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Additional Tips on Retirement

In a previous communication on retirement, available at "Will I have enough to retire?", I indicated that some of the most complicating factors associated with retirement issues revolved around: 1) longevity risk, or the uncertainty associated with the timing of our own death and, 2) the proper calibration of our yearly withdrawals once in retirement. Obviously, for any given level of retirement assets, the faster we withdraw from the pot, the higher the likelihood that we will run out of money. Similarly, the longer we live, the higher the likelihood that we will run out of money.

Below is a summary of some research on these two key retirement issues. The conclusions and tips provided come from two well-known names associated with asset management research: **Moshe Milevsky**, Finance Professor at York University in Toronto, a prolific writer and researcher on retirement issues, and the firm of **Ibbotson Associates**, a very familiar name for the readers of asset management journals.

On the issue of calibrating withdrawals

If you have read my previous article on retirement you are familiar with the rule of 25. It says that if you expect to need $50,000 per year during retirement, you will need 25 times that amount, or $1,250,000, at retirement time in order to fund the annual payouts for thirty years. Another way of looking at this is to say that if you consume 4% of your assets annually, you should not run out of money. This is a broad rule that is based on portfolio return assumptions and longevity statistics that may or may not prove right for every individual.

Professor Milevsky offers a more nuanced approach that I summarize below:

"An initial withdrawal rate of 4%, indexed on inflation (assumed to be around 3% per year), should be sustainable if the retiree follows three rules:

- If the portfolio shrinks during any given year, the withdrawal the following year cannot increase. In other words, if your portfolio finishes the year below where it started on January 1, after your annual withdrawal, you should deny yourself an inflation-based raise the following year,
- No matter how high inflation gets, you should not give yourself an annual raise superior to 6%,
- After a bad market, do not sell hard hit stocks. Instead, each year, start by lightening on winning stocks".

These points make a lot of intuitive sense. If you can afford it, I would tend to play it even safer and follow his recommendations while aiming for a withdrawal rate of 3.5%.

On the issue of longevity risk

The only sure way to get around this risk is to benefit from a significant lifetime pension and/or to have lifetime annuities. These days, few of us have pensions. Often, when we still do, they are small.

Potential pension substitutes, such as lifetime annuities, come with serious problems. One of the biggest obstacles to their use is that once you die, the money you have paid upfront to the insurance company stays with it, irrespective of how many annuity payments have been made to you. This problem can be remedied, but usually at a serious cost, with the value of the annuity dropping so much as to make it much less useful. As a result, relatively few people include annuities in their arsenal of retirement investment vehicles.

Nevertheless, whatever the drawbacks, a lifetime annuity does answer the risk associated with longevity. Here is an intriguing research-based conclusion from Ibbotson and Associates on this subject:

"Investing 50% of retirement savings at age 65 into a lifetime annuity and investing the remaining 50% of your assets in a 60% stock, 40% bond portfolio increases the odds that you will not run out of money by age 100 to 58%. In contrast, investing 100% of your savings in a 60/40 portfolio at age 65 provides only a 42% chance of still having money at age 100".

On the one hand the increase in positive outcome from 42% to 58% is significant enough. On the other, you still have a 42% chance of not getting there even after investing 50% of your savings in the lifetime annuity. What I conclude from all of this is that lifetime annuities are a useful tool to consider for retirement planning purpose. In the current economic environment, with interest rates so low, I would not recommend them. They are simply too costly. However, should the general level of interest rates rise over the next few years, as expected, including them in your retirement investment kit may make sense then. May be it is worth keeping this much-maligned retirement planning product in mind after all!

Please feel free to call me with any questions and comments.

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