INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Biggest risk to retirees?

Demographic and economic structural changes have elevated longevity risk. Retirees are simply living longer

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Today, retirees are rightly concerned with the risk exposure of their portfolios. Therefore, financial advisors appropriately spend considerable time designing portfolios that meet their clients' downside risk tolerances.

Unfortunately, the focus on volatility and drawdown can mean that the single biggest risk for many retirees – outliving their capital – remains unaddressed.

Demographic and economic structural changes have elevated that risk. For one, retirees simply are living longer. Based on the Canadian Institute of Actuaries' 2014 Canadian Pensioners' Mortality Report, a 65-year-old couple has a 25% chance that one spouse will live to at least age 97 and a 10% chance that one will live to at least age 101.

Increased longevity increases the pool of capital needed to fund retirement. Although extending time horizons reduces the standard deviation of annualized returns, it increases the deviation of terminal wealth. An investor who lives longer is exposed to more severe market events, which increases the magnitude of potential losses.

Worse, fixed-income returns have waned. Long-term Canadian government bonds currently yield about 2.2%. The picture for real interest rates is even bleaker: long-term real-return bonds yield about 0.5%. Although monetary policy is a factor in today's low rates, structural changes – lower productivity, slower labour force growth and massive government debts – are signals that low interest rates could persist for the foreseeable future. Meanwhile, current stock valuations suggest future returns from equities will be middling at best.

The Financial Planning Standards Council and the Institut québécois de planification financière recently released their 2018 projection guidelines. Their recommended annual return assumptions: Canadian equities, 6.4%; foreign developed market equities, 6.7%; and emerging markets, 7.4%.

On top of these challenges, affluent retirees face soaring tax rates. In 2009, an Ontario investor with a taxable income of more than $126,264 had a marginal tax rate of 23.1% on Canadian eligible dividends (based on actual dividends received).

Today, additional tax brackets with higher rates mean investors with taxable incomes of more than $144,489 face marginal tax rates of 29.5%-39.3% on eligible dividends. Above the new highest income threshold – $220,000 – the tax rate is more than 70% higher than it was in 2009.

To manage longevity risk, you must assist your clients in establishing realistic retirement budgets that include recurring and non-recurring expenditures. Cash-flow elements, such as pensions, gifts to children and the impact of inflation, must be incorporated.

A critical input is the long-term expected return (net of fees and taxes) that reflects the asset mix of the portfolio. In conjunction with volatility parameters, Monte Carlo simulations can be run to determine the likelihood that a particular withdrawal rate is sustainable over the retirement horizon.

Frank dialogues between you and your clients on the interplay between spending levels, portfolio composition and downside, and the probability of running out of capital can lead to a strategy that better balances volatility risk with longevity risk.

A major benefit to addressing longevity risk with clients is that it incorporates investment management costs. Fortunately, there is an expanding array of ETFs and low-cost active portfolio managers to allow more cost-effective implementation.

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The firm, its principals, employees and clients may own securities mentioned in this article.

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