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## Risks That Can Ruin a Retirement

By George A. (Sandy) Mackenzie Thu, Feb 28, 2019

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*In the first of a two-article series, the retirement expert, author and editor enumerates and describes the many risks that retirees face. (Spoiler alert: Mortality is not one of them.)*

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Older and retired Americans must confront a series of risks that could upend or jeopardize their retirement security. This article offers a Cook's tour of these risks: Longevity risk, financial risk, health care cost risk, long-term care (LTC) cost risk, political risks and the risk of miscellaneous contingencies.

**Longevity risk** is the risk entailed by uncertain lifespans. Whatever our life expectancy—how long on average we think we will live—we confront this risk. It underlies or aggravates other risks, especially financial and LTC cost risk.

**Financial risk** comes “with the territory” of investing; especially these days, an adequate return *on average* to a portfolio requires taking it.

**Sequence of returns risk** is an aspect of financial risk, as is **interest risk**, which arises when maturing assets must be reinvested at lower than expected rates of interest. (Another type of interest risk occurs when rates rise and existing bonds are marked down in value.)

**Health care cost risk** arises because of our inability to predict our susceptibility to illness, especially serious illness. It is mitigated for Americans aged 65 years and older by Medicare and by policies that supplement Medicare, but not eliminated.

**Long-term care cost risk** depends in part on longevity—we are more likely to need it in advanced old age—and on our generally unknown genetic endowment and the state of our health in advancing years.

**Political risk** arises when we rely on Social Security for a significant part of our retirement income. In fact, the financial positions of both Social Security and Medicare/Medicaid are not sustainable, and we do not know what changes Congress may make to the current structure of benefits or the payroll taxes that finance them.

**Non-routine expenditures** other than health care and LTC expenditure are also not

always predictable. Many Americans, young and old, are hard-pressed to deal with even comparatively minor unforeseen but necessary outlays.

Finally, and for completeness' sake, we should acknowledge that the elderly face risks that may not have direct financial consequences: the **risk of isolation and loneliness** come to mind.

### **Longevity risk**

Longevity risk and financial risk are linked—you can't have one without the other. Longevity risk plays a role with the other risks as well. Nonetheless, it is useful to isolate the effects of longevity risk in financial decision-making before we address more basic financial risks.

Leaving aside the hedge against longevity risk that Social Security and defined benefit pensions can provide, longevity risk poses a basic question for the investor: how long must someone's retirement savings last? The answer: we don't know. We may not be very healthy, or may have short-lived forebears, but that doesn't mean we are doomed to die young or that longevity will become predictable.

A basic rule in such circumstances is to be prudent. For example, a 65-year-old retiree with a life expectancy of 20 years might assume that he or she will live for 30 or 35 more years. Retirees should make a conservative assumption about the average rate of return on their investments, and then calculate the amount of money that they can spend each year without running out.

It's not necessary to assume a constant level of expenditure each year. Some studies suggest that annual spending declines over time, as people engage in less travel and certain other activity-related expenditures. Other studies find that rising out-of-pocket health care costs can push expenditures up with age.

There's a problem with this approach: the retiree is likely to die before the assumed 30- to 35-year planning period ends. A partial solution to the problem is to redo the calculation every few years: for example, if the retiree reaches age 70 in relatively good health, the calculation might be redone using a maximum planning period of 27 years instead of 30 or 35. Nonetheless, money is still likely to be "left on the table" by those who don't live to the end of the planning period.

This raises the question of annuitization. Annuities are longevity insurance, so why not address longevity risk directly by buying one from an insurance company? The private

annuity market has never held much appeal for older Americans, however. Economists for the most part think annuities are a good form of protection against longevity risk and refer to the anemic market for them as the “annuity puzzle.”

For retirees whose working incomes have been modest, Social Security will offer an indexed life annuity that replaces a large share of that income. This will not be the case for most of the clients of the advisors who read this publication, however.

The large upfront cost of an immediate annuity (IA) is probably a deterrent for many potential investors. One possible solution is to purchase a standard investment that can cover expenses during, say, the first 20 years of retirement, and a deferred income annuity (DIA) that starts paying at age 85 (assuming retirement at age 65). This combination is certainly less expensive than an immediate annuity starting at retirement, but an IA can provide significantly higher income over the first 20 years of retirement (conditional on survival).

Longevity risk also affects how LTC cost risk will affect a retiree. The risk of needing care in a nursing home or an assisted living facility obviously increases with age. We'll return to this issue when we address LTC care risk.

**Next week:** Other retirement risks you and your clients should anticipate.

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