While there’s no sure-fire recipe for a financially successful retirement, this layer-cake analogy may give plan participants an overview of what needs to be done.
ome
To adequately cover retirement needs, one way to approach the challenge of retirement income is to call up the image of a “four-layer cake” customized to your needs and wants.

Providing sufficient income during retirement can be a daunting task: Where to start? Where to go for advice? Whom to trust? What about my spouse’s needs? The questions boggle the mind, so this tasty metaphor of retirement income as layer cake just might help.

Customization

Whether you bake a cake or order it from the bakery, cakes are rarely the same. While some consumers want a fluffy white cake, others want a chocolate cake and chocolate frosting. Many people are happy with a very simple cake, but others want a cake that reflects their interests or personality—perhaps one that looks like a golf course or shaped like the Eiffel Tower. Some cakes must feed 200 people while others are just for two or eight or 16. Retirement plans are much the same—People have different needs and tastes.

The Layers of the Cake

When you bake a cake, you gather the ingredients and follow the instructions in a recipe. When planning for retirement, you gather information and follow a series of steps to achieve the retirement lifestyle you want. Think of these five steps as the layers of the cake plus the frosting.

1. **Bottom Layer:**
   *Determine Retirement Spending Requirements*

   Have an honest conversation with your family, your financial advisor and yourself about your annual spending requirements when you retire. Factor in travel plans, club memberships, insurance and health care costs, housing, extended family responsibilities, taxes, etc. If possible, determine whether your expenses over the next few years are likely to be higher or lower than the past few years. This will help you build your bottom layer. The bottom layer is critical. Without a firm foundation, both your cake and your retirement plan could collapse.

2. **Second Layer:**
   *Decide How to Fund Expenses*

   The key challenge to retirement planning is how to fund retirement expenses. Just as the ingredients in your cake will vary with the type of cake you are making, the resources you will have available to fund your retirement expenses probably will differ from what others will use. You may have Social Security, a pension, personal savings or any combination of these.

   If you have or plan to put aside personal savings for your future retirement, decisions about where you will put your money are critical. Just as you need baking soda, eggs or another leavening agent to help your cake rise, you will need a return on your savings and investments (e.g., interest, dividends, rent and capital gains) to help your savings grow.

3. **Third Layer:**
   *Planning for a New Set of Risks*

   All sorts of things can go wrong when baking a cake. You might forget to add an important ingredient, you leave the cake in the oven too long and it burns, or your cat decides to taste the cake while it is cooling on the counter. Retirement planning has its own set of risks that must be managed and balanced.

   **Inflation risk** is the possibility the return on your investments won’t be enough to keep up with the increasing prices of the goods and services you will buy during retirement. Such is often the case when you put money in conservative

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money market accounts with low interest rates. By investing in stocks, you have a better chance of keeping up with inflation, but the short-term price volatility can be nerve-racking. Stocks and higher performing bonds can help address inflation risk; however, they also result in more investment risk.

The risk of running out of money during retirement—longevity risk—is among the greatest of all fears. Monthly checks from Social Security and perhaps a pension reduce longevity risk. If you are concerned these payments will not be sufficient, using some of your retirement funds to purchase an annuity may be appropriate.

When dealing with risk, timing is also important. Take too much from savings too early or withdraw savings too aggressively, and you could run out of savings. If you begin taking Social Security or retirement benefits before the normal retirement age, you will have a flatter cake—in other words, lower regular benefit payments for meeting your everyday expenses.

4. Top Layer: Be Strategic About Taxes

When an investment portfolio is a major source of retirement income, an effective tax strategy is essential. As you save for retirement, consider which combination of ingredients best suits your income needs and tax situation in retirement. Just as you are faced with many cake flavors, you have a variety of accounts you can choose from, including taxable accounts, tax-deferred individual retirement accounts (IRAs) and tax-free accounts (Roth IRAs). Upon retirement, you should carefully consider which account(s)

A Glimpse of the Sweet Life in Canada, Australia and the U.K.

We’re not alone in the United States trying to solve this retirement income issue. Other countries are also developing their own “retirement layer cake” recipes with a goal of satisfying their own citizens’ need to properly save and invest and thus pull a tasty and secure retirement out of the oven.

Three major English-speaking countries in particular—the United Kingdom, Canada and Australia—provide a glimpse at how various societies are working out these issues.

U.K.: Moving Away From Annuities

In its 2014 budget, the British government has removed a requirement to annuitize retirement accounts at the age of 75. This was done to provide more flexibility but coincidentally has also provided some much-needed tax income in the near term. So while the U.S. is looking at ways to encourage more secure retirement products such as annuities, the U.K. is moving in a completely opposite direction.

It’s interesting to note the immediate impact this change has had on retirees’ decisions. The Association of British Insurers (ABI), which tracks annuity sales, documented a decline of over a third in annuity sales between the first and third quarters of 2014. This clearly shows the power of government regulation or deregulation, as the case may be.

Also, ABI has noted an increase in the average size of annuity purchases, which makes sense as people with smaller balances are electing lump sums, leaving people with larger balances continuing to elect to purchase annuities.

Australia: Land of Opportunity . . . But Maybe Too Much!

Now contrast the U.K.’s situation with that of Australia, where the retirement system has been dominated by mandatory defined contribution plans called superannuation funds. Many Australians own significant assets in these plans, as they require significant contributions from both workers and employers. However, a study by Challenger in 2012 illustrates that a majority of Australians are using their superannuation funds not for retirement, but for other purposes:

- 32% buy a home/pay for home improvements/pay off a mortgage.
- 27% invest the money elsewhere or put it in a bank account.
- 21% keep it invested in a pension scheme.
- 19% buy or pay off a car.
- 14% pay for a holiday.
- 12% clear other debts.
- 5% help family members.
- 4% purchase an immediate annuity.
- 17% other.

Australia’s government is concerned about this and has been looking at the issue in terms of whether it should change its tax rules to provide incentives for other behaviors, such as buying annuities. However, to date, nothing has changed.

Canada: Like the U.S. But With a Twist

Canada historically has had a strong defined benefit system but recently has begun moving along the same lines as the U.S. by installing more defined contribution plans. The Canadian federal and provincial governments have put in place a system similar to the U.S. minimum required distribution rules but with a twist. In Canada, both a minimum and maximum payout is allowed from retirement accounts. In effect, this provides individual flexibility while also supporting a public policy that targets strong support of retirement income.

Endnote

to “consume” (i.e., redeem) first to minimize tax consequences.

5. Frosting: Stay Engaged and Flexible

Achieving personal financial goals is an ongoing process. Once the framework is established, the plan must be checked and modified as priorities and circumstances change. No frosting ever tasted so good!

The Final Touch: Seek Advice

You probably could bake a cake without any recipe at all—You might just get lucky! But it would, of course, be foolish and inviting failure to try it. The smart way is to take advantage of all the knowledge of professional and even talented amateur bakers who have worked on countless recipes before you. They already have learned what works and what doesn’t work, so why ignore them?

Baking is basically a controlled chemical reaction: Put only so much of ingredient A into your mixing bowl, then only so much of ingredient B. Do it right and your cake will rise. Do it wrong and the cake stays flat. Retirement works precisely the same way. As finance expert Bob Merton has said, when it comes to retirement income, “We don’t have a science problem, we have an engineering problem.” In other words, we know what to do, so we just need to do it.

So start with a foundation and build up from there. Your end result should be the same whether a cake or retirement plan: a creation you can enjoy.
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