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Seven steps to a sound retirement

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BOSTON - There are seven keys to a lot of things in life. There are seven steps to heaven and seven types of intelligence and seven habits of effective leaders.

Now we have seven steps to retirement planning courtesy of the Society of Actuaries, which just released a 64-page report with the not-so-consumer-friendly title "Segmenting the Middle Market: Retirement Risks and Solutions Phase II Report."

"Retirement financial planning requires a methodical approach that identifies and quantifies each important component that affects the asset accumulation, income management and product selection/investment decision processes," according to the report, which was sponsored by the society's committee on post-retirement needs and risk and written by Noel Abkemeier of Milliman.

Not surprisingly, Abkemeier says this approach is especially important for middle-income Americans who likely have less than $100,000 set aside for retirement. So what are those steps?

1. Quantify assets and net worth.

The first order of business is taking a tally of all that you own - your financial and non-financial assets, including your home and a self-owned business, and all that you owe. Your home, given that it might be your largest asset, could play an especially important part in your retirement, according to Abkemeier.

And at minimum, you should evaluate the many ways you can create income from your home, such as selling and renting; selling and moving in with family; taking out a home-equity loan; renting out a room or rooms; taking a reverse mortgage; and paying off your mortgage.

Another point that sometimes gets lost in the fray is that assets have to be converted into income and income streams need to be converted into assets. "When we think of assets and income, we need to remember that assets can be converted to a monthly income and that retirement savings are important as a generator of monthly income or spending power," according to SOA's report. "Likewise, income streams like pensions have a value comparable to an asset."

One reason retirement planning is so difficult, according to SOA, is that many people are not able to readily think about assets and income with equivalent values and how to make a translation between the two. Assets often seem like a lot of money, particularly when people forget that they will be using them to meet regular expenses.

Consider, for instance, the notion that $100,000 in retirement savings might translate into just $4,000 per year in retirement income.

2. Quantify risk coverage.

Take stock of all the insurance that you might already have or need - health, disability, life, auto and homeowners. In addition, consider whether you might need long-term-care insurance, especially in light of the cost associated with long-term care and the very real possibility that you might need some assistance at some point in your life.

According to the report, those households with limited assets - say, less than $200,000 in financial assets - may need to spend down their assets and rely on Medicaid, while those with more than $2 million in financial assets can cover long-term-care costs out of pocket. But those households with assets in between $200,000 and $2 million should include long-term care insurance in their plan, according to the SOA. And the best time to buy such insurance is in the late preretirement years.

The SOA also notes in its report the possible need for life insurance, the death benefit of which can be used for bequests or to provide income to a surviving spouse. Life insurance premiums can be expensive if you're getting on in years. That's why the SOA report suggests that you continue "existing preretirement coverages during the retirement period."

Of note, there will soon be many policies that combine long-term-care insurance with life insurance and annuities.

3. Compare expenditure needs against anticipated income.

The thing about retirement is that it's filled with expenses, which according to the SOA report "can be thought of as the minimum needed to sustain a standard of living, plus extra for nonrecurring needs and amounts to help meet dreams." What's more, those expenses are likely to change over time.

So to make your retirement plan work in reality, you first have to make it work on paper. You need to compare whether you'll have enough guaranteed income to cover your essential living expenses, including food, housing and health-insurance premiums, at the point of retirement and then compare what amount of income you'll need to cover your discretionary expenses, such as travel and the like (if those are indeed what you might consider discretionary expenses).

Your guaranteed sources of income include Social Security and possibly a pension and annuity. Not so guaranteed: earnings from work and income from assets such as capital gains, dividends, interest and rental property.

No doubt, as you go about the process of matching income to expenses, you might find yourself having to revise your discretionary expenses, especially if there aren't enough guaranteed sources of income to meet essential expenses.

4. Compare amounts needed in retirement against total assets.

So here's where your math skills (or your Google search skills) might come into play. Besides calculating your income and expenses at the point of retirement, you need to figure out whether your funds will last throughout retirement. In other words, you need to calculate the net present value of your expenses throughout retirement.

Now, truth be told, finding the present value of your expenses is a bit tricky, especially since there are many factors that can affect how much is really needed, including the date of your retirement, inflation rates, gross and after-tax investment returns, and your life expectancy.

But the bottom line is this: If, after crunching the numbers, the present value of your expenses is greater than the present value of your assets, you've got some adjustments to make. And the good news is that there are plenty of adjustments that you can make.

You could, for instance, delay the date of your retirement. You could return to work or work part-time. Those actions might be enough to offset the difference. In addition, you might consider trimming your expenses or consider a more tax-efficient plan to draw down income.

5. Categorize assets.

The SOA also recommends that assets be grouped to fund early, middle and late phases of retirement. Thus, assets for early retirement should be liquid, while mid-retirement assets should include intermediate-term investments such as laddered five- to 10-year Treasury bonds, Treasury Inflation-Protected Securities, laddered fixed-interest deferred annuities, balanced investment portfolios, income-oriented equities, variable annuities and the like. And late retirement assets include longevity insurance, TIPS, balanced portfolios, growth and income portfolios, laddered income annuities, deferred variable annuities and life insurance.

6. Relate investments to investing capabilities and portfolio size.

This should come as no surprise. The SOA recommends that you invest only in things that are suitable, relative to your risk tolerance, investment knowledge and the capacity of the portfolio to accommodate volatility. "In short, a retiree should not invest beyond his investment skills, including those of his adviser," the SOA report stated.

7. Keep the plan current.

This too might be a bit obvious, but retirement-income plans must not be built and set on a shelf. The plan is a point-in-time analysis that must be reviewed on a regular basis.

Consider, for instance, just some of the things that could change in one year, according to the SOA. Health status or health-care costs could change; your life expectancy might change; your investment returns and inflation might be quite different than your assumptions; and your employment status and expected retirement date might change.

What's more, you might suffer the loss of a spouse through death or divorce, or perhaps you might not be able to live independently any longer, or perhaps you might need to sell your house or unexpectedly care for dependents, or change your inheritance plans.

Said Abkemeier: "You want to keep your plan current. You need to tie everything together and go back to the start of the process each year. You want to enjoy retirement, but you don't want to be at rest."