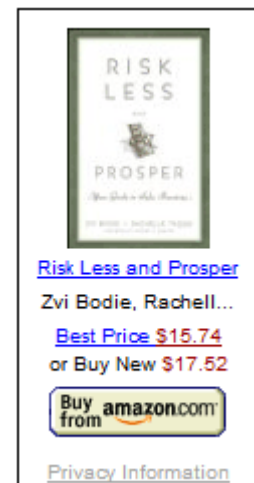


## The Safety-first, Goals-based Approach to Financial Planning

By Wade Pfau  
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Little of what is taught in traditional investment textbooks is of value in personal financial planning. Risk is not standard deviation; it is the probability and consequences of not meeting one's goals. That real-world perspective animates a new book by Zvi Bodie and Rachelle Taquq that implores advisors and their clients to lock in the funding of their essential expenses before worrying about their discretionary goals.

Bodie's and Taquq's *Risk Less and Prosper: Your Guide to Safer Investing*, helps bring the safety-first, goals-based investment portfolio approach to the forefront of financial planning, especially when it comes to preparing for retirement. The idea from which the book proceeds is to focus on retirement spending goals and to decide what is essential and what is discretionary. Essential spending needs should be locked in by funding them with safe investments – the sort that cannot possibly fail to achieve clearly defined goals – while more discretionary and aspirational retirement expenditures are funded with volatile assets that allow for a chance that risks manifest and goals are not met. By considering both future income and future expenses, those looking ahead to retirement can develop a strategy to meet their goals while taking as little risk as possible.



### What's new, and what's not

For clients to whom the guiding principles of a safety-first, flooring approach to retirement planning are brand-new, Bodie's and Taquq's book provides an effective introduction. Though in some ways client-centric, however, for advisors the book helpfully synthesizes several different approaches that can help to build an advisor's retirement planning toolkit. Advisors looking for a more detailed manual spelling out the flooring approach, however, may be better served by Michael J. Zwecher's *Retirement Portfolios: Theory, Construction, and Management*. Bodie and Taquq focus more on the intuition of flooring.

They also specifically emphasize the use of inflation-protected bonds (TIPS and I Bonds) to create inflation-adjusted flooring. The focus on TIPS follows from Bodie's and Michael J. Clowes' 2003 book, *Worry-Free Investing: A Safe Approach to Achieving Your Lifetime Financial Goals*, but the newer book expands beyond TIPS to also consider single-premium immediate annuities, a means of protecting against longevity risk past the bond ladder's terminal date.

Bodie and Taquq also describe a lifetime approach to broader financial planning, adopting some features found in Dan Nevin's [Goals-based Investing: Integrating Traditional and](#)



[Behavioral Finance](#) from the spring 2004 *Journal of Wealth Management*. These features include allowing for mental accounting so that different goals (retirement vs. children's education, for instance), are funded with separate portfolios, as well as the emphasis on distinguishing needs from wants. The broader message is also shared with goals-based investing: The objective is not to maximize returns or to beat a benchmark, but rather to find investments that will help to reach financial goals with as little risk as possible.

Bodie and Taqqu also emphasize the inclusion of human capital in the lifetime balance sheet. Lifetime assets, including both financial assets and potential future earnings, must balance lifetime liabilities (retirement spending, spending on other goals, pre-retirement spending). More risk can be taken both when the time horizon is longer (because this provides more opportunities to adapt and save) and when income is more flexible (because this provides opportunities to work more should investment risk manifest).

### **Differences from other retirement planning approaches**

The approach described in *Risk Less and Prosper* is one of three competing possibilities for retirement income planning. For Bodie and Taqqu, there is no question about which is best. They reject the other two frameworks as flawed and dangerous.

The first of those frameworks, systematic withdrawals guided by research on "safe withdrawal rates," describes how much one can sustainably withdraw from their savings over time with a reasonable probability of not running out of funds during the planning horizon. The approach focuses on the total returns of the retirement portfolio, and it traditionally calls for a well-diversified portfolio of stocks and bonds. There is no attempt to guarantee an income floor.

The goal is to draw down wealth from a volatile portfolio in a sustainable manner. From this approach comes the well-known 4% inflation-adjusted withdrawal rate rule-of-thumb for a 30-year retirement. In their book, Bodie and Taqqu mention that the 4% rule is probably too high, but they don't explicitly explain why. In the floor/upside framework, the "safe withdrawal rate" hardly matters, because retirees have already guaranteed income for their basic needs and may freely spend from their remaining assets with the understanding that these assets are for discretionary expenses and may eventually run out.

The second retirement income framework has many names, such as time segmentation, time diversification, bucketing, or asset dedication. This approach moves away from a total-returns analysis to provide a mental-accounting framework that distinguishes different accounts (or buckets) of the portfolio to be used at different time horizons. Short-term spending needs (such as over a 3-10 year horizon) are locked-in with fixed income assets, as with the flooring approach. But greater volatility is accepted for assets dedicated to longer-term expenses. The idea is that the long-term buckets can benefit from higher



expected returns as the volatility cancels out (losses are balanced by gains) in a process known as “time diversification.”

Bodie and Taqqu make great effort to discredit this notion. With time diversification, the probability of suffering a loss decreases over time, but the size of potential losses grows rather than shrinks. As risk is properly defined as probability times magnitude, stocks are riskier over the long term.

### **Critiquing the book**

It is hard to fault the safety-first, goals-based approach to retirement planning. The intellectual foundations are solid. But if there are grounds for any critique, it is with respect to Bodie’s and Taqqu’s conservative take on an already conservative retirement planning framework.

My concern about their conservatism begins with an important question: How much should one save in order to follow their framework? Their approach requires greater elaboration and evidence that the resulting amount will be realistic. As I write, the yield on 30-year TIPS is 0.69%. Because of the risks associated with reinvestment and future interest rates, one would need to save even more than this paltry rate implies, since even that interest rate can’t be 100% guaranteed going forward. With a 0% real yield, an investor who is looking to save over 30 years to fund a 30-year retirement (during which they spend 50% of their constant real pre-retirement salary) would be required to save a whopping 50% of their pre-tax earnings.

Four possibilities exist when falling behind in an effort to meet financial goals: Revise the spending goals downward, work longer, save more, or move to more volatile assets and hope for the best. Bodie and Taqqu strongly discourage the fourth option. Only use volatile investments to meet goals you are willing to sacrifice. Just pick one of the other choices, instead, they say.

But if saving more or spending less are not viable options, and we open up the possibility of retiring later, then who is to say whether people would choose not to accept volatility and increase the probability of retiring when first planned (which would also increase the probability of having to retire even later as well)?

What’s more, a less conservative alternative option not discussed in the book is to be constantly vigilant about the amount needed to lock in the desired floor, but to invest in more volatile assets with the surplus and some of the flooring amount. As long as one is prepared to act and get the floor locked in if asset values start declining too much, this approach can provide greater upside potential while still protecting the floor.

In an interview with the [American College New York Life Center for Retirement Income](#), both Michael Kitces of the Pinnacle Advisory Group and Jonathan Guyton of Cornerstone



Wealth Advisors expressed concerns with the floor/upside approach. Understanding the value of the underlying guarantee to meet one's minimal needs, Michael Kitces argued that retirees may still consider their retirement to be a failure if they lose the discretionary expenses that would help make retirement enjoyable. Retirees may not think in terms of dividing expenses between essential and discretionary, but rather they have a particular standard of living in mind, one that they hope to maintain. He has written more about this issue at his [blog](#).

Jonathan Guyton added as well that results from the 2011 Financial Planning Association survey of planners showed that clients using the floor/upside approach were more likely to experience downward adjustments to spending as a result of the financial crisis of 2008 than those using other approaches. Because so much wealth is devoted to funding the essential expenses, retirees were left with a smaller sub-account to finance their discretionary expenses and felt more forced to make cutbacks to this spending than they otherwise might have. These cutbacks would have been amplified for retirees using a more aggressive asset allocation for their discretionary portfolio, as is often suggested when essential needs are guaranteed. That might be a case of unintended consequences.

Finally, though the book may provide a philosophical overview of the safety-first approach, it is short on details about implementation. Finding an optimal level for the income floor, deciding when to start establishing the floor, and determining how much risk to take with the upside are all important questions that require more elaboration for readers than Bodie and Taqqu provide.

For the full story, one must also study a book such as Michael Zwecher's *Retirement Portfolios*, or even the curriculum book used by the [Retirement Income Industry Association](#)'s Retirement Management Analyst<sup>SM</sup> (RMA) program. Zwecher's book explains how a traditional accumulation-based portfolio will often look similar to the flooring portfolio. The functional difference may only be that with flooring the fixed-income component will have clearly defined maturity dates, rather than being a constant-maturity bond fund.

Bodie and Taqqu's book suggests a much larger allocation to TIPS than retirees may actually need. Nonetheless, its intuitive explanations make it a great companion. It's little wonder that it is already part of the required reading list for the RMA<sup>SM</sup> designation.

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The goals-based financial planning approach is fundamentally flawed, because people don't know their goals until first evaluating the possibilities! From the rapid growth of goals-based financial planning software like MoneyGuidePro, to the recent announcement that even legendary wirehouse Merrill Lynch will be focusing on a goals-based planning approach, financial planning is on the rise, and is increasingly focusing around an approach of identifying and understanding client goals, and then crafting a plan to help the client succeed in achieving them. Yet at the same time, the reality is that in practice the goals-based approach doesn't always go as smoothly as hoped. Goals-Based Financial Planning. A growing body of research is focusing on the potential benefits of helping clients accomplish their goals. This research generally moves beyond the potential benefits of a single strategy and takes a more holistic perspective with respect to the benefit of financial planning. For example, Shefrin and Statman (2000) demonstrated that portfolios optimized using a behavioral approach will differ from mean-variance optimized portfolios. One goals-based approach is to create a "portfolio of sub-portfolios," where a specific portfolio is designed to meet each specific client goal. This approach has been discussed by Brunel (2003), Nevins (2004), and Chhabra (2005).