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Post Retirement in-Flows Managing New Income Sources

by Francois Gadenne

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Do you think that a retiree's Personal Income Statement looks like the one they had during their employment days? Typically, an employee's major source of income comes from their Human Capital in the form of wages. Lest we forget, getting old is quite literally earned. Yet, where do your in-flows come from when you are retired?

DURING EMPLOYMENT YEARS

As an employee, we are used to seeing one major and often single source of in-flows in our Personal Income Statement: employment income in the form of W-2 wages arising from the steady growth of our Human Capital.

The self-employed will see Human Capital in-flows in the form of 1099 Income. They may also see in-flows from business investments in the form of rental income, royalty income, etc.

Most of us will not see much income from our social capital during our employment years. While we may see the occasional gift or inheritance, Social Security and defined benefit pensions only begin to pay monthly income after retirement. On the other hand, those of us with medical and/or disability conditions may see income from matching social or insurance programs.

During our employment years, we are also in the accumulation phase with regards to our financial capital. During the accumulation phase, we convert what we save from our Human Capital in-flows into financial capital. If we invest this financial capital well enough and do not lose it, it may even grow at a compound rate that makes up for inflation and taxes.

Most of us do not see in-flows from financial capital on our Personal Income Statement during our employment years. Most of such savings are in tax-deferred investment vehicles, 401(k)s, IRAs, etc. and the investment vehicles are geared for total return and capital gains instead of monthly income generation.

DURING RETIREMENT YEARS

This in-flows state of affairs changes during retirement. A retiree's sources of income become more diverse and may include in-flows from Human Capital (part-time work, self-employment, income from hobbies, etc.), business investments (rental income, royalties, etc.), social capital (Social Security, Defined Benefit Plans, etc.) as well as financial capital.

To Summarize:

Income from Human Capital

W2 Wages, 1099 Income

Income from Business Investments

Rental Income, Royalties

Income from Social Capital

Social Security, Health and Disability, DB Plans, Children, Church and Community Support Gifts

Income from Financial Capital

Investment Income, Annuity Income

In recent data from a CRS Report for Congress - November 7, 2005, Table 1, page CRS-4, Topics in Aging: Income and Poverty Among Older Americans in 2004, Debra Whitman and Patrick Purcell suggests that the median, annual in-flows into the Personal Income Statement of current retirees (age 65 and above) are as follows:

Income from Human Capital

Wages: \$15,000

Income from Social Capital

Private DB: \$6,720

Public DB: \$15,600

Social Security: \$10,399

Income from Financial Capital

Annual Income: \$952

These numbers are counter-intuitive for most of us in the financial industry. In particular, two questions come to mind:

Is the median annual income from financial capital really this small?

Medians and averages can easily be misleading. Clearly market segmentation matters greatly and answers to this questions will vary depending upon your target market.

Will the Baby Boomers display the same pattern since this data speaks to the prior generation?

It is very likely that they will not display the same pattern. Consensus suggests that they may not benefit to the same amount of social capital as the prior generation and there is evidence to suggest that much of the existing financial capital may be concentrated with the Baby Boomers. While time will tell, we are all making business decisions that answer this question one way or the other.

Independently of our answers, we can observe that this Personal Income Statement format is often not used in the accumulation-focused advisory process. Looking at the difference between the employee's and the retiree's Personal Income Statement, we can understand why this is the case. However, we probably all agree at this point that it should be used in the retirement income planning process.❖