7 RISKS OF RETIREMENT PLANNING

Learn how to overcome them and secure your retirement income

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CREATE AN INCOME FOR LIFE

Managing Retirement Risks

Hi there, my name is Mike Sikar. I am the Founder and Principal adviser of Delta Financial Group. I'm here today to talk about the subject of retirement income planning, which is very different from retirement accumulation planning.

The tools, the strategies and the investments that you use to get you to retirement are very different from the ones you need at retirement to get you through the retirement years.

In fact, in retirement, you face many new challenges and risks that you did not face in the accumulation years. There are risks around;

1. Sequencing market risk
2. Longevity of life
3. Inflation
4. Consumption
5. Withdrawal rate risk
6. Declining cognitive skills
7. Execution

Getting all of these things to work together is complicated and there's a risk of execution taking place inappropriately, which is why you really need the help of a financial adviser to work through these different challenges, to build the right plan for you, so that you minimize the execution risk.

As you begin to transition into the longest vacation of your life, you should make sure that your retirement income plan is structured to withstand these seven common risks.

Retirement income planning has changed drastically over the last three decades.
Thirty years ago most Australians could safely rely on Social Security and a pension to provide the income they needed in retirement. That's no longer the case.

Today we have much greater personal responsibility to create our own retirement income plan.
To help make sure that a retirement portfolio lasts a lifetime, we will have to prepare for and manage the following common risks to retirement income.

In this e-book I will explain some of the challenges that you face going into retirement and what you can do about them. You know the word retirement means different things to different people. To some people, retirement is a very, very long vacation that they've earned and they will take towards the end of their life.

To some people, the word "retirement" is a period of slowing down, retrenchment, living at home, relaxing. To other people, the word "retirement" has negative connotations. They don't want to retire. They enjoy what they're doing. They plan to continue doing this for as long as they possibly can.

There are many decisions that you face as you transition into retirement. Lifestyle decisions, plans for where you want to live. Who will take care of you in your older years? Who would you like to be around? How do you want to spend your time? There are so many aspects of retirement planning. One of them is financial.

You want to make sure that your nest egg, your retirement savings, will be enough to sustain your plans. You want to make sure that you can live within a budget. You want to make sure that your money will actually be able to implement all the wonderful plans that you have.

Retirement can be a phenomenal period of your life. It can be something to look forward to. But you want to make sure that it's affordable.

Sequencing Risk

When you're in retirement and you're spending money, the economy is a lot more important than you think. Even though you're not participating in the labor market as much, even though you're not looking for a job or employed, the economy is going to be very, very critical in determining how long your nest egg is going to last.

Specifically financial markets will have a much bigger impact on the sustainability of your nest egg in retirement than it does prior to retirement.

Here's a hypothetical example. Even though you're earning an average of 7%, an average of 7% over the entire course of your retirement, how you earn that 7%, the order in which you get those returns, whether you get negative returns first and then positive returns, or you have stronger markets first and then weaker markets, the order will have a disproportionate impact on how long the funds are going to last.

Sequencing risk is something that you have to be aware of, but you have to learn to manage. I think it's very important to consider strategies to protect your portfolio against sequencing risk.

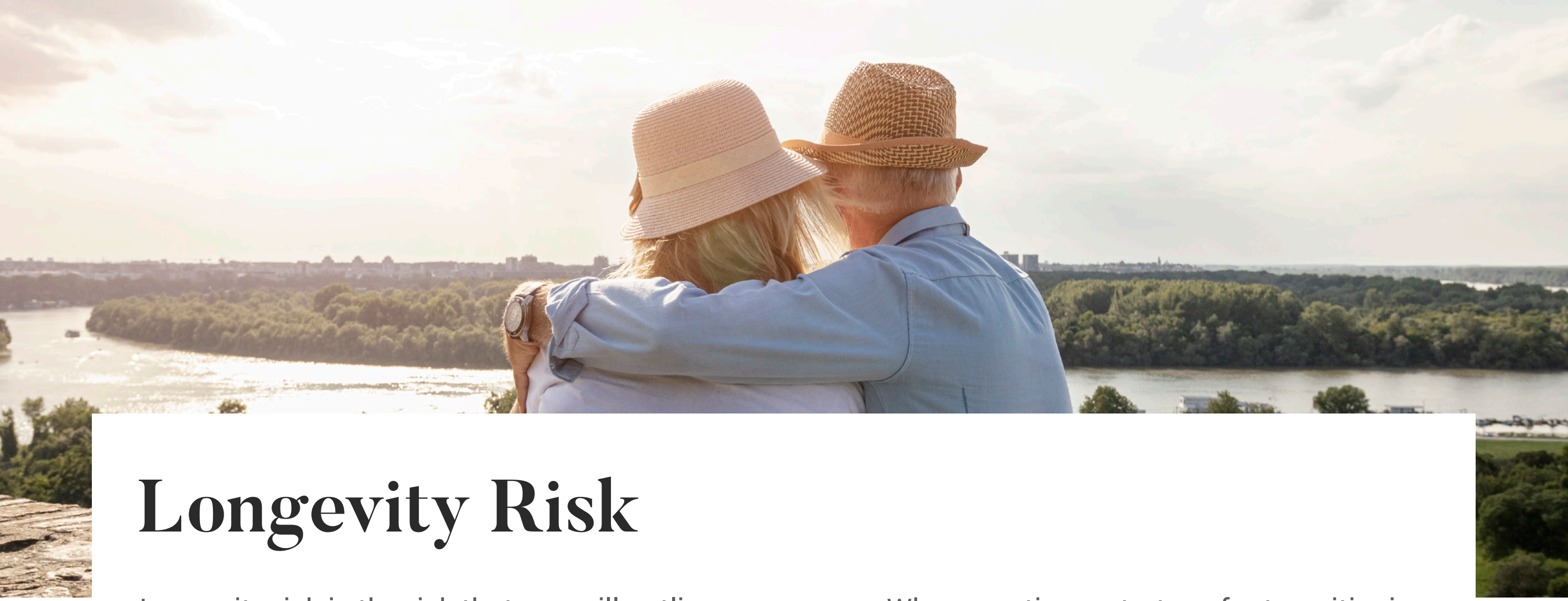
When you're working, when you're approaching retirement, in your early years, you're better able to manage or adapt to sequencing risk by the fact that you have flexibility on how much you save, flexibility on work.

Once you're in retirement, all the heavy lifting, all the work is being done by the nest egg and you want to protect it against sequencing risk.

Taking withdrawals during a bear market will accelerate the depletion of retirement savings, adversely affecting a portfolio's ability to provide lifetime income. During the accumulation phase of retirement planning, the sequence of returns doesn't much matter. The average rate of return is what's important.

However, during the income phase of retirement, the sequence of returns matters greatly. Beginning your retirement in a time of positive market performance increases the chances that retirement savings will last a lifetime. However, negative market returns in the early years of retirement will likely require the retiree to liquidate more investments to provide the income they need.

This, of course, will increase the likelihood of depleting their retirement savings sooner. Unfortunately, no one can predict whether they will be retiring into a rising, flat or a negative sequence of market performance.



Longevity Risk

Longevity risk is the risk that you will outlive your money. When creating a strategy for transitioning savings to retirement income, the issue of longevity must be addressed. A 65-year-old married couple has nearly a 50-percent chance that one member will live to age 92 and 25-percent chance to age 97. Of course the challenge is how to generate income that will last 30 years or more.

A question I am often asked is, “How long should I plan for in retirement? How long will I be spending in retirement?” and the truth of the matter is that there really isn’t one number that you should be planning for. Twenty or thirty or ten years. The answer is a curve.

In fact, if you were to open up the obituaries of the newspaper on any given day, you will see the age in which people die, the age in which they pass away. Some of them live 100 years. Some of them live 70 years. Some of them live 80 years. The dispersion and the number of years people live is quite wide.

On average, people will be spending 20 to 25 years in retirement. But there’s a 50% chance that you will be living beyond life expectancy. By definition, that’s what life expectancy means. In fact, there’s about a 20% chance that you will be spending 30 years in retirement and possibly longer than that.

Of course on the pessimistic side, there’s a chance that you will only spend 5-10 years in retirement. There’s a name for this. It’s called longevity risk. Now, longevity is a blessing. Living a long time is a blessing. It may seem odd to call it a risk. But the cost of longevity, the cost of spending so many years in retirement is a risk. It could be very expensive.

In fact, if you take a look at someone at retirement, the probability that they end up living to become a centenarian is not as small as you think. That will be really expensive.

Longevity risk has to be managed. You have to have a discussion about it. You have to think about whether you want to insure it just like other risks that you face in your life.

When you’re younger, life insurance is important, home insurance, car insurance, property insurance. You want to protect your family. You want to protect your wealth. In retirement, insurance is important as well. But you’re protecting different things. You’re protecting against living longer than you anticipated and it being very expensive.

Have a discussion about the uncertainty and longevity and what you can do about it. At the very least, awareness of this will help you better prepare to manage the challenges of retirement income.

Inflation Risk

Most agree that the interest rates today are low. This creates additional pressure for the average retiree to create the income they need to live comfortably in retirement. In the past, many could rely on an interest of 5 % or more. In fact, the Australia 10-year bond yield was above 5% from 1968 until 2012.

With interest rates at those levels, obtaining a decent return on their retirement dollars was as simple as going to the bank and purchasing a term deposit. However, with the Australia 10-year bond yield hovering around 1%, retirees may be forced to withdraw more from their retirement savings to make up the shortfall caused by low interest rates or invest more aggressively in search of greater yields.

Now inflation is never good. In fact, that's the mandate of central banks, the Reserve Bank in Australia, to try to keep inflation low. Nobody wants high inflation rates.

But when you're in retirement, inflation has a much more devastating effect than when you're accumulating wealth and saving for retirement. You have to understand that inflation is a number that's an average of many different goods and services. Inflation is an average of thousands of numbers.

Some of those numbers are very high. The prices have gone up quite a bit in the last few years. Some of the numbers are actually negative. The prices of technology, women's clothing for example, have actually gone down in the last decade.

If you average all of these numbers together, inflation in Australia has been around 1.9%, but that's an average. Some people experience inflation that's higher than 3% if they spend their money on items that have gone up by more than the average.

Other people might have experienced deflation over the last 10 years, if their basket of goods that they were consuming actually went down. Inflation for the elderly, inflation for retirees tends to be different. It tends to be personal and in many cases, it tends to be higher. You see, retirees tend to spend their money on goods and services that historically have appreciated by more than inflation.

What this means is that even though inflation might be at 1-2% going forward, your personal inflation rate in retirement might actually be higher 2-4%, let alone numbers that are bigger than that.

Because inflation is personal and might be higher in retirement, we face a new type of risk called "inflation risk" which is different than the risks we face when we save for retirement.

After all, when we're working in our working years, inflation embeds itself in our wages. Our wages grow over time and keep up with inflation. Inflation doesn't scare me as much when I'm working because my wages tend to keep up with inflation.

Consumption Risk

Retirees have a harder time making money and a reduced earning capacity. Whether it's because of physical limitations or limited job compatibility, it's simply not as easy to find an extra job and create a financial cushion against poor market returns.

While investments were once a place for saving and accumulation, retirees must turn that around and create an income stream from existing assets. Where investment risk was previously just a part of the financial picture along with salary and other income, it takes center stage, severely limiting spending.

You know, it's actually quite interesting that no two people's retirement is alike. Retirement spending patterns are the same thing. Some people spend a lot early on in retirement. They want to enjoy themselves in the first 5-15 years when they're more active and they don't want to spend as much in their later years.

Perhaps there are medical expenses, but they are not going to be as mobile. They certainly won't be spending as much on travel. Other people want more of a stable spending pattern. They want to have the same lifestyle for the rest of their lives. And for others yet, they want to spend the first few years perhaps working a little bit more part-time, but the real spending will take place later on.

Everybody is unique. They have their own spending patterns. They have their own consumption patterns. Consumption is a word we use to describe different people's behaviour as it comes to spending. There's a very big risk that people think that there is a typical consumption pattern that they have to adhere to.

You want to make sure not to fall into the trap of fixing your spending at a particular rate and being too rigid about it. We have to keep some flexibility in our spending plans.

It's very important to build a portfolio with a strategy that allows for that flexibility, allows you to change your patterns over time to adapt to circumstances, not to lock yourself into something that's difficult to change.

Make sure to build a portfolio that reduces your consumption risk.

Withdrawal rate risk

Retirees should be mindful of how much they withdraw from their accounts each year. A safe and sustainable withdrawal rate is defined as how much can be taken from a portfolio with little probability of depleting the account. The success of these withdrawal rates are dependent on several factors including age of the client, length of retirement, asset allocation, market conditions and interest rates at the time.

A 4-percent minimum withdrawal rate, first made popular by William Bengen, was long viewed as safe and sustainable. In light of people living longer in retirement and a prolonged low interest rate environment, new research is suggesting a sustainable withdrawal rate closer to 3 percent to 3.5 percent.

Declining cognitive abilities

A retirement income plan must take into account that a retiree will experience declining cognitive abilities, hampering portfolio management and other financial decision-making skills.

It will become increasingly difficult to make sound portfolio investment and withdrawal decisions as one enters advanced ages.

In addition, many couples don't share management of personal finances equally. When the spouse who knows what's going on financially dies first, the surviving spouse can run into serious problems without a clear plan in place. He or she can be left vulnerable to financial predators and other financial mistakes.

But there is still hope, as retirement plans can be built to manage these varying risks, hence retirement income planning's emerges as a distinct field.

Execution risk

Investor behavior has a profound impact on portfolio performance. Investors are often influenced by their emotions. These emotions, which can include fear, excitement, greed, euphoria or panic, can disrupt a long-term investment strategy. We also have an aversion to loss that could affect our ability to stay in the market. Investors will often get in and out of the market at the wrong time. This is evidenced by the fact that net inflows to equity funds tend to rise with stock prices and net outflows tend to occur when stock prices fall.

There are countless fantastic tools and resources available for people who wish to handle their finances and plan on their own. However, even with all the resources available, unless you have at least a basic knowledge of how money works, a lot of time, and are very disciplined, most people are simply unable to stay on top of things consistently.

Planning for the future involves far more than simply researching funds and staying up to date with the markets. There are many moving parts, and like a jigsaw, unless each piece is put in the right place, the picture won't be complete.

Creating income security and ensuring a successful and happy retirement is no easy task. Many Australians have been saving and preparing for retirement their entire working life. As they begin to transition into the longest vacation of their life, they should make sure that their retirement income plan is structured to withstand these seven common risks.

Investing in our help is essentially an investment in your happiness. It reduces the risk of making a potentially irreparable mistake by missing a crucial step, or not keeping on top of economic and market developments, as well as other important but often overlooked factors, such as unexpected life changes or events.

Managing money is serious business. Most of our clients are living busy lives, and rather than wasting their valuable time trying to sort out their financial affairs, they work with us so they can focus on the fun stuff—planning for a more enjoyable life – today and in the future.

Making it possible - Mike Sikar

Hi, I'm Mike Sikar - Founder and Principal Adviser of Delta Financial Group.

I've been a leader and innovator of the financial services industry for almost 2 decades, as a stockbroker from 1997 – 2007 and as a financial adviser from 2008.

I'm passionate about business, travel and life, but most of all, I love helping people make smart choices with their life and finances..

I believe that people who consciously create a positive mindset and believe in 'what's possible' get more out of life.

Challenging myself, building long-lasting relationships, and seeing my successes mirrored in my clients reinforces why I do what I do.

Managing money comes down to basic psychology - understand how it works, know what you want it for and consistently apply the key principles to get the most out of it.

Because life's too short for anything less.

Helping you make smart decisions that impact your entire life

We get that managing money is serious business.

Rather than waste your valuable time sorting out your financial affairs, let us give you a hand so you can focus on planning what gives you a better return on life.

You're worth it!

To find out more or see what's possible... please get in touch

Call us: 02 9327 4338 Email us: enquiries@deltafinancial.com.au

Visit: deltafinancialgroup.com.au

Visit: deltafinancialgroup.com.au

02 9327 4338

enquiries@deltafinancial.com.au