



Financial Sustainability Of Retirement: Three Key Risks And How To Be Prepared

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With the oldest baby-boomers now reaching the age of 67 the need to understand the financial realities of retirement is becoming more relevant with every passing year. In the past, retirees expected to live fewer than 10 years in retirement. However, longer life spans, chronic illnesses such as Alzheimer's disease, and changes in family dynamics are all affecting the economic reality of retirement making it increasingly difficult to predict and manage.

Central to this issue is determining the sustainable level of income a retiree can enjoy based on a particular amount of financial resources (savings and assets); or the opposite, determining the amount of financial resources necessary to sustain a certain level of income.

Danger In Averages

Most conventional retirement planning methods apply the same principles during the withdrawal phase of a plan as during the accumulation phase. Unfortunately, the latest research is proving to totally refute this approach. For example, it is often assumed that a retiree will experience average inflation, average investment returns, and live an average lifespan. While these assumptions appear reasonable it statistically means that the plan also has a 50% chance of failure; not an attractive proposition when considering the stakes.

Plan For Adversity

"Prepare for the worst but hope for the best". While this proverb may be sage advice it should not be taken to extreme in managing retirement resources. In general, planning for the worst case scenario requires that the retiree have greater financial resources or reduces his or her expenses in preparation to weather a financial storm of the worst magnitude. This may pressure retirees to unnecessarily live below their desired lifestyle, out of fear of running out of savings and in preparation for an event that will likely never occur.

Instead of preparing for the average or worst case scenario a more balanced approach would be to prepare for financial sustainability in the face of economic and financial adversity. This gives retirees the comfort of knowing that they have enough financial resources to withstand several negative economic events or circumstances but in the end they will still be standing on sound financial footing.

Longevity Risk

In the last century life expectancy has increased by 30 years. In fact, today there are more people alive in the world over the age of 65 than there has been cumulatively in the history of our planet. While this is a great testament to progress, living a longer life brings financial challenges that have never before existed. Obviously, living longer demands that financial resource last longer but there are other considerations such as costs increases due to living with chronic illnesses, which are on the rise, and changes in family dynamics. It is now rare to find three generations of a family living together under one roof.

Inflation Risk

Inflation has always been a concern for retirees; however, this risk may be more serious now than in the past. The key issue is that the longer a person is in retirement the greater their exposure and therefore risk to the vagaries of inflation. In addition, inflation does not necessarily move up in a steady rhythm as is often assumed in retirement planning forecasts. This means that the cost of living in retirement surges at varying rates over time. The irregularity of cost increases can negatively impact the longevity of savings. For example, if higher inflation is experienced in the earlier years of retirement this would require greater withdrawal from savings long-term causing permanent damage to the longevity and income sustainability of savings.

Investment Risk

It is vitally important to recognize that the rules for investing during the accumulation phase are different than during the withdrawal phase of an investment portfolio.

The first difference is that the primary goal of an investment portfolio in accumulation is different than during retirement (withdrawal). During the accumulation phase the goal is normally growth and the risk is volatility of returns. However, in retirement the goal is normally income longevity and the risk is the sequence of returns. The sequence of returns is critical in retirement because regular withdrawals from savings during times of low investment valuations (to pay for living expenses) will cause permanent damage. This occurs because the withdrawn funds cannot participate in any future recoveries. In other words, making regular withdrawals from fluctuating investments (usually to pay for living expenses) will have a negative impact on the longevity of the investment portfolio. This effect is called reverse dollar cost averaging.

Back Test And Stress Test

Mark Twain wrote, "History does not repeat itself but it does rhyme."

Most conventional retirement planning methods produce a forecast based on a wide range of assumptions. In many cases these assumptions can act like quicksand for the retirement plan. Research has proven that most standard retirement plans fail when put to the test in the real world. Likely, this is due to the assumptions, averages, and the unaccounted for risks that are prevalent in the majority of retirement plans.

A way of avoiding these pitfalls would be to use actual market history and back-test retirement plans to evaluate their potential outcomes. With this method few assumptions are made. For example, the actual inflation, investment returns and interest rates applied to the plan are real and analyzed in the order of their occurrences. There are no assumptions and

the impact on the individual plan is calculated in its entirety. Obviously, different periods of time in history will have different results and therefore testing all historic periods will result in a landscape of varying historic outcomes. However, this does offer a complete perspective of the good, bad, and average outcomes that would have occurred in history for a single plan.

How can this information be used to evaluate the potential success of a plan today? Of course, using the average historic outcome cannot be used as that would violate the principal of "preparation for adversity".

Stress testing the back test: A retirement plan's potential for success can be evaluated by segmenting the historic outcomes. For example, a good stress tested plan would be successful above the point where 90% of historic outcomes succeeded and only 10% failed. Put another way, that specific plan would succeed in provide life-long income (within an historic context) with a 90% probability of success.

Protecting The Plan

While it is important to map out retirement expenses, optimize investments, back test and stress test a plan, events can occur that could still knock a plan right off its foundation. For example, an unexpected health event, such as being diagnosed with Alzheimer's disease could significantly increase costs and jeopardize the viability of the most well funded plan.

One way to protect a plan from health related risks is to obtain critical illness and long-term care insurance. Obviously, paying for this protection has an impact on regular expenses but it could also protect your plan from a devastating event and when it comes to funding your retirement, failure is not an option.

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MoneyTip

Confirmation Of Dividend Growth

S&P 500 companies are directing 40% of their cash usage back to shareholders compared to less than 30% in the late 1990s...More than half of that amount (22%) has been devoted to buybacks while 18% has been used to pay dividends. Since 2010, dividend payments have grown nearly 50% while buybacks are up 40% on a trailing four quarter basis.

(Goldman Sachs via Business Insider)