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How To Beat 2 Of The Top Risks Retirees Face

When you combine longevity with inflation, it adds up to a perfect storm for baby boomers, who must make their savings stretch for decades. Here's how to help safely steer around the danger.

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The Retirement Income Specialists

If you are like many boomers, your spending will not drop significantly at retirement. In the beginning, you'll be fulfilling the many dreams and desires you postponed during your career and child-rearing years. Later on, the cost of health care may become a significant factor in determining your income needs.

How can you help ensure that your money will last as long as you do? By addressing these two retirement risk factors.

One Of The Biggest Risk Retirees Are Up Against: Longevity

Longevity is perhaps one of the greatest challenges for boomer retirement planning. Most boomers seriously underestimate their life expectancy. Perhaps this is due to a misunderstanding of what mortality age really means. In fact, half the population will outlive their life expectancy.

When the mortality table tells us that a 65-year-old man has a mortality age of 82, it means that half of all men who are 65 today will die before age 82[1], and the other half will live past that age. The mortality tables also include the entire population, not just those who receive the level of nutrition and health care that you probably enjoy.

Another frequent misunderstanding about mortality age is the statistical increase in mortality age that occurs when calculating joint mortality. A man age 65 has a 50% chance of living to age 82. A woman age 65 has a 50% chance of living to 85[1], but as a couple, they have a 50% chance of one of them living to age 92. In fact, as a couple, they have a 25% chance that one of them will still be alive at age 97.

A worker retiring early at age 55 may need to generate more than 50 years of retirement income. This is the basis for the new definition of long-range planning.

Another Risk Retirees May Face: Inflation

The increased longevity that boomers can expect contributes to the serious risk presented by inflation, which is the long-term tendency for money to lose purchasing power. This has two negative effects on retirement income planning. It increases the future costs of goods and services that retirees must buy, and it potentially erodes the value of their savings and investments set aside to meet those expenses. Even at a modest inflation assumption of 3% annually, the effects of inflation over a quarter century of retirement could be devastating.

For example, say a 65-year-old needs $56,250 of income a year in retirement. The impact of inflation on a 25-year retirement means that each year a higher amount would be required to meet that income need. By the time this 65-year-old turned 90, that initial $56,250 in income would need to increase to $117,775 to maintain the same standard of living.*

In prior generations, inflation was not such a worry, since retirees were not expected to live much more than five or 10 years past the age of 65. In fact, when the Social Security retirement age of 65 was enacted in 1935, the average mortality age for a man was 64 years old.[2]

The Planning Process To Address These Risks

Explore all sources of guaranteed income available when retirement begins. Social Security, defined benefit pensions and any other income sources must be quantified as to how much, from what source, and for how long. Pay careful attention to whether benefits are indexed to grow with inflation and whether they continue to a surviving spouse, since survivor planning is an important part of retirement income planning. Develop three cash-flow models — both spouses living, husband dies, wife dies — to identify any gaps in cash flow that need to be addressed by additional savings or insurance.

Next, inventory all your assets that will be used to generate retirement income. This is where traditional financial planning tools, such as Income Maximizer, RetireUp Pro and Riskalyze, are needed to project future values and income streams from various types of assets. Be alert to the differences in taxation during distribution among various types of assets. Retirement accounts may generate less spendable income than investment accounts, because of the taxes due on distributions from retirement plans.

Set a realistic withdrawal rate. The withdrawal rate is the one variable over which you have the most control — not your mortality, not your health, not your investment returns, not inflation — just your withdrawal rate. You must understand that this is the lever you will need to pull when things don't go as planned. Being realistic about what you can spend and keeping a sufficient contingency reserve fund will ease the pressure that withdrawals put on retirement portfolios.

Traditionally, many financial professionals recommended a 4% withdrawal rate as a sustainable rate that would preserve principal while providing enough retirement income. To ensure that such a rate doesn't exhaust savings, you can select a withdrawal rate and then apply it to your current retirement plan balance instead of keeping your withdrawal consistent based on your initial retirement savings balance. That would mean withdrawing less when your portfolio declined in value due to the market and more when the market was higher.

For example, if your initial balance was $500,000 and your withdrawal rate was 4%, you would withdraw $20,000 the first year. However, if your portfolio value dropped by 10%, the next year you would withdraw $18,000 rather than $20,000. This strategy helps ensure that you will preserve your retirement balances as long as possible through retirement. With the recent low bond yields and equity returns uncertain, some retirement experts now argue that the 4% rule as an initial rate of withdrawal for a 30-year retirement may be too high.

This may leave investors with the prospect of having to spend less in order to give themselves the best chance to have enough money to keep up with inflation and maintain their retirement lifestyle. The alternative is to first determine the income need to sustain basic monthly expenses, adjusted for inflation, and then design an income plan with various payout strategies to ensure meaningful diversification among asset classes and investment styles.

Note: Be cautious about considering your primary residence as an investment asset. You may be thinking of downsizing later, but experience tells us that people are often reluctant to leave a familiar home in their advanced age. Be ZIP code flexible when making your retirement plans. Many areas of the country have low to no income tax, and there can be significant differences in the cost of housing and health care.

The Crossroads: Asset Allocation

The double whammy of longevity and inflation creates an asset allocation dilemma for boomers. The old adage of subtracting a person's age from 100 to obtain the optimal percentage of equities just doesn't hold for a five-decade retirement portfolio. Invest too conservatively, and your money may not grow enough to last your lifetime considering the erosion of long-term inflation. Invest too aggressively, and you run the increasing risk of outright capital loss without adding significant years to your plan under average market conditions.

Working with a financial professional, determine an appropriate exposure to equities, then design an allocation within those equities to ensure meaningful diversification among asset classes and investment styles. Cash and fixed income will play a larger role in retirement portfolios, since provisions must be made for the orderly withdrawal of assets.

Have your financial professional set up regular portfolio transfers to your bank account to enable you to manage your income just as you did when paychecks were funding your expenses. This tends to dampen overspending by imposing some discipline on the withdrawal process. Otherwise the portfolio could easily become an ATM.

The challenges facing boomer retirees are significant — but not insurmountable — with some realistic and prudent planning. You will need to consider what you own, what you owe, what you will make, and where it will go in order to develop a workable retirement income plan.

1 https://www.ssa.gov/oact/NOTES/as120/LifeTables_Body.html

2 https://www.ssa.gov/history/lifeexpect.html

** Calculation uses the retirement income calculator from National Life Insurance Group, assumes the person had a gross income of $75,000 and wanted to replace 75% of that income in retirement.*

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Kelly Carter is the CEO of Beacon Retirement Planning Group and has more than 20 years experience as a financial retirement adviser with emphasis on estate and tax planning, life insurance, annuity programs and retirement strategies. Kelly has headed up the forum for hundreds of wealth preservation seminars and has spoken to thousands of retirees. The result has been the development of an extensive network of clients throughout Southern California.

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