A Framework for Finding an Appropriate Retirement Income Strategy

by Manish Malhotra

Manish Malhotra is the founder and CEO of Income Discovery, a firm focusing on building new approaches for generating retirement income and new tools to help planners build an appropriate income strategy for their clients. (manish.malhotra@incomediscovery.com)

Executive Summary

- Even though retirement distribution is the most actively researched area in the world of financial planning, the profession still lacks comprehensive analysis framework for comparing retirement distribution strategies.
- Such a framework should do an apples-to-apples comparison among various retirement distribution strategies such as the appropriate time to claim Social Security or the use of systematic portfolio withdrawals in combination with fixed annuities, variable annuities, and bond ladders.
- The proposed framework in this paper includes two reward and three risk metrics. The widely used metric of probability of success is complemented with two additional risk metrics: a view into what happens when the plan fails and the amount of income generated from fixed sources of cash flow. The proposed reward metrics are retirement income and average legacy.
- A general outline of the effect of various income strategies on the metrics is provided, which can help planners practice the art of building an income plan mixing a systematic withdrawal portfolio with a fixed source of cashflow such that the plan provides acceptable confidence and reasonable protection in unfavorable markets with a potential to leave a legacy (if so desired) in favorable markets.

Even though retirement distribution is the most actively researched area in the world of financial planning, we still lack a comprehensive analysis framework for comparing retirement distribution strategies. The majority of the research primarily focuses on safe withdrawal rates from a total-return-based systematic withdrawal portfolio (SWP). There are many alternative income strategies that can be used in isolation or in combination with total-return-based SWP, such as time segmentation, bond ladders, and life or period-certain fixed annuities or variable annuities with guaranteed lifetime withdrawal benefits (GLWB). There are additional decisions to make, such as when to take Social Security.

How does a planner judge which strategy is better? If it is better, by how much is it better? An analysis framework that helps guide these decisions is needed. This paper proposes such a framework. After explaining the framework, case studies will demonstrate the power of the framework in constructing an appropriate retirement distribution strategy based on the unique situation of the client.

Literature Review

The safe withdrawal rate (SWR) has been a very active research area since the seminal work using historical sequence of returns-based analysis by William Bengen (1994). Philip Cooley et al., in their two studies, showed success rates for different withdrawal rates and asset allocations (Cooley 1998), and recommended stock allocations for maximizing success rates for 30 years of real retirement income (Cooley 2011) using historical sequence of returns-based analysis. More recently, Wade Pfau has made significant contributions to the field of safe withdrawal rates by first showing that a 4 percent

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