October 2016

Retirement Planning and Scenario Testing

By Max J. Rudolph, FSA CFA CERA

Retirement Planning

I recently spoke at the BILTIR sponsored Life and Annuity Conference, sharing my thoughts on interest rate risk for insurers. It was an after lunch session, following an hour talking about cyber security (an important but dull subject). I needed an excuse to get everyone to stand up and stretch. Here is what I did. I asked if we had any millennials in the room, then had them stand up briefly. Then I told the rest of the group of about 200 that their job was to provide an assumption for the millennials to use for their retirement planning; a long-term assumption and I gave them 2.5% intervals. No one suggested the rate should be less than 0%, and only 1 attendee voted for less than 2.5% (or maybe was just desperate to stretch!). Most of the attendees stood up at either less than 5% or less than 7.5%. A few stragglers voted for 7.5-10%, and no one was above 10%. I joked that if you voted above 10% that you should be at the pension conference (pension fiduciaries have backed themselves into a very small corner with little wiggle room available).

I personally would vote for something a bit less than 5%. I remember reading that Warren Buffett thought 7% would be a reasonable assumption in 1999, similar to the most recent 10 year annualized record of the S&P 500.

A technique that I use personally is to take the portfolio value at the end of the year and project it out to the year I turn 80 using 5%, 10%, and 15% returns. It is amazing how much it matters, even at my advancing age. ☺ This is a form of personal scenario testing. This should be part of your personal plan where you anticipate expenses if any member of your family dies, becomes disabled, or needs long-term care. Assets can be managed in total or segmented based on goals, as long as these goals are flexible enough to endure life changes.

Another technique I use is to calculate expected retirement income prior to accessing accumulated capital. I add up my expected Social Security benefit, my wife's SS benefit, any defined benefits from employers, and then I add up the expected annual payments from all of our investments. This number is where we start our discussion of budgets since it is a floor.

Scenario Testing

Each year in the fall I suggest a set of scenarios that could be used as part of reserve adequacy (cash flow) testing. This year I suggest the following:

- NY 7 without floors (allow negative rates, parallel shifts)
- **Annual increases of 3% over 4 years**
- Pandemic spike in mortality of .5% (absolute increase)
- High credit risk – double default rate for below investment grade bonds
- Equities – down 35%
- Indexed products – report separately including options, test derivative market failure
- **Measure exposure to counterparties**
- Global climate change scenario – qualitatively assess markets, suppliers
- If you are worried about a couple of specific scenarios from the past; e.g., the 1930s or 1970s – include them in this year's stress testing

Bold reflects update from prior year

Look at stress scenarios qualitatively and graphically in addition to quantitative focus. Consider a combination of several deterministic scenarios, including one where the Wall Street tool kit (e.g., derivatives market) is not available.

Election Thoughts

As the Presidential election nears I find myself concerned about the direction the country is going. I have a tendency to think with a longer time horizon than others, and my ERM work trains me to consider risk interactions. There is a scenario, hopefully remote, that concerns me. The Republican Party has nominated Donald Trump, whose greatest successes have come by building a brand where no publicity is bad publicity. When he actually built buildings he was not successful (he lost $1 billion at least once), but when he allows his name on the building more people come (at least initially).

The current financial environment is setting up for hyperinflation. I said a long time ago that if the Fed could contain interest rates to 15% on the way up they will have done well. This scenario tells the investor to buy stuff you can feel – gold, land, art, etc. When combined with a populist message this challenges everything. How can I buy things when I can't defend them? I've had this same discussion with myself if I stockpile food for some type of spillover dust bowl event. If I can't defend it why build it? This is what is scary about Trump. Even if his underlying ideas are not that extreme, his methods that manipulate the populace using hate and shaming remind me of past demagogues that became dictators. Each started with mild ideas, but had ultimate plans. It's not Trump I worry about, it's who comes next.

On my short list of books to read in 2017 is The Fourth Turning, a 20 year old book where William Strauss talks about how everything cycles. This argument has always had a familiar feel to it, and I am looking forward to diving in. Also this fall Jim Rickards has a new book, The Road to Ruin, about the rise of SDRs and the fall of the dollar as a reserve currency. Michael Lewis, with The Undoing Project, talks with Daniel Kahneman

(Thinking Fast and Slow) about behavioral finance. Lewis is such a good story teller that anything he writes is good, but I expect that I will gain a better understanding of how to approach a unifying theory that incorporates value investing and neuroscience. I have several other books going now that are very good, and am backed up on book reviews of the ones I have completed. Readers can expect several book reviews and recommendations in 2017.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!