Planning For Certain Risks in Retirement

While your retirement date may still be several years off, and the goals you set today may seem even further off, it is never too early to begin preparation.

Along the way there will be some bumps and pitfalls during your savings years. More importantly there are certain risks in retirement that need to be considered and planned for before you retire in order to maintain a comfortable retirement lifestyle.

Happy 90th Birthday

With the steady improvement in life expectancy, many more people will be around to celebrate their 90th birthdays than in the past – but will they have enough retirement income to last their lifetime? According to Statistics Canada, a 65-year-old man can expect to live an additional 18.1 years (to age 83), while a 65-year-old woman can expect to live an additional 21.3 years and celebrate her 86th birthday.[1] No one knows how long they will live, nor, therefore, how long they will need to rely on their retirement savings. This risk is known as longevity risk.

Bulls vs. Bears

Another uncertainty is the timing of returns or more importantly, the sequence of returns. A bad year or two in the early years of your retirement can have a major impact on how long your retirement savings will last. That is because you have to draw down from the capital of an already shrunken asset. The impact of the sequence of returns on a retirement portfolio is called market risk.

For instance, the market downturn of 2008 put a major dent in the retirement savings of many Canadians. For those in the accumulation stage and for whom there is still time before retirement to recoup losses, the market decline may even have represented an investment opportunity. Indeed, the market has essentially returned to pre-2008 levels already. But for those who were on the verge of retirement, the downturn may have altered their retirement plans significantly.

The experience may have shaken their faith in the market's ability to provide sustainable earnings, causing them either to resign themselves to living with less or, in some cases, to postpone their retirements.

How much for latte in 2047?

Even a relatively low rate of inflation can seriously erode retirement assets. In fact, even if the inflation rate is low when you retire, it may rise significantly during your retirement years and reduce your ability to maintain your living standard – this is known as inflation risk.

If inflation averages four per cent annually over the next 25 years, an annual income of $50,000 today will need to grow to over $130,000 in 2047, for the recipient to maintain his or her living standard. Even if inflation is at the lower rate of two per cent annually, the income will need to grow to over $80,000 in 2047 for the recipient to maintain his or her living standard.

How are you feeling... tomorrow?

The costs for health care are trending upwards, especially as a result of longer life expectancies. There is an ever-present uncertainty about health and long-term care expenses. At some point as you age, these expenses will begin to manifest themselves in the basic day-to-day expenditures that figure into most retirement plans. Indeed, when asked to rank a number of risks when planning their retirement, respondents of a survey overwhelmingly selected unexpected costs as the biggest risk, ahead of outliving their retirement assets, keeping pace with inflation, and unpredictable investment returns.

The risks are two-fold: health care expenses are rising more rapidly than inflation, and there is a general trend of items being excluded over time by public and private sector healthcare insurance providers. Long-term care is a wild card, because you can't forecast what your personal needs will be in the future; but as boomers age and the demand for long-term care facilities grows, it is highly likely that the costs will grow too. Paying for these expenses may require drawing down additional capital, which, in turn, will have an impact on how long your retirement savings will last.

Tips to manage these risks

Longevity risk
Direct a portion of your retirement savings to investments or products that offer a guaranteed lifetime income.

Market risk (sequence of returns)
Start the retirement income planning process ten years before your retirement date to implement retirement income planning strategies and reposition your portfolios for drawdown in retirement.

Inflation risk
Consider investments that will deliver returns above inflation or products that will provide inflation adjusted incomes.

Health and Long-term care risk
Set aside a portion of your savings to budget for health care costs or long-term care insurance in the future.

Everyone should have a retirement plan that acknowledges the risks in retirement. To secure the retirement lifestyle you have spent years planning and accumulating for. Work with a BMO financial professional to develop a retirement income plan that will take into consideration your financial circumstances and retirement lifestyle goals.

For more information, please speak with your BMO financial professional.

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[1] www.statcan.gc.ca/daily-quotidien/100223/t100223a1-eng.htm

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