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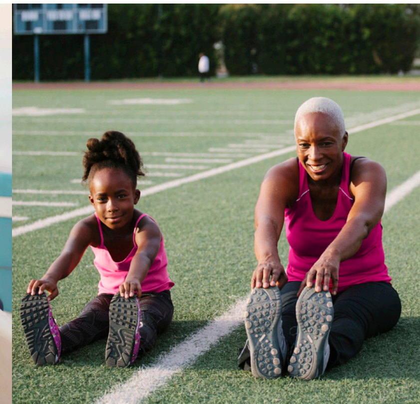
Emergency

Living

Lifestyle



Legacy

A building block framework for lasting retirement income

Key takeaways

01 Investing for retirement income requires an understanding of each client's unique objectives.

02 Using a "building blocks" framework, financial professionals can help guide conversations on spending needs in retirement.

03 This framework can help build portfolios that balance emergency, living, lifestyle and legacy goals against the fear of outliving one's assets.

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Many financial professionals have spent the better part of their careers helping clients accumulate assets. Now, an increasing number of Americans are fast approaching retirement — and conversations are changing. Clients need answers to the following questions: "How much retirement income will I need?" "How much spending will my nest egg support?" And most importantly, "Will I outlive my assets?" Making the mental switch from saving to spending assets isn't easy and neither is managing a nest egg to support multiple retirement objectives over a lifespan. The value of advice has perhaps never been greater.

But first, financial professionals need to have an understanding of what retirement looks like for each client, including how much they may want to spend — or not spend — and how much income variability they can handle along the way. Consider a framework designed to do just that: facilitate the types of in-depth conversations needed to form the foundation of an objectives-based retirement income plan.

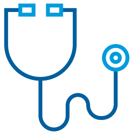
A research-based framework

While it's tempting to think about retirement assets as one lump sum, as many retirees do, it may be helpful to think instead of allocating assets among separate buckets aligned with personal retirement objectives. For example, four objectives frequently prioritized by retirees are unplanned emergencies, basic living expenses, discretionary expenses and leaving a legacy.

We believe a framework consisting of these four distinct categories, or building blocks, can help guide conversations between financial professionals and clients — making it easier for retirees to understand, quantify and prioritize their retirement spending and legacy objectives. This approach has been informed by in-depth qualitative research conducted for Capital Group, including interviews with hundreds of retirees and near retirees.*

*Source: Aeffect (for Capital Group). Retirement Income Product Development Research Findings, 2015. Based on a survey of 800 people who are either current retirees or investors who expect to retire within 1–2 years.

The conversation starts by asking clients these four questions:



1. Emergency – Do you have a cash cushion?

A well-funded and liquid emergency fund can provide retirees with more confidence that they can weather unexpected market, health or household shocks. Having adequate emergency savings put aside can provide retirees greater flexibility so they don't have to liquidate other assets when unforeseen expenses arise.

- The amount of emergency savings to proactively put aside will vary for each investor. Emergency fund assets that are held in cash or more readily liquid assets can be used as a contingency when needed.

2. Living – What are your essential expenses?

Living expenses typically include day-to-day necessities such as food, housing, transportation and health care. While an investor may have some flexibility with these types of expenses over time, many investors will seek to have an objective of 100% confidence in meeting these expenses.

- It is important to review investors' sources of income available to meet their retirement income needs and to help determine whether that income is secure enough to be sustained in all environments.

3. Lifestyle – What are your optional expenses?

The lifestyle block includes discretionary spending – the spending you can live without if necessary, such as travel, spending on grandchildren, dining out and entertainment. What constitutes a lifestyle expense will vary from retiree to retiree, as will their comfort level with variations in income and spending as their lifestyle evolves over retirement.

- When it comes to lifestyle spending, investors can cut back or live without these expenses if necessary in order to meet their basic expenses. For that reason, a lower level of confidence in meeting their lifestyle expenses, such as 75%, might be an acceptable objective for many investors.

4. Legacy – Do you plan to pass on your wealth?

An important objective for many investors might be to leave a legacy by setting aside money for their grandchildren's education, charitable donations and inheritances for heirs. Many others simply plan to leave behind "whatever is left." Identifying a retiree's legacy goals upfront can help inform both locations of assets and retirement income spending decisions. Legacy goals can and often do change over time, so it's important to revisit this goal throughout retirement.

- It may be most efficient to adopt a total portfolio approach to emergency, living, lifestyle and legacy goals – one in which assets are invested in portfolios designed to balance income, growth and capital preservation objectives.

Case study

Harry and June

Retiring couple:
65 years old and in good health

Income	
Social Security	$28,000
Retirement portfolio	**solution needed**

Assets	
Emergency savings	$45,000
Retirement assets	$1,000,000
House	$500,000

Annual spending	
Living expenses	$40,800
Lifestyle expenses	$27,200

This hypothetical illustration is shown for illustrative purposes only, is not indicative of any specific investment and does not reflect the impact of fees, expenses or taxes that may be owed.

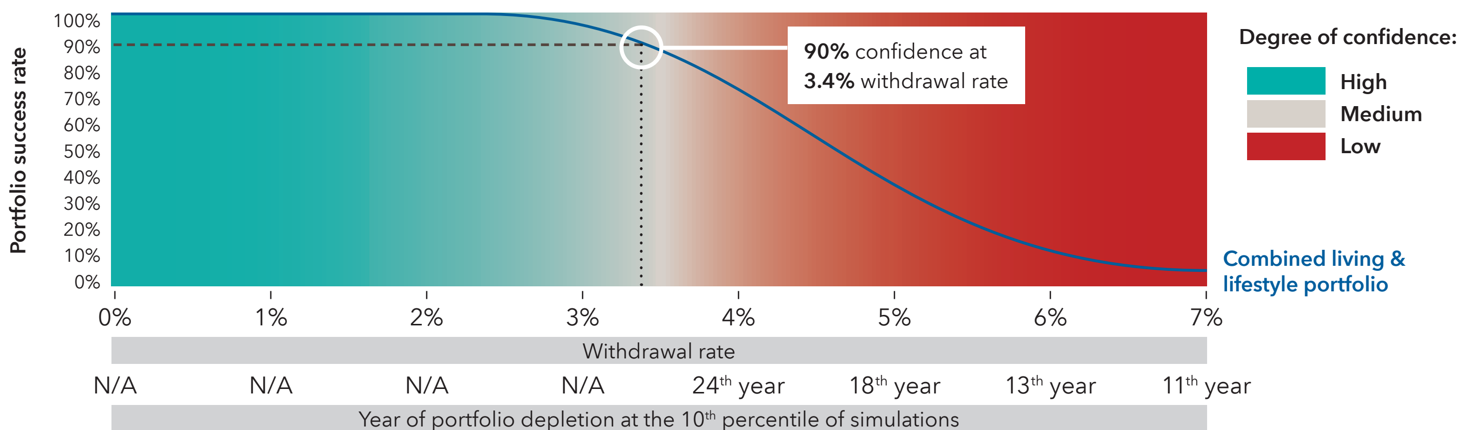
Putting the building blocks into action

In this case study, we discuss a hypothetical example of putting the building blocks framework to work – one that helps identify an optimal withdrawal rate from the couple's retirement portfolio assets that is designed to support more than one income objective. When sitting down with their financial professional, Harry and June employed the four building blocks framework to engage in a deep discussion concerning their spending goals and available resources and came to the following conclusions:

- Their annual basic living expenses are $40,800. They would like to set an objective to achieve 100% confidence in meeting these essential living expenses through retirement.
- They desire $27,200 annually for spending on their lifestyle expenses in retirement. Since they have more flexibility when it comes to achieving this spending goal, they agree that a 75% confidence objective is acceptable given that the portfolio needs to balance income, growth and asset preservation.
- They have cash savings of $45,000 in their emergency fund if needed for any unforeseen expenses.
- They would like to leave a legacy for their children, which would include the family home valued at $500,000.
- Their $1,000,000 portfolio would need to generate $40,000 ($68,000 less $28,000 from Social Security) annually to cover both their living expenses and desired lifestyle spending – a 4% withdrawal rate.

To stress-test this single 4% withdrawal rate to confidently support both living and lifestyle expenses, their financial professional looked at a Monte Carlo simulation, which uses a large number of scenarios based on a set of assumptions. Since Harry and June were most concerned with the risks to their retirement income plan, the simulation focused on the lowest 10th percentile of possible scenarios. Here we see that a 4% withdrawal rate may be too ambitious. With the proposed split between living and lifestyle, combined for a weighted success rate of 90%, the simulation shows a 3.4% withdrawal rate or less would provide them more confidence in sustaining their spending needs. The analysis suggests that Harry and June may need to discuss with their financial professional the trade-offs and implications of decreasing their spending objectives, delaying retirement and making portfolio adjustments, as well as exploring opportunities to increase their level of protected income to improve their overall confidence in retirement.

Exhibit 1:
Retirement income confidence chart (30-year time horizon)



Source: Capital Group. Annuities in Portfolio Construction, 2018. Chart is for illustrative purposes only.
Note: Taxes and fees not considered in this assumption.

Building retirement confidence — one client at a time

Given the many unknowns of retirement, a building blocks framework may help investors better define their retirement income needs. With insights gleaned from this framework and the benefit of professional advice, investors should be able to invest in portfolios that align with their desired lifestyle and legacy goals and objectives as they navigate through retirement. For financial professionals, that means creating portfolios designed to help clients pursue overall income security, meet their essential living expenses no matter how long they live, and invest for a high degree of confidence.

A Monte Carlo simulation was used to calculate the probable range of outcomes and probabilities shown on page 4. A Monte Carlo simulation is a statistical technique that, through a large number of random scenarios, calculates a range of outcomes that are based on a set of assumptions. This simulation is provided for informational purposes only and is not intended to provide any assurance of actual results.

The following assumptions were used in the Monte Carlo simulation:

The investor withdraws a fixed percentage of the initial portfolio value each year for up to 30 years. The initial withdrawal amount is increased by 2.0% each year.

The hypothetical portfolio is composed of 60%/40% S&P 500 Index/Bloomberg U.S. Aggregate Index. Hypothetical results are for illustrative purposes only and in no way represent the actual results of a specific investment. 60%/40% S&P 500 Index/Bloomberg U.S. Aggregate Index blends the S&P 500 with the Bloomberg U.S. Aggregate Index by weighting their cumulative total returns at 60% and 40%, respectively. This assumes the blend is rebalanced monthly. The market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

For the first 10 years of the simulation, assumed hypothetical returns for the S&P 500 Index were 3.75% with a standard deviation of 15.00%; assumed hypothetical returns for the Bloomberg U.S. Aggregate Index were 3.25% with a standard deviation of 4.00%.

After the 10th year of the simulation, assumed hypothetical returns for the S&P 500 Index were 7.50% with a standard deviation of 15.00%; assumed hypothetical returns for the Bloomberg U.S. Aggregate Index were 4.20% with a standard deviation of 4.00%.

The portfolio success rate shown in Exhibit 1 is the percentage of simulations where the hypothetical portfolio sustained the applicable withdrawal percentage each year for 30 years (inclusive of a 2.0% annual increase). While we believe the calculations to be reliable, we cannot guarantee their accuracy. Simulation results may vary.

The assumptions for the characteristics (return, volatility and correlation) of the hypothetical portfolio represent the opinions of a small number of macro-focused analysts based on their individual research and should not be interpreted as the view of Capital Group as a whole. As Capital Group employs the multiple manager system, the views of other individual analysts and portfolio managers may differ from those presented here. These assumptions are provided for informational purposes only and are not intended to provide any assurance or promise of actual returns, volatilities or correlations. All market forecasts are subject to a wide margin of error, including our own.

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