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Managing the personalised risks of retirement



By Daniel R Wessels

Retirees are fully aware of the abundance of financial risks that may adversely affect their retirement plans. Some of these risks relate to the macro-economic environment over which individually we have little control, like spiralling living costs and medical care expenses, the eroding of the purchasing power of one's financial assets over time (inflation and weakening exchange rate), disappointing or below-par market returns, and lower-than-expected interest rates.

One can plan and manage for those risks by factoring in such dire scenarios in your planning; i.e. to ensure an adequate "margin of safety" in your retirement plan, if things go haywire. For example, using conservative return assumptions and not necessarily recent market returns (relatively high real returns) as the norm going forward. If the outcome of such "stress testing" indicates a thin margin of error it probably means one should work longer than you initially planned for and save more, unless you have viable backup plans to supplement retirement income.

But macro-investment risks are not the only retirement risk one will endure, there are a number of other risks that can be categorised as personal, or if you fancy the more stylish term, idiosyncratic, which we all are potentially prone to, one way or the other. Personalised risks are to a certain extent more preventable than macro-risks, but not necessarily more manageable once manifested. In fact, the financial consequences thereof are probably much harsher in a retiree's life than the effects of macro-economic risks.

Personalised retirement risks include:

Health care needs – Healthcare expenses (medical aid premiums and expenses not covered in full by medical aid) tend to increase at a higher rate than consumer price inflation, the yardstick used to determine inflation in the economy. Interest rates and expectations are based on the latter, not medical inflation. Thus, it may become increasingly more challenging for retirees as they grow older to meet their ongoing medical expenses.

Outliving your retirement assets (longevity risk) – No one knows how long one will live, and while it is a blessing to live longer, it may come at a steep price, namely depleting and outliving your financial resources. Today people expect to live longer than previous generations because of huge medical advances, better lifestyles and healthier diets. Therefore, it is wise to plan beforehand for a longer post-retirement period than “normal” expectations. For example, in my retirement planning I use a post-retirement period of thirty years, although I have no specific reason to believe it should exceed the “normal” life expectancy of, say, fifteen to twenty years after retirement.

Changes in marital status (death and divorce) – This may turn out catastrophic for the surviving spouse, especially if the deceased or separated spouse controlled and managed all the household finances. Ideally, spouses should communicate clearly and share their financial position. But based on my own personal experiences, it is much easier said than done – it is difficult to discuss issues with the other party if he or she is not really interested in finding out more or does not want to be taxed with the burden of “extra worries”. When such an event plays out, the “surviving” partner in the relationship is left stranded, if not bewildered what to do next. Knowledgeable, trustworthy friends and financial advisors often play an invaluable role in steadying the ship through these stormy waters.

Changes in housing needs – Retirees often scale down from their existing family home to a smaller dwelling, preferably a dwelling in a residential complex that offers security, meals, medical care and assistance, like retirement villages. But it comes at quite a price tag, and do not expect too much “change” from exchanging the larger family home for a small home in a retirement village. Clearly, it is not something that many retirees readily can afford. The latter group of retirees are dependent on the goodwill of friends and family to provide or arrange the necessary support as the ability to live independently declines over time.

Family dynamics and never-ending demand for financial support – Unfortunately, some children simply never learn to grow up and do not take financial responsibilities for their own irresponsible behaviour. Parents often act as the “financiers” of children’s unrealistic lifestyles, fantasies and “business schemes”. Well, when those “schemes” blow up, which they do more likely than not, it may also cause the parents financial hardship and ruin their retirement plans. It is very difficult to say “no”, we all think our kids are special and gifted, but always try to maintain an objective business perspective when dealing with these issues. When you decide to give the nod, maybe because of family pressures and not strictly business logic, prepare yourself living with the consequences of writing off those monies. No need to be surprised that it all went wrong after the fact.

Lavish spending and no budget constraints - At retirement day many people will have access to the largest pool of money they probably ever have dealt with in their lives. That dream car or holiday destinations becomes so much more a “reality”, although the same were never affordable during their working lives. For some reason people think they can now live an upgraded version of their former lifestyles, which is seldom true. But reality will kick in a few years later when those retirees realise they dipped too much into their savings, but by then it is probably too late. The damage done is irreversible. Next, one will find those same retirees are making “weird” (actually irresponsible, if not dumb) investment choices in “search of high yield” to make up for lost ground. But this movie always end in the same manner with retirees losing basically everything, and often much more than just financially.

What happens thereafter is everyone’s worst nightmare because many of those retirees will become charity cases, and others may suffer from severe stress-related illnesses. No one deserves such a dire financial end to their lives and it can be prevented by applying one simple discipline: Budgeting and sticking to it!

Budgeting is not only for accountants and financial managers, nor do you need such expertise. The basic idea is not to implement a sophisticated record-keeping system to account for every rand all the time, but to develop a good understanding what spending level is manageable at retirement and when it is simply not. It basically forces one to think twice about one's spending habits. Therefore, every retiree household should be able to budget and keep their expenses in line with those budgets.

Declining cognitive abilities – Even the smartest brains cannot escape the slow-grinding effects of the “Biological Clock”, we simply lose our cognitive sharpness over time. Issues that we easily dealt with, say, ten, twenty years ago now poses a major challenge to unravel. Often, we simply do not recognise the basic flaws in investment proposals (we become in many ways naïve investors). Basically, we become vulnerable to the onslaught of scrupulous operators.

Dubious financial schemes and investment promises – Not surprisingly, such schemes are targeting retirees. Besides that retirees are becoming less attentive, others are desperately seeking high-yielding returns to meet the toll of rising living costs and fast-declining financial resources. Then it is not too difficult to understand why so many retirees are falling prey to schemes ending in nothing but despair and permanent sorrow. Again, trustworthy family, friends and advisors are invaluable to steer one's finances clear from the debris of empty investment promises.

Note, while the effects of macro-risks can be modelled in retirement planning by changing return and inflation assumptions, it is basically impossible to do so with personalised risks, simply because no one will be effected in the same manner, nor is it possible to foresee exactly how such events will impact one's financial position.

Let me discuss a conceptual framework for mitigating some personalised risks one may encounter as one is heading towards the final stage of one's life:

Risk capacity is becoming more important than risk tolerance

We tend to generalise and say men like that and do not like this, women like so and so, and in any event they are from Mars! It is no different with investment matters and we say men generally have a higher risk tolerance (willingness to take on investment risk) than women, but in fairness it is probably more to do with testosterone levels and their upbringing ("boys don't cry", "boys are strong and brave") than sheer intelligence and know-how. In reality, we are all different with our unique preferences and bug bears. Likewise, all of us have our own investment risk tolerance, i.e. taking on investment risk only we are comfortable with. For example, a person with a high risk tolerance has the ability to stomach market volatility and incurring shorter-term losses from time to time, while a risk-averse investor does not want any uncertainty and are happy to settle for much lower returns, but no anxiety along the way.

Another dimension of one's investment risk profile is the ability or capacity to take on investment risk. It is one thing to be a risk-seeker by nature, but quite another given your specific financial situation, investment horizon, and one's ability to seamlessly recoup financial losses, like re-entering the job market, if the retirement plan fails. Thus, risk capacity refers to the ability to withstand declines in portfolio values without substantially reducing one's living standards.

While you are working towards your retirement (saving for retirement) your *risk capacity* is perhaps of lesser importance than your *risk tolerance* and the *investment risk required* to meet your financial objectives. This holds true because poor investment returns can be countered by increasing one's savings rate or delaying your retirement age by a few years. But once retired, these options are not (readily) available. Retirees are more likely to live on fixed budgets to meet their living expenses. At that stage one's risk tolerance should play less an important role in investment decisions. What is becoming increasingly more important is one's risk capacity – the ability to withstand major financial shocks - because in reality very few retirees will have the luxury of re-joining the workforce and earning a decent salary to make up for losses on their investments. Basically, once retired a large reduction in one's risk capacity automatically will take place because the financial worth of one's human capital declines. Therefore, *risk capacity* is a sensitive risk parameter once retired.

A catchy phrase to remember and I quote from Charles D. Ellis, a famous investment consultant and author: "You get *old* pilots and you get *bold* pilots, but you don't get *old, bold* pilots!"

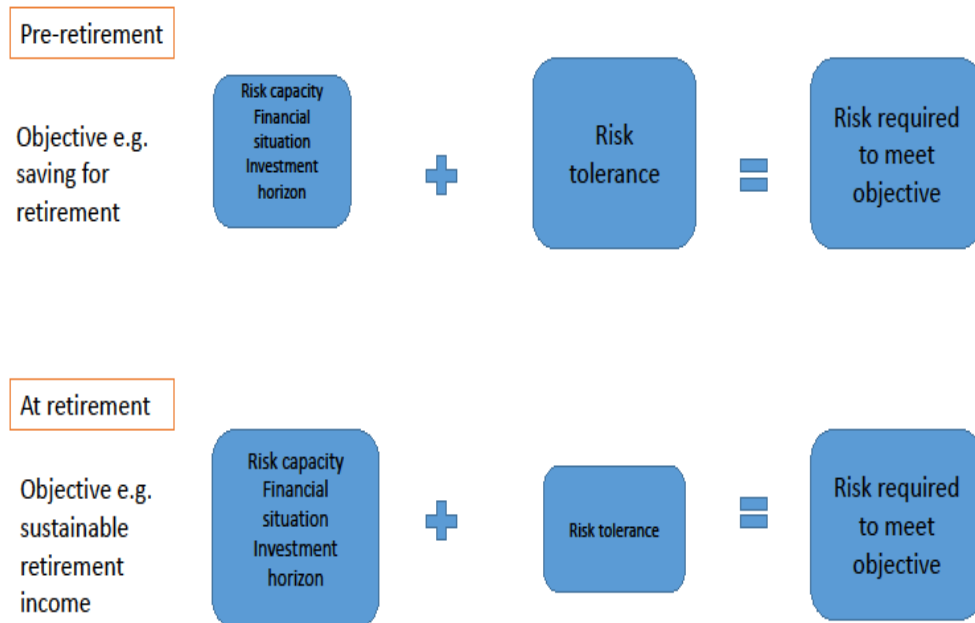
Schematically, the above-mentioned can be presented as follows:

Dimensions of investment risk profile:

Risk capacity = investment risk one can *afford* to take

Risk tolerance = investment risk one is *willing* to take

Risk required = investment risk one *should* take to meet financial objectives



How does one determine one's risk capacity? Well, it is not quite as simple as answering a few questions and then plotting the answers on a graph. It may well be that one may over-estimate the wellbeing of one's own financial situation or perhaps are too confident that one will meet the retirement income objectives in the long run. In this regard financial advisors may act as a good soundboard, simply because they often have a rich reference framework from which they can draw upon and contextualise one's specific position relatively to other situations. Also, they should be knowledgeable enough that one cannot simply plug in current return expectations, interest and inflation rates into a formula and thereby declaring one's financial position is "good to go".

Investment decisions should be considered carefully, preferably in conjunction with investment experts and advisors. One's risk capacity will provide an upper limit to the amount of investment risk that should be borne. Well-diversified portfolios should always be preferred to specific asset classes or "hot themes". Obviously, inflation and the loss of the purchasing power of one's monies pose a major threat to any retiree's financial well-being in the long run. Therefore, having only risk-free assets in one's retirement portfolio will not protect the sustainability of the retirement plan to yield sufficient retirement income over time. The key is to strike a fine balance between "too little" and "too much" investment risk.

Furthermore, one must wake acting on sensational media reporting, both positive and negative, what's "hot or not", because it has no long-term financial value, and if one is brutally honest about it, it will only detract from one's overall financial gains.

Why can a short-term focus hurt your overall returns? Well, to my mind many market commentators erroneously ascribe a specific short-term movement in the market to specific economic or fundamental factors changing "permanently", which in the fullness of time only proves to be a false alarm. The market is in essence a social animal and do not adhere to specific economic theories at particular points in time. Sentiment and market opinions matter, but it is not predictable in advance because, well, you cannot predict major news and events. Over a reasonable period of time though, a pattern emerges which will closely correlate with the underlying fundamentals - that is the wonder of the market mechanism in action. Sanity prevails and that is just reward for patient investors who are sacrificing "uncomfortable" periods.

Further reading:

Wade Pfau's excellent articles on these topics:

The Changing Risks of Retirement

http://retirementresearcher.com/changing-risks-retirement/?utm_campaign=Retirement+Researcher&utm_source=hs_email&utm_medium=email&utm_content=28073425&_hsenc=p2ANqtz-8GMd7qvFbp0sd10Rr1V5pvYvGPLMIXA7gysQgYRnFpyw40Slbx0YFXvTcmPI-QslAi0zTATR3DqDvHGN5HR5i5DRk7Q&_hsmi=28073425

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<http://retirementplannerblog.wordpress.com/2016/04/08/wade-pfau-retirement-risks/>