Reflections on my Basketball Career and the Reality of Retirement Planning

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I grew up a basketball junkie.

As a kid, I spent every spare moment playing basketball, watching basketball or reading about basketball. After basketball practice, I would pick up the new issue of "Basketball Weekly" and catch a basketball game on TV, then make the trek downtown to see Al McGuire's Marquette Warriors (not the Golden Eagles).

> *Old days*
> *Good times I remember*
> *Gold days*
> *Days I'll always treasure*
>
> -Chicago

Like all young kids, I had a dream of an NBA career and a lifestyle of fame and fortune. But alas, draft day came and went and the NBA never beckoned. My big payoff was just that, a dream.

Define Your Retirement

Watch any TV commercial about retirement: the happy couple walking on a sandy beach, golfing in the morning, playing with the grandkids, sailing into the sunset. It is the idealized version of retirement. But it will not likely be reality for many Americans.

The good news: there are ways to define what your retirement will look like. But, both plan sponsors and participants must change in order to overcome the challenges of retirement saving.

First, the industry must use incentives that encourage all employees to build a nest egg, features such as auto-enrollment and auto-escalation. These incentives must be applied to all employees, not just the newly hired.

Second, employees must better manage their own retirement income. This includes planning for the Low Probability Event.

Low-Probability Event

The market meltdown of 2007-2009, one of the worst bear markets in history, was a low-probability event. Its consequences have been severe. It has indelibly marked investor psyches and will likely affect investment behavior for years to come. Our confidence in the future has fundamentally changed.

Let’s consider two hypothetical couples, the Johnsons and the Murrays.

John Johnson is a welder nearing retirement. He worked hard, saved a tidy little sum, and budgeted carefully. John and his wife, Joan, assume their golden years will be much like those TV ads.

Mary Murray has a high-paying job as Managing Partner at a major accounting firm. She and her husband, Mark, have a second home in Arizona, and anticipate an enjoyable retirement.

But then Lehman Brothers folded, the housing bubble burst, and the stock market went into a tailspin. As so often happens, life had other plans.

The Johnsons were largely unaffected by the economic meltdown. Income from John’s 401(k) plan did not change. John and Joan will be able to live out their retirement years much as planned.

The Murrays, however, were not so fortunate. As the stock market tanked, so did Mary’s retirement portfolio. Mary and Mark tried to bolster their portfolio by selling their vacation home, but they were unable to find a buyer because of the real estate collapse. All of the Murrays’ carefully laid plans failed to factor in the Low-Probability Event, especially one so early into their retirement.

Why such a difference in outcomes?

> “Someone is sitting in shade today because someone planted a tree a long time ago.”
>
> \- Warren Buffet

John’s employer prepared for the inevitability of the Low Probability Event. His company’s 401(k) plan had an option called Lifetime Income Guarantee that provided pension-like benefits and long-term security.

Mary’s did not.

Limit the Risk in Your 401(k) Plan

In 2006, Congress passed the Pension Protection Act. Legislators recognized that people can be “nudged” toward better savings if their employers offered automatic enrollment, automatic contribution increases, and qualified default investment alternatives (QDIA).

Since then, participation rates are way up, and the number of plans offering automatic enrollment and contribution escalators has increased. Studies show that participation in plans without auto-enrollment is just 65 percent while participation in plans with auto-enrollment are 73 percent[i]. Best of all, just ten percent of enrollees opt out of the plan.

Conversion Risk and Longevity Risk

While these investors are more likely to achieve their retirement goals, they must still be wary of:

- Market Risk (future downturns)
- Conversion Risk (inability to convert savings into income without loss)
- Longevity Risk (money not lasting)

If you're married, there is a 50-50 chance that either you or your spouse will reach age 92, and there is a one in four chance that one of you will live to 97. If you retire at age 65, figure you will need enough of a nest egg to generate an income to last about 30 years[ii].

While you're still working, you should be aware of market risk and invest accordingly. But when you retire, you will also need to manage conversion risk and longevity risk.

Plan sponsors recognize the need for investors to have income options. According to a recent study, four out of five agree it is their duty to provide a secure income-generating option in their plan. (Source: Blackrock Retirement Survey: www2.blackrock.com/us/defined-contribution/news-insight/research/retirement-survey.)

> Plan sponsors: "Our biggest concern is that participants will not accumulate enough money in their plans to retire."
>
> - AllianceBernstein Survey, 2009

Further, a majority (71 percent) of plan sponsors agree that guaranteed Income Target Date Funds are either "appealing or extremely appealing."[iii]

The marketplace Responds

Many 401(k) plan administrators now offer Lifetime Income Guarantees among their options. This allows an investor to convert a portion of his or her retirement account into a "private pension" account. The goal is to transfer conversion risk, market risk, and longevity risk from the investor to an insurer.

Plan sponsors now offer retirement income in the defined contribution plan without the cost and funding requirements of a defined benefit plan. Some sponsors have also introduced models that employees understand better and can therefore better appreciate.

There is a multitude of options. One provides a guaranteed minimum withdrawal benefit around a series of traditional Target Date Funds. Each year, on your birthday, your Withdrawal Base (or "pension account") is locked in at either the current market value or the highest birthday value, whichever is greater.

This is the amount that determines your retirement income. Your withdrawal rate is a simply a percentage of the Withdrawal Base. The amount you withdraw annually depends on your age when you begin withdrawing. A spousal survivorship benefit is also available.

These new Lifetime Income Guarantee plans combine the best features of a 401(k) plan and a traditional defined-benefit pension plan while avoiding the negative aspects of each.

It's a slam dunk for both the investor and the plan sponsor. Just like a pension, you receive a minimum fixed income for life. But, unlike a pension, if the market goes up, so does your income.

Most importantly, you maintain control over your assets and reduce your risk. Another benefit: you can pass residual assets on to your beneficiaries – unlike a pension.

Sequence of Returns Risk

Saving enough for your retirement may seem difficult, but it's easy compared to managing your withdrawals after you retire.

> "Success is the sum of small efforts repeated day in and day out."
>
> - Robert Collier

Retirees face a unique problem known as "sequence of returns risk." This refers to the risk of market volatility in the years just prior to and just after retirement.

A market loss during those five years just before you retire will be difficult to recover. For example, let's say you receive returns of 12 percent in the fifth year before you retire and 10 percent in the fourth year. But in the next two years, you experience losses of 19 percent and 15 percent, respectively. In that single year before you retire, you would need a return of 45 percent to recoup your losses.

Or say you retire at age 62 with a nest egg of $250,000. Your plan is to withdraw 5 percent of your retirement account's value each year ($12,500) with a 3 percent annual inflation adjustment. You expect 7 percent average annual return over the next 30 years.

Let's say your portfolio gets off to a poor start with three straight years of bad returns (off 18%, off 13%, and off 4%, respectively), before the market recovers and you realize your average of 7 percent.

Because the timing of this poor performance coincides with your need to make withdrawals, your nest egg will be broke before your 80th birthday.

What will happen if your investments do well in the early years of your retirement? Not only will your savings last for 30+ years, but a substantial portion may be available to your beneficiaries[iv].

What's the Payoff?

According to the Blackrock Survey, a huge majority of employees, 89 percent, say they would like their plan sponsor to provide income-generating options in their retirement savings plan. Participants with an Income Benefit in their plans defer 38 percent more income, and are 2.5 times more likely to stay invested.

Employees are likely to become more prudent, long-term investors. They are more relaxed. They are less likely to make irrational investments because they know their income is secure.

For me, that childhood dream of a NBA career turned out to be just that, a dream. But I know that, as an investor, my nest egg is secure. I can watch my favorite team in comfort, and my retirement income will be there when I am ready to hang up my basketball shoes.

So can you.

P.S. If there's a game on, call me. My golden days are long gone, but I'm always up for some refreshments after a little one-on-one.

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[i] "Report on Retirement Plans 2009," Diversified Investment Advisors
[ii] Annuity 2000 Mortality Table. Society of Actuaries.
[iii] Inside the Minds of Plan Sponsors, AllianceBernstein 2010
[iv] Prudential Retirement Red Zone.