Two Philosophies of Retirement Income Planning

My Comments: I'm sharing this article from Wade Pfau because it might help you better understand conflicting messages you encounter from those with whom you might seek financial help.

I created an online school, Successful Retirement Secrets™, in an effort to help anyone and everyone learn **HOW to think about their financial future**. In other words, to help you first define **HOW you want your life to play out financially**. You need that 'road map' before you decide which of the two philosophies described here will serve you best. Unfortunately, the response to my limited marketing was such that I pulled it from the shelves.

My personal belief is you should adopt both strategies described below. **Where** you place the emphasis is largely an emotional decision and not an empirical one. And know that it's ok to change the emphasis as you grow older.

by Wade Pfau \ 14 APR 2016 \ https://tinyurl.com/y7ssrwep

Within the world of retirement income planning, the siloed nature of financial services between investments and insurance leads to two opposing philosophies about how to build a retirement plan. There is an old saying that if the only tool you have is a hammer, then everything starts to look like a nail. This tendency is alive as those on the investments side tend to view an investment portfolio as a solution for any problem, while those on the insurance side tend to view insurance products as the answer for any financial question.

While we have just reviewed the general benefits and disadvantages of the general categories of investments and insurance, it is worthwhile to dig deeper into how the two schools distinctly approach the retirement income challenge. We can bridge the gap between these two philosophies. Ultimately, we can integrate both philosophies into a comprehensive strategy that can promote more efficient overall retirement income plan and support more income and legacy.

I distinguish the opposing schools as either *probability-based* or *safety-first*. Understanding the distinctions and thought processes of both schools is important; discussions about retirement income planning can become quite confusing. There are basic and fundamental questions that advocates from each school answer in the opposite way. Each individual investor must ultimately identify which school can best support both their financial and psychological needs for retirement.

Indeed, advocates of the two schools view retirement income planning very differently. They provide opposite answers for basic questions such as:

- Can people effectively prioritize among different financial goals in their retirement?
- What is the best way to approach investing financial assets for retirement income?
- Is there a sustainable spending rate from a portfolio of volatile assets?
- What role do income annuities play in a retirement income strategy?

As a basic introduction to these schools, a simple litmus test can be applied. Monte Carlo simulations are often used in financial planning contexts to gain a better understanding about the viability of a financial plan in the face of market and longevity risks. Suppose a Monte Carlo simulation identifies that a retirement plan has a 90% chance of success. Both sides of the debate might accept this as the correct calculation from the software, but they will have dramatically different interpretations about what to do with this number. For probability-based thinkers, 90% success is a more than reasonable starting point and the retiree can proceed with the plan. It is likely to work. In the event that future updates determine that the plan might be on course toward failure, a few changes, such as a small reduction in spending, should be sufficient to get the plan back on track.

Those identifying with the safety-first school, however, will not be comfortable with this level of risk, focusing instead on the 10% chance of failure. The safety-first school makes a distinction between essential expenses and discretionary expenses and seeks a solution that practically eliminates the possibility of failure for meeting essential expenses. Jeopardizing success is only reasonable for discretionary expenses.

Financial service professionals and retirees should understand which school they most identify with, and to what extent their own thinking might incorporate views from each of the schools. Consumers of the financial services profession must understand whether they and their advisor are speaking the same language. Advisers able to communicate effectively from both sides will be more likely to deliver successful retirement income outcomes.