Your Winning Retirement Plan

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Overview

The purpose of this book is to introduce a technique developed by the author Henry Hebeler know as **Autopilot** use for developing and implementing both a saving plan before retirement, and a spend-down plan after retirement to ensure your retirement is fully funded for you life.

- **Chapter 1** Compares some of the more popular planning methods to the Autopilot method using real-world historic data.
- **Chapter 2** identifies the factors that need to be taken into consideration when developing a plan including Savings, Life Expectancy, Inflation, Taxes and Uncertainty.
- **Chapter 3** dives into investments covering Asset Allocation, Investment Vehicles and Real Estate.
- **Chapter 4** is devoted to determining Return on Investment, reviewing factors that need to be considered, and instructions on how to determine what Return on Investment to expect for the asset allocation that represents your portfolio.
- **Chapter 5** focuses on Preretirement planning, providing a step-by-step detailed instructions in building and implementing your plan.
- **Chapter6** is dedicated to budgeting and planning after retirement to ensure you set expectations based on what assets you have accumulated, and details a process to re-assess and make appropriate adjustments to ensure a successful implementation of your retirement plan.

Introduction

If you are not yet retired, you will be armed with tools that will show you realistic annual savings to meet your goals for all your savings needs, not just retirement. If you are already retired, you will have a competent method that will show you how much you can budget so your investments will last until you reach your goal line. This book does not address detailed insurance and estate plans, which at some point, require attention, but if you take the planning actions in this book, you'll be the winner with a winning retirement plan.

Resources:

- Financial Planning Association – locate a professional planner
- Analyzenow.com – Hebelers website

Chapter 1: The Realities of Financial Planning

Chapter Summary

This chapter points out the importance of having pre and post retirement plans on how to save and spend-down your nest egg. It identifies risk of out-living your savings and provides real-world scenarios on how some of the various approaches would have faired in different historic market conditions. Common mistakes and incorrect assumptions that many plans make are identified. A side-by-side comparison on how theses methods would have performed in comparison with the Autopilot method is provided.

Terms and Concepts

- PreRetirement Plan – A plan that tells them where and how much to save to meet a retirement goal.
- PostRetirement Plan – Plan that tells how to control their financial matters so that their investments will support them until they die.
- Dollar Cost Averaging – A phenomenon that benefits savers who make regular savings deposits. Deposits made when the market is low generate more growth than an equal number of deposits made when the market is high. The net result is a larger overall growth rate than would be predicted using steady market conditions.
- Reverse Dollar Cost Averaging –The opposite of Dollar Cost Averaging, in Retirement when money taken out of their accounts on a regular basis receives a lower rate of return in a fluctuating market. Most retirement models to not take this into consideration.
- Retirement Autopilot – The concept of applying airplane control technology to financial planning where compensating equations are applied to provide stability to your retirement to avoid large swings in savings requirements as market conditions fluctuate.
- Cost of Living Adjustments (**COLA**) – Adjustments made to a pension payout to counter rising cost of goods and services due to inflation.
- Feedback – The method of making periodic minor changes to a retirement plan based on current inflation rates and market performance.

Real-World Planning Problems

Mistake 1: Adding Apples and Oranges – Many plans assume pensions include Cost of Living Adjustments (COLA); Most do not. Even when plans do have COLA's they are generally capped at 2-3%. Although Social Security does include COLA adjustments these don't even keep up with inflation in the real world[1]. The overall impact of this is that over time the purchasing power of money received from a pension plan and even Social Security is eroded.

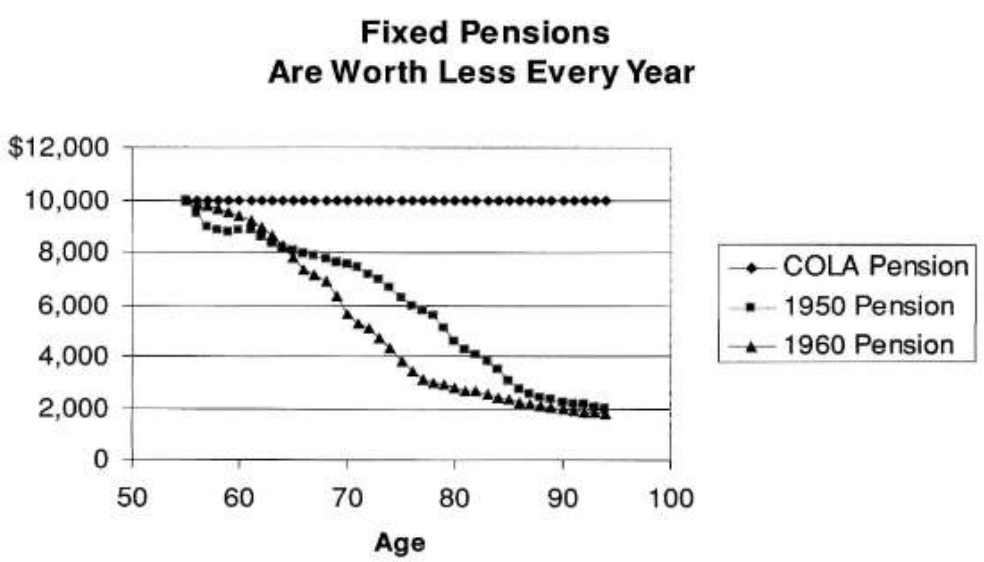

FIGURE 1.1 The actual value of a COLA pension compared to the real value of fixed pensions starting in two different years, after inflation has taken its toll.

Mistake 2: Assuming the Real World is Smooth – Many planning programs assume a theoretical constant inflation and return on investments. In practice, this will not provide a valid scenario when planning retirement. In the chart below a $1,000,000 retirement fund is spent at age 85 using historic values for market returns and inflation. Real world data from 1950 (good time to retire) shows the funds would run out at age 76. While Real world data from 1960 (bad time to retire) shows funds running out at about age 96.

Another issue identified by Hebeler is that many Funds and investment planners tend to give absolute rate of return values when trying to make a sales pitch. This can be very deceptive if inflation is not included. For instance a fund with 6% growth but with a 4% inflation for the year is actually only gaining 2% growth when it comes to spending power.

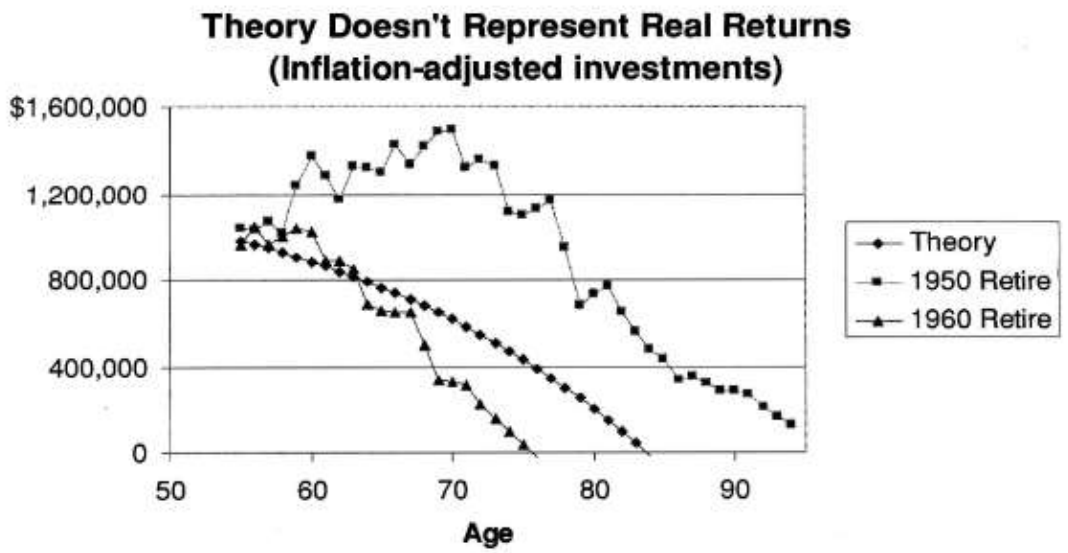

FIGURE 1.2 Inflation-adjusted investments are substantially different when comparing theory to real annual returns for retirement beginning in 1950 or 1960.

Mistake 3: Ignoring Investment Cost – Many paid planners and investment funds will not include their fees when providing projections of or histories of their plan/fund returns. Using the same historical data from Figure 1.2 in figure 1.3 but including a 1.5% fee, we can see that the age when funds run for the 1960 retirement scenario from 76 down to 73 (**3 years decrease**) while the 1950 retirement scenario has been decreased from 96 to 85 (**11 years decrease!**). You may think that a 1.5% charge is overstated in this scenario, but consider if you are paying a retirement planning company 1% fee (which is not uncommon) that does not include fees associated with funds that the retirement planner may be using. These combined fees may very well be in the 1.5% range. Another point of interest is how over time the fees really start to impact your return, where the difference in the 1950 vs the 1960 scenario shows a 12 year difference, but the impact of the fees goes from 3 years to 11 years (8 years difference!) over those 12 years.

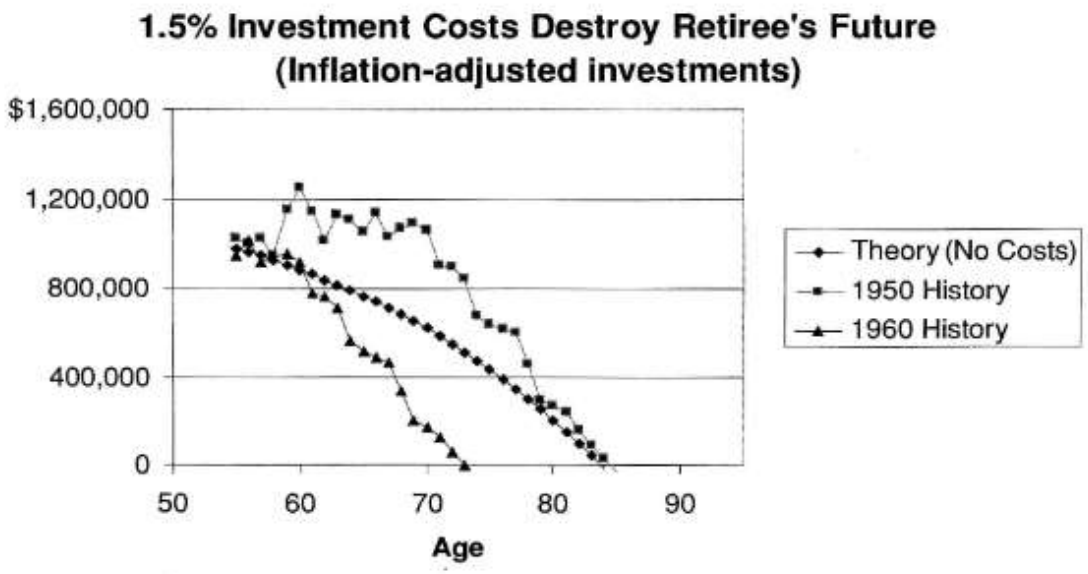

FIGURE 1.3 Inflation-adjusted investment balances, after accounting for investment costs, decline quickly.

Mistake 4: Not Defining Your Terms – It is important to take into account taxes when planning both for saving for retirement and in retirement. Remember while getting a tax break when contributing to a tax differed plan (ie 401k, IRA, etc.) the taxes will be due on these investments once you start to withdraw from these accounts. With Roth accounts the taxes are paid up front allowing growth and gains to go untaxed when withdrawn. After tax investments straddle these two where gains are taxed at different rates based on the time the investment was held.

Mistake 5: Using Calculations without Shock Absorption – Market fluctuations can make severe impacts to your retirement planning especially in immediate years just before and after retirement. For example lets say you are nearing retirement with $2,000,000 and the market takes a 30% dive for the year, as a result your $2,000,000 has now decreased to $1,700,000 (assuming you only had about $1,000,000 in the market) you have just seen a decrease of your retirement savings of 15%. This could severely impact your retirement plans! One of the primary focuses of this book is to provide a method to dampen these shocks to your retirement plans.

Mistake 6: Ignoring the Effect of Reverse Dollar Cost Averaging – Dollar cost averaging is the phenomenon where when a person invest on a regular basis in a stock they get better returns than the overall average over time since they purchase more shares when a stock drops. Reverse Dollar Cost Averaging is the exact opposite. Where a constant withdraw from an investment sees lower returns over time than the average since you are selling **more** shares when the price drops. This is exhibited in Figure 1.4 where it compare the ending balance after 10 years where a 23% loss occurs on the 2nd year followed by a 37% increase in year 3, still providing a 7% overall average return but as you can see with the funds depleted about 1 year earlier than if the returns were constant over this time period. Hebeler points out that retirees average about 0.5% less return than pre-retirement savers.

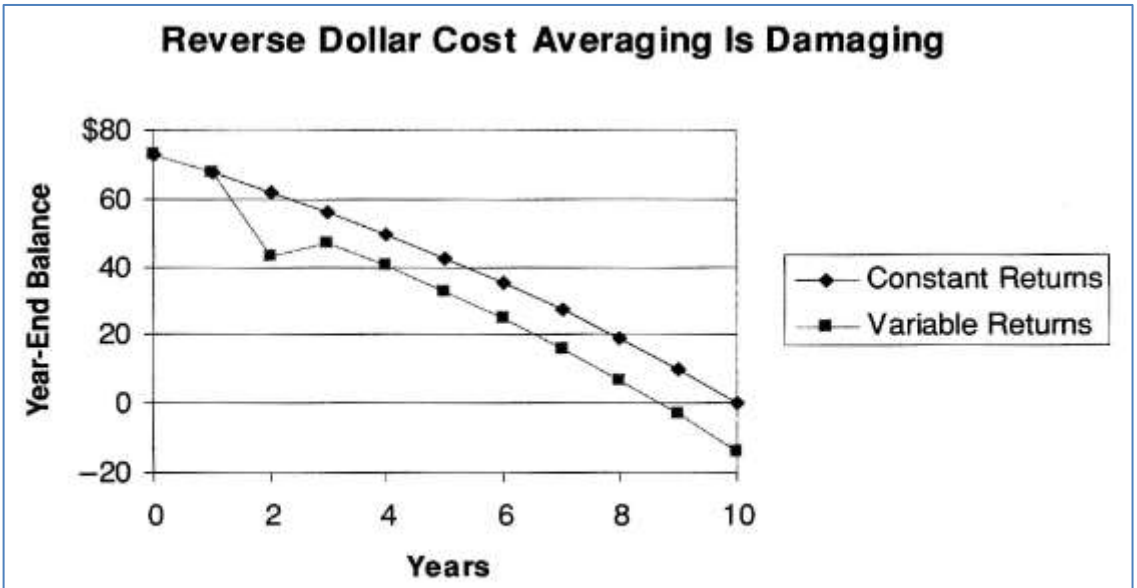

FIGURE 1.4 Reverse dollar cost averaging in action. When investments go down in a volatile market and you are withdrawing principal, you seldom bounce back.

The Hazards of Postretirement Projections

In order to do preretirement planning, one first must know how much money is needed in retirement. Provided below is a basic summary of the methods you can use for your postretirement projections from worst to best. The descriptions provided below are to summarize the plans, while some flaws for these approaches are pointed out; they are not an analysis/comparison of each; this will be done latter.

Spend-All This technique assumes you can live off of interest and dividends from your investments and not touch your principle. This requires you to have a huge pool of assets for investment, since just for a $60,000 budget, you would be required to have $2,000,000 assuming you have a 3% return on investment every year. This plan is also flawed in that years with higher inflation would require higher returns, something that may not be possible in practice; finally dividends change year to year for each investment, so this plan would be highly volatile.

Inflation-Adjusted Spending Many factors such as inflation, life expectancy, and the present value of your investments are utilized in this calculation. Recent versions of this have even taken into account large one-time expenditures (such as purchasing a house or car). In this method you get an inflation-adjusted increase amount each year to match inflation. The flaws with this method is that it does assume constant rates of return/inflation, so funds likely run out before this method predicts due to Reverse Dollar Cost Averaging.

Fixed-Percent Withdrawals Here a percentage (usually 4% to 8%) of the overall year-end investment balance is used for determining the amount allowed for expenses and taxes for the year. In this book Hebeler uses 6% as an example where an investment of 100,000 would imply $6,000 could be withdrawn.

Successive Annual Calculations An annual budget is established each year based on analysis of long term market returns, inflation and new life expectancy. This method is subject to overly optimistic assumptions and typically does not take into account management fees, mutual fund cost and other expenses associated with owning securities.

Retirement Autopilot Method The method utilized in this book, incorporates a technique to adjust to swings in market performance, and changes to inflation. Reverse Dollar Cost Averaging is also taken into account. This method also takes into account large purchases that may be made in retirement. Additionally it utilizes historic data. Hebeler then describes how this method is singular to auto pilot in an airplane where minor adjustments are automatically made reduce the jolt that may be felt as aircraft encounters turbulence. One of the primary goals of this method is to provide a steady consistent plan, reducing whiplash that may be encountered based on market gyrations my making small adjustments to the overall plan on a regular basis (ie yearly). This process of making minor adjustments on a regular base due to changing inflation rates and market performance is known as feedback.

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Comparing Methods A hypothetical example will be used to compare the different plans:

- Retirement at age 60
- Expected date of death at age 85
- Numbers provided in the figures below are Inflation adjusted numbers.
- $1,000,000 in investments
    - 50% in S&P 500 index fund initially, decreased 1% each year.
    - 50% in long term corporate bonds, increasing 1% each year.
- Assumptions
    - Data utilized using two different periods
        - 1955 (Good times)
        - 1965 (Not so good times)
    - All funds are in deferred tax accounts (ie 401k, IRA, etc.)

Comparing Three plans

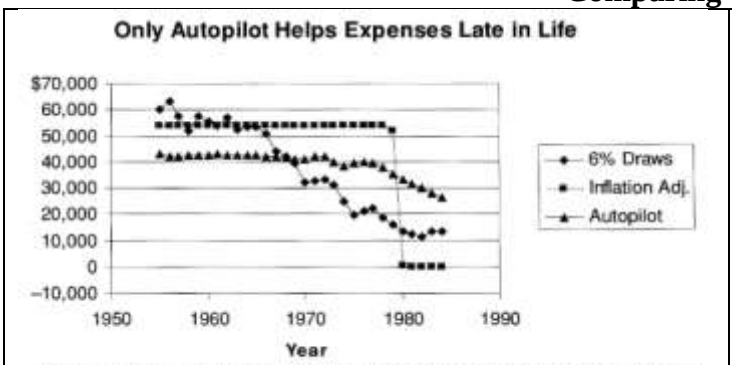

FIGURE 1.5 Annual withdrawals (adjusted for inflation) for three different retirement methods starting in 1955.

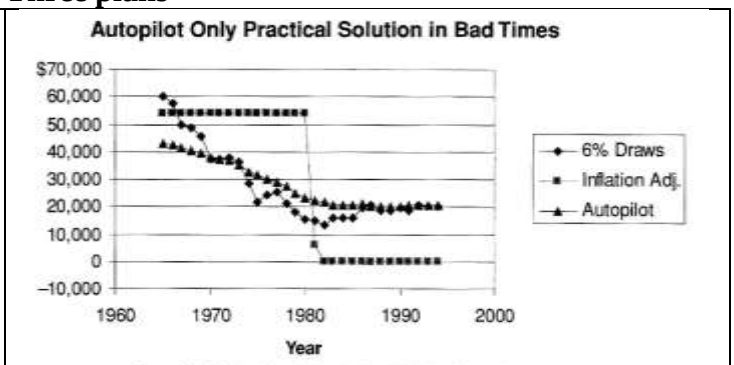

FIGURE 1.6 Annual withdrawals (adjusted for inflation) for three different retirement methods starting in 1965.

Method	1955 retirement (Good Times) Observations	1965 Retirement (Bad Times) Observations
Inflation Adjustment	• Initial withdraws at $**55,000** • No changes in standard of living until funds run out. • **$0** funds remaining at age **80** • 5 years before date of death. You are now on welfare	• Initial withdraws at $**55,000** • No changes in standard of living until funds run out. • **$0** funds remaining at age **75** • **10** years before date of death. You are now on welfare
6% Draws	• Initial withdraw mount at $**60,000** • Initial withdraw amounts higher than other plans, but rapidly decreases over time. • Final withdraws ending at about $**15,000**	• Initial withdraw mount at $**60,000** • Initial rapid decrease in withdraws reflecting poor market behavior over time that stabilizes as market rebounds. • Final withdraws ending at about $**20,000**
Autopilot	• Initial withdraw mount at $**55,000** • Gradual decrease in amounts over time. • Final withdraws ending at about $**25,000**	• Initial withdraw mount at $**42,000** • Gradual decrease in amounts over time. • Final withdraws ending at about $**20,000**

One of the lessons we can draw from these examples is that there is no perfect way to overcome really bad economic times. However the autopilot systems, however provides the best results with the least amount of system shock over time.

The Hazards of Preretirement Planning

Some observations on saving for retirement:

- The further away from retirement you are the more risk you can take. Over a 20 year span a person more heavily weighted in stocks can realize a double in savings over a person heavily weighted in Bonds. Over a 30 year span this can be triple.
- The earlier you start savings the more benefits you will enjoy from the miracle of compound growth.
- Live below your means and save for retirement. Take full advantage of tax savings and use tricks like devoting raises to go to savings plans.
- As you near retirement estimates can whiplash based on market conditions, the autopilot method tries to dampen these gyrations.

Open-Loop Shortcut A one-time estimate and scheduled savings plan that does not adjust on a regular basis to compensate for accumulated savings value (based on current market valuations) or inflation variations. This method does not take into account investment cost and reverse dollar cost averaging. This method is dependent on the year the calculation is performed that may cause people to over-spend (if it is a good market year), dramatically decreasing the number of years funding may last. This method is also very dependent upon estimates of future market performance and inflation rates. These estimates tend to be overly optimistic (ie 5% before retirement, 4% after retirement of inflation adjusted returns).

Quick and Dirty This method estimates returns based on a classification of your investment allocations:

- Conservative – Mostly Bonds
- Moderate – 50% Bonds, 50% Stocks
- Aggressive – Mostly Stocks

Investment cost are assumed to be 1%. This method does not take into consideration one-time purchases.

Open-Loop vs Quick & Dirty

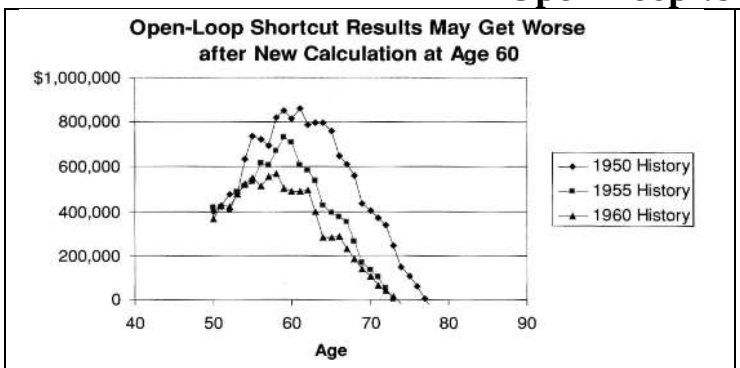

FIGURE 1.8 Making a new estimate with the open-loop shortcut just before retirement does not always improve results, as in the 1950 scenario.

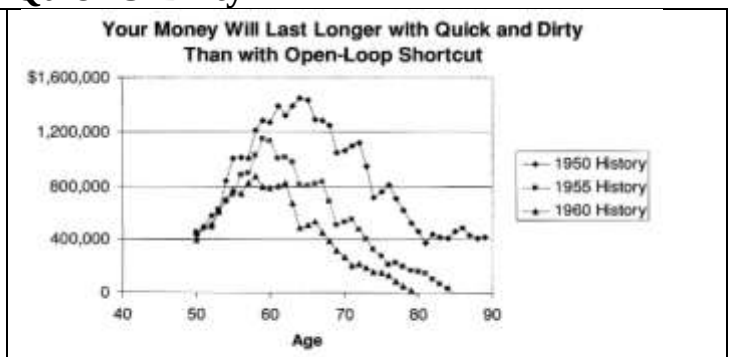

FIGURE 1.9 The quick and dirty method shown here uses more conservative returns than the open-loop shortcut in Figure 1.8 and so demands more saving before retirement and lower spending after retirement.

Recalculation Methods Reassessing your retirement plans on an annual basis allows you to make adjustments to your plans to ensure you stay on track and on time for your retirement. On downside to this process is that the closer you get to retirement, the more volatile these adjustments can become in reactions to current market fluctuations.

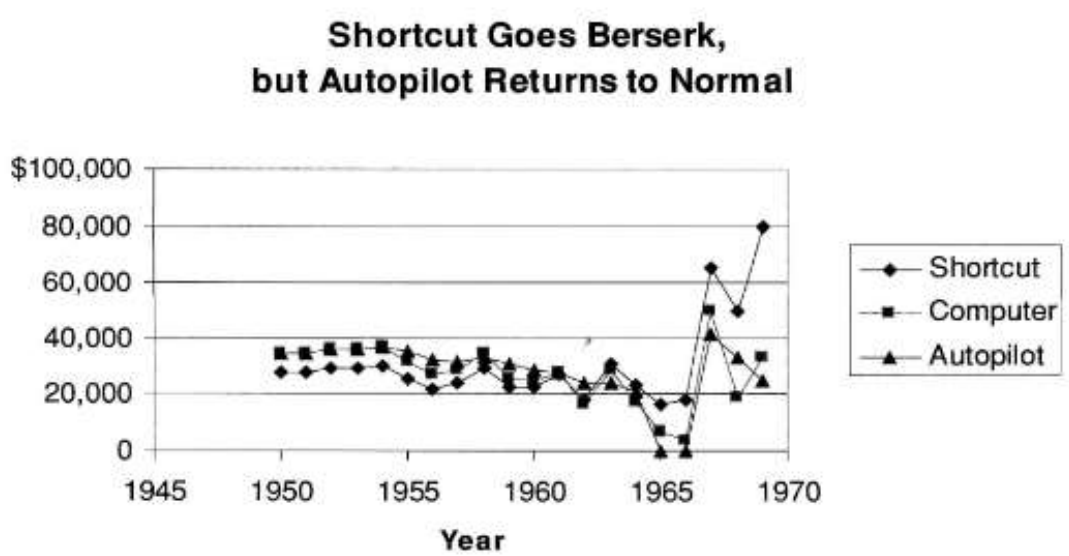

FIGURE 1.11 All of the planning methods try to cope with adverse market conditions near retirement. The shortcut calls for unreasonable savings in the last year.

Observation: Both the Computer and Autopilot methods drop savings to zero in the 1965 region. I think if you introduce a general rule of never cutting saving more than ½ of the previous year was introduced, it would have greatly stabilized the huge jumps in savings requirement years just previous to 1970. Better yet, if you never decrease savings for retirement, the savings increase for the autopilot method may have been eliminated. Worst case scenario following this approach would be that you exceeded your target savings.

It is vital that one avoids optimistic theoretical assumptions on future investment performance and use realistic data that represents what can realistically be expected from your investments based on what your **asset allocation** is (Bonds vs Stocks), **investments cost** and **inflation** expectations.

References

Chapter 1: The Realities of Financial Planning

1. PBS.org Why Social Security's Annual Increase Doesn't Actually Keep Up with Cost of Living
2. Global Financial Data website