Tips on Handling Today's Retirement Challenges

By Jason Stipp | 7-11-2012

Jason Stipp: I am Jason Stipp for Morningstar. Retirement and challenge are two words that shouldn't have to go together, but unfortunately for today's pre-retirees and retirees the pairing is very common. We checked in with Katherine Roy at J.P. Morgan Asset Management's recent investor conference here in Chicago to learn a little bit about the behavioral decisions that people make about Social Security as well as the very difficult inflation environment for retirees and also the realities about working longer.

Katherine, Social Security is a centerpiece for a lot of folks in their retirement planning, but it's also something that you need to formulate a strategy for. What are some of the ways that investors can maximize their Social Security payout, and what are some of the pitfalls that they may encounter as they're planning how they want to take Social Security?

Katherine Roy: We think it's really important that people understand the basics of Social Security and the fact that the Social Security Administration will give you an 8% increase for every year you wait to claim. And so for example, today a 62-year-old in 2012 is eligible for roughly $1,800 a month if they claim at age 62. If they wait until age 66, because of that 8% plus cost-of-living increase, but if you just take the 8%, they would be eligible for about $2,500 per month, which is a pretty sizeable increase. If they wait until 70, it goes up as high as a little north of $4,000 a month, but clearly there is the cost of waiting. So having other sources of income is really important if you're able to wait and are interested in waiting longer.

I think what we find interesting is research that looks at how people actually claim and what, as an advisor, people might be seeing or from what they get from the Social Security Administration in terms of their statement. The way in which the people's benefits are presented to them might not be optimal in terms of how they actually translate that information. For example, there has been a body of research that was done by [Wharton School professor] Olivia Mitchell that focuses on testing simply anchoring people differently. So, if you started instead of kind of as I walked you through 62, 66, or 70 starting and saying as an individual at age 70, you are eligible for $4,000 and then walking back to the 66 and 62, people are more open to waiting and looking at other alternatives.

Likewise, if you position again the 8% increase as an investment gain or you understand that's a gain in the amount that you're going to receive versus claiming earlier as a loss of income or investment loss, people are just much more open, and it creates somewhat of a neutral playing field. What we do see is that in actual behavior, people are claiming early, so majority of Americans do claim as early as possible, and as we work with financial advisors, we clearly see that there is an emotional trade-off in terms of mathematically we can do our best to help people understand that if they have longevity in their family, waiting and having the maximum benefit they could receive will help them get the most they can out of Social Security. But in reality lots of times, individuals are just very nervous about tapping their portfolios, and turning on that benefit from the government is just emotionally an easier thing to do.

I think the other thing we hear is that people want to make most of their retirement, and they don't necessarily want to have more money later, particularly at different affluence levels. So, it is an emotional, as well as a mathematical question. So the more you can think about it in a neutral frame, have the right current behavioral-finance techniques to understand what the benefit is, and make the right choice for you, is the most important thing.

Stipp: One thing that's certain is an 8% gain that's an actual gain that you can expect to have. It's not something that you're getting anywhere else in the market at least in this current environment.

Roy: Particularly over an eight-year period. It's a sizeable amount, yes.

Stipp: A second issue that a lot of retirees are facing is the need to work longer because they haven't saved enough or maybe they just want to be in the workplace longer than the normal retirement age. What trends are you seeing there, and given that more folks in that age range may need to work longer, what are their prospects for finding the kind of employment that they might need or want?

Roy: We definitely have seen a trend over time. The baby boomer of population that just turned 65, the first one at the beginning of last year, they see work as a fundamental component of their retirement plans. And when you ask them why, lots of time it is needs-based but overwhelmingly the majority of respondents say, "I enjoy what I do. I want to remain active and intellectually engaged, and it's my social network." For a lot of boomers, that's how they engage with people. So work is increasingly something that people that people want to do. We see the largest growth in the labor force, looking at 65 to 74, basically over the next 20 years.

[There's] tremendous growth, and so the byproduct of that is a tremendous amount of retirement income, or offsetting and delaying the need to tap your portfolio to meet your retirement, is a benefit. But we always recommend that someone have a backup plan because we see when you compare and contrast current workers' expectations, the majority will say, 70% will say, I want to work beyond 65, but when you look at the experience of actual retirees, it's actually the reverse. Really only about 20% or 30% of individuals, I guess about 28% of individuals, were actually able to work beyond the age of 65, and that's driven by a number of factors: Health costs, or health issues and disability, often are unpredictable and drive people out of the workforce early.

The other trends that we see particularly with women is in the sandwich generation, they are responsible for often providing care, so two thirds of all private-care-giving arrangements are done by women over the age of 50. So, oftentimes, they take a step back. They leave the workforce earlier, or they do different work-life balances in order to do that care-giving. That can be a significant derailer for their retirement plans, particularly given the longevity they experience.

So, we think it's really important; it's great to have work be a part of what you want to do. It can be a fabulous source of income for retirement. But you always have to have that backup plan.

Stipp: The earnings potential of your portfolio is obviously a key part of your retirement plan, but also your spending. How much you're going to be drawing down on your assets and relying on Social Security are important parts of your plan, as well. When you think about how much you might spend in retirement, there's the 80% rule, 80% replacement of your pre-retired income that a lot of folks think about. Is that a realistic rule, and what swing factors should you consider as you are making your spending plan for retirement?

Roy: We think that's an excellent question. I think we would say that, if you're in a savings mode, if you're in accumulation mode, you really should be targeting 100% of your aftertax, aftersavings value. It's really what you're spending today if you want to maintain your current lifestyle. So helping people understand what their lifestyle is. Most people don't have a good grasp on what they spend, but [we

really want to help them factor] in and save for 100% of income replacement because you're seeing retirement being a very different world than what our parents or grandparents might have experienced.

One example is, 10 years ago, only 20% of people turning the age of 65 or retiring, carried a mortgage into retirement. Now, we're seeing that at about 33%. So, this reduction in the amount of income you need because you don't have a mortgage is increasingly not something that's a reality for people in retirement, so it's something to factor in.

So, with that said, I think what we're seeing is that for retirement, it really is a phase and has multiple phases of time within it. So, rules of thumb are great in terms of creating a target to aspire to and to drive behavior today, but when we work with financial advisors and clients, we see most advisors indicating that clients are spending more in the first several years post retirement than they were spending before, so even more than a 100% in those first few years. It's not something that's sustained all the way through retirement, it's when they have the luxury of time, and they are doing a lot of activities they've always wanted to do. Travel goes up quite a bit. And then you see natural decline in spending over time. Simply, you're just not consuming as much.

A lot of the data suggests actually that Americans' consumption spikes or peaks between the ages of 40 and 50. Then we gradually decline with one major category, health care, being the one cost that is growing over that period of time. So if people are naturally spending less over time in retirement, it makes sense, and then we do see a spike up at the end relative to health-care costs, gifting and those types of strategies happen later in retirement. So having a well-thought-out spending plan just as much as you have a well-thought-out savings plan we think is really important.

Stipp: We discussed spending and how those patterns may change. Another thing that folks in retirement or approaching retirement need to factor in is inflation and how their inflation might actually change depending on what they're spending money on. How do you counsel advisors in thinking about factoring inflation into the retirement plan and how much things will cost based on what retirees spend on?

Roy: I think it's really important. We do a great job I think overall tracking the inflation course and headline inflation and understanding on a macro-environment perspective what's happening. But it's really important to look at the basket of goods that older people buy versus younger, and the allocation of spending is on higher-inflating categories on which people who are aged 65 or older are spending.

So, a primary example is that about 15% of expenses for today's 65-year-olds are related to health care, and we know that health care is the fastest-inflating category bar none. So, it's inflating at about 5.3% range, and that's simply to maintain the health-care costs we have today. If you have increased need for health care, we see that inflation rate more in the 7% to 8%, so really it's the high inflation in terms of the spending that individuals are doing.

We also candidly see a high amount of spending for older individuals still on housing and those costs are also going up in terms of care, maintenance, real estate taxes, those types of things.

So, it's really important as you think about building your spending plan and your retirement, with the inflation rate that you use to save in your analysis to figure how much you need to save, you probably want to up that to reflect the fact that you are going to be probably subject to higher overall inflation based upon how you're spending money. But more importantly, I think working with an advisor and

really delving in and making clear that health care is a line item in your plan and it's inflating at the right rate, can go a long way to making sure you're on track.

Stipp: Katherine, success in a financial plan often depends on doing certain things right, but it also means avoiding mistakes, avoiding the pitfalls, and not doing the things wrong that can cause you pain as an investor. If you had to say some of the biggest pitfalls that you see retirees falling into in today's environment, what are some of the top ones, and what can they do to avoid those?

Roy: I think some of the biggest pitfalls are not having a clear vision of what your spending needs are and using rules of thumb or using high-level estimates to try to get to what your reality is going to be. I think the surprising research that we see is around many individuals or people who have retired who would say, "You know what, I wish I could have spend more time thinking about how I was going to spend my time and what I wanted to be doing rather than on the numbers, right and making sure I was saving and doing everything I could." Both are clearly important, but I think where we get concerned is when people get into retirement, having had a well-thought-out plan and investment strategy and finally, they want to do something completely different but that is not what they had it cracked up to be. I think also not having that backup plan [is a pitfall].

So not doing and stress-testing your plan enough around, "What if I'm not able to work, what if we have another market shock, what if inflation rates do go higher, what if interest rates go up tremendously? Is my plan going to be on track given all those different environments?" I think particularly spouses working together and understanding what those ups and downs are and particularly [working] with an advisor can really give you the confidence that you are on track for retirement that you're envisioning.

Stipp: What about longevity? Do you see that folks in retirement are expecting a shorter period in retirement than you're actually getting when you move into retirement, that it could be 25- or a 30-year process?

Roy: It always surprises me. As optimistic as a culture we are, Americans are fairly horrific at underestimating how long they are going to live, and there are a lot of great studies that have gone out and studied. There is a behavioral element on how long you're going to live, but a major driver is your genetics. So, the most basic question you could ask is, "Did I have a mother, father, grandfather, grandmother, aunt, or uncle that lived beyond the age of 90 by themselves?" If that's the case, then you have longevity in your family. It's likely you're going to live a significant amount of time beyond 90. Having a realistic and personalized view of what your likelihood is, is really important, and we do see people continue to underestimate just how long retirement can be.

Stipp: Katherine Roy, great insights on retirement. Thanks for joining us today.

Roy: Thank you for having me.