



## **Facing Distributions in Retirement**

By Michael T. Prus

Congratulations! You've finally made it to retirement. Years of hard work and diligent saving have paid off and the result is a sizable portfolio. But before you make plans to travel the world or join the pro-golf circuit, there are several things to consider.

For one, the portfolio you've managed to build during your working years is now expected to sustain you for the rest of your days. It will be drawn upon to pay for everyday items as well as any extraordinary expenses that may arise. This is a daunting task for any portfolio, which is why it is important to understand **all** the potential risks that may prevent your portfolio from achieving the goal of literally lasting a lifetime.

Risks such as longevity risk, inflation risk and market risk, as well as external factors such as health issues can cause unforeseen downward pressures on a retirement portfolio. These pressures can range from slight to significant depending on the depth, breadth and magnitude of the event as well as the portfolio's ability to meet these challenges.

Understanding these risks and their potential effects is of paramount importance so that appropriate investment strategies and portfolios can be implemented that can best manage the appropriate risks. This commentary will evaluate and illustrate those risks that are specific to anyone drawing upon their portfolio for living expenses, especially retirees.

### **Longevity Risk**

Possibly the largest single concern for retirees is that they will outlive their assets. Even sizable portfolios can be quickly drawn down given a combination of unsustainable distribution levels and/or an uncooperative market. Longevity risk is a greater concern now more than ever. People are living longer, an average of 77.9 years in 2004, while as recently as 1960 the average life expectancy was just 69.7 years, a significant increase.<sup>1</sup> Furthermore, if we look at couples at age 65, at least one person has a 50% chance of living beyond age 92 and a 25% chance of living to at least age 97!<sup>2</sup>

Considering advancements in healthcare these trends are likely to continue.

Additionally, fewer retirees than in the past will receive distributions from defined benefit pension plans. The days of working 40 years for the same company and receiving a percentage of salary during retirement are coming to an end for many. In 1980 there were 148,000 private sector defined benefit plans compared to just 47,000 in 2004. Also in 1980 there were 30.1 million active participants in defined benefit pension plans, but by 2004 that number fell to only 20.5 million.<sup>3</sup> These statistics suggest that a lower percentage of retirees' income is being received in a regular 'paycheck-like' manner.

The responsibility of both funding and managing retirement assets - a tall order given that many investors make poor investment decisions, and don't save enough - now falls squarely on the shoulders of the individual.

## **Inflation Risk**

Compounding longevity risk is the fact that future dollars won't be able to purchase the same amount of products and services they do today. Yet many retirees fail to estimate the effects inflation will have on their portfolio and lifestyle despite often living twenty years or more into retirement. Furthermore, medical and healthcare costs have historically risen more quickly than inflation. For comparison, in 2006, employer health insurance premiums rose more than 7.7%,<sup>4</sup> double the rate of inflation.

Using examples from a previous Commentary, '*Eating Away at Your Portfolio*', we can clearly see the corrosive effects of inflation. The purchasing power of \$100,000 is significantly decreased in both low (Exhibit 1) and high (Exhibit 2) inflation environments during a ten-year period.

### **Exhibit 1**

| Year Ended | CPI % Increase | Value of \$100,000 |
|------------|----------------|--------------------|
| Dec-97     | 2.34%          | \$97,660           |
| Dec-98     | 1.55%          | \$95,427           |
| Dec-99     | 2.19%          | \$93,970           |
| Dec-00     | 3.37%          | \$91,957           |
| Dec-01     | 2.82%          | \$88,959           |
| Dec-02     | 1.60%          | \$86,519           |
| Dec-03     | 2.28%          | \$85,156           |
| Dec-04     | 2.68%          | \$83,258           |
| Dec-05     | 3.37%          | \$81,085           |
| Dec-06     | 3.24%          | \$78,442           |

Source: *Economy.com*

### **Exhibit 2**

| Year Ended | CPI % Increase | Value of \$100,000 |
|------------|----------------|--------------------|
| Dec-77     | 6.47%          | \$93,530           |
| Dec-78     | 7.63%          | \$86,900           |
| Dec-79     | 11.25%         | \$78,112           |
| Dec-80     | 13.50%         | \$68,821           |
| Dec-81     | 10.38%         | \$62,349           |
| Dec-82     | 6.16%          | \$58,731           |
| Dec-83     | 3.16%          | \$56,932           |
| Dec-84     | 4.37%          | \$54,549           |
| Dec-85     | 3.53%          | \$52,689           |
| Dec-86     | 1.94%          | \$51,686           |

Source: *Economy.com*

### Exhibit 3

#### Actual Values for Retiree Starting in 1973

| Year | Rate of Return (%) | Amount in Fund | Interest Earned | Amount Before Withdrawal | Amount Withdrawn |
|------|--------------------|----------------|-----------------|--------------------------|------------------|
| 1973 | -14.75             | \$ 1,000,000   | \$ (147,500)    | \$ 852,500               | \$ 117,460       |
| 1974 | -26.40             | \$ 735,040     | \$ (194,051)    | \$ 540,990               | \$ 117,460       |
| 1975 | 37.26              | \$ 423,530     | \$ 157,807      | \$ 581,337               | \$ 117,460       |
| 1976 | 23.98              | \$ 463,878     | \$ 111,238      | \$ 575,116               | \$ 117,460       |
| 1977 | -7.26              | \$ 457,656     | \$ (33,226)     | \$ 424,430               | \$ 117,460       |
| 1978 | 6.50               | \$ 306,971     | \$ 19,953       | \$ 326,924               | \$ 117,460       |
| 1979 | 18.77              | \$ 209,464     | \$ 39,316       | \$ 248,780               | \$ 117,460       |
| 1980 | 32.48              | \$ 131,321     | \$ 42,653       | \$ 173,974               | \$ 117,460       |
| 1981 | -4.98              | \$ 56,514      | \$ (2,814)      | \$ 53,700                | \$ 117,460       |
| 1982 | 22.09              | \$ (63,760)    | \$ (14,085)     | \$ (77,844)              | \$ 117,460       |

Source: "An Analysis of Investment Advice for Retirement Plan Participants" Zvi Bodi, *The Pension Challenge: Risk Transfers and Retirement Income Security*, Pension Research Council, 2002

It turns out that average returns over the twenty years in question were actually 11.2%, significantly higher than the 10% required return, yet the investor burned through their assets about twice as fast as expected. This tells us two important things: 1) the "average" is somewhat meaningless in terms of explaining future expected returns, especially when a portfolio is in distribution mode; and 2) timing of market downturns, especially early in retirement, can be of critical importance and require an investment plan that can manage that risk effectively, demonstrating the importance of the *time path* of returns. (This particular phenomenon regarding average returns and their timing was explained in greater detail in a prior Commentary, 'Time Path of Returns.')

### **Event Risk**

Event risk refers to the possibility that an unforeseen capital-consuming event such as major unreimbursed medical expenses or natural disasters could negatively impact the portfolio. Such an event could be of significant concern if the investment vehicle is not flexible enough to allow for such a one-time distribution.

Event risk by definition is unexpected. Therefore, it is important to have a flexible retirement solution in the event liquidity is needed. Having the ability to adjust distributions from a portfolio on an as-needed basis can be critical. Some retirement solutions, such as annuities, are designed to provide a pre-determined dollar amount on a regular basis, but are not designed to be elastic; yet, often circumstances may call for increased flexibility.

### **The Bottom Line**

The risks facing those drawing down their assets are much different than the risks faced by those in the accumulation stage. Therefore, traditional portfolio risk measures such as standard deviation or beta are not necessarily the best benchmarks for measuring risk.

Measures such as inflation risk or longevity risk, on the other hand, are much more important and relevant to an investor in decumulation mode. Likewise, given the different risks and needs of investors in the drawdown phase, portfolio implementation should almost certainly be different for an accumulator than it would be for a decumulator.

We've found that quite often retirement 'products' have fallen short in effectively addressing many of the needs of this type of investor. In a subsequent commentary we will compare different investment approaches that retirees have traditionally used for the distribution phase, and compare and contrast their effectiveness in dealing with each of these specific risks.

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**Footnotes:**

<sup>1</sup> National Center for Health Statistics, *National Vital Statistics Reports*, Vol. 54, no.19, June 28, 2006

<sup>2</sup> U.S. 2000 Actuarial Male and Female Tables

<sup>3</sup> U.S. Department of Labor, Private Pension Plan Bulletin: Historical Tables, Employee Benefits Security Administration, March 2007, Table E1, various years

<sup>4</sup> National Coalition on Health Care, <http://www.nchc.org/facts/cost.shtml>