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Scott Burns and Laurence J. Kotlikoff: Get real about retirement

Forget what financial planners have told you; a new approach allows for life's peaks and valleys

Economists have a hard time making up their minds. President Truman asked for a one-handed economist so he could stop hearing the phrase "on the other hand." But economists are sure of one thing – the need for proper financial planning. Unfortunately, two-thirds of all Americans never attempt to formulate a financial plan. Of those who do, two-fifths end up ignoring it.

Perhaps we're relying on our employers and Uncle Sam to fund our retirements. If so, it's time for a reality check.

Corporate America is busy abandoning its pension commitments. And Uncle Sam will go broke before he can pay the retirement entitlements of the baby boomers.

Most boomers are saving far less than what's needed to maintain their lifestyles – even with no tax hikes or benefit cuts. They're good kids, following the example set by their parents, two-thirds of whom are largely dependent on the deteriorating Social Security system.

Depressed yet?

Take heart. The economists are coming.

We believe the "dismal science" can unlock the problems with standard financial planning and prescribe solutions. Indeed, we believe it's time for economists to shift from studying financial pathology to writing financial prescriptions.

The solution is a planning tool for the 21st century that can be done on virtually any personal computer. And the first generation of software, developed by Dr. Kotlikoff, now exists.

It's called Economic Security Planner, ESPlanner for short, and it uses the economic principle of "consumption smoothing."

For our purposes, that means calculating and maintaining your sustainable lifetime standard of living. It means reaching your retirement needs by adjusting the amount you save over time, based on the changing realities of your life.

It means not guessing at a constant level of saving and then finding out in retirement that it's not enough. And it means not living like a miser and dying on a big pile of money (unless you're into that sort of thing).

Consumption smoothing underlies everything economists have to say about saving, insuring and investing.

Until now, economists have had no practical way to convey consumption smoothing to the public. So they've stuck to their research.

They let financial planners and investment companies dispense financial advice. Imagine doctors locking themselves in their labs and letting unlicensed practitioners and tonic vendors determine our ailments and medications.

Financial quackery, like medical quackery, is dangerous.

Determining how much households need to spend, save, insure and diversify to smooth their living standards is incredibly complicated. The short list of interconnected factors includes household demographics, earnings, taxes, housing plans, economies of shared living, the relative costs of children, medical costs, retirement accounts, mortgages, special expenditures, pensions, Social Security benefits and estate plans.

Conventional financial planning asks us to do this rocket science in our heads. Specifically, it asks us to set our own savings needs for retirement and insurance needs if a spouse dies. Guessing our target within even 10 percent of the sustainable level – the level that provides the same living standard now and in the future – is virtually impossible.

Even mistakes of 10 percent, because they apply to all the potential years of retirement and survivorship, can lead to huge mistakes in saving and insurance recommendations. They can also lead to major disruptions – on the order of 30 percent – in our living standards when we retire or become widowed.

Sales vs. your needs

The worst offenders when it comes to financial guessing are the large investment companies. Their interest is not financial planning but sales. That's why their Web calculators suggest very high saving targets and offer simple and quick answers. The goal is to move us quickly from planning to purchasing.

Well-meaning authors also lead us astray.

Today's hottest personal finance book is Lee Eisenberg's *The Number*. It's about the amount of money you need to retire. It's also, we're told, the path to self-knowledge, enlightenment and inner peace. Because once you know your needs, you can actualize them.

We tried out these other methods.

First, we contemplated our needs and figured out our Numbers. They're kind of big. We're talking roughly \$200 million for Larry and \$10 million for Scott.

Why the difference? Well, Larry is rather needy. He needs the Lear jet, the big yacht, a private island in the Caribbean, lots of attendants, etc. Scott has more modest needs, mostly involving a vintage trailer collection.

One catch. Neither of us can save anywhere near enough money to hit our numbers. Our needs, we realized, must fit within our budgets. Worse, the needier we are in retirement, the less needy we can be before retirement.

Current spending

After lots of fussing about forgoing the jet and the trailers, we decided to set our retirement needs based on our current spending. This is what financial planners generally advise you to do – set your retirement spending target based on your current spending.

But this didn't work either. Larry's current spending was far too high to maintain, and Scott's was ridiculously low. What we really needed to figure out was the most we could safely spend on an ongoing basis.

This consumption smoothing would balance our pre- and post-retirement needs the way economics recommends.

So Larry pulled out ESPlanner, the software program he developed. In 10 seconds, it figures out your highest sustainable lifetime living standard, even taking into account

future earnings, regular assets, retirement accounts, Social Security benefits, federal and state taxes, housing plans, estate plans and special expenditures.

Before we proceed, we should clarify: Larry sells ESPlanner on his Web site. It costs from \$149 for individuals to \$1,500 for financial professionals. Scott has no financial interest in this venture.

ESPlanner told Larry to start living within his means. It told Scott he could start living it up.

It also told us the right Number we'd need to retire with – not a guess.

And that's reassuring, because retirement and widowhood can last a long time. Small targeting mistakes, because they're being made for so many years, can really foul up a financial plan. You could save far too much – or far too little. You could buy silly amounts of life insurance.

Hypothetical couple

To further explore matters, we used ESPlanner for a hypothetical couple.

They're 40-year-old Californians with two kids, a modest home, \$125,000 in annual labor earnings, \$75,000 in savings, a big mortgage and lots of future college expenses.

ESPlanner knows what to do. With the extra mouths to feed and the mortgage payments, the couple should save modestly – only \$1,440 this year – and then do a ton of retirement saving as soon as they've got the kids through college. This plan maintains the couple's living standard through time.

That's consumption smoothing.

What if this couple were to use the Number system and set their retirement needs just 10 percent too high? They would be told by conventional financial software to save \$11,955 a year. And if the couple set their number just 10 percent too low, they will be told to save nothing at all. Clearly, saving recommendations are highly sensitive to the Number.

What about life insurance recommendations? ESPlanner tells us the couple needs to hold \$600,000 in life insurance. But if they set their target just 10 percent too high, they'll be told to hold \$1.3 million. And if they set their target just 10 percent too low, they'll be told to hold only \$100,000!

Small mistakes in your number also mean large disruptions in your living standard at retirement or if your spouse or partner dies. For our illustrative couple, a mistake in the Number of 10 percent led to a roughly 30 percent change in living standard for retirees and survivors.

That's consumption disruption, not consumption smoothing.

Margin of error

The really scary part is that a 10 percent targeting error is minor for conventional financial planning.

Fidelity Investments' online Retirement Quick Check calculator recommends a retirement spending target equal to 60 percent of annual earnings. According to ESPlanner, for our stylized couple this target is 36 percent too high.

TIAA-CREF's Retirement Goal Evaluator recommends a retirement spending target equal to 80 percent of annual earnings. For our stylized couple, this target is 78 percent too high.

We think life's too short for target practice or wishful guessing. So read *The Number*, think about the Number, but be advised that any number chosen by you or by financial planners using horse-and-buggy tools is likely to be dangerously wrong.

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