RETIREMENT RISKS: DOES LONGEVITY OR MARKET VOLATILITY RANK FIRST?

When a client evaluates retirement risks, what risk comes first? It turns out that perceived risk and objective risk may not match up.

Will a retiree accurately evaluate his or her risks in retirement? According to a Boston College Center for Retirement Research study,[1] many retirees list market volatility as their top perceived retirement risk, followed by medical costs and longevity. This seems to be the result of retirees' views of their survival probabilities, assessment of the market, and lack of understanding of healthcare costs.

Yet, objectively, longevity and healthcare present greater risks than market volatility.

This means that retirees may underestimate the need to financially prepare to live longer than expected. While longevity often is discussed in terms of living to age 100, the longevity risk is simply that a person will outlive their money. That is, if a person expects to live to age 82 and in fact lives to age 87, longevity risk could be an issue.

As a financial professional, you can help clients better understand the proper order of their objective retirement risks. Here are some questions that may help.

What are the ages of the client's older relatives, such as parents, aunts, and uncles?

It can be difficult to persuade a retiree to discuss longevity. For many, longevity is difficult to evaluate. They may be reluctant to give much weight to the evaluation and may adopt a "Who knows? But I certainly don't buy green bananas anymore," attitude. Asking about relatives can make the conversation easier and still provide some insight on their rough odds. If most of their relatives have passed away in their late 70s, planning for age 100 may be a stretch. A retiree with parents who are active and healthy in their 90s can suggest the need to plan for a longer life.

TIP: Social Security has a basic longevity estimator that can be used as a springboard for the "how long will you live" conversation.

Does the client have guaranteed lifetime income that covers all, or most, of the essential monthly expenses?

Every retiree has certain expenses that must be covered every month. Typically, these include housing cost, utilities, food, Medicare premiums, and similar items. If these necessary expenses are covered by income that is guaranteed to arrive every month for life, it reduces the risk that the client will fully deplete other resources.

The volatility of the underlying portfolio is a normal risk of investing in the market. Sequence-of-returns risk occurs when a retiree must take a distribution from the portfolio at the same time normal volatility causes the portfolio to drop in value. If the market drops 20%, and the retiree must sell securities to cover his or her expenses, the account suffers a permanent loss. That is, the retiree had to sell more shares to get the same dollar amount. The extra shares that had to be sold are gone forever.

[1] Hou, Wenliang. *How Well Do Retirees Assess the Risks They Face in Retirement?* Center for Retirement Research at Boston College, July 2022. © Trustees of Boston College, Center for Retirement Research.

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It's important to note that other than Social Security benefits and pensions, annuities are the only way to help your clients create guaranteed lifetime income. Sources of guaranteed income can significantly reduce longevity risk by limiting the need to use discretionary assets at a point when the market is down.

TIP: Encourage clients to write down their monthly expenses and compare the total to the amount of all the guaranteed income sources they have in place, such as Social Security benefits. If the gap between these numbers is negative, they might consider other sources of guaranteed lifetime income to maintain their lifestyles.

Is There an Inflation Plan in Place?

Longevity risk also is affected by inflation. As inflation increases expenses over time, the guaranteed lifetime income amount may not keep up with the retiree's rising costs. Social Security does provide cost-of-living adjustments (COLAs), but most corporate pensions do not. While some government pensions have COLAs, the calculation used may not provide a sufficient increase to cover expenses.

There are two ways a retiree might consider addressing inflation:

1. **Invest in equities**. As you know, equities tend to grow over the long term. Individual equities, mutual funds, and ETFs allow an investor to enjoy market participation through a bucket of various securities. While at any point the market may be down in value, over longer periods, say 10 to 20 years, the equity markets typically grow assets. This growth can help the retiree keep up with rising costs.

2. **Cover essential expenses with guaranteed lifetime income**. Guaranteed income can help with inflation by providing the monthly cash flow for essential expenses. If your clients' essential expenses are covered using guaranteed lifetime income payments, discretionary funds can be managed for growth and used when appropriate. Periodic reviews of the amount of guaranteed lifetime income versus essential expenses permit the opportunity to add guaranteed income as expenses rise. This strategy reduces sequence-of-returns risk. Some financial professionals incorporate both deferred income annuities and deferred annuities into clients' portfolios to create staggered income start dates for guaranteed lifetime income, creating more predictable income in the future. An annuity, or series of annuities, is "set" to begin payments periodically, such as every five years, helping clients manage inflation of essential expenses.

Longevity Month is the perfect time to review your retired clients' guaranteed lifetime income sources. Take the opportunity to address any income gaps and create a plan for future potential inflation-related expenses. Reach out to clients today!

This material is educational and intended for an audience with financial services knowledge.

Additional Resources and Links

[How Well Do Retirees Assess the Risks They Face in Retirement?]

[Build Your Practice with the Lifetime Income Conversation]

[Buckets for Bears – Annuities Can Help]

For more information about retirement planning,
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