. Those agencies would likely be the Departments of Labor, Treasury, Health and Human Services, Housing and Urban Development, and Veterans Affairs, and other tangential agencies, like Commerce, Transportation, Energy, and even Homeland Security (for immigration or expatriot issues), and obviously some doctrinal input by the Department of Education. This will be the default notice that addresses the most common risks in retirement (why not suggest that they start with the Society of Actuary’s report and subsequent publications on this subject). Such educational materials will ultimately be distributed to employers through the Department of Labor, so that all members of the workforce will receive it.

This basic publication will be very generic, will provide the education discussed above, and will provide a more detailed summary of the various federal government programs generally geared towards retirees and older persons: Old Age, Survivor and Disability benefits that will be paid from Social Security, and a basic education on timing choices; medical care costs that will be covered under the 4 parts of Medicare, and the associated out-of-pocket costs (most individuals have no idea that the portion of payroll taxes diverted to Medicare only cover the premiums for Part A, and that the individual must then either pay all other premiums, deductibles, and co-pays out-of-pocket, or if indigent, then welfare, in the form of Medicaid, can be applied for to pay those other costs); a general discussion of long-term care, how it differs from medical care, and realistic costs for Nursing Homes and in-home care; and aid and attendance benefits available for Veterans with a disability. This new law, if enacted by Congress, can require the DOL to develop an additional model notice for employers that sponsor retirement plans, which can combine various communications already under their jurisdiction, such as a hypothetical disclosure of relative values, even in a defined contribution plan, whether or not it provides for any conversions to annuities (like a Qualified Longevity Annuity Contract), and the IRC §402(f) Notice (yes, which is under Treasury’s jurisdiction) so that individuals understand income tax issues well in advance of actual decisions, and the receipt of communications about their actual retirement benefits.

Then, for employers who want to provide additional education as an employee benefit Congress gave us a fringe benefit in EGTRRA 2001 called “qualified retirement planning services.” All we know from the statute is that employers who maintain a qualified plan can provide such education to their employees and their spouses, as long as the advice is available to non-highly compensated employees on a non-discriminatory manner. Since there is scant guidance under
IRC §§ 132(a)(7) and 132(m) about what constitutes qualified retirement planning services, it is up to employee benefit plan consultants, together with other disciplines, such as social workers, dementia-care nurses, geriatric doctors, in-home medical and long-term care providers, grief counselors, funeral planners, estate planning attorneys, financial services professionals, speech therapists, and all other professional disciplines that educate, support, and advocate for people as they retire and age, to collectively develop the landscape of qualified retirement planning services.

So, this article suggests that we, in the industry, complicate the retirement planning discussion, and then wonder why individuals have the glazed-eye look. Individuals of all socioeconomic and educational levels understand that while working, the paycheck covers monthly bills, and all other assets (whether cash in the bank, a line of credit, or the sale of grandma’s engagement ring) can be used to cover emergency expenses. Bankruptcy is the option when all else fail. Similarly, in retirement, the aggregate income stream replaces the paycheck to cover monthly bills, and the nest-egg is spent-down to cover all emergency expenses. Welfare and other specific programs specifically for the elderly, is the option when all else fails. Congress should enact a law that requires that model educational materials be prepared with input of all relevant federal agencies, and then employers who want to provide a higher level of financial wellness, should embrace those employee benefits professionals who provide “qualified retirement planning services” as a fringe benefit.