LGIM America

Retirement Risk #1: Not Understanding Risk

“Retirement” is a relatively new concept. Not so long ago, leisure-filled, post-employment days simply did not exist.

Shortly after the founding of the United States, one could expect to live to the ripe old age of 35[1]. People worked their entire lives.

When Congress passed the Social Security Act in 1935[2], life expectancy had risen to a robust 61 years. Interestingly, the “retirement age” for full benefits was set at 65 years, four years beyond life expectancy.

Today, “retirement” in some form is widely expected, and for many, a persistent cause for concern. With current life expectancies, retirement can easily stretch into a person’s 90s.

Employees are working to fund a goal that may be decades away, and could span decades, in a rapidly changing and uncertain environment.

The risks are many. We begin with four.

Four fundamental risks

Investment risk

Allocation and diversification decisions – before and during retirement – can directly impact asset retention, growth potential and retirement income streams.

Longevity risk

Longer life expectancies increase the risk of retirees outliving their assets.

Liquidity risk

Certain investment vehicles, such as annuities and CDs, are less liquid and can restrict participants’ access to, and feelings of control over, their assets.

Utilization risk

Investment solutions must allow retirees to manage the drawdown of their wealth and help them maintain a desired standard of living throughout retirement.

1 Estimates of Regional and Global Life Expectancy 1800-2001. Population and Development Review. Volume 31, Issue 3 September 2005.
2 Social Security Fact Sheet, ssa.gov

The retirement investing lifecycle can be split into two phases: Saving (pre-retirement or accumulation) and Spending (retirement or decumulation)[3].

Saving: Early and often

The pre-retirement period aims to achieve one singular objective — to maximize the assets available to fund retirement. To do this, one needs to begin saving consistently, as early as possible, using instruments that can let those assets grow. Ample savings, invested prudently over time, should create (ideally) a sizable nest egg.

Spending (pt. 1): This could last a while

A realistic retirement plan rejects a definitive timeline. Any retirement plan must address the reality of *longevity risk*.

To start, we tend to underestimate our expected lifespans.[4] This helps to explain why a typical retiree reports a financial planning horizon of only five years and a general planning horizon of ten years.[5] Put simply, although not a certainty, we must plan for the possibility of a long life.

In the worst-case for longevity risk (*but best case for us biologically speaking*) we live a long, healthy life with a long, rewarding retirement and enjoy sufficient assets for the experience. However, as the Allman Brothers poignantly remind us, “You can’t take it with you when you go.” In the best-case for longevity risk (*worst-case biologically speaking*) we die pre-maturely and our assets become a generous bequest.

Given this substantial uncertainty, retirement assets must provide growth to support what could be decades in retirement, while seeking to mitigate volatility that could diminish a retiree’s standard of living. And don’t forget about keeping pace with inflation which can quickly erode the buying power of those retirement dollars.

Put simply, a retiree’s investment portfolio must aim for a Goldilocks-like level of risk and return: not too-hot where point-in-time risk may diminish the standard of living, but not too-cold where there is insufficient growth to fund for a long life or a bequest.

Spending (pt. 2): Surprises (not the good kind)

Uncertainty doesn’t stop at life expectancy. It permeates retiree spending patterns as well. A 2015 Society of Actuaries study explored the experiences of individuals in retirement. Among a variety of insights, the study[6] exposed one often overlooked issue.

- Financial shocks have a material impact on many retirees. More than one in three survey respondents experienced financial shocks that depleted at least 25% of their assets
- More than one in ten retirees stated that they needed to reduce their spending by 50% or more as a result of shocks.

Events such as major home repairs, dental expenses, prescription drug costs and divorce (to name a few) illustrate the need for flexibility, such as the ability to adjust spending. The random and often sudden nature of these events require a degree of *liquidity* to meet these expenses. Such expenses also highlight the potential benefit of maintaining some exposure to growth assets (such as equity). This provides an opportunity for participants to recover, at least in part, from shorter term downside volatility.

Utilization: If you build it, will they come?

Fifteen years of post- Pension Protection Act experience reinforce the importance of default options. Default options, with target date funds being the most prominent, typically garner the majority of quarterly inflows[7].

This begs the question of whether an income solution that is not part-and-parcel of the default can successfully appeal to those in and near retirement. Patterns of usage suggest these participants are less likely to utilize default options[8]. A survey conducted by Franklin Templeton[9] found that 52% of those over 50 years old preferred to self-manage their DC investment options, while 62% reported rebalancing or making changes to their portfolios at least annually. These utilization and behavior patterns suggest that, if given clear and objective educational tools, those in and near retirement would appreciate solutions more specifically tailored to a “de-cumulation” objective.

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3 Although we often think of these as distinct phases there is an increasing gray area between when one phase ends and another begins.
4 O’Connell, A. (2011). How Long Do We Expect to Live? A Review of the Evidence. *Journal of Population Ageing, 4*, 185-201.
5 Risks and Process of Retirement Survey Report, 2012 Society of Actuaries
6 Survey Says: 2015 Survey of Post-Retirement Risks and the Experience of Long-Term Retirees, Cynthia Levering Pension Section News Sept 2016, Issue 90
7 Callan DC Index www.callan.com/dc-index as presented in the Quarterly Net Cash Flow Analysis.
8 Source: EBRI.org: Target Date Funds: Evidence Points to Growing Popularity and Appropriate Use by 401(k) Plan Participants (Sept 9, 2021)
9 “The Anchor Leg of the DC Plan: Helping Participants Finish Strong with a “Retirement Tier” Topic Paper 2017. Carrington, Drew; Glotzbach, Mary Beth and Waters, Tom

Even if a solution can provide an elegant drawdown, it isn't worth much if participants don't understand it. A solution must allow participants to easily engage and understand not only how income is generated but the level of income they can reasonably expect in retirement. Perhaps most important: A participant's level of difficulty in getting money from the plan to a checking account, will largely determine the success of a drawdown solution for a given population.

Challenging? Sure. Insurmountable? No.

Successful drawdown solutions must, to some degree, accommodate the behaviors and preferences of those in and near retirement. Moreover, they must address the risks associated with this phase of the investment cycle in a manner appropriate to a participant's specific situation.

To meet these requirements, we suggest approaching retirement as a series of distinct phases, rather than a single monolithic period. In our next paper we will discuss

- the key elements of each phase,
- the prominent risks, and their potential impact, in each phase
- adjusting income strategies as spending patterns and needs evolve.

We're here to help

For more information about this whitepaper or LGIM America's capabilities, please contact Jimmy Veneruso at: Inquiry.DefinedContribution@lgima.com.

About LGIM America

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