A Primer on Safety-First Retirement Planning

By Editor Test *Thu, Jan 24, 2013*

Pfau reviews a new book on retirement income planning by financial planner Erin Botsford, who he says "does a good job explaining the safety-first approach to readers who may be unfamiliar with the concept."

One book I picked up on a whim for my new Kindle is Erin Botsford's *The Big Retirement Risk: Running Out of Money Before You Run Out of Time*. I didn't know what to expect. And I almost stopped reading in the first chapter when she laid claim to creating something she calls Lifestyle Driven Investing.

This is the basic goals-based approach to investing, which is already called Liability Driven Investing when used by pension funds. Changing the word liability to lifestyle is a good idea, because while pension funds think of their future payment promises as corporate liabilities, individuals also have liabilities that are less natural for them to identify as such. These liabilities are their future spending needs to support their lifestyle.

Investing, especially in retirement, shouldn't be driven by maximizing risk-adjusted returns over a single time period, but by what can best help you to secure your future spending needs.
That being said, I'm glad I finished the book. She did cite other resources, and she does seem to be well-intentioned and not just another snake oil salesperson claiming credit for others' work.

What she describes in the book is a good example of the safety-first approach to retirement planning. As she is a practicing financial planner, it is nice to be able to add another name to the list of planners using the safety-first approach.
Usually, the safety-first approach is criticized as being too academic and too unrealistic for the real world. The book doesn't really contain anything new, but it is a nice overview and introduction to safety-first ideas.

Erin does a good job explaining the safety-first approach to readers who may be unfamiliar with the concept, and whose knowledge about retirement planning may be based mostly on concepts like the 4% rule from the diametrically opposed school of thought of retirement income: the probability-based approach.

First she explains four Wall Street myths: The stock market always goes up in the long-term; the modern portfolio theory concepts of diversification and asset allocation are the keys to retirement success; financial service firms provide a broader range of investment options than are otherwise available to household investors; it is net worth which determines one's lifestyle in retirement.

The book then takes an excursion about the relationship between investment returns and demographic trends and also the relationship between demography in the social welfare system. It's a nice overview, but perhaps not all that relevant to the overall purpose of the book.

Next, she returns to safety-first principles by describing how one's lifestyle spending can be separated into different categories. She identifies four categories in her house of security: Needs, wants, likes, and wishes. Here she is talking directly about the spending, rather than the assets that will cover each of those spending categories, but the overall concept is the same. This is because different assets are used to meet the different spending categories.

For spending needs, she recommends using what she calls lifestyle investments. These are investments that produce income, and that must be considered either safe or predictable or guaranteed. She also suggests that these assets be in a legal entity that will provide protection in the event of a lawsuit.

This is the basic concept of goals-based investing in which you first build a floor to meet basic needs. Investment categories can include bonds and annuities. She describes a variety of different types of annuities, and I think she did a good job in explaining advantages and disadvantages of different approaches.

For wants and likes, she suggests hybrid investments. These are investments that would generally provide an income that is not safe or guaranteed. Examples include preferred stock, publicly traded REITs, covered calls, master limited partnerships, dividend stocks, etc. Once needs, likes, and wants are met, more volatile, [growth-oriented] investments can be used to achieve one’s wishes.

Again, these are all basic tenets of the safety-first school of thought, which provides a stark contrast to probability-based notions like failure rates and “safe” withdrawal rates. Anyone seeking a basic introduction to this school of thought could be well served by reading this book.

This book review was adapted from a post at wpfau.blogspot.com.