SMART STRATEGIES FOR YOUR WHOLE LIFE

November 2013

Proportional Perspectives on Work and Retirement

For all the window-dressing the financial service industry can add to the process, it is possible to distill the essential issues in retirement planning to two, expressed as a ratio of **working years** to **retirement years**. This ratio does not produce an exact number for retirement, but it gives you a sense of the task at hand, and how long you have to complete it. This ratio can also be quite instructive, particularly when placed in a historical context, because the numbers used to create it reflect significant demographic and economic trends that impact individuals.

Life Expectancy – then and now

A standard calculation of life expectancy is anticipated average lifespan at birth. According to geoba.se, a global statistics website, the current life expectancy for someone born today in the United States is 78.6 years; in 1935, the year Social Security was established, the life expectancy at birth for Americans was 59.9. While this seems like a dramatic improvement in longevity, using life expectancy at birth can be misleading.

There is strong evidence that improving at-birth longevity over the past 100 years is primarily due to the dramatic decline in infant deaths; because more people survived childhood, the overall averages have moved up. Further skewing the at-birth number is the fact that life expectancy improves with age; the longer you live, the more likely you are to live past your at-birth life expectancy. For example, a 25-year old American male born in 1988 had a life expectancy at birth of 71.4 years. Using the Social Security Administration's Life Expectancy Calculator, his life expectancy today is 82.0 years. If he lives to age 62, life expectancy increases to 86.2 years.

A more relevant life expectancy comparison is at age 65, because this group has lived long enough to need a retirement plan. While life-expectancy-at-65 numbers have improved steadily since the middle of the 20th century, the increase isn't as significant as at-birth life expectancy. Here's a chart from the Social Security Administration (Table 1), showing the historical life expectancies of 65-year-old Americans at selected intervals since 1940:

Table 1: Life Expectancy for Social Security

Year Cohort Turned 65	Percentage of Population Surviving from Age 21 - Age 65		Avg. Remaining Life Expectancy for Those Surviving to Age 65	
	Male	Female	Male	Female
1940	53.9	60.6	12.7	14.7
1950	56.2	65.5	13.1	16.2
1960	60.1	71.3	13.2	17.4
1970	63.7	76.9	13.8	18.6
1980	67.8	80.9	14.6	19.1
1990	72.3	83.6	15.3	19.6

Sixty-five (65) is an arbitrary retirement age (more on this later), but it is relevant when considering the life expectancies of retirees. A 65-year-old male in 1940 was projected to live 77.7 years. In 1990, the number was 80.3. Current data from the Social Security Administration estimates a man age 65 today can expect to live on average to age 84, a woman to age 86. The increase in longevity over the past 75 years is only seven years. (What is significant: *a lot more people are reaching age 65*.)

In This Issue…

Working Years and Retirement Ages – then and now

A person who turned 65 in 1940 was born in 1875. For able-bodied Americans in this cohort, the majority of whom still lived on the farm or in rural communities, regular working life often started at age 15. High school and college graduates might have entered the workforce slightly later, but by age 20 most were working full-time.

In the 1930s, the Committee on Economic Security (CES) observed that the prevailing retirement age for the few private and state pension plans in existence varied between age 65 and 70. After confirming with actuarial research that a government-run Social Security program could be made "self-sustaining with only modest levels of payroll taxation," the CES chose 65 as the age workers would be eligible for full benefits. Based on the CES decision, a typical American retiring in 1940 had worked 45-50 years (from age 15-20 to age 65).

Since then, a variety of factors have led to a later start date for successive generations of Americans beginning their working years. The high school diploma became the minimum standard for a "basic education." Government assistance allowed more people to pursue college degrees, which also meant later entry into the workforce. In recent years, stagnant economic conditions have made it harder for willing workers to secure full-time work. A Georgetown University study "found that on average, young workers are now 30 years old when they first earn a median-wage income of about $42,000, up from 26 years old in 1980" (*Wall Street Journal*, September 30, 2013).

At the same time, the average retirement age declined from 1940 to about 1990, and has only recently begun to climb. Amy Langfield, in a May 16, 2013, article for cnbc.com, cited the following statistics from a recent Gallup survey:

- The average U.S. retirement age has climbed to 61, up from 57 two decades ago.
- The average non-retired American now plans to retire at 66, up from 60 in 1995.

The Ratio – then and now

Some of these calculations are "back-of-a-napkin" numbers; they use simple math and broad assumptions. But consider the retirement ratios of four different generations of Americans that result:

YEAR OF BIRTH …..	1875	1925	1950	1990
1. LIFE EXPECTANCY AT 65	78	80	86	87
2. EST. AGE ENTERING WORKFORCE	15	20	25	30
3. EST. AGE AT RETIREMENT	65	57	66	70
4. WORKING YEARS (Line 3 - Line 2)	50	37	31	40
5. YRS IN RETIREMENT (Line 1 – Line 3)	13	23	14	16
6. RATIO WORK/RET (Line 4/Line 5)	3.8 to 1	1.6 to 1	2.2 to 1	2.5 to 1

Source: data at Social Security and other sources listed above

Those born in 1875 were the first generation to receive Social Security, and part of a completely different economic era. The group born in 1925 represents the tail-end of the "greatest generation," which enjoyed the post-World War II economic surge in America. The 1950 contingent comes from the heart of the Baby Boom generation. And the 1990 cohort is today's college graduates, for whom an estimated retirement age is just a guess.

In this hypothetical assessment, a person born in 1875 had to work and save for 3.8 years to realize and pay for one year of retirement. In contrast, the individual born in 1925 worked just 1.6 years for every year of retirement – less than half as long. For later generations, it appears the ratio is climbing.

Some Broad Conclusions, Individual Applications

- Empirically, these ratios are plausible representations of the retirement realities for different generations. The 1925 generation greatly benefited from steady employment, generous pensions, proportionally higher Social Security payments and extended periods of economic prosperity. The combination of later workforce entry, uncertain employment, longer life expectancy, and diminishing government and employee benefits seems to point to **longer working periods, and later retirements**.
- Individuals may find it interesting to project their retirement plans by first **considering what their own numbers look like**. Given their family histories and personal health, how long do they expect to live? How long do they anticipate working? Do these projections result in a ratio in line with the broader numbers?
- Keep in mind that life expectancy is a median number; half of men age 65 today can expect to live past 84, and half of the women past 86. This means **it might be prudent to be "above average" in the longevity department, at least for planning purposes.** Ernst & Young Insurance and Actuarial Advisory Services has calculated that "One in four people age 65 will see their 96th birthday."
- It is important to understand that **personal choices can significantly adjust your ratio of working to retirement years**. Clearly, forgoing a higher standard of living today to save more for retirement will lower the ratio. Accepting a lesser lifestyle in retirement may also move the ratio. The large numbers show trends, but you have quite a bit of control over the determination of your own work/retirement ratio.
- An awareness of one's potential life expectancy and the necessity of providing either earnings or savings for the cost of living should prompt **consideration of financial issues beyond mere retirement accumulation**. An under-funded retirement can be overcome by working longer, but declining skills and failing health might undo this plan in an instant. Risk management, typically through life and disability insurance, is essential financial protection.

WARNING: ***GRAPHIC RETIREMENT IMAGES; VIEWER DISCRETION ADVISED!***

Three-Legged Retirement Stool Has One Missing, One Shaky Leg

A generation ago, a typical retirement discussion usually included a reference to or illustration of the "Three-Legged Stool." This was an analogy to describe the three most common sources of retirement income – pensions, personal savings and Social Security.

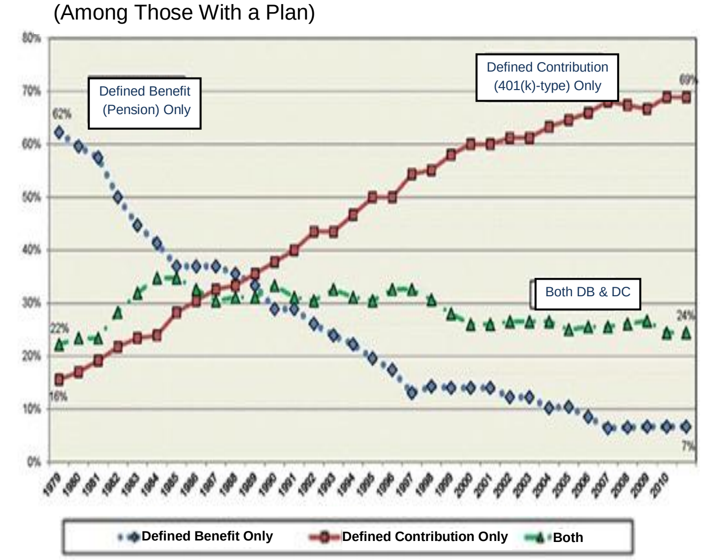
While many from the previous generation enjoyed a stable retirement from the three-legged stool model, changing circumstances are rocking each of these retirement sources. As Mary Beth Franklin puts it in a May 26, 2013, *Investor News* article, the three-legged stool looks "more like a pogo stick for many Americans."

Sometimes the best way to explain the details is with pictures. Here are two charts that, along with short explanations, articulate the shaky current status of these three retirement assets.

Pensions

Three decades ago, almost two-thirds of all private sector employees had a defined benefit, company-funded pension. Today, private sector pensions are almost extinct. Instead, future retirees have defined contribution plans. And most of the contributions come from their pockets, not the company's, as employer matches have declined or been eliminated during the recent recession (see below).

Private-Sector Participants in an Employment-Based Retirement Plan, by Plan Type, 1979-2011
(Among Those With a Plan)

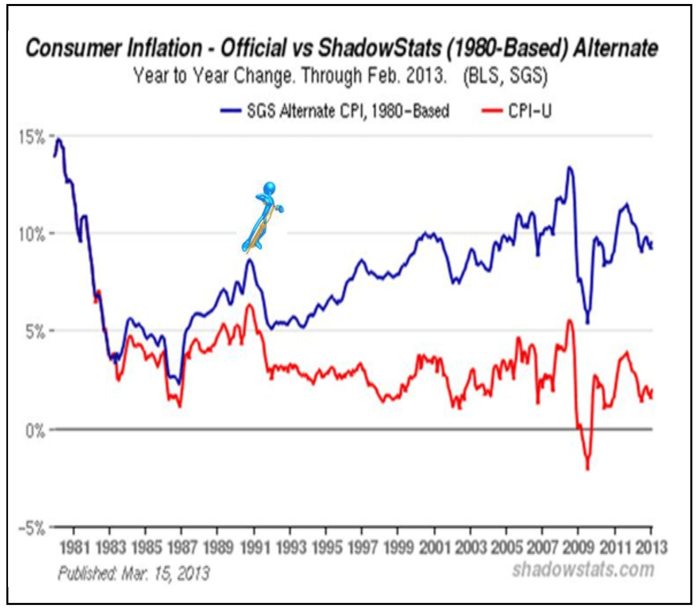


Source: U.S. Department of Labor Form 5500 Summaries 1979-1998. Pension Benefits Guaranty Corporation, Current Population Survey 1999-2011. EBRI estimates 1999-2010.

Social Security

Dennis Miller, a CBS *MarketWatch* columnist, noted in a September 3, 2013, commentary that because retirement benefits are tied to the changing standards for the Consumer Price Index, "Social Security is not keeping up with the times."

Miller says that consistent measurements of inflation used by the US since 1980 show a far different picture of rising costs. If the "shadow" figure for inflation is correct, it means "Washington has been cutting Social Security payments for years, just in a way that wasn't obvious to most newscasters and taxpayers."



The pictures aren't pretty, and probably aren't going to get better in the future.

Fortunately, it's possible to implement a successful retirement plan without relying on a company pension or Social Security.

But the approach requires personal savings and puts most of the responsibility on the individual to see the plan through to completion.

Now, perhaps more than ever, the difference between a rewarding or subsistence retirement depends on an individual's financial program.

If History Repeats Itself, Innovation Is Coming

Could the PPACA trigger new employee benefits?

Inherent in any new legislation is the potential for unintended or unforeseen consequences. The recently-enacted Patient Protection and Affordable Care Act (ACA), designed to expand health-care benefits to all Americans, may inadvertently compel businesses to consider new strategies for compensating valuable employees.

While the ACA requires individuals, not businesses, to obtain healthcare coverage or pay penalties, the law also includes a "large employer mandate," which requires employers with at least 50 full-time workers to provide affordable health coverage or face a $2,000 fine per worker after the first 30 employees. Due to logistical issues, implementation of this provision has been delayed until January 1, 2015. However, in an ironic twist, the mandate is already impacting ***part-time*** workers.

A number of large companies, particularly chain retailers and franchises, have a high percentage of part-time employees (defined by the ACA as those who work less than 30 hours a week). These part-time employees often had the option of obtaining health insurance through plans sponsored by their employer. But after reviewing the new standards for coverage set by the ACA, many of these employers are no longer offering health insurance for part-timers. Some companies, such as Trader Joe's grocery stores, will pay each part-time employee $500 to help with the costs of obtaining individual health insurance, but, as Sean Williams noted in an April 27, 2013, *Motley Fool* article, part-time workers "fall into a gray area in the ACA…Businesses are under no obligation to offer health care benefits to part-time employees, nor will they be penalized by the federal government for not doing so. What this has done is create the impetus for a dramatic shift from full-time to part-time workforces."

A shift to a part-time workforce is probably not what lawmakers had in mind when they passed the ACA. But when the costs and benefits of new legislation don't align with economic realities, these are the unintended consequences. Instead of following the new guidelines and absorbing the higher costs, history repeatedly shows that individuals and businesses look for alternatives to obtain the same benefits at acceptable prices.

In fact, the prevalence of employer-sponsored health insurance today began as a "work-around" response to a legislative mandate during World War II. Because a large number of working-age men were called into military service, competition for labor was fierce. Greater demand usually leads to higher prices, so the US government, in an attempt to manage the wartime economy, imposed wage freezes. Unable to attract talent with higher pay, companies began offering other employee benefits, including health insurance.

Since then, non-wage benefits have become a key component in employee compensation. Their exact monetary value may be hard to quantify, but benefits are a powerful "extra" to attract and retain good employees. It is not uncommon to hear "The pay isn't the highest, but I can't afford to give up the benefits."

Navigating Between "Fair and Equal"

In any organizational structure – a family, a business, a government – there is often a tension between fair treatment and equal treatment; sometimes fair is not equal, and sometimes equal is not fair. In businesses, this tension is reflected in the challenge to reward employees commensurate with their value to the company.

Productive employees legitimately merit higher compensation. But if the rewards to one worker diminish the benefits or opportunities of others in the organization, the business may suffer. If the company is perceived as treating its employees unequally, it may not be able to retain or attract the talent needed to sustain or grow the business. Additionally, unequal treatment can lead to legal action, adding additional costs and negative publicity.

When the only measure of compensation is salary or hourly wage, evaluations of "fair" and "equal" are easy. But when compensation expands to include other benefits (such as health insurance or a pension), the determination becomes less clear. There are subjective values to these benefits which make it harder to represent fairness or equality with just a number.

Since many of these employee benefit programs include tax advantages (for both employers and employees), the government has also established qualifying standards, most of which are understandably tilted toward equal treatment. If businesses want the tax breaks, they must provide these benefits in a consistent manner for all who qualify. For example, ERISA law mandates that employer-sponsored retirement plans, such as 401(k)s, cannot be "top-heavy," where the majority of deposits come from a few highly-compensated employees.

The new ACA regulations reflect this inclination toward equal treatment. And employers are responding in kind. Discontinuing employer-sponsored health plans and giving every part-time employee, regardless of position or wage, an extra $500 to buy individual insurance is definitely equal treatment.

Given these conditions, how can employers provide "fair" benefits that reward and motivate key employees? This is where innovation comes in.

Individual Benefits for Key Employees

Businesses large and small have a long history of developing creative ways to provide unique benefits to key employees. Often these key employee benefit plans aren't "plans" at all, but specially designed employment agreements between the company and one employee. These agreements may be as simple as an annual performance bonus, a profit-sharing agreement, or an option to receive company stock. They can be sophisticated deferred compensation agreements where the benefit is earned today, but received at a later date, perhaps as a supplemental retirement benefit. It could include insurance, such as personal life or disability policies.

These agreements can not only offer attractive individualized benefits, but also be structured to protect the company's personnel investment by including vesting schedules or other incentives that encourage a key employee to remain with the company. These conditions are sometimes referred to as "golden handcuffs," in that the employee is compensated for his/her willingness to continue with the company. In the financial services industry, these plans may be classified by generic designations, such as a Supplemental Executive Retirement Plan (SERP) or Non-qualified Deferred Compensation (NQDC), but while these formats describe similar features, the design possibilities are nearly infinite.

These plans offer freedom for both employee and employer to construct unique compensation packages. But these personalized employee benefit agreements are still subject to regulatory scrutiny; if compensation is involved, so is the IRS. There are financial firms that specialize in plan design, usually integrating the expertise of tax, legal, insurance and investment professionals. Most private employment agreements are not do-it-yourself projects.

A Good Time to Consider Individual Employee Benefits?

It is logical to believe the higher standards for equal benefits in the ACA will prompt employers to seek other ways to fairly reward key employees, and spur innovative financial minds to invent new ways to meet this demand. Business owners who embrace these changes (and the subsequent innovations in employee benefits) may realize a distinct advantage in attracting and retaining talented and productive employees.

"People find loopholes and workarounds or just invent new ways to make progress possible. This is because people will not be caged. They struggle to be free and sometimes they succeed."

– Max Borders

FLUCTUATING VALUE IN INSURANCE ASSETS

- **Life insurance becomes more valuable if bad things happen.**
- **A lifetime annuity becomes more valuable if good things happen.**

As insurance products, life insurance and fixed annuities are sometimes explained as opposites of each other. A life insurance policy provides financial protection against one dying too soon, while an annuity, with its guarantee of lifetime payments, protects against one living too long.

Consumers can easily understand the rationale for life insurance. Life comes with no guarantees; accidents or other unforeseen events can end it abruptly. Life insurance is a prudent (and financially efficient) response to this risk, reducing the financial uncertainties that might result from an unexpected passing.

In contrast, financial commentators have long noted that consumers don't appear to have a similar appreciation for annuities. In 1965, theoretical economist Menachem Yaari published a seminal research paper titled "Uncertain Lifetime, Life Insurance and the Theory of the Consumer." Not a catchy title, but as one financial manager put it, "Today every graduate student in economics and insurance is forced to read this paper, for very good reason. To put it simply, he introduced and then legitimized life annuities to all economists."

One of Yaari's primary conclusions was that absent the desire to leave an inheritance, the most effective use of one's accumulated savings was to purchase a lifetime annuity, i.e, a stream of payments guaranteed for as long as one lived. Yaari provided statistical evidence that lifetime annuities resulted in higher payments and lower risk, and subsequent studies have confirmed this finding.

Yet economists have also noted that relatively few consumers buy lifetime annuities. They even have a name for this behavior: "The Annuity Puzzle." Why don't more people make a rational economic decision to use their savings to purchase lifetime annuities?

The prevailing answer: People are not rational; they make stupid choices. But this simplistic perspective may overlook some very logical reasons for consumers ***not*** to annuitize their savings. Instead, they might be better served by buying life and disability insurance.

Researchers Felix Reiching and Kent Smithers are the authors of a working paper on why annuities may not always be the optimal choice for retirement. In an interview with *AdvisorOne*, released July 2013, Smithers articulated the main points of their study.

- Consumers have two great financial risks during their lifetime. While they are working, the big risk is they become disabled, and lose their ability to earn an income. When they retire, the big risk is they incur large medical expenses, particularly to pay for long-term care, and lose their savings.

- Both of these events are financial shocks that require a dramatic re-ordering of one's financial life. But not only finances are affected. Each of these events – a disability or a long-term care situation – decrease life expectancy. And diminished life expectancies affect the current value of insurance assets.

Smithers presents the example of someone receiving a lifetime annuity payment in retirement who incurs large expenses from a long-term care incident. On the secondary market, the annuitant could exchange his/her lifetime payments for a lump-sum ("It's my money and I want it now.") But because of the change in health status – one is likely to die sooner – the lump-sum value of the annuity will be diminished.

In the same circumstance, Smithers explains that a consumer receives a "negative annuity" from life insurance; while a lifetime annuity becomes more valuable the longer one lives, an existing life insurance policy becomes more valuable with ***decreased life expectancy***. If one wanted to assign life insurance benefits in exchange for a lump-sum to meet long-term care expenses, the amount received would be higher because of diminished life expectancy.

This observation, that some insurance benefits become more valuable when life expectancy declines, is an interesting twist. In general, Smithers thinks consumers realize greater financial value when they obtain, at an early age, the types of insurance that increase in value, should either of two great financial shocks occur later in their lifetimes. His comment: "Most younger people should negatively annuitize, which they can do by buying a fair amount of life insurance."

Conversely, because an incident of disability or long-term care has a negative impact on the present value of a lifetime annuity, Reiching and Smithers see their infrequent purchase as a rational decision by most consumers (although Summers also says older purchasers of lifetime annuities "can get a very large return").

If you understand this financial paradigm for insurance, a logical application is to secure life, disability, and long-term care insurance when you are young, healthy, and can be insured at the most favorable rates. This concept also implies that life insurance should be viewed as a long-term – if not lifetime – asset. If you encounter a financial shock because of a disability or long-term care, you want the negative annuity qualities of life insurance to absorb the blow.

IS YOUR INSURANCE PROGRAM STRUCTURED TO DELIVER MAXIMUM VALUE – UNDER ALL CIRCUMSTANCES?

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