

### New Reality TV Show: “The Retiree”

We have a great idea for a new reality TV show. Rather than *The Bachelor* or *The Apprentice*, we think *The Retiree* would offer a unique flavor of excitement and suspense. We would select a random group of baby boomers for participation. Each week, after reviewing their current assets, anticipated needs in retirement, and their savings and investment plans for getting there, we would begin eliminating those contestants whose plans did not approach reality.

Most statistics show that the vast majority of boomers would be candidates for elimination, but, with luck, we may find a participant whose plan for retirement does approach some degree of financial reality. The survivor on the show would be the one who would most likely survive in retirement. There would be no faking, double-crossing or tricking on this show – either they can or they can’t survive in retirement. While Donald (Trump) excites with a “you’re fired” each week on *The Apprentice*, we will excite with a “you’re broke” on *The Retiree*.

### Social Security Support

The boomers are aging with the oldest being around 57. When an individual reaches age 65, the life expectancy is up in the eighties,

and at age 75, the odds are he or she will reach 90. What percentage of retirees will be able to fund a 20- or 30-year retirement period? Most baby boomers are relying on Social Security for some level of support. As savings and retirement problems go, Social Security is the 6,000-pound elephant. Unfortunately, that huge beast becomes totally invisible when in the presence of a politician.

When Social Security started in 1935, we had 13 workers for each retiree. Today, we have three workers for each retiree, and this “declining denominator” is heading toward two in a few decades. This problem will not go away. Action must be taken either to lower benefits, primarily hurting lower income citizens, or to raise taxes, primarily hurting middle- and upper-income people. Either, of course, is political dynamite, but every year the fuse shortens and the cure worsens. It is difficult to envision how Social Security will work through these enormous problems. Therefore, for those with mid to upper incomes, it would be better to think of the program more in terms of the “social” than the “security.”

### Market Support

To restate our reality show question, will these aging boomers be able to retire in the next five to ten years? Most do not have nearly the savings needed to retire on the date or at the level they expect. How will they accumulate

those savings in the short time that remains? In the 1990s, many thought the market would rescue them from this savings deficit. For some, this hope has been rekindled with the market jump last year. Given the articles just published in our March newsletter which present the case for a more modest investment return environment going forward, we believe this is a false hope. Let’s briefly review those articles and take a closer look at the returns that a hopeful future retiree might expect.

Bond returns will have to be modest given the current 4% yield on 10-year Treasury notes. This yield could increase over time, but it will probably be coincident with inflation and, more importantly, these retiring boomers do not have a lot of time. Stocks are currently trading at around 25 times earnings. Except for brief flings with fantasy, we see little opportunity for a multiple expansion from this point. Corporate earnings have tended to grow around 4% to 5% a year over the long-term, so, we would expect real returns to be something in that modest range.

The scramble for real returns is not unique to the individual investor facing retirement. Pension plan sponsors and other institutional asset overseers suffered through the same 2000 to 2002 bear market. In their search for a way to replenish those bear market losses, both the corporate guy and the guy on the street hope to “create” market gains that will

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obscure those market losses. Since traditional stocks and bonds are only expected to produce modest returns over the next decade or so, and given that our boomers are in a hurry, where can these investors go?

In droves, these institutions are turning to hedge funds, private equity transactions, and other alternative investments to close the asset/liability gap. In the past, these niche asset categories represented only a small portion of the total assets invested. This is changing. Not since the tech bubble (all of four years ago) have we seen investors have such confidence in a bundle of investments, all predicted to have positive, double-digit returns and risks that are reduced because of their non-correlation with traditional stocks. It is even more amazing that these risk/return rationalizations are causing a dismissive attitude toward high costs, high leverage and low liquidity. This bubble in the making will self-destruct at a later date and in a manner yet to be determined.

### Self Support

How do we find a more attractive cast of retiree candidates for our TV show? Our retirees will receive little support from Social Security. With the traditional age of retirement (i.e., 65) rapidly approaching our baby boomers, the modest market return environment will not provide enough time for

the compounding effect to perform its magic. Although not very glitzy for our TV viewers to watch, part of the solution will be either to work more years (i.e., age 65 is losing its relevance), or to plan on a lesser lifestyle – or some combination of each. Not an audience pleaser.

The deductive reality is that one's own personal savings will principally drive the standard of living for an individual's retirement. How much savings is needed to meet a retiring person's anticipated needs? For our TV show, we need some parameters for evaluating the retirement realities for our candidates. We also need someone to judge these contestants. While we do not have access to a character like Donald Trump, we have many high character clients who have successfully solved the dilemma facing our hopeful retirees.

In providing a framework for evaluating the feasibility of our retiree candidates, we'll make a few simplifying assumptions. We'll assume a 2% inflation rate, a 30% federal/state income tax rate, some income from Social Security, and conservative net investment returns (8% equity and 5% bond). We will also assume a balanced investment objective and that half the assets are in tax exempt accounts and half are in taxable accounts. Of course, the two key

forecast assumptions are (1) how much money do we start with in savings and (2) how much money do we need to take out to live each year?

Using the above assumptions, the table below forecasts how well our retiree will survive over a 30-year period following retirement at age 65. As noted by the line items along the left side of the table, we have four potential starting balances for our retiree's savings accounts, ranging from \$1 million to \$4 million. As noted by the columns at the top, we have three potential pre-tax living needs, ranging from \$100,000/year to \$200,000/year. The results are presented as either years or dollars.

### Years Until Money Runs Out OR Money Remaining After 30 Years

Savings (\$mm)	-----Annual Pre-Tax Income-----		
	<u>\$100,000</u>	<u>\$150,000</u>	<u>\$200,000</u>
<b>\$1.0</b>	23 Yrs	12 Yrs	8 Yrs
<b>\$2.0</b>	\$2.2	\$0.4	20 Yrs
<b>\$3.0</b>	\$4.7	\$2.9	\$1.1
<b>\$4.0</b>	\$7.3	\$5.5	\$3.6

- **Years** -- This represents the number of years our retiree can live with those initial savings at that spending level before his money runs out. For example, an investor with \$1 million in savings who needs \$150,000/year pre-tax to live is expected to have fully depleted his savings after 12 years.

- **Dollars** -- This represents the assets remaining (present valued back to today's dollars) in our retiree's investment accounts after 30 years of living at that spending level and starting with the savings noted. For example, an investor with \$3 million in savings who needs \$150,000/year pre-tax to live is expected to live on that amount, adjusted upward for inflation, for 30 years and still have approximately the same amount (\$2.9 million, present value) of investable assets remaining.

These results are based on many assumptions, and we have noted the more important ones. The results are also based on CornerCap's forecasting model. The only thing we know for certain about forecasts such as these (or any forecast) is that the results are incorrect. Another model or a different set of assumptions will provide different results, and those results would be just as incorrect. The purpose of these forecasts is to provide a feel for the approximate savings required for a given level of spending. We have also tried to

show the sensitivity to changes in a couple of the key assumptions.

Our nation has a large population bulge approaching retirement age, and for most of the retirees, their retirement is substantially under-funded. Politicians like popular solutions, and there are none – all potential solutions are painful. For retirement above a basic subsistence, individuals will be accountable for accumulating the needed level of savings. And, as was witnessed from the recent market collapse, individuals and institutions will also be accountable for the quality of their long-term investment decisions. This is not a dress rehearsal, and the survivors will be those who understand the consequences of performing poorly in this real life drama. Save early and often, and invest wisely.