

# Facing Up to Longevity Risk

Issues we face when  
we plan for our  
retirement funding

## CHAPTER 1

Determining your ideal  
retirement income

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Risk versus return

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Defining our personal  
longevity risk

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Taking control of your  
retirement income

.....  
'Basic needs', 'wants'  
and 'wishes'

.....  
A new approach

When it comes to retirement, each of us has very personal and very individual dreams and aspirations. Some of us want to travel; some of us want to start a new hobby or continue enjoying an old one; some want to go back to university. What is it that you want to do? The possibilities are endless.

Retirement is a time when we want to be free of most responsibilities and be able to do what we want without restrictions. The key to being able to fund all of our needs and wishes during retirement lies in accumulating a sufficient amount of investment assets which will be dedicated to funding our retirement. For some to be 'free' means to have 'financial freedom'.

There is a parallel in the insect world, in the lives of ants; they pick and store food all summer so that they can live off it during the winter time. We also need to accumulate investment assets during our working life so that when the time comes to stop working we can mobilise these investment assets to pay for the ongoing cost of living without the *need* to generate income from work. (You may still want to do some work but that is another matter.)

The imperative is to ensure that once we are retired we can support ourselves financially for the remainder of our lives. We need to make sure that our money doesn't run out before we do. I am certain you will agree that the worst outcome in retirement is to be old, frail and broke. Thus, the main questions we need answers to are the following: how can we ensure that we will not outlast our money, and how can we guarantee that we will have the income we need for our chosen lifestyle for the rest of our life?

Well, the simple answer is that we *can* save and invest, and the positive thing about accumulating investment assets is that once we have saved some money and invested it, the magic of compounding returns starts to work. Albert Einstein coined the effect of compounding interest as the 'eighth wonder of the world'.

The value of our investment assets starts to accelerate when the compounding effect kicks in. If we start with \$100,000 and we receive 10% p.a. return, we will earn \$10,000 in the first year, and at the end of the first year we will have \$110,000<sup>1</sup>. If we continue to earn 10% p.a. in the following year, we will receive \$11,000 because not only do we receive a return on our initial capital of \$100,000 but we also receive a return for the \$10,000 we earned in the first year. Thus, by the end of the second year we will end up with \$121,000<sup>2</sup>. As time goes by, the value of the investment assets increases because of this principle.



Up to this point it all seems relatively simple, but there is always a villain in the story, and in our case it is the fundamental rule of investments; the Return vs. Risk principle. It is a stark fact of life that, in order to be able to fund our retirement, we need to take some risks when we invest.

When I ask a new client how much they would like to accumulate in order to fund their retirement, most of the time I get the answer “as much as possible”, or words to that effect. I then ask them what level of ‘potential risk’ they are prepared to take in order to achieve their goal of “as much as possible”. The answer to this question will vary between those who don’t want to take any risk and those who are prepared to take some level of risk. It’s very rare that I meet a client who responds by saying, “I am prepared to risk everything in order to reach the maximum wealth that I can.”

The cardinal rule of investments dictates that the higher the return we are aiming to achieve, the more risk we need to take in order to achieve it. Thus, if we truly want to achieve as much as possible, then we probably need to risk it all.



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1 The capital of \$100,000 plus return of \$10,000 ignoring tax

2 The end of year one value \$110,000 plus the return of \$11,000 ignoring tax

## **Determining your ideal retirement income**

What are your goals regarding your retirement income and the investment assets you want or need to accumulate? What is the level of potential risk you are prepared to take in order to achieve these goals? Is there a match between the two? If there isn't a match, which of these do you want or are prepared to adjust? Are you prepared to reduce your goals; in other words, reduce the level of investment assets you need to accumulate? Or, are you prepared to increase the potential risks you need to take, in order to give yourself the potential to reach those goals?

Certainly we may simply ignore the fact that there is a direct relationship between return and risk, but this is dangerous, as it could lead to either of two situations. The first situation is that our risk profile is so adverse to risk that we invest in an overly conservative way, yet still having goals to accumulate significant investment assets. This will more than likely result in us having to live with ongoing frustration because our level of investment does not accumulate enough for the goals we desire. However, we are unlikely to ever reach our desired level of returns because the conservative nature of these investment strategies doesn't offer the potential to accumulate them.

The second situation would arise if we invest in high potential return investment strategies but our risk profile is such that our tolerance to risk is low. This situation typically occurs if a person didn't have a full understanding of the potential risks at the time the specific investment strategies were chosen. In this situation, should a potential risk be realised, we can find ourselves losing a big percentage of the value of our investment assets. The price we may be required to pay could be far beyond what we ever expected or were prepared to suffer.



## **Risk versus return**

The issue of return vs. risk is a fundamental point in our retirement funding planning. Let's explore this issue further firstly by looking at it in general terms of investments. To illustrate: let's adopt a fictional character, Sam; a high flyer who received an inheritance of \$100,000 from an elderly uncle. Sam had a passion for flashy speed boats, so he decided to spend the \$100,000 on a boat. After long research and after visiting many boat dealers, Sam came to the conclusion that the only way he could get what he wanted was by ordering a brand new boat from the manufacturer, built to his own specifications which included a custom-designed fridge for the beers and an audio system. By the end of the meeting with the boat designer, everything looked perfect.

The total cost of the new boat would be \$103,000. Sam was required to pay \$10,000 as a deposit, and the balance of \$93,000 to be paid in twelve months, upon delivery. Sam paid the \$10,000 deposit and went home. In the evening Sam logged on to on the internet and began looking for investment opportunities for the \$90,000 he had left in his bank account. His target was to earn at least the \$3,000 which he would need in order to pay the remaining \$93,000 for the boat twelve months later.

While he was browsing the various financial websites, he came across two advertising banners. The first was an advertisement for a managed fund that specialised in Australian shares. The second banner was an advertisement for a major bank offering a term deposit with an interest rate of 5% over 12 months. Sam did some research on the first advertisement, the fund manager with the specific investment into Australian shares. He was pleased to find out that the return for the last 12 months had been 22% and the fund manager was highly regarded by various research houses. He became ecstatic when he worked out what a return of 22% p.a. could mean for his \$90,000. On this basis, Sam could receive an additional \$19,800 at the 22% return on his initial \$90,000 investment.

Sam had visited his accountant that week. He recalled the accountant mentioning that his tax rate was based on a 30% marginal rate. He searched for a tax calculator on the internet, and after entering the information concerning an investment return of \$19,800 and a tax rate of 30% the result was that he should expect to be left with \$13,563<sup>3</sup> after tax.

The situation looked perfect and Sam quickly devised a plan. In twelve months, he would pay the \$93,000 for the boat and he would still have over \$10,000<sup>4</sup> left in his bank account. He would then take unpaid leave from work for two months at the start of the next summer, financing this time off with the leftover \$10,000.

It all seemed too good to be true; the combination of summer, a new boat and a two-month holiday looked like it could be the best time he had in a long while — something he felt he deserved after a very hard working period. Sam did not even consider the option of investing in the other ad he had seen — the term deposit with an interest rate of 5% over twelve months. His mind was already ticking with thoughts of who he should invite on board to ride in the new boat. A couple of months after executing his investment plan, Sam got a statement from the fund manager which reported the return was even better than the year before, and had risen to 35% per annum. Sam could not believe it. He felt like a genius and began thinking about extending his unpaid leave to three months for a full summer on the water; what a life.

Sam became busier at work and didn't have the time to follow his investment. When he got a letter from the boat manufacturer notifying him of the boat delivery date in two weeks, he remembered that he hadn't spoken to his employer about the unpaid leave. He also thought to himself that he should start the redemption process

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3 31.5% tax (30% + 1.5% Medicare) paid on \$19,800

4 A Net return of \$13,365 added to the initial capital of \$90,000 will result in \$103,365. Paying out of that \$93,000 for the boat will result with an amount left over of \$10,365