Retirement Hazards

Common risks to manage in the "golden years"

American culture generally perceives retirement as a joyful and leisure-oriented time of life. This image is a bit oversold, however. Many new retirees encounter more difficulties than they faced while working. Aside from the normal challenges, retirement brings other hazards that must be carefully assessed and managed. Consider these:

• **Emotional stress.** The end of work produces changes and stress that may spawn a personal crisis for a retiree. An inactive and unstructured lifestyle can bring isolation and boredom, loss of identity, marital conflict, financial anxiety, depression and/or failing health. Years before retirement, you should begin to form personal goals, acquire outside interests and learn new skills to help you pursue fulfilling activities later.

• **Outliving retirement assets.** This is perhaps the most common worry among retirees, regardless of their age or portfolio size. Experts refer to this as longevity risk, although living too long isn't the problem. Outliving your assets usually results from these factors:

(1) *Insufficient asset base* — Some retirees don't start with enough wealth or misjudge their portfolio's ability to produce income. The best remedy is to give retirement assets more time to grow by delaying retirement, saving more, supplementing income through work and/or reducing lifestyle.

(2) *Unsustainable payout rate* — They withdraw too much from their portfolio too early in retirement.[1] Payout rate rises when an investor withdraws a fixed or increasing amount of cash without a proportionate increase in wealth. Retirees must closely monitor withdrawals and adjust as necessary to maintain a sustainable rate.

(3) *Inappropriate asset mix* — Retirees may position assets too conservatively for their lifespan and investment time horizon. Although they intend to reduce volatility by avoiding equities, the strategy exposes their wealth to inflation risk. All but the most senior retirees should keep an equity component in their portfolio and diversify to manage return volatility.

• **Unrealistic assumptions.** Retirees often tie their portfolio mix, spending level, estate planning and other key decisions to a hopeful view of the future. Your strategies are only as prudent as your assumptions regarding future market returns, tax and interest rates, inflation, health care costs, Social Security and Medicare benefits, life expectancy and other important factors. A miscalculation in a few key areas may compromise the quality of your retirement and force difficult tradeoffs later. Using conservative estimates can enforce discipline in your personal finances and provide a more comfortable margin for error.

• **Return sequence.** For retirees who are living on accumulated wealth, the sequence of portfolio returns has a greater role than average return. Sequence is most relevant in the early years of retirement, when a major market downturn could shrink portfolio value below a level that can sustain your withdrawal rate over the long term. Financial history confirms that the sequence of returns and inflation can make or break a new retiree's ability to maintain lifestyle.

For this reason, average return assumptions don't provide a complete view of the range of possible outcomes in a portfolio. Simulation and other techniques can help investors better evaluate sequence risk probabilities, while diversification and cash withdrawal techniques may help reduce the impact of a market meltdown or hyperinflation. The key is to avoid liquidating depressed assets during a major stock market downturn.[2] But planning tools and strategies can only help so much. Once you retire, the economy and markets in large part determine the retirement you may afford.

• **Financial mistakes.** Retirement provides abundant time to watch daily market swings, second guess portfolio decisions and worry. Not surprisingly, retirees often abandon a well-conceived investment plan to follow human impulse.

Emotions often short-circuit economic sense when individuals overrate their stock trading skill, chase the latest top performing investment, put their retirement capital at risk in speculative business ventures, try to make up a savings shortfall with a higher return, and of course, live beyond their means. Retirees should get qualified outside advice before making decisions that could put their retirement security at risk.

Conversely, many retirees act too passively. They fail to adjust their investment, financial and estate planning strategies in response to changes in the market, economy, personal finances and health status. In these cases, a portfolio manager's experience with retirement issues may prove invaluable in planning for the unexpected and inevitable events of life.

(1) The common view is that a retirement portfolio has a high probability of supporting a 4% average annual payout rate over 25 years, assuming a 75/25 stock/bond mix. (Source: Philip L. Cooley, Carl M. Hubbard, and Daniel T. Walz. *"Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable,"* AAII Journal, Feb. 1998, pp 16-21.)

(2) One method is to maintain a fixed-income account worth at least two years' retirement cash flow — and to withdraw from this account during a bear market. Proper diversification and periodic rebalancing also are useful tools since asset groups won't likely experience bear markets simultaneously in a portfolio with low return correlation among asset groups.

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