F&A
FOSTER & ASSOCIATES

In the Long Run…

High on the list of current concerns among many facing retirement is that if they live long enough they will run out of money. It is especially the later years, when physical and cognitive difficulties compound, that are so worrisome. They want a comfortable life beyond their eighties without being a financial burden on their families. Those dreamers who think the government will provide the later-life TLC we deserve have our sympathy.

Anyone who reads the obituaries knows that people are living longer. The over-65s are reputed to now outnumber the under-25s. Adding to the problem, interest rates are so meager on fixed income investments, including annuities, the rate of return barely keeps up with the official but woefully under-stated inflation rate. Also, rents at the better senior care facilities start at $4500++ per month and rising. The lengthy waiting lists have assured 100% occupancy for years to come.

Given that people will persist in living longer, there is no simple solution to the potential horror of running out of money. First, some might choose to work longer, a partial solution for those who like their work and are not faced with mandatory retirement. I didn't retire until I was 82, but my position was sufficiently senior that I was not "let go" for sometimes falling asleep at my desk. The value of working longer is enhanced if one's pension can be deferred without tax consequences on the income from invested capital. Usually such is not the case.

For those who intend to live in their house when they retire, the "Chip" mortgage is a popular and practical choice. It's as if the owners take out a mortgage but don't have to pay the principle and interest until they leave their principal residence. Of course, it does not address the monthly costs of living in a retirement home. On the other hand, it might enable some home owners to be cared for in their own home at a cost likely to be less than a senior's residence or nursing home.

There is also the likelihood of interest rates rising. Interest rates generally have something like a forty-year full cycle. However, the highs of the present cycle will not necessarily reach the 12% seen in the early 1990s. Even a move to 6% would nearly double the rate of return from safe fixed income investments.

Among the multitude of studies and suggested solutions to the problem of ballooning later-life costs is a recent commentary published by the C.D. Howe Institute (Commentary #500). The author is Bonnie-Jeanne Macdonald PhD, FSA, a senior research fellow at Ryerson University and resident scholar at Eckler Ltd. Her proposal is the creation of an optional government program called LIFE (Living Income for the Elderly).

The essential features of LIFE are that of a pooled deferred annuity, with plenty of crucial differences, including some of the characteristics of a tontine. The definition of a tontine is a mortality agreement among a small group of individuals to pool their funds for a fixed period at the end of which the survivors share the pooled funds, or until there is only one survivor. Most jurisdictions have outlawed tontines, probably because they promote murder.

Low interest rates and longevity have created a situation where retirees are increasingly on their own.

The units of the LIFE pool would be purchased at a specified age (e.g. 65), and there would be no payout of any kind prior a specified age (e.g. 85). The funds would be aggressively invested for the 20-year period, thereafter very conservatively invested. Members of the pool who die prior to reaching age 85 would have the value of their units remain in the pool to the benefit of the survivors. This is called “mortality risk pooling.” Post age 85, the investment income and any “mortality” benefits would be paid out annually to members along with their fixed annual income. According to Dr. Macdonald, “$1 is expected to grow to $2.65 between ages of 65 and 85 based investment returns alone – but it would grow to $5 including the mortality premium.” The success of Dr. Macdonald’s LIFE proposal depends on changes in Canada’s tax code which now would tax the incomed earned in the initial 20-year period. While a policy paper of the Association of Canadian Pension Management recommends tax changes to support longevity pooling, Canadian Pension regulations would also need to be amended. Pooled funds like LIFE are legal in the United States and some European jurisdictions.

Interestingly, many pension funds have problems that mirror the later-life financial crunch. Low interest rates have caused their investment portfolios to under achieve. Pensioner longevity has caused many pensions to be under funded. Low interest rates and longevity have created a situation where retirees are increasingly on their own. Those with good genes and a healthy lifestyle have something to think about.

Briar Foster is an active investor and recently retired portfolio manager at Foster & Associates.

FOSTER & ASSOCIATES FINANCIAL SERVICES INC.
372 BAY STREET SUITE 1100
TORONTO ON M5H 2W9
416.369.980
800.559.8853
WWW.FOSTERGROUP.CA