

# “POST-RETIREMENT”

FOR QUARTER ENDING JUNE 30, 2007

With the impending retirement of the baby boom generation in the not so distant future, the financial press has been cranking out article after article offering advice on investment strategy for this phase of people’s lives. The predominant topic addresses the fear of outliving one’s money in his golden years. While it is true that as a society we may be saving less and living longer, a sound financial plan that incorporates an appropriate asset allocation and realistic spending projections, coupled with a consistent, disciplined investment philosophy should provide a safeguard against running out of assets. We would go so far as to argue that all of this media focus on just the retirement phase is entirely too short-sighted – that in fact, one should be planning for his “post-retirement.”

## “Insurance” for Longevity

Longevity risk – the risk that one will outlive one’s money – is not a new phenomenon. In the past, employers who provided defined benefit pension plans managed this risk by funding a plan to provide benefits during a retiree’s life expectancy. Those employees who outlived their life expectancy (and level of plan funding) were “subsidized” by those who died prematurely. Therefore, the plan sponsor only needs to worry about the average life expectancy of the group and not about the deviations from the average. This “pooling of participants” enables a plan sponsor to operate the plan cost-effectively, in the same manner as a life insurance company. However, with the almost total elimination of defined benefit plans in today’s world, more and more people enter retirement without the luxury of the traditional check-a-month pension from their employer.



*“I’m not financially prepared to live to 100.  
Can I get a second opinion?”*

Individuals not covered by a traditional pension plan can manage their longevity risk themselves, and there are two primary ways that this can be accomplished. One method which is being heavily promoted in the press and in numerous advertising campaigns is to transfer the risk by purchasing insurance in the form of an immediate annuity – “guaranteed income for life.” Another method is to carry the risk yourself – in other words, to self-insure. We will analyze both methods.

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## **Insure or Self-Insure**

Self-insuring one's own longevity risk means that one will retain or bear all of the risk of outliving one's assets. But with an appropriate asset allocation, realistic spending projections and a consistent, disciplined investment process, this risk becomes quite manageable. The first step begins with an evaluation of one's spending relative to assets. In order to determine a level of spending that can be supported by a pool of assets over the long term without eroding principal, begin with a reasonable long-term investment return projection (7% - 9%). Now subtract expected long-term inflation (2 - 3%) and the remainder is the percent of assets that can “safely” be withdrawn from the portfolio each year. Following this guideline should allow assets to remain relatively constant over the long-term after adjusting for inflation. Should an unforeseen need for capital arise, one would certainly have access to principal, and any assets that are “left over” would pass on to one's heirs or charity.

Purchasing an immediate annuity will transfer one's longevity risk to the underwriter of the annuity, but, as we shall see, there is a cost to off-loading this risk. The annuity works much like the monthly pension check, providing a set monthly amount for the remainder of your life. The monthly amount remains fixed, so while you will always have monthly income, there is no protection against the ravages of inflation over time, and your standard of living will regress. Moreover, you forfeit access to the principal amount, regardless of whatever misfortune or emergency might befall you. And should you expire before your expected check-out date, whatever remains of your principal

becomes the property of the insurance company, leaving nothing for your heirs or favorite charities.

Due to the inherent shortfalls of the annuity - fixed payment not indexed to inflation, no access to principal - we do not feel that this is the best option. So why is this option being advanced in the financial press? Simply put, it is “safe” advice to offer to the general public when the advice giver has no knowledge of or control over the amount of spending in proportion to accumulated assets, risk tolerance, asset allocation or financial discipline of the advice receiver. And the insurance companies promote the purchase of fixed annuities because they are exceptionally profitable to the insurance companies. In the commercials featuring the 800 pound gorilla, ask yourself one question: How did the gorilla get to be 800 pounds? Answer: He was well fed!

## **Invest for Success**

Once a realistic level of spending relative to one's assets has been established, the next step is to examine one's ability and willingness to accept risk, tax status, liquidity requirements (spending, special one-time events), needs for capital preservation, investment time horizon, and desired goals for the assets in “post-retirement.” These are the inputs that will determine the appropriate asset allocation. Notice that age has not been mentioned as the primary determining factor for setting an allocation, which is in contrast to the conventional “wisdom” often mentioned in the media. This is because age is merely a component of risk tolerance, which itself is only one of several key factors employed in setting allocation policy.

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Asset allocation is the key component of one’s investment policy, which is the roadmap that guides the construction and composition of the portfolio in order to provide a regular stream of payments and provide growth to counter inflation. Contrary to the opinions expressed in the financial press and by countless “financial advisors,” a portfolio does not need to generate income solely in the form of dividends and interest in order to cover planned withdrawals. In other words, a portfolio does not have to generate exactly enough interest and dividend income to cover expected living expenses. We recommend the total-return approach, which also incorporates investment gains for meeting portfolio distributions. Consider the following example:

A recent retiree with a \$1 million lump-sum pension rolls the amount into an IRA and plans to draw income from this account to meet living expenses. At one extreme, the entire amount can be invested into 10-year U.S. Treasury bonds with a 5% average yield. The portfolio is generating \$50,000 per year in interest, which is then used to cover living expenses. The problem with this strategy is that your payment remains fixed – the only time it will change is when an existing bond matures and is replaced with a new bond with a different coupon rate (which can be higher or lower than the previous rate). With a fixed payment, inflation will erode the purchasing power of this income stream over time, and at some point in the future this fixed payment may no longer cover the inflation-adjusted living expenses.

Alternatively, the portfolio can be structured with a mixed allocation of stocks and bonds – let’s assume that the mix is 60% stock and 40% bonds. This new balanced IRA will generate \$24,000 of interest income from a corporate bond allocation and roughly \$12,000 in dividend income from the equity allocation. In order to cover \$50,000 of living expenses, the portfolio must generate a minimum of \$14,000 in capital appreciation. An additional \$25,000 in stock appreciation will offset projected inflation for the first year, bringing the total required average annual return for the equity portion to 8.5%. This should allow the balanced portfolio to compensate for inflation and grow over time.

## **Invest with Success**

The last key ingredient is to employ a consistent, disciplined investment philosophy for investing the assets. Who should one select to manage one’s assets? There is no way to avoid the self-serving tone of the following statement, we will let the facts speak for themselves: CornerCap’s value-oriented contrarian philosophy and disciplined investment process is responsible for our favorable long-term record. Over shorter time horizons, CornerCap’s results are oftentimes favorable, but sometimes they are not. This should not be a great concern if one has a long-term investment horizon – typically 10 years or more.

A recently completed study by the investment consultant DiMeo Schneider & Associates LLC shows that roughly 90% of investment managers with top quartile performance over 10 years suffered through a below-median stretch of 3 years or more during that 10-year period. This study goes on to discuss

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how most investment consultants select money managers based upon superior 1-year and 3-year return comparisons, when the best selection criteria may in fact be to choose a manager with a solid long-term track record with a consistent investment philosophy who has underperformed in the short-term. This illustrates the principal of reversion to the mean, a concept that CornerCap has been preaching since our inception. Indeed, our investment process is based upon this premise.

Sticking with an investment process with proven long-term results is the key to successful investing. By adhering to the spending projections and resisting the urge to tinker with the asset allocation, one's assets should last not only throughout one's retirement but into the “post-retirement” phase. No doubt by now

you have figured out that the euphemism “post-retirement” refers to the period following one's death. This is a key facet of an investor's lifecycle, and it is prudent to plan for this stage. Think of pre-retirement as the accumulation phase, retirement as the spending and gifting phase, and post-retirement as the accomplishment phase. One may wish to provide a sound financial future for their children or grandchildren, or bequeath a sum to his alma mater, or leave assets to a favorite charity or church, or even establish one's own charitable foundation.

One thing is certain: Without a plan, there can be no guarantee that you will ultimately accomplish any of the “post-retirement” goals that you may have worked an entire lifetime to bring to fruition.