CHAPTER 6

Understanding the Key Retirement Risks

They're out there…they're everywhere! If you really just spent all of your time worrying about all the risks, concerns, and challenges that people face as they get closer to retirement or in retirement, you would probably be paralyzed by fear and anxiety. So, the purpose of this chapter is not to scare you into paralysis, but rather to provide awareness. Awareness that leads to a plan of action. The whole idea here is to look out into the future and see what could possibly derail or destroy your financial plan and then come up with a plan on how to deal with each one…and then move on with your life! So, in this chapter we will take a reality check and see what we're up against. Once we do, we can move confidently forward by making plans and eliminating or minimizing these risks.

Here is a list of the primary concerns, risks, and challenges people face as they near or entire retirement: Longevity, inflation, taxes, healthcare costs, long-term care, stock market risk, traditional investment approaches, regulation, investor behavior, and the lack of a plan.

There is an entire chapter dedicated to taxes—Chapter 7—and long-term care—Chapter 8. When it comes to traditional investment approaches, I covered that risk in Chapter 3 dealing with a paradigm shift. So, in this chapter we will touch on the other risks listed above.

The nature of your risk has much to do with your investment phase of life. An economic downturn just before or during retirement, when you are preserving and distributing your money, can hurt you far more than during your working years of accumulation. That is why I put so much emphasis earlier in on understanding those phases. If you are at the point where retirement is in sight, or you already have launched into it, market volatility will have a major impact not only on your portfolio but also on your peace of mind.

Risk management, however, involves more than the markets and investments. Most people think that managing risk is all about finding just the right asset allocation. It is that but also so much more. Retirees must deal with inflation, fluctuating interest rates, taxes, hidden fees, and medical and long-term care costs. No matter what financial products you own, you cannot be ready for retirement unless you have addressed those risks.

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You face financial threats on multiple fronts, all of which could diminish your future income. One of my five principles that I shared in the introduction to this book is: *Protect the Income; Grow the Rest.*

In other words, if you are going to take a risk, it should be with money that you can afford to lose.

Too much is at stake to leave it to chance, particularly in retirement, when you and your portfolio are particularly vulnerable. In this chapter, we will take a closer look at some of those threats to peace of mind. Later chapters will examine two major ones: taxation and the potentially devastating cost of long-term care.

Now, let's take a look at a few key risks that must be addressed such as:

- Healthcare costs
- Inflation risk
- Regulation risk
- Stock market risk
- Investor behavior risk
- Lack of a plan
- Longevity risk

Healthcare Costs

This is one of the biggest expenses you will have in retirement. If you retire prior to age sixty-five, it can be very costly. However, at age sixty-five, most workers are eligible for Medicare. Here is a quick breakdown of the various parts of Medicare.

Part A, inpatient/hospital coverage. Typically no monthly premium for most (deductibles and out of pocket costs apply).

Part B, outpatient/medical coverage. Set monthly premium that Medicare declares each year and possibly has higher premiums based on an earnings test called IRMAA (Income-Related Monthly Adjusted Amount).

Part C, an alternate way to receive your Medicare benefits (also known as Medicare Advantage plan). Offered by a private company that bundles Part A, Part B, and usually Part D.

Part D, prescription drug coverage. Premiums vary based on which plan you join and out of pocket costs apply (possibly higher premiums due to IRMAA).

Part G, an alternate way to receive your Medicare benefits (also known as a Medicare Supplement Plan). Offered by private companies that bundle Part A, Part B, and usually Part D. This typically provides more benefits than Part C, but with a higher premium.

Obviously when it comes time to enroll in Medicare, don't do it alone! Talk to a professional who has access to all of the options available before making any decisions. That being said, even with all of the programs available, most couples over age sixty-five will spend more than $300,000 over their lifetime in retirement on health-care related costs. This estimated cost does not factor in additional expenses, such as over the counter medication, most dental services, or long-term care.

Make sure to include in your living expenses, an accurate amount for monthly costs of Medicare in retirement. If you're not sure, it's always best to estimate your future expenses higher than you think.

Inflation Risk

During your working years, inflation may not be much of a worry. You more than likely get regular pay raises that tend to keep pace with it. When you are on a fixed income in retirement, however, the impact of inflation matters much more to you. Unless you can create your own raises, it will erode your purchasing power. For seniors,

inflation can be even worse than for the general consumer. The Bureau of Labor Statistics (BLS) created a separate index that tracks the health-care and shelter expenses that disproportionately erode the buying power of older citizens.

Saving and Investing

This seems like the right time to bring up the difference between saving and investing. Most of the time, people use these words interchangeably. But I want to challenge you not to do that. Saving is what you generally do at the bank and is the right place to put money that you need in the short-term. Investing is what you generally do at a brokerage firm and is the right place to put money that you need in the long-term.

Savings accounts are not designed to outpace inflation; they are designed to keep your money safe and provide liquidity. Investment accounts are designed to outpace inflation, and they are designed to provide compound growth to your assets.

I recommend that you look at short-term as anything within five years and long-term as anything that is five years or longer. Therefore, your emergency fund should be left in savings at a bank since it is always a short-term potential. Also, any known or planned purchases or expenses within five years should be kept safe and free from market risk as well. The impact of inflation is minimal in comparison to the

financial peace of mind of knowing that these funds are safe for their intended purposes. On the other hand, if you have no plans to access certain assets for at least five years, then it's best to let those assets grow in a market-based account that has risk and can outpace inflation.

Inflation is one of the big three among the risks that you will face in retirement, along with healthcare costs and taxes. To keep on top of it, you need sufficient growth in your retirement portfolio to overcome its effects. You shouldn't be ultraconservative with all your retirement assets out of fear of losing them. You will still be losing if your portfolio's rate of growth falls short of the inflation rate. You can beat it only if you put some portion of your money at risk. It needs to be a diversified risk, however, that you take only with an amount that you can afford to expose that way—and your return, of course, needs to outpace inflation.

It is difficult, if not impossible, to beat inflation using bank products. Certificates of deposit (CDs) have never been an effective hedge against inflation, but that is not their purpose. They are not designed to beat inflation. Their proper function in a portfolio is to keep your money safe—so CDs may be a good place for emergency funds and money that you will need in the short-term. For example, if you are planning to buy a car in a year or two, CDs will give you a modest return in the meantime without risking your principal.

Since 1900, inflation has averaged about three percent per year. There will be—and indeed there have been—periods (years and even

decades) of higher-than-average inflation and there have been periods (years and even decades) of lower than average inflation. The best course of action is to use a rate of inflation that matches with the long-term annual average rather than the current inflation rates at the time you are near or in retirement.

Inflation isn't going away. Even at a modest inflation rate of 2.5 percent, the cost of goods will double over twenty-eight years. Back when time spent in retirement was relatively brief, inflation wasn't as much of a concern. Today's retirees need investments that are up to the task of seeing them through many more years. Over the course of one's years in retirement, they could very easily see things cost twice as much at the end of their life as they did at the beginning of their retirement! This is something that must be addressed in your retirement income plan. I address it in the growth-bucket portion of our three-bucket approach.

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Regulation Risk

This is the risk that the government could change the rules at any time. This is a hard one to plan for, but there are a couple of key areas where this could become a challenge in retirement. The biggest one is

in the area of Social Security.

Right now, the Social Security Trust fund is empty, but Social Security income payments are being paid to retirees because there are enough wage earners paying into the system to cover what is being paid out. So, there is no money in the bank and everything that comes in through payroll deductions each month to the Social Security Administration is being paid right back out to eligible recipients. This is working…for now. But someday soon (most estimates say in 2034), the tide will turn and the government will receive only about seventy-eight percent of promised benefits. In other words, there won't be enough workers paying into Social Security each month the amount equal to what will be owed out each month to eligible retirees.

Here's what they say, "Even if legislative changes are not made before 2034, we'll still be able to pay seventy-eight percent of each benefit due."

Obviously, something is probably going to have to happen legislatively prior to 2034 to make sure this does not happen. But for pre-retirees and retirees there are two inherent risks:

1. For pre-retirees there's a real risk that the amount of income that is subject to Social Security taxes could increase and/or the amount of those taxes could increase.
2. For retirees there's a risk that benefits could be reduced and/or more of Social Security income could become taxable.

Either way, from a planning perspective, you just have to ask yourself and be prepared – how would I handle it if my Social Security income in the future went down by x percent? Make sure you have a PLAN for that and then don't let that unknown fear keep you awake

at night. Just knowing it's a possibility is all you need at this point and a plan of action if it does happen. We will address how to plan for this in Chapter 9, the three bucket approach.

The other regulatory risk is that the government could make changes to the amounts and limits of contributions to qualified retirement accounts and the tax status of each. This, of course, is impossible to plan for other than to have a plan for if your tax rate increases by x percent in retirement. We will address this in Chapter 7 as well.

Stock Market Risk

There are three areas of stock market risk that I want to discuss in this section. They are volatility, average vs. real rate of return, and sequence of returns. The first one is the most obvious; the other two may be the most over-looked, least understood, biggest investment risks you have never heard about!

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Volatility

Since 1928, the S&P 500 has experienced fourteen bear markets. A bear market is defined as a twenty percent decline from a previous market high. Over the past nearly 100 years, there have been more than

fourteen times where the S&P 500 had declines of greater than twenty percent. Sometimes these were quick declines and sometimes the decline took years to descend. Four out of those fourteen bear markets have taken place since the year 2000. So, just in the past twenty-three years, there have been four bear markets. Needless to say, if this were to happen within a few years of most people's retirement date, the results would be devastating.

On average, there is a bear market in the S&P every seven years. So, over one's retirement years of say thirty years, this would mean at least four times this person will experience a more than twenty percent drop in the value of the S&P 500 just during the retirement years! And, if it's anything like the last twenty-three years, it will be closer to once every 5.5 years. No wonder, most people spend their retirement years in anxiety and fear of running out of money.

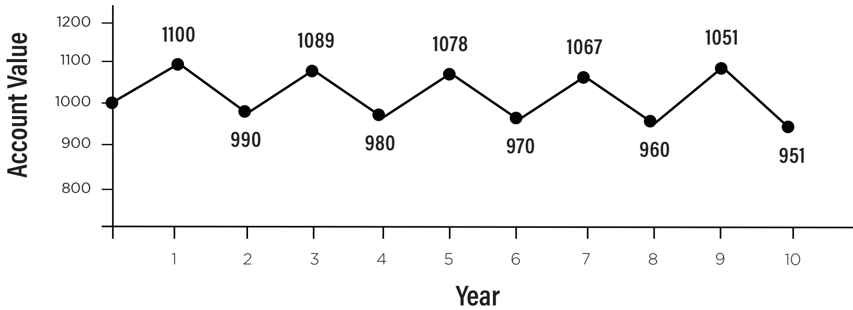
It does not have to be this way…especially for you since you are reading this book. Sadly, many so-called professionals in the financial advice industry pay little attention to these facts, and instead focus on the long-term average annual rate of return. But keep reading, because that is a fallacy as well.

Average vs. Real Rate of Return

The risk here is assuming that the average annual rate of return of a mutual fund or a portfolio is equal to what your actual, personal rate of return would be. Let's say you invested $1 million in the market. The first year you lose ten percent, and the second year you gain ten percent—and that pattern repeats itself for a decade, with ten percent losses and ten percent gains in alternate years. How much would you have in the end?

You might believe that you would break even. After all, the average rate of return for those ten years comes out to zero, so clearly you

gained nothing. But that does not mean that you lost nothing. You would end the decade with $950,990.05. You would have taken a loss of $49,009.95, or 4.9 percent.



The math is clear. The average rate of return over a period of time does not equate to your real, personal rate of return for that same period, if there are any negative returns added into the mix.

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Another example: You invest $100,000 in a mutual fund for two years, and the first year it loses 50 percent and in the second year it

gains 50 percent. Your average annual rate of return is zero, but you would have suffered a loss of $25,000. Your investment is down by twenty-five percent.

Think about this long and hard—*the average annual rate of return never equals the real rate of return over time if there are ever any negative returns mixed in*. This is an extremely important concept to come to terms with because it directly affects what investments you should use to draw income from in retirement. *And it should lead you to the following conclusion – don't make your investment decisions based on an average annual rate of return.*

It doesn't mean that the average annual rate of return is not accurate, it just means that it is not the return you would have experienced if you had been invested in it during that same timeframe. Unfortunately, there is no way of knowing when an investor gets into or out of a portfolio or fund, so all the companies can do is report average annual rate of return. Whenever you hear that phrase in the future, a red flag should pop into your mind.

People tend to be impressed if they learn that some mutual fund has averaged a six percent annual rate of return over the last forty years. If you plan to withdraw five percent a year, that sounds like a good place to put your money. But it doesn't work that way. It would only work if you were getting a fixed rate of return of six percent every year, guaranteed. However, that six percent is an average, which means some years the fund might have been down ten percent and other years up fifteen percent, with a variety of other annual performance results. Logically, it sounds good—average six percent and withdraw five percent and you will never run out of money. But it is simply not always true—it does not always work out that way. This is because of something called sequence-of-returns risk.

Sequence of Returns

If your retirement income is dependent upon an account that fluctuates with the market, it is essential that the sequence of returns fall in your favor. If the economy delivers a blow to your investments early in retirement while you are starting to withdraw money from that account, you might never recover. Your investment accounts could evaporate.

See the following chart for an example of how this works. There are two couples—Dave and Joan and Jeff and Wendy. They both start retirement with a balance of $500,000, they each average a six percent annual return on their investments over their lifetime, and they each *withdraw* five percent of their balance annually adjusted for inflation. As you will notice, Dave and Joan ran out of money in thirteen years! But Jeff and Wendy not only did not run out of money but their accounts grew. How is this possible? This is the *sequence of the returns*.

Dave and Joan had poor investment returns early but better returns later when it was too late. Jeff and Wendy, however, had better returns early and poorer returns later when it didn't really matter. Which one will represent you? No one knows, but it is an extremely important risk to address in a retirement income plan.

The point here is that you can't just blindly choose a portfolio with a long history of average annual rates of return of six percent or more and then just assume that as long as your annual withdrawal rate is below that, then you will automatically be okay. *This is one of the biggest mistakes that retirees make.*

If you talk to Dave and Joan, they would tell you not to leave all of your money exposed to market risk in retirement, because you will run out of money. And they would be right.

Dave and Joan				Jeff and Wendy		
Sequence of returns: Poor, then strong				Sequence of returns: Strong, then poor		
Hypothetical New Return	Withdrawal	Balance	AGE	Hypothetical New Return	Withdrawal	Balance
		$500,000	65			$500,000
-27.1%	$25,000	346,275	66	26.7%	$25,000	601,825
-16.5%	25,750	267,638	67	10.1%	25,750	634,259
-1.9%	26,523	236,535	68	4.3%	26,523	633,869
3.1%	27,318	215,702	69	8.9%	27,318	660,534
10.9%	28,138	208,009	70	17.6%	28,138	743,697
-9.4%	28,982	162,199	71	22.5%	28,982	875,527
7.4%	29,851	142,141	72	-3.7%	29,851	814,385
8.1%	30,747	120,417	73	18.1%	30,747	925,477
15.4%	31,669	102,415	74	-6.1%	31,669	839,286
9.4%	32,619	76,356	75	9.2%	32,619	880,880
6.2%	33,598	45,410	76	7.6%	33,598	911,675
12.4%	34,606	12,143	77	9.6%	34,606	961,268
2.8%	12,143	0	78	22.4%	35,644	1,132,964
11.4%	0	0	79	-11.0%	36,713	975,663
9.0%	0	0	80	24.3%	37,815	1,165,745
24.3%	0	0	81	9.0%	38,949	1,288,207
-11.0%	0	0	82	11.4%	40,118	1,323,532
22.4%	0	0	83	2.8%	41,321	1,318,113
9.6%	0	0	84	12.4%	42,561	1,433,720
7.6%	0	0	85	6.2%	43,838	1,476,055
9.2%	0	0	86	9.4%	45,153	1,565,407
-6.1%	0	0	87	15.4%	46,507	1,752,811
18.1%	0	0	88	8.1%	47,903	1,843,006
-3.7%	0	0	89	7.4%	49,340	1,926,397
22.5%	0	0	90	-9.4%	50,820	1,699,273
17.6%	0	0	91	10.9%	52,344	1,826,444
8.9%	0	0	92	3.1%	53,915	1,827,478
4.3%	0	0	93	-1.9%	55,532	1,738,278
10.1%	0	0	94	-16.5%	57,198	1,403,702
26.7%	0	0	95	**-27.1%**	**58,914**	**980,350**
Average Annual Net Return 6%				Average Annual Net Return 6%		

If you talk to Jeff and Wendy, they would say that you should leave all your money exposed to market risk in retirement because you will never run out of money and actually still gain…and they would be right, too. Both couples would be telling the truth based on their own personal experiences. Both of these scenarios are possible. This is why it is also extremely important *not* to base your own retirement investment decisions on the experience of someone else or do it the way someone else did it just because it worked for them. It may have worked or not worked for them, but that does not mean that it will work or not work for you.

It is also extremely important not to base your own retirement investment decisions on the experience of someone else or do it the way someone else did it just because it worked for them.

The point here is that you must realize that you can't just accept stated average annual rates of returns and that you must also decide how you are going to manage against a very real, yet most often overlooked retirement income risk—sequence of returns. Later, we will discuss how we recommend our clients mitigate against this risk. It's one of our core principles—*Protect the Income; Grow the Rest*.

This is another paradigm shift that prospective retirees must acknowledge. You are moving from the days when you were building

your retirement portfolio to the days when you will be using it. Earlier in life, the sequence of returns did not matter as much, because you were not taking withdrawals. Now it plays a critical role. It presents a real risk that must be addressed. If you are depending solely upon stock market performance for retirement income, you may be gambling with your future.

The sequence of returns only matters if you are withdrawing money or taking income. The order of the returns didn't matter very much during the accumulation phase (most of your investing life), but now suddenly it does. Still, many financial advisors will make a simple statement such as this: "Mr. and Mrs. Jones, if you average six percent per year in this portfolio and you withdraw five percent every year, you should not run out of money in retirement." It sounds as if it must be true. Logically, it makes sense. But as you can see, it is an illusion. If the average rate of return includes any losing years, it will not be the same as the real rate of return that you actually experience. That's the case even if you never withdraw a cent.

In Chapter 9 we will explore the three-bucket approach to retirement income planning that I recommend to my clients. Sequence of returns risk needs to be addressed in the income bucket portion of the retirement income portfolio because it is uniquely associated with distribution, but it will not be as much of a concern in the growth-bucket portion, since no regular withdrawals will be planned from there.

Diversification

To invest wisely, you need to properly diversify your assets. It's the wisdom of Solomon: "Divide your portion to seven, or even to eight," we read in Ecclesiastes 11:2, "for you do not know what misfortune may occur on the earth." How do you know if your portfolio is diversified?

Most people mistake being diversified for owning a bunch of different stuff. But you could have investments in several mutual funds with a lot of overlap in those investments. Perhaps they're all US large-cap funds. They're all doing pretty much the same thing. Your only diversification there is within that one asset class.

For a portfolio to be truly diversified, the asset classes within it should have low correlation with one another. In other words, they should react differently, with almost an inverse effect. Think of sunscreen and an umbrella. Typically, there is an inverse relationship between the two—if I need sunscreen, I don't need an umbrella and when I need an umbrella, I don't need sunscreen. This is how asset classes in a portfolio should react to one another. When one is lagging, another is surging ahead. Historically, certain asset classes have had low correlation with others, although at times they all seem correlated—as in 2008, when they all joined in the slide. So, the way to lower the risk, or standard deviation, of a portfolio is to reduce the correlation among the assets within it.

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Your asset allocation will be based on the rate of return that you need in order to meet the objectives that you have identified. *Your aim*

will be to take the least amount of risk possible to obtain that return, choosing the appropriate asset classes. Over time, however, some of those asset classes will perform better than others. Unless you act, they will soon represent a disproportionately large share of your portfolio.

Rebalancing is the process of getting the asset mix back in line with your original intentions and your risk tolerance. It helps to keep you in the discipline of selling high and buying low. Let's say that you decided on a mix of sixty percent stocks and forty percent bonds. You also wanted a certain percentage of your stocks in international equities, a certain percentage in emerging markets, and the remainder in US companies. You notice after a few years that the US equities make up a larger piece of the pie, by virtue of their consistent performance. As tough as it might seem to do, it's time to sell off some of the gains from your winners and use the proceeds to buy more stock in your weaker performers at a bargain price. How often should you do that? Some suggest quarterly, but I believe it's wise to let the winners have more of a run and rebalance annually.

You should only put at risk, however, what you can afford to lose—and once you have determined that amount, you should remain committed to that decision. You either believe in the market in the long-term, or you do not. If you are investing money for growth to meet future needs and to deal with inflation and tax increases, then you should not be constantly getting in and getting out on the market. After all, in any given year, most of the returns can be attributed to just a few days – and missing even one or two of them will have a dramatic impact on your return. Nobody knows in advance which days those will be. Market timing simply does not work. Long-term commitment does.

Investor Behavior Risk

This is the person in the mirror risk. That means that sometimes when it comes to investing our own worst enemy is the person we see in the mirror each day!

We can put together the best plans, but human nature can still get the best of us. We can make good, rational retirement planning decisions, but still be tempted by fear and/or greed. It's best not to make any decisions based on fear or greed. This is where many investment mistakes are made.

One of the behavioral finance pitfalls is something called confirmation bias – only believing what you want to believe about a certain investment and not being open-minded or aware of other information that could help inform your decisions. If a person thinks stocks are bad and the stock market is a casino, then that person will only find evidence to support this viewpoint. Alternatively, if someone thinks all annuities are bad and the insurance companies are out to take advantage of you, then that person's research will amazingly only yield results that match the preconceived opinion.

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You may hear of a good investment opportunity that may be good for someone else but is not good for you because it doesn't fit in your

plan or in your phase of investing life. When that happens, let it go, because it also leads to another area where people can make investment mistakes and that is FOMO (fear of missing out). Yes, the raw land in New Mexico by the big lake that they want to turn into luxury condos may be the best possible investment deal ever assembled, but don't do it if it doesn't fit in the plan. And just because the Smith's are investing in it doesn't mean that you should, too. It's tempting when the market is down to do something, but sometimes the best, wisest, most lucrative thing you can do is…nothing! The trap of selling low because "this time it's different" is one that captures a lot of people and their hard-earned assets with it.

A research firm called DALBAR out of Boston conducts studies of twenty year annualized investment returns. They compare the average investor's returns to major stock indexes such as the S&P 500 and to a diversified portfolio like a 60/40 mix among many other asset categories. In every annual report of the previous twenty year period, the average investor earned a much lower annual rate of return than the indexes. The reason is that the average investor (someone who does it on their own in their 401(k) or other brokerage accounts) tends to buy and sell, get in and out of the market, and over-weight and under-weight asset classes.

In other words, the average investor typically lacks the discipline to simply earn what the market provides over time.

Lack of a Plan

These risk factors demonstrate why it is so important to have a plan. In fact, the biggest retirement risk facing everyone in my humble opinion is the lack of a plan. Not only should the plan determine

which products you are in, it should also provide you with a matrix (or a framework) by which you can make all investment decisions. And, it is the tool that you can use to understand why you own what you own…and ultimately, I believe that financial peace comes from having a plan. Making work optional and being able to enjoy it when you're no longer working because you have to—is all a result of proper planning.

Longevity Risk

To live a long, prosperous life would seem to be the ideal. You worked hard for decades to position your family for a comfortable retirement. You want to make the most of what could be the best years of your life. And yet surveys have indicated that the greatest fear among many people of retirement age is that they will outlive their assets. What's wrong here?

It's not that older people have lost the will to live. On the contrary, countless retirees show the world daily how much they can offer. The word retirement, in fact, is somewhat misleading, since many remain highly active and engaged. What they are lacking, all too often, is *financial* confidence. They fear that they will run out of money before they run out of years.

If we lived only a short time beyond our working years, the risks that we have examined in this chapter would not matter so much. Our longevity accentuates the potential impact of those risks. Why do we care about inflation? Because we are living long enough to feel how it can drag us down.

Why do we care how the stock and bond markets perform? Because our investments need to serve us well for many years to come.

As we will see in the chapters ahead, we must also manage taxation effectively and confront the risk of long-term care so that they do not deplete our savings that must last a lifetime.

Longevity risk is the risk multiplier. It makes all of the other risk riskier. The longer we live, the higher the potential impact of the other risks affecting us.

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With diligent planning that addresses all these risks, you need not worry about outliving your assets. Using my three-bucket approach (see Chapter 9) and following the principles outlined in this book, you can enjoy a long and fulfilling retirement with confidence.

TAKEAWAYS

Chapter 6

Top tips for Simplifying Your Retirement:

1. Risks are everywhere, which is why you need to Protect the Income; Grow the Rest.
2. The key risks to your retirement plan include:
   - Healthcare costs
   - Inflation risk
   - Regulation risk
   - Stock market risk
   - Investor behavior risk
   - Lack of a plan
   - Longevity risk
3. Your average annual rate of return will never equal the real rate of return over time if negative returns are ever mixed in.
4. If your retirement income is dependent entirely on an account that fluctuates with the market, your primary risk is sequence of returns risk.
5. Truly diversified portfolios have asset classes that have low correlation with one another.

Take the Retirement Income Quiz
www.wisewealth.com/quiz