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Longevity Risk

How Investors Can Protect Themselves



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Key Points

- *The issue of longevity risk is crucial for investors to consider.*
- *What is a reasonable withdrawal rate from a retirement portfolio?*
- *Besides savings, what are some other items investors should consider when it comes to combating longevity risk?*

Financial columnist Robert Powell recently wrote an article¹ this spring entitled “The Top 10 Retirement Risks You Face.” Inflation risk, interest rate risk and stock market risk were all named but the first one he listed was longevity risk. Basically, this is the risk of outliving your financial resources. Mr. Powell goes on to say the average life expectancy in the U.S. is 78 years. The problem, of course, with averages is we all know people (a parent, aunt or uncle who lived or is still living well into his/her 90s) whose life expectancy is anything but average.

Longevity risk is getting a great deal of attention not just because people are living longer, but also because more individuals are responsible for funding their own retirement. When we prepare financial plans for clients of Kobren Insight Management, we are seeing fewer and fewer individuals who have a defined benefit pension plan. Such plans typically pay a monthly benefit based on length of service, or perhaps some average of final three or five years of compensation. In essence, the provider is obligated to pay the employee as long as he or she lives. This was doable when the obligation lasted 10-15 years, but became an albatross for the provider when more retirees were living 20-30 years past retirement age. Most companies and organizations have reverted to defined contribution plans such as 401(k) and 403(b) plans. These plans shift responsibility away from the employer to the employee, both in terms of how much of your compensation is deferred (for retirement) and how those funds are invested.

Since responsibility for our retirement is now largely in our own hands, a logical question is how much one can safely spend in retirement without prematurely exhausting the funds? For many years, a 4% annual withdrawal rate was (and still is) considered prudent. A 1994 research study² by Larry Bierwirth and William Bengen suggested that an initial 4% withdrawal rate, adjusted annually for inflation, would last for at least 30 years. The authors assumed an equity (stock) allocation of between 50-75%, with annual rebalancing back to the original stock and bond allocation weights.

A follow up study in 1998² by Cooley, Hubbard and Walz confirmed the findings of the above study, but put a qualifier on the results. They found a historical success rate of 95% assuming a 30-year time horizon, a 4% annual withdrawal rate and an equal balance between stocks and

bonds. Interestingly, the success rate climbed to 98% when the stock allocation was raised to 75% (from 50%). I wonder if above average equity returns of the 1980s and 1990s might have affected the simulations they ran?

I think the appeal of the 4% rule is its simplicity. A person who retires at age 60 and expects to live another 25 years can take out 1/25 (4%) annually, and hopefully increase their withdrawals modestly over time with the growth and income from the underlying investments.

If you think the so-called 4% rule is a settled matter in the investment world, it's not. Many articles that have since been published question the assumptions and findings of the original studies. According to one author, the primary flaw of this rule (or rule of thumb) is that the retiree's spending plan is constant while the underlying investments that support the plan can be volatile. U.S. stocks (as defined by the S & P 500 Index) averaged 8.21% for the 20 year period 12/31/09. That sounds wonderful until you realize that the S & P 500 Index return for the past 10-year period was actually negative (-0.95% average annual return). A retiree who started a 4% annual withdrawal plan 20 years ago would have a very different experience from the retiree who began the same plan 10 years ago.

Critics of the 4% rule would not only argue that some retirees might prematurely exhaust their savings, but that other retirees might spend too little. In effect, living a substandard life style given their resources. This resonated with me, as many of our clients tend to be quite active during the initial phase of retirement. Spending may be elevated given the costs involved with world travel, a vacation rental in warmer climates during the winter, and perhaps taking up a new hobby. A spending table tied to the 4% rule may allot you \$50,000 today (at age 65) when you need \$70,000, and allot you \$80,000 (at age 75) when you are only spending \$65,000.

My objective in writing this article is not to dismiss the 4% withdrawal rule as irrelevant, but rather encourage investors to think beyond simply what they have in savings and what they think they need to live on. When we develop a financial plan for an investor, here are some items we deem important in protecting him/her from longevity risk:

- **Social Security**- if possible, consider delaying taking Social Security until you reach full retirement age. Let's say your full retirement age is 66. If you elect to draw Social Security at age 62 instead, you'll receive 25% less than had you waited. If a younger spouse is involved, the ramifications can be even more dramatic.
- **Long-term care insurance**- if you're concerned a debilitating illness could ravage your savings, you should at least price long-term care insurance. If the premiums for full coverage are too steep, consider a policy with partial coverage for expected health care expenses
- **Annuities**- these products sometimes get a bad rap for being expensive and inflexible, and in some instances, the criticism is deserved. I wouldn't dismiss these totally though. An immediate or deferred annuity for a part of your portfolio might make sense. These can be structured to pay a

certain sum for your life-time, a joint life time with a spouse, or a period certain (e.g. 10 years).

- **Real Estate-** if you were to sell your primary residence, what could you realize? Also, what would be the annual savings in real estate tax and insurance? Will renting a condo or apartment allow you to extend your retirement for another 5-10 years? If you can't stomach the thought of selling your home, does a reverse mortgage make sense to tap some of the equity?

A holistic approach to financial planning will consider these factors and others. There is no magic solution to longevity risk. We live in an uncertain world. The key is to plan, implement, monitor carefully and adjust over time. The old adage "failure to plan means planning to fail" is true.

¹*The Top 10 Retirement Risks You Face, published 4/9/10, www.marketwatch.com*

²*"The 4% Rule-At What Price?", April 2008, by Jason S. Scott, William F. Sharpe, and John G. Watson.*

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