The New Three-Legged Stool ....Update

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The Original Three-Legged Stool—An Explanation

I did a radio interview the other week for a station in Ocean City, MD. The first question my host asked me was "Whatever happened to the old three-legged stool?" It occurred to me that there are probably a lot of people that don't know what the three-legged stool was to begin with. Let alone know why they even need a new one.

The concept of the three-legged stool for retirement began in the early 1970s when Congress passed The Employee Retirement Income Security Act of 1974 (ERISA). ERISA was enacted to protect the interests of employee pensions and their beneficiaries by requiring the disclosure of financial and other information concerning the plan. ERISA also gave birth to the individual retirement account (IRA). Taxpayers could contribute up to $1,500 a year and reduce their taxable income by the amount of their contributions. Initially, ERISA restricted IRAs to workers who were not covered by a qualified employment-based retirement plan.

In order to provide a solid financial foundation for your golden years, you needed three legs of income for your retirement. The first leg was a pension from your employer. Most employers provided their employees with a plan that would replace a percentage of their salary when they retire. The formula would typically be based on a combination of years of income and final average salary. ERISA provided minimums and standards for how these benefits could be calculated. A formula might credit one percent for each year of service multiplied by the employees highest five years of earnings. An employee retiring with 35 years of service would receive a pension equal to 35% of his salary.

The second leg was your Social Security benefits. Social Security had been around for nearly 40 years by the time ERISA was passed. But it became a much more important part of an individual's retirement plan in 1972 when Congress granted a 20% increase in benefits and made future increases automatic by tying the benefit to the Consumer Price Index beginning in 1975. Few private pensions had cost-of-living increases. Now retirees would have one leg of their income that would rise as their expenses increased.

The third and final leg of the old stool was personal savings. Many retirees could reasonably expect pension and social security to replace two-thirds of their income at retirement. The balance would need to be made up from personal savings. Investment considerations for these funds were not a concern because interest rates were very high throughout the 1970s. The Certificate of Deposit Index (CODI) during 1974 ranged from 8 ½% to 10 ¼%. (See chart on page 2) By the end of the decade, CODI topped 13%. Who would bother with the stock market when you could get 13% in a Certificate of Deposit?

The original three-legged stool strategy for retirement in the 1970s was sound and fairly easy to implement. What made it even easier is the fact that life expectancy in 1974 was only to age 68. The worker retiring at age 65 only needed his finances to last 3 years.

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Why a new three legged stool is needed.

Fast forward 36 years and we see a completely different landscape. The number of companies offering pensions grew through the 1960s and '70s, peaking in the mid-1980s, with 112,000 plans then in effect. About 40 percent of American workers were covered. Over the past two decades, the number of these pension plans has fallen to about 29,000 and currently cover less than 20 percent of the private-sector work force. Many companies that still have pension plans are trying to get rid of them by freezing benefits or switching them to a 401(k) type of plan. To make matters worse, the majority of pensions are under funded. According to a survey released last month, pension assets totaled $1.09 trillion in 2009 versus obligations of $1.33 trillion. The first leg of the original stool is not available to 80% of workers and is very wobbly for the 20% that do have it.

Social Security benefits, the second leg of the original stool is in even worse shape. From The 2009 OASDI Trustees Report, officially called "*The 2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.*"

"**Conclusion** - Under the long-range intermediate assumptions, annual cost will begin to exceed tax income in 2016 for the combined OASDI Trust Funds. The combined funds are then projected to become exhausted and thus unable to pay scheduled benefits in full on a timely basis in 2037... The projected trust fund deficits should be addressed in a timely way so that necessary changes can be phased in gradually and workers can be given time to plan for them. Implementing changes sooner will allow their effects to be spread over more generations. Social Security plays a critical role in the lives of 52 million beneficiaries and 160 million covered workers and their families in 2009."

The Trustees are warning you to make other plans. What you see today is not what it is going to look like down the road. The program will ultimately be means-tested in my opinion. Social Security will be there only for those that have no other leg to stand on.

The final leg of personal savings is the only one left and has split into three different legs to form the new three-legged stool. However, we need a completely different strategy for investing these new three legs. The first reason is that investing only in fixed income won't work. CODI is currently well below 1%.

You wouldn't even be able to keep up with increases in the cost-of-living. Secondly, you now have to plan for a much longer life expectancy. A worker retiring today at age 65 has a life expectancy of age 82 and life expectancy continues to improve each year. It is conceivable that a couple retiring at age 65 will need to plan for 30 years or more of retirement. You just can't make it on a portfolio of fixed income investments facing 30 years of rising costs.

I hope this clearly explains the original three-legged stool of retirement and why it won't work today. Next month I'll elaborate on how to structure an investment strategy for the new three-legged stool.

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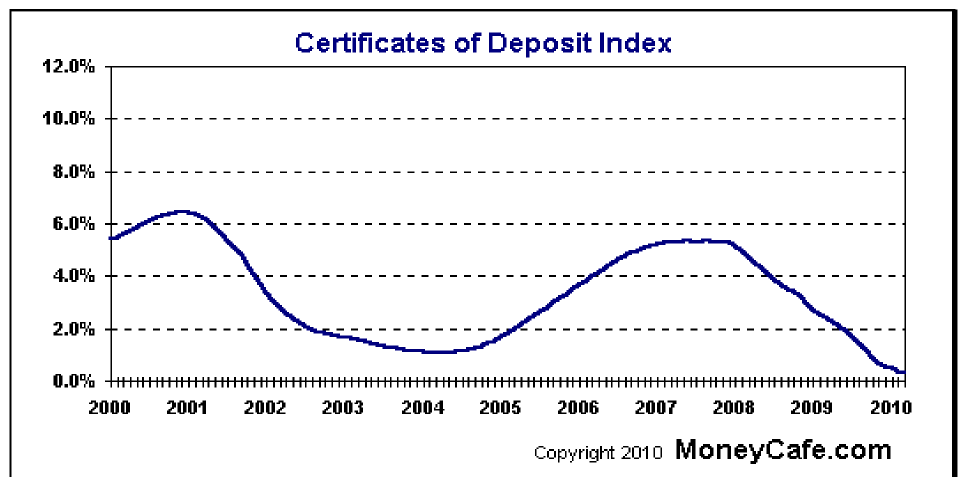

The Certificate of Deposit Index (CODI) is the 12 month average of the monthly average yields on the nationally published 3-Month Certificate of Deposit rates. Information on monthly yields on 3-month certificates of deposit (secondary market) is published by the Federal Reserve Board. The values are calculated by us using the H.15 Federal Reserve Statistical Release data.

Why shouldn't financial advisers act as fiduciaries?

As I saw the grilling of the executives of Goldman Sachs unfold on the public stage, I watched intently to see if the subject of fiduciary obligations came up. Quoting from an article from April 28, 2010 in the Wall Street Journal, "Just before lunch Maine's Susan Collins (R.) asked the Goldman honchos an equally straightforward question, which should be a slam dunk for any self-respecting professional–namely, whether the firm puts its clients' interests first. And several pointedly refused to give a direct answer. Dan Sparks, former head of the mortgages department at Goldman paused briefly, then said: "I believe we have a duty to do well for our clients."

I've written several letters that had to do with the issue of acting as a fiduciary for our clients. As our elected representatives work through the debate on new financial regulations, quite a few consumer groups and several industry groups including the National Association of Financial Advisors (NAPFA) and the Financial Planning Association (FPA) have been calling for all financial advisers to be required to act as fiduciaries. *That means that they would be required to always act in the client's best interest, disclose any conflicts of interest and disclose how they get compensated.* Brokerage firms, Insurance Companies and others have been lobbying against this idea. Why?

That's my question. Why wouldn't you want to always act in your client's best interest? Read the quote from the Journal again. Nobody wanted to answer a question which should have been a "slam dunk". Instead, Dan Sparks said they have a duty to do "well" for their clients, whatever that means.

Where are you getting your financial advice? Is your adviser always acting as a fiduciary for you? Ask the question and you may find answers to some of the questions you've been wondering about for the last two years or so. Call me at 560-3800 if you need a better understanding of this important matter. And then call your congressman to demand that anyone offering financial advice be required to act as a fiduciary. To me it's a no-brainer.

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Is your retirement plan tax efficient?

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The New Three-Legged Stool

A Tax Efficient Approach to Retirement Planning

By Rick Rodgers

Imagine you're playing a game called Retirement Distribution. Your opponent, the IRS, wrote the rules of the game. The secret to winning this game is to keep the IRS out of your financial affairs before they have the right to interfere. To win, you will need a guide to the fine print in the rule book, and a sound strategy.

www.thenewthreeleggedstool.com

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Rick's Tip - Finding Money

An important step in putting together a financial plan is taking an inventory of assets. Where do you have your money and investments and what is the current value. I started a checklist of documents some time ago to help people remember all the places they have funds. Some of them are pretty obvious but one that is often overlooked is US Savings Bonds. For some reason, people forget they have these lying around or stashed away in their safety deposit box.

Now would be a great time to pull together your savings bonds and check what they are worth. Even more importantly you should check what they are earning or even if they are still earning anything. The last series E bond was issued by the US Treasury in June 1980 and will stop earning interest next month. The Treasury issued EE bonds beginning in July 1980.

Treasury Direct has a bond calculator that allows you to enter your bond information to determine its current value, interest rate and the last day it will earn interest.

You only have to enter this information once. You can elect to save the file on their web site so you can refer back to it and keep track of your bond holdings.

This is a helpful way to keep track of the savings bonds you know about. You may also have savings bonds you don't know about. The Bureau of the Public Debt estimates that $16.7 billion worth of savings bonds have not been redeemed. Some of the bonds were probably lost or destroyed. Some were bought by parents or grandparents and the recipient may have never known they existed. To find out if you have any of the unclaimed bonds, go to www.treasuryhunt.gov. Enter the Social Security number of the owner or purchaser. Be sure to check the Social Security number for members of you family that are deceased. There is a claim process to recover these bonds. Unfortunately the database only covers bonds issued since 1974.

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