Phrases that should be banished from retirement planning

Michael Kitces | Pinnacle Advisory Group | 27 October 2014

As the research into behavioral finance has shown, the words we use and how concepts are framed can have a powerful impact on how we see the world and consider the opportunities that may lie before us. A strategy can go from being appealing to terrifying (or vice versa!) based solely on how it's explained. And, in the context of retirement, there are a lot of words and phrases that may unintentionally be hampering our efforts to have a productive planning conversation. For instance, with the rise of Monte Carlo analysis, it's become increasingly popular to talk about the probability of success, leading retirees to naturally want to minimise the probability of failure as much as possible, given the catastrophe that implies. Yet the reality is that for most retirees, a "failure" doesn't just mean running off the retirement spending cliff, but instead a gradual spend down of assets that necessitates adjustments along the way to get back on track. So what happens if "probability of failure" is reimagined as a "probability of adjustment" instead, to reflect what actually happens in the real world? All the sudden it doesn't seem so bad; it simply raises the question of how much of an adjustment will be necessary, and when or under what conditions.

Similarly, the focus of generating retirement spending from retirement "income" creates other unnatural distortions, as retirees potentially stretch for income (especially in low-yield environments!) and introduce new risks, not to mention possibly confusing-yet-appealing-sounding retirement "income" products that are actually just returning principal and not income at all. If we talk about retirement "cash flows" instead, and move away from an income-centric conversation, it opens the door to looking more holistically at the retirement portfolio and how it can support retirement spending.

But, perhaps the most crucial change in our language of retirement planning is simply to rename "retirement" itself. After all, when the concept of "retirement" was originally created, it wasn't really meant to be an entire multi-decade phase of life without work. In fact, recent research has found that, for many retirees, stripping away work can leave them devoid of purpose altogether, actually reducing happiness and well-being. Of course, that doesn't necessarily mean "retirees" want to do their current job. It simply means they may want to choose work that is independent of the financial compensation it provides. So maybe it's time to rename the goal of retirement planning altogether, and to recognise that "financial independence" from the need to work for money is the real goal of saving and investing?

FROM MONTE CARLO "PROBABILITY OF FAILURE" TO "PROBABILITY OF ADJUSTMENT"

Over the past 15 years, retirement planning has shifted away from simple projecting returns in a straight line of growth, to using Monte Carlo analyses to evaluate a large number of "random" retirement scenarios and then quantify the frequency that the outcomes are favorable or not. If 10,000 Monte Carlo trials lead to 9,000 outcomes where there is something left at the end, and 1,000 scenarios where the assets come up short, the plan is said to have a 10% "probability of failure".

Yet, the challenge is that "probability of failure" conjures up rather harsh images of retirement outcomes. Its implication is that those retirement scenarios were paths to destitution, where people might be unable to provide for their basic retirement needs, be evicted from their retirement homes, or be unable to afford their own basic medical care. Such outcomes are justifiably scary. If you ask someone "what risk of failure are you comfortable accepting" most rational human beings will answer "0%, or as close to it as we can get!" In fact, our brains confuse the risk of the event with the intensity of the possible outcome. As a result, the harsher the image of "failure" in their minds, the more likely it is the client will be unwilling to accept any probability of it occurring.

Yet in the real world, most people don't actually go from enjoying their normal spending to abject retirement plan destitution in a single step, where they continue their full retirement lifestyle right up until the day they wake up and find out all their payments are bouncing because there's absolutely nothing left. Unless there's a sudden and extreme financial loss in an investment, in practice, most people will deplete their retirement assets more slowly over time. Portfolio balances get lower and lower, the ongoing withdrawals become a larger and larger share of the total account balance, and it becomes clear that eventually this is going to be a problem and that something must be done.

The implicit "advance warning" that comes with even the most basic monitoring, though, means that retirement plans don't have to result in total (and sudden) failure. Instead, they force a change. If the change comes early enough, it may not even take much to necessarily to get back on track. If the change comes later, and the situation has become more severe along the way, the requisite adjustment is larger. But nonetheless, the reality is that what a probability of "failure" really describes, for most people, the probability that they will need to make an adjustment to get back on track again to avoid failure.

Yet if that's the reality, consider what happens if we actually call it a "probability of adjustment", instead of a "probability of failure". When we frame the outcomes as failures, the natural response from clients is to think up terrible images of what failure might look like, and then seek to avoid it at all costs. But when we frame the outcomes as adjustments, it leads to very different – and much more productive – conversations instead. Such as "How big would the adjustment be? When would I have to make the adjustment? How will I know when it's time to adjust?"

In other words, framing probability of failure rates as "likelihood of [needing] adjustment" instead changes the context of the conversation. When we say you have a 10% probability of failure, it conjures up a 1-in-10 chance of catastrophe. When we have a 10% probability of adjustment, and then explain the adjustment might simply be "you'll need to sell your vacation home" or "you'll need to tap your home equity with a reverse mortgage" or "you'll need to cut your spending by 15% to get back on track" it's far less scary. It goes from a chance of catastrophe to a chance of simply executing a plan for adjusting to get back on track.

And, notably, it's not just the probability of failure that's misnamed. It's also the probability of success, which is more like a probability of excess. It's the likelihood of having excess money left over and, sadly, makes no distinction about how much will be left over. A Monte Carlo analysis in traditional retirement planning software treats having $1 left over the same as $1 million and the same as $10 million – they're all "successes" – yet clients would react to this very differently. When you call it a probability of excess it again raises the question "how much of an excess are we talking about?" and a more productive conversation.

FROM "INCOME" TO "CASH FLOWS"

When a prospective retiree decides it's time to stop generating income from employment, the natural alternative is to replace it with "income" from retirement assets instead. That's arguably the whole point of saving for retirement in the first place – to accumulate enough assets that you can support your ongoing expenses from the income generated by those assets, rather than the income generated by your labor.

Yet the caveat is that, ultimately, the goal for most retirees is not merely to spend income from their assets for the rest of retirement, for the simple reason that doing so actually leaves a huge amount of retirement spending on the table – the assets themselves, or underlying principal, that will get passed on to the heirs when it could have been spent by the retiree. In other words, for those who don't specifically have a goal to leave a large inheritance to their children, a charity, or some other beneficiary, the real goal in retirement is not merely to generate "income" but to create a series of retirement "cash flows" that will allow them to spend down throughout retirement the wealth that was accumulated in the years leading up to it – the income and, ultimately, the principal, too. Obviously, the retiree will want to be cautious not to deplete that principal too soon, for fear of running out and failing the retirement goal. But never touching principal at all, and leaving a huge inheritance on the table, may be "failing" the retirement goal, too – or at least, significantly underutilising the available retirement assets.

Another problem with tying a retiree's spending goals directly to portfolio income is that the income itself can be highly volatile. For a retiree that spends only the actual income in the form of interest and dividends, the past decade has resulted in a brutal spending cut, as the decline in interest and dividend rates has drastically curtailed available income, leaving retirees between a rock (spending far less than desired or anticipated) and a hard place (taking more risk in search of yield and the danger that things will get even worse). And, of course, focusing solely on traditional "income" payments like interest and dividends ignores the rather material role that capital gains can play as well, given the non-trivial amount of equities that are often held in retirement portfolios.

The challenge of focusing only on "income" has been even further exacerbated in recent years, as many products have dubbed their payments/distributions as "income" when they are actually a combination of income/growth and a return of principal - the comparison of traditional income payments to these kinds of "income" vehicles is apples to oranges.

So what's the alternative? To clarify the situation and slow down the confusion, perhaps it's time to stop calling it retirement "income" and to call the payments what they really are - retirement cash flows that will fund retirement spending. The distinction of focusing on what are truly retirement cash flows to be spent is that it avoids all the confusion around what really is income, what income is actually a blend of income and principal, and what income is really nothing more than spending principal.

When focusing on generating retirement cash flows, it becomes clearer that the cash flows don't have to be traditional income payments at all. It could be from interest and dividends, but it could also be from capital gains, or a liquidation of principal (at least as years advance and retirement assets can be safely spent down). Notably, payments from pensions are themselves also self-liquidating assets that combine principal and income, and would be better dubbed as cash flows than income.

The bottom line: when we talk about retirement "income", we focus retirees on the often-flawed assumptions about what constitutes income, and the danger than the income term will be misused, misconstrued, or misapplied. With a focus on retirement cash flows, it's easier to talk about all the different ways those cash flows can be generated (which might include income payments as one methodology), and retirees can more effectively evaluate what is a sustainable cash flow to withdraw on an ongoing basis.

FROM "RETIREMENT" TO "FINANCIAL INDEPENDENCE"

Perhaps the greatest challenge in the words we use in retirement planning, though, is the label "retirement" itself. For virtually all of its history, retirement has been synonymous with "not working". Whether it’s the traditional view of retirement - a life of leisure, with lots of golf and vacation and walks on the beach near lighthouses - or the actual historical context where it was a mechanism to "force" people out of job they were no longer competent at and capable of doing (typically manual labor), retirement has always been about the end of work. Arguably, one of the primary purposes of social security programs in the early years was essentially just to soften the blow of forced retirement for those who were too old to work in traditional job... at a point where they weren't actually expected to live very long in retirement, either.

The caveat, as a growing base of research is finding, is that a total cessation of work and trying to live of life of leisure does not actually create the happiness we might have expected. To some extent, this appears to be one of the downsides of our adaptability as human beings - leisure as an occasional break from work is appealing, but a full-time life of leisure can become boring once the novelty wears off. For others, the problem is not simply that the leisure life feels less rewarding over time, but because being productively engaged in work actually brings about the meaning and purpose in life that fuels our positive well-being (not to mention that for many, our work environment is also a source of interaction with others that fuels our social well-being, too).

For many retirees, this phenomenon is leading to the rise of part-time work in retirement - a confusing and implicitly self-contradictory concept for many. It's driving others to adopt an entirely new encore career. The primary distinction for most of these post-retirement jobs is that the purpose of the "work" is not for money and income. The purpose of the work is for purpose in life, whether that's about engaging in meaningful work, leaving a legacy, impacting the world, or simply maintaining social ties.

The challenge is that for so many retirees, what started out as a phenomenon to get older workers out of the way and into what would be a relative short retirement transition has now become an entire phase of life unto itself. And because "retirement" (and its non-work connotations) has been put forth as the ultimately goal at the end of a working career, retirees often transition into a full non-working retirement and then find themselves unhappy and unfilled after a few months or years. Perhaps it's time to rename retirement.

What's the alternative? Consider recharacterising "retirement" as "financial independence". The point of financial independence is simply to recognise that, once sufficient assets are accumulated, the decision about whether, where, and how much to work, can be made independent of the financial ramifications of the work itself. In other words, being financially independent is about being independent from the need to work, which then opens the door to more productive conversations about whether we want to work, and what meaningful work might be. For many prospective retirees, the whole conversation of "what would you do, work or otherwise, if money was no object" can be a remarkably freeing conversation, and lead to entirely new and productive avenues to explore.

Reframing retirement as financial independence goes beyond just what one will do in that "retirement" phase. It also changes the context of the retirement goal, where the target instead is simply to reach that point of financial independence, and to recognise that the accumulation of assets is just part of the transition of replacing income-from-work with cash-flows-from-assets instead. The approach allows for a much more productive transition into partial retirement as well. After all, for many people, their financial independence job might actually still be a job that does generate some income, which means the transition point to financial independence may be far closer than what it takes to fully retire instead. Or, viewed another way - for many, their "Findependence Day" may be much more achievable than a full-on retirement, in addition to being more personally satisfying and conducive to well-being.

But, it's not possible to plan for financial independence until it's identified as an option in the first place. So, the next time you're talking about "retirement", think about "financial independence" instead and see where the conversation goes.

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