FREDERICK VETTESE

THE ESSENTIAL RETIREMENT GUIDE

A Contrarian's Perspective

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To Michelle

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Preface

> The grasshopper watches the ant working diligently all summer long, making a home and gathering food for the winter. Thinking the ant a fool, the grasshopper spends his summer days playing in the sun and consuming whatever food comes his way. When winter arrives, the ant is cosy and well-stocked in the shelter she has constructed while the ill-prepared grasshopper starves in the cold.
>
> ***Aesop's fable of the Ant and the Grasshopper***

A recent study by the Employee Benefit Research Institute (EBRI) reports that 20.6 percent of Americans who died at age 85 or older had no housing assets at the time of death and 12.2 percent had no assets at all. Corresponding percentages for Canada are not available but would probably be comparable.

It seems there are two ways to spin these data. The obvious conclusion is that the 20.6 percent group or the 12.2 percent group were classic Aesopian grasshoppers who failed to prepare adequately for retirement and received their comeuppance at the end of their lives. If this is the spin I thought you should put on it, this would be yet another retirement book exhorting you to save more.

There is another way to interpret the same facts. Given that fewer than 70 percent of Americans or Canadians own their home, it is remarkable that only 20.6 percent had no housing assets when they died. Some would have been too poor to own a home and would have been lifelong renters; there is no shame in that. Others, in King Lear fashion, would have given up their home to their grown-up children years earlier. Finally, some would have sold off their home to finance long-term care in their declining years. And yet nearly 80 percent *had* housing assets at the time of death. Equally amazing is that nearly 88 percent of all persons dying after age 85 had not exhausted their assets yet; many of them would not have expected to live that long.

What I take away from this is that we are not as ill-prepared for retirement as some people would have you believe. The majority will be more or less retirement-ready. Still, there is no question we can do better and do so with less pain and uncertainty during the accumulation process.

If we revisit Aesop's fable, maybe the real moral is more subtle than it appears. Nobody in his right mind would want to suffer the grasshopper's fate, but how appealing was the ant's life, really? She had no time for fun when the days were long and the sun warm—that is to say, during her youth—and while she may have been comfortable in the winter of her life, she was also old and stiff, with a diminished capacity for joy. The grasshopper, on the other hand, had enjoyed his days in the summer sun and yes, he did eventually die in the cold, but at least he had the solace of fond memories to assuage the harshness of approaching winter.

This is not to suggest that you do not need to prepare financially for retirement but it helps to be aware of the mindset you are bringing to the act of preparation. The very fact you are reading this book suggests you are more likely to be an ant than a grasshopper. In fact, both statistical and anecdotal data indicate that the majority of Canadians are ants (Americans apparently less so). As an ant, you are apt to oversave, to be unduly anxious about your retirement prospects, and to accept too readily any news story declaring the country is headed for a full-blown retirement crisis.

In this book, you will find a variety of evidence that, for the most part, should make you feel better about your retirement prospects. You will learn that your retirement income target is less daunting than you might have been led to believe; that government sources of pension are not going to vanish when you need them; and that if you make any reasonable effort at all to save, you will most likely find that finances are going to be the least of your worries in retirement. The trouble is, you will have a difficult time believing the evidence. There are three reasons why.

First, as the ant that you probably are, you are naturally inclined to give credence to pessimistic forecasts while regarding good news with a great deal of skepticism.

Second, the good news I will present—though I should warn it is not all good news—runs contrary to the vast majority of newspaper articles you will read on the subject. It is hard to change perceptions.

This brings to mind an observation by Daniel Kahneman in his book, *Thinking Fast and Slow,*

> A reliable way to make people believe in falsehoods is frequent repetition because familiarity is not easily distinguished from truth.

The astute reader will be quick to point out that even if Kahneman's remark is true, frequent repetition alone does not make a statement false. In the context of whether our retirement anxiety is unfounded, that case still needs to be made.

The third reason why you will find it hard to believe in a positive prognosis for retirement is that supporting evidence for the most part is statistical in nature, whereas refutation tends to be anecdotal. Unfortunately, our brains are wired such that anecdotes carry more weight than statistics, even though the latter are no more than a compilation of the former. "When one man dies it is a tragedy; when thousands die, it's statistics."[1]

I have encountered this phenomenon myself many times. A woman once told me she would never wear a seatbelt because she had an uncle who escaped from a car accident virtually unscathed; he wasn't wearing a seatbelt at the time and had the good fortune of being "thrown clear." (I have always wondered how that works.) My pointing out to her that *not* wearing a seatbelt is 50 times more likely to end badly failed to change her mind. Indeed, any statistic seems less compelling than a pithy anecdote to most people, male or female. My hope is that the reader is not most people.

In case the reader is wondering, the author himself is a closet ant. Yes, I ended up saving much more for retirement than I will realistically ever spend. In my defense, it happened because of fortuitous circumstances that I could not have foreseen. One event in particular that occurred in the latter part of my working life markedly improved my financial situation at a point when it was too late to "un-save" in an orderly fashion. By the way, our tendency will always be to err on the side of caution, and not just because we are more like ants than grasshoppers. We do so because we need to protect ourselves if the downside risk is high, but we cannot afford to do nothing merely because we can see some upside potential.

If you are a fellow ant, I hope the information in this book will alleviate your anxiety about your financial future without tipping you over into outright profligacy. If, by chance, you are one of those rare grasshoppers who got a hold of this book (maybe as a gift or you picked it up in a dentist's office out of boredom), I hope it will mitigate the guilt you may have felt up until now and help you to mend your ways without fundamentally changing who you are.

This book makes no claim to being a beginner's guide, but at the same time it attempts to avoid professional jargon. While some of the ideas explored are fairly sophisticated, I try to describe them in layman's terms.

One distinguishing characteristic of this book is that it is intended to be equally relevant to both Americans and Canadians. This precludes delving into the details on retirement vehicles or tax strategies, and I am happy to acknowledge that there are many other books out there already that do this admirably well. What this book can do is address the perennial retirement questions such as how much you need to save and how fast can you draw down those savings. These big retirement questions transcend borders.

Finally, the reader may be wondering about how the contrarian perspective promised in the title manifests itself within the book. When it comes to some of those perennial questions, my conclusions can differ markedly from many others in the field. Fortunately, corroboration from certain experts I respect has reinforced my own convictions. The challenge is in explaining how I got there without being too ponderous. I leave it to the reader to judge whether I have been successful.

Frederick Vettese

Note

1. Attributed to Stalin. From the book, *The Time of Stalin, Portrait of Tyranny* by Anton Antonov-Ovseyenko.

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- Alex Melvin of Cannex Financial, for his insights and data on the annuity market.

PART I

THE RETIREMENT INCOME TARGET

CHAPTER 1

The Road to Retirement

Take a good look at Figure 1.1. For those of you who have had to watch a loved one succumb to a critical illness, this chart might not surprise you. For others who assume they will sail through their first decade or two of retirement with no problem more serious than how to pay for the next Caribbean cruise, the chart may be a wake-up call.

In a time when we are constantly being told that we are living so much longer than we used to, it may be hard to believe that the average person has little better than a 50–50 chance of making it from age 50 to age 70 without dying or incurring a critical illness. By critical illness, I mean something really serious, such as a life-threatening cancer, cardiovascular disease, or kidney failure. (The full list is given in Chapter 21.) We might be living longer, but we humans continue to be a fragile species.

So why dwell on the morbid? These statistics are an important part of one's retirement planning. If we can change our focus from how many years we will live to how many years of healthy living we have left, it will better inform our actions while we still have the time and ability to act.

If you are age 50, for example, you might be thinking you have 35 to 40 years to go and possibly more. On the other hand, if you can expect to enjoy only 20 more disability-free years (or less), it might very well affect when you retire, what you do in your 60s and how quickly you draw down your retirement savings. Healthy life expectancy is just one of the issues we will consider in this book. But I am getting ahead of myself.

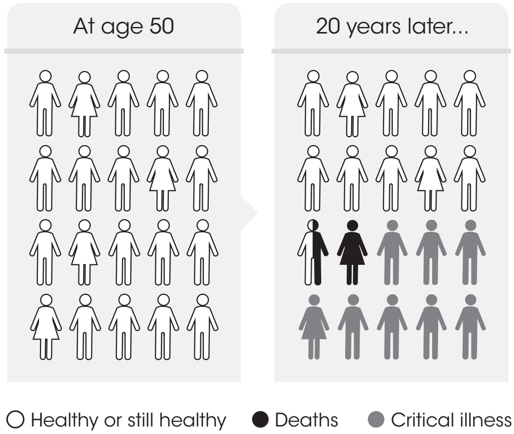

Figure 1.1 The Fragility of Life
Source: Canadian Critical Illness Tables (2008), reconfigured by Morneau Shepell

I will let you in on a little secret. Retirement planning can be as straightforward as following these six steps:

1. Save 10 percent of your pay each year.
2. Invest it in low-cost pooled funds, weighted toward equities.
3. Keep the asset mix the same, through good times and bad.
4. Apart from the mortgage on your home, avoid going into debt.
5. Pay off your mortgage by the time you retire.
6. Buy a life annuity at retirement.

This road map sounds rather simple, and it is. If you are able to follow it to the letter for your entire working lifetime—and experience no long-term unemployment or critical illnesses along the way—you will not go far wrong. In fact, you will fare better than most of your contemporaries. So why do you need this book, or any book on retirement planning, for that matter?

If arriving at your retirement goal was analogous to traveling to a destination, then the above six steps might get you to the right country but possibly not the right state or province. Moreover, the route may not be the cheapest, the shortest, or the most pleasant way to get there. At the risk of beating this metaphor into the ground, you might not be able to recognize the potential hazards along the way without a little more knowledge to guide you.

In this book, I try to define your retirement goal as well as the possible ways to reach it. I will use the following process to do so:

1. Define your retirement income needs as a percentage of your final employment earnings. We will call this your retirement income target.
2. Using your retirement income target, determine how much money you will need to have saved up as of the day you retire. We will call this your wealth target. Knowing this figure makes it much easier for you to monitor your progress toward becoming retirement-ready.
3. Having established your personal wealth target, consider the possible savings strategies that will get you there.
4. Assuming you arrive at your wealth target by the time you are ready to retire, you now need a strategy for drawing it down in a sensible and sustainable fashion throughout your retirement years.

My intent is not so much to be prescriptive as it is to provide useful and hopefully interesting, information. Along the way we will learn these realities:

- Saving 10 percent a year is not a bad rule of thumb if you could follow it, but the odds are, it will be too difficult to maintain in the early stages of your career and it might not even be advisable that you try.
- Retirement planning is as much about how you manage your cash flows during your working career as it is about accumulating wealth for your retirement.
- Most people never spend more than 50 percent of their gross income on themselves before retirement, which is why the retirement income target is usually much less than 70 percent.
- Interest rates will probably stay very low for the next 20 years or longer, which will affect how much you need to save.
- A constant asset mix for your retirement savings such as 60 percent equities and 40 percent bonds is not bad, but you can improve the odds of reaching your wealth target with a more advanced strategy.
- Your lifestyle can materially affect how long you will live and how many healthy years you can expect.

- You can withdraw 5 percent or more of your retirement savings each year in retirement, even if your total investment return is a little less than 5 percent.
- As people reach the later stages of retirement, they become progressively less capable of managing their finances, even though they grow more confident of their ability to do so.
- Annuities have become very expensive, but they still make sense for a host of reasons.

Detours

Although it is important to optimize your retirement planning strategy on the basis that everything goes smoothly, you will also need to be able to deal with adversity. When the preparation process takes as long as 30 or 40 years, you are bound to encounter some problems along the way. Below are a few of the events that can complicate your life:

- Losing your job and not finding another for a prolonged period
- Incurring a significant investment loss
- Suffering a business setback that forces you to draw down your life savings
- Being exposed to high inflation after you retire
- Having to help a family member in financial need
- Experiencing a serious illness or an accident involving yourself or someone within the immediate family
- Getting divorced, requiring you to split your assets

I wish I could tell you how to avoid trouble, but the truth is that we are not in as much control of our lives as we think. Yes, we can insulate ourselves from some of these calamities, but ultimately, success in retirement planning is best measured not by how adept or lucky we are at avoiding trouble, but rather, how we respond to trouble when it arises. Your best protection against misfortune is knowledge.

Of course, unforeseen events are not always bad news. Sometimes, good things happen that bring you that much closer to your retirement goal. It could be a big promotion, an inheritance, or an unexpected capital gain from an investment. It could even be something less dramatic like joining the pension plan in your workplace, which you might not think of as good news when you are 25, but you will eventually come to appreciate it.

Just as negative events in life call for a change in retirement strategy, so do the positive events. Either way, the key is to modify your planning appropriately whenever something happens. The better you understand the science behind retirement planning, the greater your chances of success.

CHAPTER 2

Doubts about the 70 Percent Retirement Income Target

You will no doubt have heard that one's retirement income target should be 70 percent of final pay, if not more. This widely accepted target was already common knowledge more than 30 years ago when I was starting out in the pension consulting industry.

As a pension actuary, I have spent much of my career helping organizations establish defined benefit pension plans for their employees. The design process usually started with the 70 percent income target from which one subtracted the portion that was deemed to be the employee's individual responsibility. The balance would then be spread over 35 or 40 years to determine a formula for the amount of pension earned each year. In the case of public-sector plans, for example, the employee was not expected to shoulder any individual responsibility, so it was a matter of dividing 70 percent by 35 years to get an annual pension accrual of 2 percent of final earnings for each year or service.[1]

When a rule of thumb is so integral to the process of determining the pension for millions of participants, you would think it would be unassailable. Over my career, the 70 percent pension target was rarely challenged, and certainly not by a young actuary like me when I was first starting out in the business. Indeed, no one to my knowledge seriously questioned the 70 percent rule until the 1990s when a few voices in the wilderness, led by pension actuary Malcolm Hamilton, made themselves heard.

Those voices were drowned out, though, as constant reinforcement by banks, insurance companies, financial planners, and investment advisors about the need to save enough to reach the

70 percent target kept the rule alive. It continues to underpin virtually every public-sector pension plan in Canada and the United States, and surely what was built to serve millions of civil servants could not be wrong. Or could it?

Niggling Doubts

For me, the doubts started to creep in a little over a decade ago. In the case of workers who earned above average income, a 70 percent target made less sense the more I thought about it. Not that there was any one smoking gun. My misgivings stemmed from a number of sources.

For starters, consider how a typical hard-working middle-income married couple divides up their paycheck. We will assume that they:

- are both working,
- raise two children,
- buy a house and spread the mortgage payments over their working careers,
- avoid going into debt, other than the mortgage,
- save 7 percent to 10 percent of pay for retirement every year, in addition to making Social Security contributions, and
- retire at 65.

If we broke down their gross income year by year into the major categories, it would look something like Figure 2.1.

After paying for all the big-ticket items including taxes, the percentage of their gross pay that remains for personal consumption dips as low as 25 percent during their 30s and never gets higher than 45 percent, something that occurs only in their last 10 years of working. If they wanted to continue spending at the same rate in retirement, they would need retirement income of 50 percent of gross pay to produce after-tax income of 45 percent. That is 20 percentage points less than the conventional target, so something appears to be amiss! Perhaps this example does not fully capture reality, so let us consider other evidence that puts 70 percent into question.

Fewer private-sector workers remain covered by a group retirement arrangement in their workplace, especially in Canada. That arrangement could be either a *defined benefit* (DB) pension plan or a *defined contribution* (DC) plan. In the United States, about half