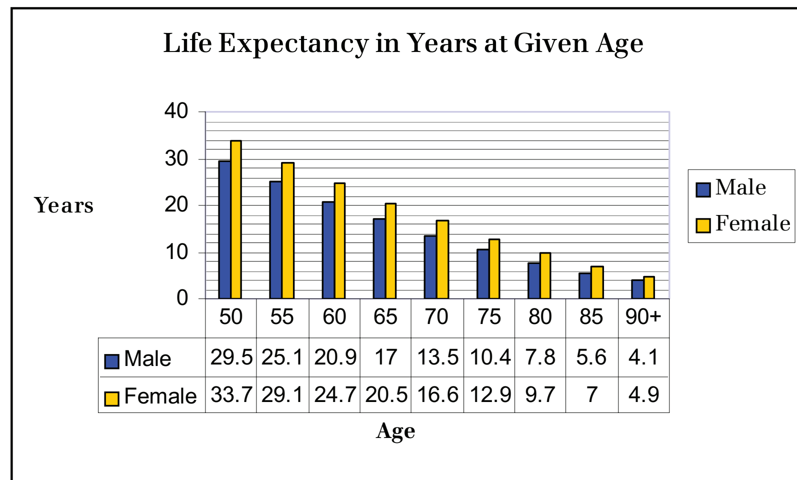
Strategies to successfully manage longevity risk

Longevity risk is the risk of outliving your money.

Who would have thought that certain hard-living rock stars would still be alive today? Now in their 60s, they're likely to be with us for many years to come. Could they be contemplating longevity risk? Probably not, but for the rest of us longevity risk is a real concern.

Theoretically, conventional investment planning provides accumulated wealth to last a lifetime—for men, 78 years and for women, 82 years[1]. In reality, only four per cent of people actually die in the last year of their expected life span.[2] For a 65-year-old couple today, there is a one-in-four chance that one of them will reach 97 years of age, and a one-in-two chance that one will reach the age of 92. This unexpected increase in life expectancy puts enormous pressure on retirement funds. Since most people wait until age 50 to get serious about saving for retirement, they leave themselves only 15 years to accumulate enough assets to fund a minimum of 20 years in retirement.

The financial implications of living longer than expected beyond the core income-earning years are significant.



Age	50	55	60	65	70	75	80	85	90+
Male	29.5	25.1	20.9	17	13.5	10.4	7.8	5.6	4.1
Female	33.7	29.1	24.7	20.5	16.6	12.9	9.7	7	4.9

Source: Canadian Life Expectancy Table 2001, Statistics Canada

In 1920, five per cent of Canada's population was over age 65; by the year 2020, that figure will be closer to 20 per cent[3]. The Baby Boom generation will continue to represent a powerful social and economic segment of Canadian society, whose impact on traditional notions of retirement preparation will be significant—not only for themselves, but also for the marketplace expected to sustain them. A recent survey indicated that Canadian Boomers intend to lead active lives in retirement vis-à-vis their contemporary counterparts,which means their spending

[1] *World Health Organization 2005*
[2] *Morningstar: How can immediate annuities help manage longevity risk?*
[3] *Clarica: About Long-term Care*

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is unlikely to decline dramatically in the post-employment years. As a corollary of living longer and spending more in retirement, Boomers face the very real possibility of outliving their assets.

The “new retirement” will require investment plans that go beyond life expectancy. Some of the strategies to income for life include:

1. Allocating a portion of one’s portfolio to annuities. Life annuities are a very effective choice because they guarantee the annuitant income for the rest of his or her life.
2. Choosing tax-efficient investments to maximize income potential. For example, certain common shares pay out regular dividends—income that is taxed more favourably than interest income.
3. Purchasing permanent life insurance, the proceeds of which can be converted to a life annuity that will provide income for life for a surviving spouse.

Income for life

Including annuities in an investment portfolio is probably one of the most effective methods to provide guaranteed income. An annuity is essentially a promise of income for life or for a specified period of time. Think of it as the opposite of a mortgage. Instead of borrowing a lump sum initially and then paying the loan back over a number of years, an annuity provides guaranteed income payments in exchange for an “up front” lump sum deposit. A life annuity will provide income for as long as the annuitant lives.

Like many investment vehicles, there is no shortage of annuity options. They can be offered on a single or joint life, indexed for inflation, and purchased with registered or nonregistered money. Generally, the older the annuitant, the higher the income payment that person will receive. The yields for annuitants who live beyond their life expectancy tend to be higher than those of GICs, T-bills, etc., because the money invested in annuities is pooled. Some annuity investors will not live beyond their life expectancy, so the funds that would have been required to provide them with income are instead allocated to surviving investors.

Consider all financial needs

It’s important to recognize that an investment in an annuity is permanent. Therefore, people usually do not invest all of their assets in annuities. Rather, they tend to allocate a portion of their portfolio to a fixed income type solution (annuity) to cover their day-to-day expenses. Hence, when considering this option, one should consider the gamut of financial needs. For example, consider the impact on an estate plan if the money invested in an annuity is not available to heirs. The question becomes “is the lack of flexibility worth the peace of mind that comes with having guaranteed income?” For many, the answer is “yes.” A financial advisor can help determine a strategy to meet unique requirements.

Choose tax-efficient investments to maximize income potential

An investor who seeks tax efficiency will discover there are many income-oriented alternatives. Specifically, certain common shares pay out quarterly dividends at a modest rate. Preferred shares, income trusts and closed end income funds also offer relatively attractive yields. In addition, convertible debentures and equity-linked notes offer investors a combination of income and the potential for capital appreciation. Distributions are paid monthly or quarterly and may consist of dividends, capital gains or “return of capital.” Distributions that are designated as a return of capital are taxable only upon disposition of the asset and are subject to the same tax treatment as capital gains.

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While equities and equity-related securities are generally considered to be riskier than bonds and GICs, they can be used selectively to enhance cash flow and tax efficiency. By diversifying an income portfolio to include both debt and selected equities, it is possible for an investor to enhance after-tax returns while reducing risk.

Create survivor income

Longevity risk is even greater for a couple. There is a 50 per cent chance that one person in a couple, age 65, will live to age 92. Survivor benefits may decline if one person dies, putting greater pressure on the remaining assets to maintain the survivor's lifestyle. In addition, the risk of needing long-term care increases as we age, which may result in a period of substantial additional expenses. Life insurance creates liquidity. Assuming the person to be insured qualifies for the insurance, the cost to create an instant estate for the survivor is justified. The death benefit proceeds flow tax-free to the surviving spouse, exempt from probate.

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