Retirement Floors and Implications for Evensky’s Cash-Reserve Strategy
By Wade Pfau
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Does sensible retirement planning call for funding basic needs with less volatile assets and investing more aggressively for aspirational goals? Or, with client goals clearly defined and prioritized, does sensible planning call for a total returns approach? Multiple schools of thought have emerged, but there is not yet any consensus about what constitutes a proper retirement income floor. These lingering unresolved disagreements reinforce the benefits of Harold Evensky’s and Deena Katz’ popular cash-reserve strategy.

When the Financial Planning Association (FPA) surveyed member advisors about their retirement planning experiences and approaches, it divided retirement income strategies into three fundamental categories: systematic withdrawals, time-based segmentation, and essential-versus-discretionary income. (Note: the link above requires an FPA membership to access.) At the same time, the Retirement Income Industry Association (RIIA) argues that the fundamental goal of retirement income planning is to “first build a floor, then expose to upside.”

The RIIA’s goal can be reconciled with the FPA’s categories by remaining aware about the potential flooring available with current retirement assets. This highlights that there are two ways to think about retirement income flooring. Evensky’s and Katz’ cash-reserve strategy offers a middle ground, with the behavioral benefits of locking flooring for several years and potential upside for remaining assets. Evensky and Katz are the co-founders of the Florida-based financial planning firm that bears their name.

Let’s look at the different ways in which a floor can be defined and then at the implications for constructing a retirement portfolio.

Michael vs. Mike

In a recent blog entry, Michael Kitces of the Pinnacle Advisory Group argued that a safe withdrawal rate (such as 4%) represents a floor/upside approach for all practical purposes. For systematic withdrawals from a volatile portfolio, a 4% withdrawal rate survived the Great Depression and the Great Stagnation of the 1970s, and so it has so far weathered the worst of the worst.

The odds of wealth depletion with systematic withdrawals are exceedingly small, while clients retain full access to their remaining wealth and a significant probability that assets will continue to grow. Economic conditions dire enough to jeopardize 4% would surely also jeopardize the ability of guarantee providers (such as insurance companies that underwrite...
annuities) to fulfill their commitments. Kitces argues further against locking in a floor only to meet essential needs, because clients generally have an overall lifestyle in mind and will view their retirement as a failure if they cannot afford any of what are typically considered as discretionary expenses.

Mike Zwecher, author of the 2010 book *Retirement Portfolios*, takes another stance. He argues that retirees only get “one whack at the cat” with their retirement plans. Adopting a retirement strategy because it would have worked historically is not sufficient. Basic needs should not be exposed to the risk of wealth depletion, which is more likely to happen with sustained fixed withdrawals from a volatile portfolio. Rather, retirees are advised to adopt strategies designed to avoid exposure to volatility, though with a minimal allowance for credit and default risk. These strategies could include bond ladders or single-premium immediate annuities (SPIAs). As retirees aim to preserve their lifestyles over an uncertain lifespan, what is most crucial is to foreclose the possibility that essential needs cannot be met.

Two views of flooring

The views of Kitces and Zwecher are not as far removed from one another as they may seem. The first boot camp for the *Retirement Management Analyst* SM designation held at Texas Tech University in February 2012 was a fruitful opportunity to discuss retirement income flooring. What became clear among those working to revise the RMA curriculum is that there are actually two competing views about the meaning of flooring. Zwecher may appear to be an adherent of what’s known as a “goals-based” approach, but he is actually a driving force behind the “investment-based” approach. Before explaining the distinction in more detail, goals-based flooring assigns specific secured assets to lock-in lifetime flooring needs, while investment-based flooring tracks the amount of flooring which could be purchased with available financial assets.

Floors are guaranteed minimum payments, in either real or nominal terms, over a specified minimum period of time. The first view of flooring is goals-based, and I reviewed it before at *Advisor Perspectives* in the context of Zvi Bodie’s and Rachelle Taquu’s book, *Risk Less and Prosper*. The “essential-versus-discretionary” category from the FPA survey reflects the goals-based approach, as the idea is to divide retirement spending goals between essential and discretionary.

Essential spending needs should be locked in with funding from safe investments, such as bond ladders comprised of TIPS or I Bonds, or inflation-adjusted SPIAs, to eliminate any chance of failure. Discretionary and aspirational goals may be funded with volatile assets that inherently include a risk that goals won’t be met. Building on the behavioral notion of mental accounting, in which investors tend to maintain separate accounting with differing investment strategies for different goals, retirees are encouraged to maintain separate portfolios for essential and discretionary goals, rather than thinking in terms of total returns for their portfolio.
In developing *Modern Retirement Theory*, Jason Branning and M. Ray Grubbs provide a comprehensive goals-based view of flooring. They emphasize that the future is unknowable and that individuals only have one life and one retirement date. They divide a client’s total balance sheet assets (financial, social, and human capital) among four prioritized categories: a base fund to cover essential spending needs, a contingency fund available for emergency spending, a discretionary fund for discretionary expenses, and a legacy fund for an inheritance or charity. The base fund should be funded with market-neutral guaranteed and inflation-adjusted sources that are “secure, stable, and sustainable.” This protects from market, inflation, and longevity risk.

A second view of flooring, however, places less emphasis on having the essential needs locked into place. This is the investment-based or engineering view of flooring. In *Retirement Portfolios*, Zwecher explores the amount of flooring from financial capital under current market conditions. No specific link is made to spending plans. Flooring is the sleeve of the investment portfolio intended to provide flooring income. The cost of building a lifestyle floor (the minimum amount required to maintain a desired lifestyle) can be tracked and monitored over time. Zwecher describes *locked-in flooring* as that which has been purchased outright, *flooring cost* as the current cost of locking in flooring, and *at-risk flooring* as having funds available to purchase flooring without executing the transactions.

In his 2007 *Journal of Financial Planning* article on *Modern Portfolio Decumulation*, Richard Fullmer describes an intriguing application of the investment approach to flooring. This approach, which I particularly associate with Russell Investments, is explained in greater detail in Timothy Noonan’s and Matt Smith’s *Someday Rich: Planning for Sustainable Tomorrows Today*. As a retiree may have both consumption (a lifetime spending stream) and wealth goals (for bequests or gifts), Fullmer develops an approach to flooring that tracks the cost of annuitizing a desired lifestyle floor and meeting any wealth goals. Systematic withdrawals take place as long as wealth stays above this cost, which provides retirees with the benefits of maintaining control over their assets for as long as possible; plus, there is a quantifiable benefit in delaying the decision to annuitize. But should wealth fall too much, annuitization triggers to lock in the lifestyle floor. This has the effect of turning longevity risk into investment risk, as the investment goal of the portfolio is to maintain sufficient wealth to annuitize the desired amount of spending and meet legacy goals.

**Flooring and the FPA’s three categories**

With this background, we can clarify how each category relates to flooring. The easy case is the essential-versus-discretionary categorization, which is simply the goals-based approach to flooring. They are one and the same. Systematic withdrawals can also be accepted as a flooring approach if we emphasize that they provide at-risk flooring, which may need to be locked in under certain circumstances.
Time-based segmentation appears as a middle-ground compromise between the other two approaches, and it is worth discussing further.

Leaving behind the purely-total-returns-focused perspective in which fixed income is represented with constant-maturity bond funds, time-based segmentation differs from systematic withdrawals primarily because fixed-income assets are held to maturity in order to guarantee upcoming retiree expenses over the short and/or medium term. More volatile assets with higher expected returns are then deployed to cover expenses for more distant time periods.

Key examples of time segmentation approaches include Stephen Huxley’s and J. Brent Burns’ *Asset Dedication*, and Evensky and Katz’ cash-reserve strategy. Huxley and Burns explain that the natural way to choose a stock allocation is whatever is left over after creating a bond ladder to lock-in upcoming spending needs for a window of three to 10 years. Asset classes are used for what they do best: bonds provide income and stocks provide growth. Though it can vary with different circumstances and is an easily customized approach, this can generally be thought to allow a higher overall stock allocation than a total returns approach would usually dictate. Another theme of Huxley’s and Burns’s is that annuitization need not play a major role, since asset/liability matching with bonds is used to meet upcoming expenses, providing a longer period for volatile assets to recover from market declines before they must be sold.

While, on the surface, their cash-reserve strategy looks to be a form of time segmentation, however, Evensky views the strategy from a total returns perspective, with the cash reserves serving as a risk management tool. Under the Evensky and Katz approach, fixed income locks in spending five years out, something Evensky calls his “five-year mantra.” Locking-in needs further than five years away may be prohibitively expensive for clients with current interest rates. Writing about the cash flow strategy in the 2006 book, *Retirement Income Redesigned*, Evensky extolled the behavioral benefits of his approach, in that it helps clients to avoid panic during downturns and stay the course with up to five years to wait for market recovery. Evensky does view immediate annuities as a useful component for a client’s portfolio when interest rates are higher.

Controversially, both approaches rely on time diversification. Spending needs only over the shorter term are fixed with bond ladders. But longer periods do not make volatile assets less risky (risk is probability times magnitude, and as more time passes the outcomes for the worst-case scenarios become even worse). Stocks are inherently risky, a point which is not always clear in the U.S. historical data as severe market drops were generally followed soon after by recoveries.

Nevertheless, in his 1997 book, *Wealth Management*, Evensky argued that clients are generally more sensitive to the probability of meeting their goals than to the magnitude of their shortfall. In the bad luck cases, it does not hardly matter if a client can spend only $\frac{1}{4}$
or ½ of their goal, their lifestyle is severely diminished either way. Thus, from a practical financial planning perspective, time diversification works.

So while these frameworks provide flooring for upcoming needs, they do not provide lifetime protections. Evensky argues that, especially in the current low interest rate environment, clients find it too expensive to lock in lifetime protections. For clients without a sufficiently large pool of assets, building a lifetime income floor can be a suboptimal strategy, with too much volatility on the discretionary expense side of the income statement. Nonetheless, such an approach is also compatible with the idea of monitoring and locking-in flooring if the need should arise.

The bottom line

Ultimately, the three FPA categories represent different attitudes about the amount of flooring which can be left at risk. With essentials-versus-discretionary, lifetime flooring protection is created for essential needs. This is really “goal segmentation.” Time segmentation focuses only on funding short- and medium-horizon spending goals with dedicated assets, with faith that volatile assets will perform adequately when left to grow for a long enough period of time. Systematic withdrawals generally leave the entire floor at risk, since spending needs must be supported from a portfolio of volatile assets. As an investment practice, though, while clients may choose to leave flooring at risk as an initial matter, they must be vigilant about the cost of locking in a lifestyle floor and taking action if necessary.

In last week’s Advisor Perspectives newsletter, Joe Tomlinson argued that a low interest rate environment bolsters the case for choosing SPIAs over bonds. However, these alternative views of flooring suggest that perhaps Evensky’s five-year mantra is an equally viable alternative.

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