Risks that Can Ruin a Retirement, Part II

By George A. (Sandy) Mackenzie   *Thu, Mar 7, 2019*

In retirement, "risk" can turn from an object of pursuit to an object of avoidance. In the second installment of a two-part article, our guest columnist continues his discussion of financial and other risks that retirees and advisors should anticipate.

The word "risk" means different things to different people. For an investment-oriented advisor, risk-taking is mainly positive: it's a path to higher returns. If that's your preference, you probably worry that your clients might take *too little* investment risk during retirement, or that they might rashly *de-risk*—by selling depressed assets—during a market correction.

To an advisor whose roots are in the insurance world, or who blends insurance and investment products in retirement, risk is less positive. From that advisor's perspective, risks represent predictable hazards that clients need to anticipate and prepare for, especially if they want to sleep easily at night during retirement.

Both attitudes toward risk are valid, but I'm approaching it from the second perspective. In an article in last week's edition of *RIJ*, I discussed the threat of longevity risk—the risk of outliving one's savings—in detail. This week, I'll focus on other, equally important risks: financial risks, health care risks, political risks, and others.

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Low-return risk. Even if life spans were completely predictable, investing at any age is fraught with risk. This is particularly the case today, given the decline in interest rates. With 10-year Treasury bond rates around 2½ percent, their return after inflation and taxes is negative for most investors. A decent rate of return on average requires risk-taking. A portfolio with an investment of 60% in S&P500 index fund and 40% in a bond index fund has a much lower rate of return than it used to.

There is no obvious solution to this basic change in the financial landscape, except perhaps making an extra effort to improve the risk-return tradeoff by lowering investment fees and more importantly, saving more.

Sequence-of-returns risk. Apart from the woefully low rates of return on safe investments, the problem of sequence of returns risk arises with portfolios with variable rates of return. Of two portfolios with the same geometric average return over some given number of years from which a specified stream of withdrawals is being made, the portfolio whose good years occur early will run out less quickly than the portfolio whose bad years occur early.

Sequence-of-returns risk can be reduced by choosing a portfolio with a less variable rate of return, but that will lower the expected rate of return. Sequence-of-return risk does not arise when no withdrawals are being made, as with some endowment funds.

Inflation risk. Inflation risk arises because future rates of inflation are not predictable. It can be seen as a form of financial risk, because it affects the real rate of return on any financial asset whose return is not indexed to inflation. It also creates a risk for recipients of sources of nominally fixed income, like pensions.

Interest rate risk. Even with risk-free assets, interest rate risk arises when the assets are redeemed, and the proceeds have to be reinvested at a lower than expected rate of interest. This problem can be minimized by a laddering strategy: matching the maturity of an asset like a Treasury or bullet bond, to the extent possible, with the year when their proceeds will be spent. Thus, the proceeds of a bond maturing in 15 years should be matched with a reasonable estimate of expenditures expected fifteen years hence. Perhaps the estimate should be conservative, so that any expenditure exceeding it would be financed in other ways. Interest rate risk can be reduced, but not eliminated, in this way.

Perhaps the most basic issue with financial risk is the investor’s attitude toward it. The level of risk of a portfolio should not be so high as to cause the investor sleepless nights. Peace of mind may well require sacrificing high expected returns; but that in turn will require higher saving rates prior to retirement to achieve a given target for retirement income.

For clients who are no longer working or have limited ways of achieving expenditure economies, boosting saving significantly may not be possible. However, advisors of clients who still have some years of work in front of them need to emphasize that shrewd investing alone will not a secure retirement make. They should also recognize that putting in extra years of work to boost income in retirement may not be an option for everyone, particularly for people who have disabilities.

Health care risk. Most Americans aged 65 years and older enjoy a reasonable degree of protection from health care cost risk. Medicare alone provides a fair amount of protection, and the gaps in its coverage can be covered mostly by acquiring a supplementary policy. About six of seven older Americans have this additional coverage. Nonetheless, even this combined coverage does not ensure that all expensive or experimental coverage of prescription medicines or treatment will be covered.

Older Americans not yet eligible for Medicare can be at risk for health care costs that are large enough to force bankruptcy. Employer-provided health care tends to be a feature of larger corporations. Even so, the loss of even a well-paying job can (and usually does) entail the loss of employer-provided health insurance.

While the unemployment rate for older American is lower than the average for all ages, unemployment spells are longer for them. Finding another job, particularly one with comparable salary and benefits, can be a challenge, and individual health insurance is typically very expensive if it is available at all.

Job loss at a relatively advanced age can affect households at all income levels. Medicaid, the poor household's Medicare, may be available to some households whose members are all less than 65 years of age even if household income exceeds the poverty line, but it is not a universal safety net. The issue of the effects on retirement security of job loss and other non-medical contingencies is taken up again below.

Long-term care cost risk. Most Americans think that Medicare covers long-term care (LTC) costs, but Medicare in fact only covers nursing home stays, post-surgical and the like, for a relatively short period. Medicaid covers the cost of nursing homes and other facilities needed by people who have difficulty coping with daily living requirements. But, unlike the care covered by Medicare, Medicaid coverage requires that participants satisfy certain income and asset tests.

Medicaid's coverage was initially limited to the very poor. Its coverage subsequently expanded considerably. Under the Supplemental Security Income (SSI) assistance program, most states now offer coverage to people with incomes up to $2,300 a month, or three times the poverty rate for individuals.

However, 33 states offer another "pathway" to Medicaid coverage known as the medically needy program. To be eligible for this program, candidates must finance out of their own pocket expenses equal to the difference between their monthly incomes and a floor set by their state of residence, over a period ranging from one to six months, also set by the state. For example, a state might set an income threshold of $500.

If a candidate for the program had monthly income of $10,000, and the period set for the test was six months, eligibility would require an outlay of 6 x ($10,000 – $500) or $57,000. This is certainly a tidy sum, although not beyond the means of many better-off Americans. Unlike the other tests, even an individual with a high income can become eligible for Medicaid, although the higher the income, the larger the up-front payment.

Certainly, for the poor, and even for many better off families, these financial arrangements make private LTC insurance look unattractive compared to its publicly-provided alternative. Private insurance, if an individual can afford it, has two important advantages, however. First, policyholders are not expected to devote a large chunk of whatever income they may have toward defraying nursing home costs when they become a resident. Second, someone with private insurance will have more control and a wider range of choice of facility. LTC insurance can be a good deal for the better off, particularly if it is offered as a group policy. Investing in a policy while still relatively young is also a good move.

Political risk. The recent annual reports of the Trustees of the Social Security system make clear that the current level of benefits cannot be sustained. Some combination of benefit reductions and/or payroll tax increases must sooner or later take place. The combination of measures that could in principle address the current financial imbalance is virtually without limit, but all would face political headwinds—strong headwinds, in many cases.

Congress cannot continue to kick the can down the road forever. It will have to act sooner or later. What will it do? Politically and morally, reducing the benefits of those already retired is a non-starter, particularly for older retirees, with high-income households a possible exception. The role of the Social Security benefit in the retirement income of wealthy households is rarely great.

Reducing the benefits and/or increasing taxes on workers approaching retirement also seems like a tall order politically. It basically leaves young workers, and young Americans who have yet to earn their first pay check, to take the hit. Consequently, the clients who patronize the *RIJ*'s advisor-readers may not have much to fear. However, anyone advising younger investors should alert them to the possibility that the implicit rate of return on their payroll tax contributions is sooner or later going to decline.

Of more concern to older Americans may be the parlous state of the finances of Medicare and Medicaid. Cuts in coverage and increases in co-insurance and copayments are not simply remote possibilities. The part of the payroll tax that finances Medicare could also increase. There may be no strategy that advisors could offer their clients to deal with the consequences of political risk, but to be forewarned is at least to be (a little) forearmed.

Other risks. Surveys of retirement confidence by both the Employee Benefit Research Institute (EBRI) and the Society of Actuaries (SOA) reveal a disquieting tendency for older Americans to be uncertain of their ability to deal with unforeseen financial contingencies. Those include not just the big ticket items we have been reviewing, but even comparatively small contingencies, like an unexpected car repair bill.

A recent survey by the Federal Reserve Board found that this is a problem for all ages. Some 40% of survey participants would be hard pressed to meet an unexpected expenditure of $400. The habit of living from paycheck to paycheck is not confined to the poor, however, as the experience of many middle-income federal workers affected by the recent partial shutdown attests.

Regardless of their clients' income levels, advisors should impress on them the need for a contingency reserve and the importance of saving. Higher rates of saving would allow older Americans to take advantage of formal insurance mechanisms (such as private LTC insurance) and would prevent comparatively minor contingencies from having major financial consequences. Finally, and not to belabor the point: no investment strategy, however brilliant, can make up for an inadequate saving rate.

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