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Opinion Editorial on Pensions

For Retirees, a Million-Dollar Illusion

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Press Clip Relevance

In 1953, when “How to Marry a Millionaire” was in movie theaters, $1 million bought the equivalent of $8.7 million today [4]. Now $1 million won’t even buy an average Manhattan apartment [5] or come remotely close to paying the average salary of an N.B.A. basketball player [6].

Still, $1 million is more money than 9 in 10 American families possess. It may no longer be a symbol of boundless wealth, but as a retirement [7] nest egg, $1 million is relatively big. It may seem like a lot to live on.

But in many ways, it’s not.

Inflation isn’t the only thing that’s whittled down the $1 million. The topsy-turvy world of today’s financial markets — particularly, the still-ultralow interest rates in the bond market — is upending what many people thought they understood about how to pay for life after work.

“We’re facing a crisis right now, and it’s going to get worse,” said Alicia Munnell, director [8] of the Center for Retirement Research [9] at Boston College. “Most people haven’t saved nearly enough, not even people who have put away $1 million.”

For people close to retirement, the problem is acute. The conventional financial advice is that the older you get, the more you should put into bonds, which are widely considered safer than stocks. But consider this bleak picture: A typical 65-year-old couple with $1 million in tax-free municipal bonds [10] want to retire. They plan to withdraw 4 percent of their savings a year — a common, rule-of-thumb drawdown. But under current conditions, if they spend that $40,000 a year, adjusted for inflation, there is a 72 percent probability that they will run through their bond

portfolio before they die.

Suddenly, that risk-free bond portfolio is looking risky. “The probabilities are remarkably grim for retirees who insist on holding only bonds in the belief that they are safe,” says Seth J. Masters, the chief investment officer of Bernstein Global Wealth Management [11], a Manhattan-based firm, which ran these projections for Sunday Business. “Because we live in this world we tend to think of it as ‘normal,’ but from the standpoint of financial market history, it’s not normal at all,” Mr. Masters said. “And that’s very clear when you look at fixed-income returns.”

Several rounds of intervention by the Federal Reserve and other central banks, aimed at stimulating a moribund economy, have helped to suppress rates, and so has low inflation. Low rates have led to cheaper mortgages [12] and credit cards, helping to balance family budgets.

But for savers, low rates have been a trial. The fundamental problem is that benchmark Treasury yields have been well below 4 percent since early in the financial crisis. That creates brutal math: if your portfolio’s income is below 4 percent, you can’t withdraw 4 percent annually, and add inflation adjustments, without depleting that portfolio over time.

And with rising life expectancies, many people will have a lot of time [13]: the average 65-year-old woman today can be expected to live to 86, a man to 84. One out of 10 people who are 65 today will live past 95, according to projections from the Social Security Administration.

“If you’re invested only in bonds and you’re withdrawing 4 percent, plus inflation, your portfolio will decline,” said Maria A. Bruno, senior investment analyst [14] at Vanguard. “That’s why we recommend that most people hold some equities. And why it’s important to be flexible.” In some years, investors may need to withdraw less than 4 percent, she said, and in some years they can take more.

Clearly, such flexibility depends on individual circumstances. Billionaires can afford to be very flexible: just 2 percent of a $1 billion portfolio is still $20 million. With economizing, even a big spender should be able to scrape by on that. But $20,000 — the cash flow from a $1 million portfolio at 2 percent — won’t take you very far in the United States today.

And if you’re not close to being a millionaire — if you’re starting, say, with $10,000 in financial assets — you’ve got very little flexibility indeed. Yet $10,890 is the median financial net worth of an American household today, according to calculations by Edward N. Wolff, [15] an economics professor at New York University. (He bases this estimate on 2010 Federal Reserve data, which he has updated for Sunday Business according to changes in relevant market indexes.)

A millionaire household lives in elite territory, even if it no longer seems truly rich. Including a home in the calculations, such a family ranks in the top 10.1 percent of all households in the United States, according to Professor Wolff’s estimates. Excluding the value of a home, a net worth of $1 million puts a household in the top 8.1 percent. Yet even such families may have difficulty maintaining their standard of living in retirement.

“The bottom line is that people at nearly all levels of the income distribution have undersaved,”

Professor Wolff said. "Social Security [16] is going to be a major, and maybe primary, source of income for people, even for some of those close to the top."

Professor Munnell said that in addition to relying on Social Security, which she called "absolutely crucial, even for people with $1 million," other options include saving more, spending less, working longer and tapping home equity for living expenses. "There aren't that many levers we can use," she said. "We have to consider them all."

THE bond market has always been a forbidding place for outsiders, but making some sense of it is important for people who rely on bond income.

Low bond yields have been a nightmare for many investors, but that's not the only issue. Today's market rates aren't stable. Steve Huber, [17] portfolio manager at T. Rowe Price, said, "Current yields are an anomaly when you consider where rates have been over the last decade or more."

Rates are expected to rise. While that will eventually mean more income for bond buyers, it will create a host of problems. Already, the market has been rattled by speculation that after years of big bond-buying, the Fed may soon begin to taper its appetite. In May, a half-point climb in the yield of 10-year Treasury notes [18] produced the biggest monthly bond market losses in nine years. (Yields and prices move in opposite directions.) Yet yields remain extraordinarily low on a historical basis. The yield on the benchmark 10-year Treasury note is just under 2.2 percent, compared with more than 6.5 percent, on average, since 1962, according to quarterly Bloomberg data.

And bond investing is likely to remain challenging for years to come. Investors may face a double-whammy — low yields now and the prospect of significant losses as yields rise. On Friday, after the Labor Department reported that the unemployment rate edged up to 7.6 percent from 7.5 percent, yields rose further, amid uncertainty about the Fed's intentions.

Despite this market instability, bonds tend to be the investment of choice as people retire, because they throw off steady income. But as the projections from Bernstein Global Wealth Management suggest, over-reliance on bonds leads to financial quandaries.

These projections, based on proprietary market and economic forecasts and portfolio analyses, as well as on standard actuarial and tax data, estimate future probabilities for investors. That's a quixotic task at best, intended to illustrate possible outcomes rather than to provide precise forecasts, said Mr. Masters at Bernstein.

Still, they are worrisome. Consider again the 65-year-old couple who are starting to draw down $1 million in savings this year: if they withdrew 3 percent, or $30,000, a year, rather than that standard rate of 4 percent, inflation-adjusted, there is still a one-in-three chance that they will outlive their money, under current market conditions.

There are ways to improve these outcomes, but they have their own hazards. Adding stocks to a portfolio is an obvious counterbalance. And there is now a broad consensus among asset managers and academics that stocks have an unusually high likelihood of outperforming bonds

over the next decade. That was the finding of a recent study by two economists at the Federal Reserve Bank of New York [19].

The Bernstein projections concur that adding stocks to a portfolio reduces the risk of outliving your savings. But it also increases the risk of big losses.

Assume, for example, a diversified portfolio that is 80 percent invested in stocks and 20 percent in bonds — a much higher stock-to-bond ratio than advisers typically suggest for someone near retirement. In that situation, under current market conditions and at a 4 percent withdrawal rate, the probability of running out of money drops to 14 percent. That's mainly because of higher expected returns for stocks. At a 3 percent withdrawal rate, the probability of outliving the portfolio is only 4 percent.

But then stock market risk comes into play. Over the long term, stocks tend to outperform bonds, but typically fluctuate much more wildly. There's a good chance that at some point, stock investments will produce major losses that many people simply can't tolerate.

"We find that people tend to think of losses in their portfolios based on the peak value they've ever had," Mr. Masters said. So Bernstein calculates the probability of what it calls a "peak-to-trough loss" of at least 20 percent in its sample portfolios.

For those with an 80/20 mix of stocks and bonds, it found a 60 percent probability of such a loss over the investors' lifetime. And, of course, some market declines far exceed 20 percent.

"Large losses may not be something that people are willing to live with, even if they are associated with higher returns over the long term," Mr. Masters said. "Which is why we'd recommend holding some stocks, but not as much as 80 percent, for most people."

Bonds would fare better in an economic environment more typical of the past, with higher interest rates, among other factors, Bernstein projections show. Should those conditions return one day, investment choices would be less stark. Under "normal" conditions, Bernstein projects, at a 4 percent withdrawal rate, inflation-adjusted, a portfolio 100 percent invested in bonds would have a 38 percent chance of running out in an investor's lifetime; at a 3 percent withdrawal rate, the chances drop to 14 percent.

Other investment companies modeling similar problems come up with different numbers, although the broad implications are reasonably close. "We're operating in the same ballpark," said Ms. Bruno at Vanguard.

T. Rowe Price projections — which don't differentiate between current conditions and a historically normal environment — include different stock and bond indexes, and don't include the effect of taxes. That outlook finds that a 65-year-old couple who invested entirely in bonds have a 21 percent chance of outliving their portfolio. That's much more favorable than the Bernstein projections.

Still, Jim Tzitzouris, quantitative analyst at the asset allocation [20] group of T. Rowe Price, said, "In the current environment, it's worth being quite concerned about the effects of low interest

rates on a retirement portfolio."

ASIDE from recalibrating a portfolio, what can be done to improve a would-be retiree's financial situation? One answer is to work longer and retire later. Yet many people can't do that, often because they are physically unable to do so or can no longer find a suitable job.

Still, the expectation of working longer seems to be the trend. An annual survey for the Employee Benefit Research Institute [21] found that in 1991, only 11 percent of workers expected to retire after age 65, while this year, 36 percent said they would retire after 65 — and 7 percent said they didn't plan to retire at all.

Working longer improves your financial prospects, and one reason is morbid: you won't have as long to live on your savings.

Working longer helps in a happier way, too. Professor Munnell notes that by delaying retirement, monthly Social Security benefits rise substantially. For example, if you delay claiming benefits past what the government calls your "full" retirement age — 66, for people retiring this year — your monthly benefits increase by 8 percent a year [22]until you reach 70.

Compared with current bond yields, that's a fabulous rate of return, for people who can afford to delay starting the Social Security income stream, she said.

It's also a much better return than a commercially available annuity will provide. Vanguard estimates that a basic fixed annuity that ends at death will produce an annual inflation-adjusted payout of only 3.7 percent if bought today for a healthy 65-year-old couple. (But the money is definitely gone when they die; there would be no surplus to pass on, as there could be in an investment portfolio.)

Paying close attention to Social Security benefits is likely to be meaningful for retirees at nearly all income levels, Professor Wolff said. "Even at the millionaire level, for most people, Social Security is going to be very important."

The maximum Social Security benefit [23] for a retiree at 66 this year is $31,000 — about the equivalent of drawing down 3 percent a year on a portfolio of $1 million.

Still, even $61,000 or $71,000 a year — the combined Social Security and cash flow from the $1 million portfolio — isn't likely to be enough for most people who have grown accustomed to living on $150,000 or more a year. And $150,000 is the median income of a typical household in the top 10 percent, roughly the ranking of a family with $1 million in net assets, Professor Wolff says.

Without another source of income, perhaps from traditional pensions from either or both spouses, he adds, a household like this won't come close to replacing 80 percent of its pre-retirement income — often considered an acceptable target level.

And, he says, if Social Security is important for the relatively affluent, it's all the more so for those with less income and wealth, especially with the decline of traditional pensions. "Social Security needs to be strengthened, not cut," he says.

Professor Munnell says this might be accomplished simply by raising the maximum taxable income level for Social Security payroll taxes. Currently, that level is $113,700. “Social Security has done its job and it can easily be made solvent in the future,” she said.

There are a few steps that people can take on their own, she said. “When you’re younger, and have a lot of human capital, you can save more and put a lot of the savings into stocks,” she said. And then you can gradually shift into bonds as you age, fully understanding that the bond income may be quite limited. “When you’re in your 50s,” she continued, “you can try to save as much as you can, and try not to get accustomed to a lifestyle that you won’t be able to afford later on.”

You can also try to pay off your mortgage, so you have the option of tapping home equity if you need to supplement your income later. And, she suggested, if you’re lucky you’ll find work that you like and can stick with for a long time — until 70, at least.

That might not be the way you imagined your life. But the numbers suggest that even if you’re a millionaire, you might have to start.

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