WHITE PAPER

The Successful Retirement Series™
Phase Two

Making a Successful Retirement Transition

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Some of the negative psychological components of this transition are implied by one dictionary definition of retirement: To be taken out of service. *Who the heck wants to be "taken out of service," like a set of brake rotors that have outlived their usefulness and end up on the junk heap?*

This *White Paper* focuses on the transition from full-time work to full-time retirement. It is written for individuals and couples within five years of their planned retirement date, and is intended to help them make a successful retirement transition.

Not Your Grandfather's Retirement

Studies suggest there is a huge gap between the pictures most Americans have of retirement, and the retirement they will actually experience. The nature of retirement is changing, as the baby-boom generation begins to move from work into retirement.

Americans in these early years of the 21st century are living longer, healthier lives, and a key part of retirement planning is understanding the dual impacts of longevity and inflation. Certain high-earning professionals, like cardiac surgeons, who begin their careers after years of schooling and preparation, may be retired for longer than they worked. (We examine the impact of longevity more completely in the third White Paper in this series, *Will You Outlive Your Money*?)

We suggest viewing retirement not as an event, like an earthquake or car crash, but as a process, with both financial and psychological elements. The new retirement is a gradual transition from full-time work to full-time retirement. For many people, managing the psychological aspects of the retirement transition may be just as challenging as managing the financial aspects.

The Successful Retirement Strategy

In the previous White Paper in this series (*How Much is Enough*), we discussed the nation's looming retirement crisis. The "three-legged stool" of traditional retirement, with income from Social Security, pensions, and personal savings combining to fund a secure retirement, has been reduced to two wobbly legs: under-funded Social Security and inadequate personal savings. The life style most Americans want in retirement will require 80% to 120% of pre-retirement income, but the reality is that less than 10% of Americans accumulate sufficient capital to fully fund their pre-retirement lifestyle after they retire.

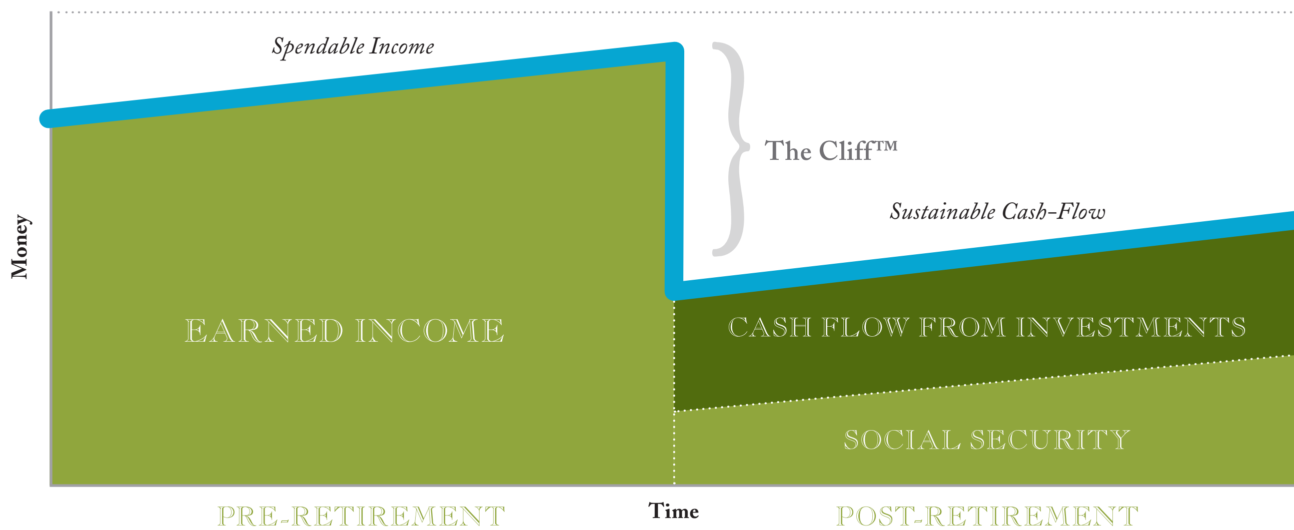
As a nation and as individuals, we face profound demographic and financial challenges. Yet worries about retirement, especially concerns about finances, can obscure a very positive reality – individuals retiring in the second decade of the 21st century have the opportunity to live longer, healthier, more productive and functional lives in retirement than any prior generation of human beings.

In this White Paper, we will focus on practical steps you can take in the years prior to retirement to place yourself on a stronger financial foundation for the rest of your life. We will also discuss strategies to manage the psychological challenges at the retirement transition, to help you set the stage for a healthy and happy retirement.

AVOID *THE CLIFF*™

The fundamental financial challenge at the retirement transition can be visually illustrated by Chart 1. You need to avoid *The Cliff*: a sudden and permanent reduction in your standard of living, either as of your retirement date, or in later years when you have exhausted your capital.

Chart 1
The Cliff™



[1] According to Pension Issues: Lump-Sum Distributions and Retirement Income Security by Patrick Purcell, many recipients of lump-sum distributions use all or part of their distributions for current consumption rather than depositing the finds into another retirement account.

THE FIVE FINANCIAL SUCCESS STRATEGIES

Once you are within five years of your expected retirement date, avoiding *The Cliff*™ requires a combination of five strategies:

Maximize pre-tax savings • Reduce current spending
Convert bad assets to good assets • Consider part-time work
Maximize the lifetime economic value of your Social Security benefits

Let's briefly examine each of these planning strategies.

Maximize pre-tax savings:

Maximize contributions to your 401k, 403b or other retirement plan. Increasing contributions has two benefits – it builds retirement capital, and it also begins the process of adjusting to a lower consumption rate in retirement.

Make non-deductible contributions to Roth IRAs, if your taxable income permits.

Consider a defined-benefit plan, to shift a large portion of earned income into pre-tax savings, reducing current taxes and building capital quickly. A defined benefit plan can be considered a "do- it-yourself" pension.

This strategy will only work if you are self-employed and have few employees, and those younger.

Reduce spending:

Pay off all consumer debt prior to retirement. Variable-rate, high-interest debt can be a killer.

Downsize your home. This will reduce maintenance costs and free capital for investments that produce cash flow.

Choose health insurance coverage wisely. There are a wide variety of Medigap plans available to supplement Medicare. Choose a plan that includes the features you need, given your health condition and family history, at the most competitive price.

Consider a move to a cheaper locale, either in the U. S. or even overseas.

Travel off-season, when costs are lower, crowds are smaller and the locals less overwhelmed and happier to see tourists.

Take advantage of senior discounts, on everything from services to travel to dining and entertainment.

Reduce auto costs. Re-visit your auto insurance policy and negotiate lower rates due to reduced mileage commuting to work. Especially if your retirement residence is in a walkable city or town, consider selling one car and making do with a single automobile.

Reduce insurance costs. For example, most retirees have no reason to carry a disability insurance policy, and many have no economic need for life insurance.

Stop being the one who picks up the check for the entire family.

Don't provide perpetual financial assistance to your adult children or grandchildren.

These last two suggestions are often the most difficult. Many of our clients have spent much of their adult lives acting as the patriarch or matriarch of their extended family, the one on whom everyone depends for counsel, direction and financial support – even for lodging, if a job falls through or a marriage dissolves.

But in retirement, the cost of remaining the family's "deep pocket" can be huge. Consuming your limited capital to fund the lifestyles of your children and grandchildren is the most common way we have seen, over our thirty years of advising clients, that retirees run out of money.

Remember, your kids and grandkids can change their lifestyles more easily than you can replace capital. If you are considering providing financial help to your heirs during your lifetime, be aware of the difference between *emergency assistance* on the one hand, and *lifestyle support* or on the other hand. If your daughter and son-in-law bought a too-expensive

"Good news, honey—seventy is the new fifty."

house, and they are now underwater, paying their monthly mortgage depletes your capital, while only delaying the inevitable sale at a loss.

Convert bad assets to good assets:

A traditional balance sheet does not differentiate between lifestyle assets that constantly drain your cash flow and those that put money in your pocket. Understand that "assets" that cost money to maintain and do not appreciate are really *costs*.

Take the cigarette boat, the shore house and the stable of Arabian ponies off the asset side of your balance sheet.

Sell unproductive, cash-draining assets and either put the proceeds into investments or use them to pay down debt.

Again, consider down-sizing your home to free up capital, reduce costs and allow you to save more aggressively for retirement. In the long-term, home prices are a function of inflation, wage growth and population. A big, expensive house is an expense, not an asset that you can count on to appreciate.

Maximize the lifetime economic value of your Social Security benefits:

Begin at the right time. Beware of a "use it or lose it" approach to Social Security. Most Americans "pull the trigger" on Social Security too early, locking themselves into a lower monthly benefit for the rest of their lives.

Play the spousal benefits game wisely. In certain cases, it can be profitable to delay claiming spousal benefits until the spouse's normal retirement age, then switch from spousal benefits to earned benefits at a later date. (The longer you defer starting to receive your Social Security benefit, the higher the monthly payments.)

Understand the tax treatment of Social Security. Up to 85% of your Social Security payments are taxable if your income is over $44,000 joint, or $34,000 single.

In the Big House

We once had a client who kept his $1.5 million Main Line mansion for more than ten years, because he had promised his daughter she could be married in the garden. Since both client and wife were in their sixties, and all three of their kids had long since moved out, this was a choice with profound economic consequences. Comparing a $1.5 million mini-estate to a $500,000 townhome, they could have had an additional $1,000,000 to invest, plus substantial annual savings on upkeep, taxes, utilities, lawn care and so on.

Over ten years those savings, plus the earnings on the net proceeds of sale, could easily have added up to $500,000 or more. That would go a long way toward a financially successful retirement.

Many people choose to keep a large family home in anticipation of visits from their children and grandchildren. Yet down-sizing from a large, multi-bedroom house to a home that more accurately reflects your day-to-day life could easily save you between $10,000 and $50,000 per year. Use a portion of those savings to put the kids and grandkids in a local hotel for a few nights when they visit. Rent a condo at the beach for a week's vacation together. Or just go to visit them at their home.

Watch out for benefit cuts based on earned income. You can lose up to 50% of your Social Security payments if you earn more than $14,160 before your normal retirement age. (Another reason to delay starting Social Security payments.)

Work part-time:

Most individuals contemplating retirement seriously underestimate the profound economic value of part-time work in the years after retirement. For example, if you work as a physician and earn $500,000 per year, earning $100,000 as a part-time utilization coordinator medical consultant for five years after retirement may seem trivial, but it is anything but.

If we assume that a couple aged 65 can withdraw only 4% of their investment net worth each year without running out of money, then generating portfolio cash flow equal to that extra $100,000 of earned income would require $2.5 million in additional retirement assets. *Part time work is of profound economic value.*

Design your part-time career around "The Retirement Trick." Reduce your areas of work responsibility to those at which you have unique ability, where you have more energy at the end of the day than at the beginning – activities that are so enjoyable that you would almost be willing to work for free.

Change your job completely. Now that you know that earning a relatively low wage can have a profound positive impact on your retirement finances, is there a job you have always wanted to do, but never pursued because it did not pay enough? Civil War battlefield tour guide? Part-time controller for a non-profit? Charter fishing captain? Delivery van driver for an artisan breadmaker? Why not give it a shot?

Putting on the Orange Apron

Some years back, I gave a presentation on retirement transition planning to a group of telephone company executives, who had been offered an early-retirement incentive as part of their firm's downsizing. We discussed whether to elect a pension or a lump-sum distribution, IRA rollover strategies and how to invest during retirement.

One senior manager spoke up: "The week after I retire, I expect to be at Home Depot with an orange apron on."

Thinking he was worried about whether his lump-sum would provide sufficient retirement cash flow, I suggested we might want to run some numbers, to see if he could make it financially without working part-time.

He shook his head. "You don't understand," he told me. "For thirty years, I've been dealing with difficult employees, negotiating union contracts and pushing paper around. To relax on the weekends, I build furniture in my basement. So the idea of hanging around power tools and answering questions about router bits is my dream job. I'd do that for free."

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RUNNING THE NUMBERS

We suggest that you view retirement cash flow planning as a process of negotiating with yourself, over years or even decades. You must balance your desire to enhance your current lifestyle against your future self's need for financial security, thirty or even forty years from now. (Remember, you may be retired for as long as you worked.)

Our retirement cash flow analysis answers the essential question, will you run out of money before you die?

As you consider your retirement transition, ask yourself questions like these:

> *What do I need to save each year to build a large enough nest egg?*
>
> *How much can I draw from my portfolio every year without exhausting my capital?*
>
> *Should I begin taking Social Security at early retirement age (62) or delay until full retirement age, or even later?*

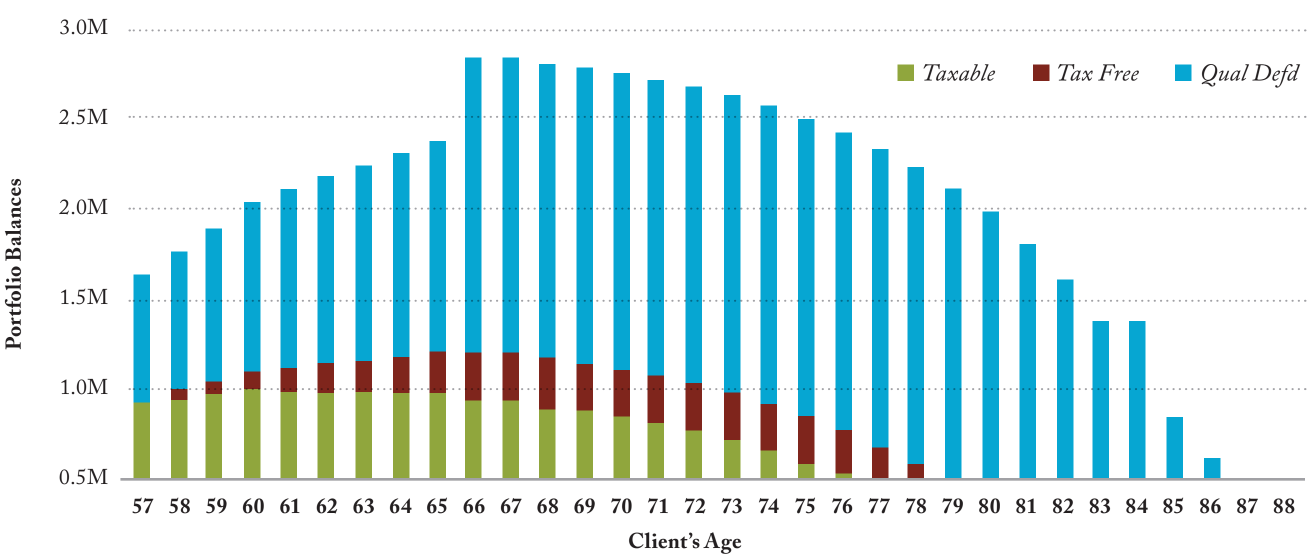
The answer to each of these questions is the same – *you have to run the numbers.*

By using best-practice financial modeling, we can provide clarity about what you need to do to make a confident transition to a financially secure retirement. Our primary concern is usually your target after-tax income in retirement, but our analysis might also examine a move to a new residence in a warmer climate, purchase or sale of a vacation home, creation of a trust to fund your grandchildren's education, etc.

Based on our fact-finding, we perform a baseline analysis of your post-retirement financial situation. This linear retirement cash flow analysis answers the essential question: *"Will you run out of money before you die?"* Chart 2 shows the linear analysis of a successful retirement scenario. Observe the gradual buildup of capital, the addition of a lump sum distribution at the retirement transition age of 66, and then the gradual draw down of capital, with just over $100,000 remaining at the projected mortality age of 86.

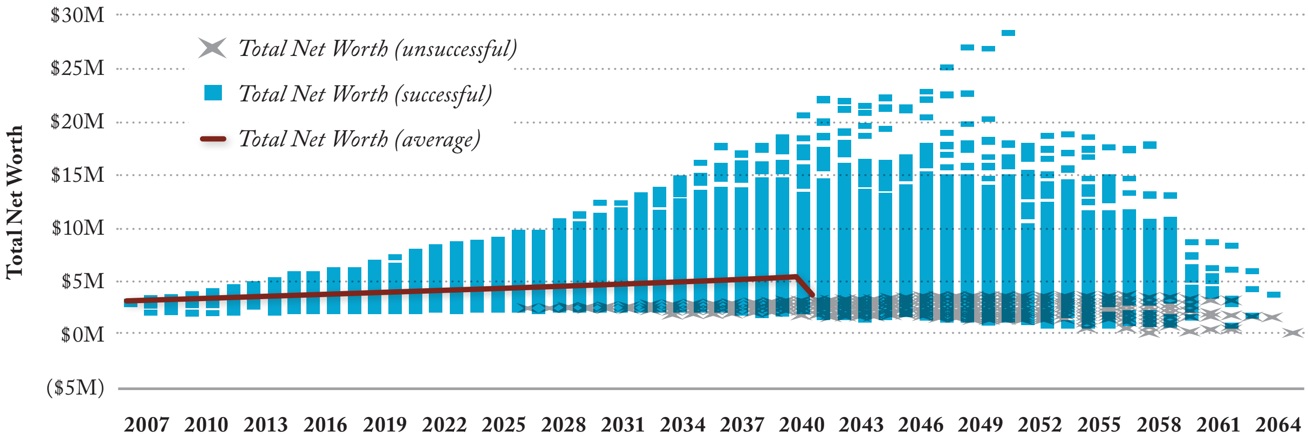
Since the assumptions in any linear projection cannot be precisely accurate, we also use *Monte Carlo analysis* to help us understand the impact of uncertainty on financial outcomes. This approach calculates the probability of successfully attaining defined financial goals, taking uncertainty into consideration by randomizing variables (i.e. investment returns, volatility and inflation) based on both historical data and capital market assumptions. The analysis also takes into account the effects of longevity by randomizing life expectancy. (see chart 3).

Chart 2
Calculating Capital Needs: A Successful Linear Analysis



This hypothetical report is not indicative of any security's performance and is based on information believed to be reliable. Future performance cannot be guaranteed and investment yields will fluctuate with market conditions.

Chart 3
Calculating Capital Needs: Monte Carlo Model



Our Monte Carlo analysis differs from the typical practice because we use prospective capital markets assumptions, not simply historical data sets, to project baseline investment returns. We believe this reduces the serious problem of end-of-period bias caused by reliance on historical data sets. Using historical returns will lead to projecting higher-than-normal returns at the end of bull markets (just when economic returns are likely to be lowest), and projecting lower-than-normal returns at the bottom of bear markets (when economic returns are likely to be superior going forward).

The Monte Carlo result is expressed as a percentage confidence that the client will never run out of money. We consider a Monte Carlo success rate of 70% the minimum acceptable result[2].

Making It Work

Once we have completed our initial analysis, we are in a position to answer the key question; *Does the set of facts and projections we have assembled support with sufficient confidence a successful retirement transition?*

Sometimes the initial retirement scenario we construct doesn't work. Our analysis shows you running out of capital before your expected mortality, or our confidence level is lower than we are comfortable with. Successful retirement transition planning often requires examining alternative scenarios, such as:

What if you delay your retirement date for five years or accelerate it by two?

How would working part-time for three years after retirement affect your long-term financial security?

What if you save more each year?

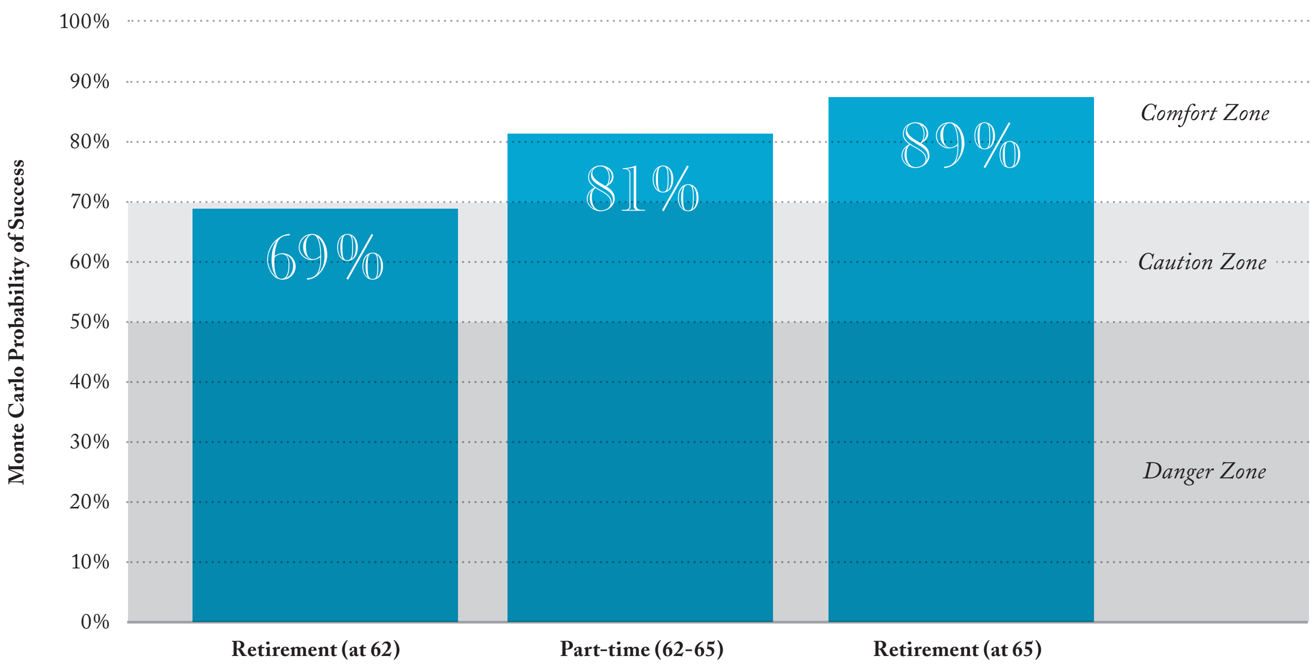
What if you sold your vacation home and invested the proceeds to produce more income?

Designing a successful retirement cash flow strategy is an iterative process, in which we examine multiple trade-offs between financial outcomes and quality-of-life issues, before finally arriving at a solution that is both realistic and actionable.

What we are looking for is your personal and unique success scenario. *Chart 4* illustrates this type of scenario planning for a physician considering his retirement options. As you can see, the effect of working part-time for three years after retirement at age 62, versus fully retiring at age 62 or 65, provides an optimal solution. In this case, the part-time option represents a feasible alternative to continuing to work full-time until age 65.

[2]Achieving 70% confidence is not an absolute guarantee of long-term financial success, but our experience suggests that an initial result in this range leaves enough margin for error to allow mid-course corrections in the future, as your financial situation evolves.

Chart 4
The effect of retiring early or working part-time
(based on Monte Carlo analysis of alternative scenarios)



After the Reset: Healthier and Happier

Research shows that older individuals, as a group, are much happier than young and middle-aged adults. With sensible decisions about diet, fitness, and maintaining a social life, retirement can simply be a different stage in life and the transition to it a gradual psychological and financial process. As you transition into retirement, re-dedicate yourself to good health, fitness and connecting with others.

Choose a physician who is committed to healthy aging.

Stop smoking

Know your numbers — blood pressure, cholesterol, blood sugar, BMI.

Get moving. The best marker for brain function in older individuals is not mental activity (doing the *Times* crossword or taking classes at the community college), but aerobic exercise. If you have never been much for exercise[3], we have another suggestion …

Pay money to put in place an exercise regime that works. A personal trainer can help you to exercise safely, to set realistic goals and to stay with it when your enthusiasm flags. Did you know that an eighty year old who works out with weights for six months can be stronger than the typical thirty year old?

Join up. Get involved with activities at your church, join a gardening club, take classes at a local college, volunteer for Habitat for Humanity, staff a desk for the USO at the airport. Make connections to other people — the more the merrier.

[3] *One of our favorite books is Younger Next Year, written jointly by a retired attorney and a doctor who specializes in healthy aging. The book is engaging, challenging and motivating. There are versions for bothmen and women.*

HOW CAN WE HELP

At TGS Financial Advisors, we have been helping families to manage the transition from full-time work to a successful, financially-secure retirement for more than twenty years. It is the core of our advisory practice.

Our great advantage is that we have gone through the retirement transition process many times with other clients, while you will go through it only once.

We can help you to perform an analysis to understand the unique economics of your own retirement transition. By using best-practice financial modeling, we can provide clarity about what you need to do, both today and in the future, to make a confident transition to a financially secure retirement.

Retirement can be a time of great joy and fulfillment. If your financial plan is strong and sound, you can stop worrying about money and focus on the quality of your life, the strength of your relationships and the profound contribution you can make to your family and your community over a generation-long retirement.

Individuals retiring in the second decade of the 21st century have the opportunity to live longer, healthier, more productive and functional lives in retirement than any prior generation of human beings.

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Jim has managed individual client portfolios since 1978. He co-founded TGS Financial Advisors in 1990. In addition to his role as the firm's *Chief Investment Strategist*, he works with a limited group of high-net-worth families, helping them with portfolio construction and with complex issues of multi-generational wealth transfer.

He has been named by Five Star of one of the Philadelphia area's *Best Wealth Managers* for four consecutive years. He has been quoted in publications including the *Philadelphia Inquirer* and *Reuters Wealth Online*. His up-to-date thoughts on the markets, investment strategy and politics are available on his blog, *The Glass Half Full* (www.jimhemphill.wordpress.com).

Jim holds the Certified Financial Planner™ (CFP®) and Certified Investment Management Analyst (CIMA) designations, the latter with the Investment Strategist Certificate.

TGS Financial Advisors is a fee-based Registered Investment Advisor (RIA) located in Radnor, PA. The firm has been recognized by *Wealth Management* magazine, *Financial Advisor* magazine, the National Association of Board Certified Advisory Practices, *AdvisorOne* and the *Philadelphia Business Journal* as one of the region's top advisory firms.

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