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How to Prepare for Two Major Retirement Risks

By Christine Fahlund on August 6, 2012

The effect of rising prices combined with increasing life spans exposes you to the chance of outliving your savings. Here are ways to prepare.

The primary goal of a retirement investment and income strategy is to ensure that your savings last throughout retirement. Achieving that all-important objective includes addressing two critical risks: longevity and inflation. American life expectancy is higher than ever and is likely to continue rising. Living longer not only requires you to continue spending over a greater number of years but also further exposes you to increases in prices for goods and services. For a retirement that may last well into your 90s, inflation may ultimately become more of a concern than market volatility. Longevity has transformed the model for how people should save and invest for retirement. We now have to prepare for a post-work life that could last three decades or more.

Longevity Risk

According to the Society of Actuaries, there is a 50% chance that one partner in a couple will live to age 92 and a 20% chance that one will live to age 98.* Those chances are likely to improve if current aging trends hold. To be prepared, it's important to have a realistic spending plan and consider ways to maximize the withdrawal amounts you receive from your investments, Social Security, and possibly continued employment.

Outliving your savings may pose the greatest threat to your retirement. Consider taking the following steps to protect your income stream throughout your life.

1 - Practice Retirement®: Keep working but start playing sooner. The traditional view of retirement divides your life into two clearly defined stages: working followed by playing. Retirement, however, has evolved—and along with it the expectation that you must receive your gold watch before you are "allowed" to start playing. We believe that in your early 60s, you can begin enjoying the lifestyle you see for yourself in retirement as long as you remain employed into your late 60s. If you envision traveling to India when you're retired, consider the option of going there on vacation when you're age 63 and still employed. Why wait?

A number of advantages may come with staying at your job longer. By carving out time to travel or indulge in a hobby while you are still working, you will be able to benefit financially from additional years of salary and benefits, and you will be able to capitalize on the opportunities during this vibrant phase of your life.

2 - Spend from your wages, not your savings. You are likely to have more to spend by remaining at your job than you would by retiring and relying on your savings to pay for the activities you want to enjoy. The longer you remain employed, the more time your current investments and savings will have to potentially grow and the fewer years you may need to support yourself from your investments in retirement.

3 - Receive employee benefits longer. Capitalize on the benefits your employer may offer—such as health and life insurance and matching contributions to a retirement plan. Remember that Medicare does not begin until you reach age 65. Retiring earlier may mean that you have to pay significant health insurance premiums each year until you reach that age when you will be at least partially covered by Medicare.

4 - Delay taking RMDs. Taking required minimum distributions (RMDs) from the retirement account you have with your current employer can be delayed if you are still employed there at age 70½ (certain restrictions apply). The IRS rule states that you must begin taking RMDs by the later of either April 1 of the year after you reach age 70½ or April 1 of the year after the year you retire from the company. (RMDs from all other prior employer retirement accounts and all

IRAs, except Roth IRAs, must begin at age 70½, regardless of your employment status.)

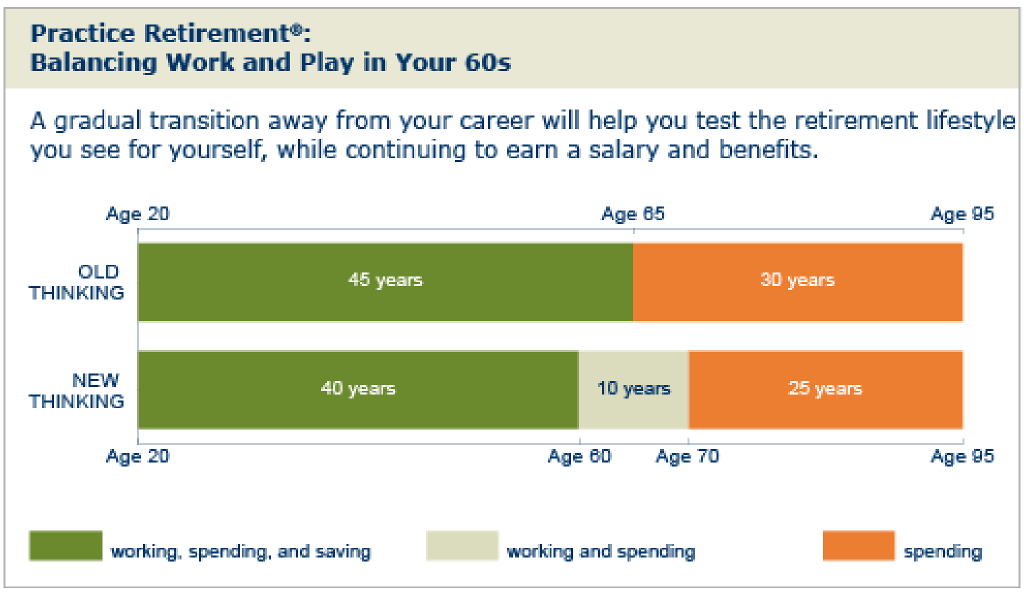
You don't necessarily have to work full time in your 60s to enjoy the benefits of additional income. A part-time paycheck will reduce the amount you need to withdraw from savings, even if it adds up to only a few thousand dollars a year. The more expenses that can be covered by wages, rather than investments, the better.Little steps like this can, over a long retirement, really make a difference in your likelihood of not running out of money.

5 - Delay Social Security benefits. You are eligible to begin receiving Social Security benefits once you turn age 62. However, your starting benefits will increase approximately 7% to 8% every year you delay taking them from age 62 up to age 70, plus adjustments for inflation. By waiting until age 70, your benefit payment would have almost twice the purchasing power of what you would have received if you had started them at age 62. The majority of retirees, will come out ahead by delaying taking their payments for even a year or two.

Inflation Risk

It's vital to consider the impact of inflation on your income. Over the long term, inflation can dampen the real—or inflation-adjusted—returns on your investments. U.S. consumers have experienced average annualized price increases of 3% since 1926. Using that number as a guide, you can anticipate that your purchasing power will erode by close to half in the next 20 years. If you need $100 to buy an item when you are age 65, you probably will need nearly $200 to buy that same item when you are 85.

A good rule of thumb for a 30-year retirement is to withdraw no more than 4% of your retirement assets in the first year that you stop working—then increase your withdrawal amount every subsequent year by approximately 3% to keep pace with inflation.



Four common-sense strategies can protect your purchasing power through retirement.

1 - Continue to invest in equities. Be sure to continue to invest a significant portion (40% to 60%) of your portfolio in equities for your retirement—especially in the years between ages 55 and 75. Over the long term, equities have been shown to provide more growth potential than either fixed income investments or cash. Because you may need to support yourself with withdrawals from your nest egg for more than 30 years, it is important that you understand that you will need to dip into principal as you age. Income from dividends and interest only will not be able to sustain the needs of most retirees for that many years. Therefore, by continuing to rely on the growth potential of your portfolio, the amounts you can afford to withdraw are more likely to increase sufficiently to keep up with inflation. In other words, we are living in a different world than that of our parents and grandparents. No longer can we plan to spend the income and never invade the principal; instead, we must take measured withdrawal amounts from the portfolio each year, regardless of whether they are principal or income.

2 - Develop an inflation-adjusted withdrawal strategy. Your aim should be to live and spend comfortably while giving your savings a high probability of lasting up to 30 years or more, depending on your retirement age. A good rule of thumb for a 30-year retirement is to withdraw no more than 4% of your retirement assets in the first year that you stop working—then increase your withdrawal amount every subsequent year by approximately 3% to keep pace with inflation. In our studies, we found that if markets decline temporarily during your retirement, you can stop those increases for a few years to provide a little cushion. Then resume the increases later when markets have rebounded. This can greatly increase your odds of a successful retirement.

Remember that your lifestyle and spending can determine how inflation affects your retirement. The larger your withdrawal amounts each year, the more rapidly inflation will erode the remaining balance of your portfolio.

3 - Consider supplemental and long-term care health insurance. Inflation in health care has far outpaced the overall annual inflation rate. This trend makes it difficult to predict medical or long-term care costs 30 years from now and makes it important to consider Medigap insurance options to supplement Medicare—and to consider the costs of future premiums, deductibles, and potential copays. Most people should also look into purchasing long-term care insurance, since the cost of nursing home or other long-term care generally is not covered by Medicare. Unfortunately, these policies are becoming increasingly difficult to find. More insurance companies are leaving the marketplace because they do not want to be exposed to significant financial risks they could face as retirees live longer, due in part to rapid advances in medicine. Consider that, today, women live an average of 4.9 years longer than men, according to the Centers for Disease Control and Prevention. A longer life span means that women are likely to have greater medical expenses than men.

4 - Use Social Security as a backstop. Your Social Security benefits are increased each year for inflation, as measured by the consumer price index. In January 2012, for example, 55 million Social Security beneficiaries received a 3.6% bump in their monthly benefits. These inflation adjustments strengthen the case for delaying benefits as long as possible: The higher your initial benefit, the larger the dollar value will be of any cost-of-living adjustments. And if your portfolio were to be completely depleted, you would still have a predictable, steady stream of inflation-adjusted income for the rest of your life—and for the life of your surviving spouse as well.

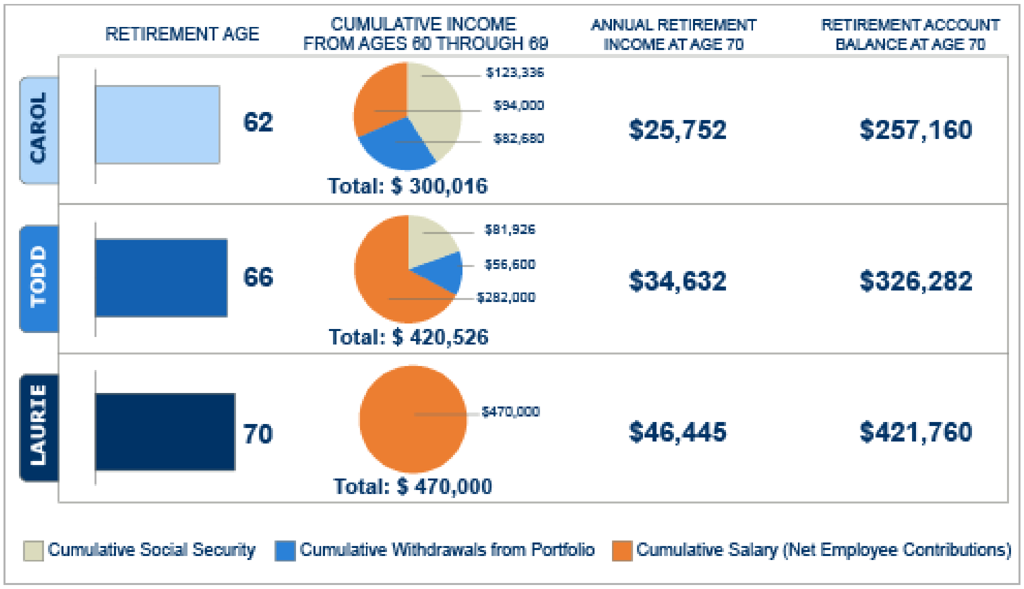
Look Ahead Together

Be sure to talk with your family about your plan for a long retirement. By letting members of younger generations know of your intentions, and what you do and don't expect from them, you can help them make their own financial plans. Those conversations, combined with sound risk-reduction strategies, will give you and your loved ones confidence that you have the financial security and flexibility to address your evolving needs throughout a long and fulfilling new chapter in your life.

Practice Retirement®: A Look at the Numbers

Staying in the workforce can significantly enhance your lifestyle during your transition years, while maximizing your income once you fully retire.

Consider the example of three 60-year-old preretirees—Carol, Todd, and Laurie. Each has a salary of $50,000, increased annually by 3% for inflation. Each has saved $250,000 in tax-deferred retirement accounts and will contribute 6% of gross pretax salary, garnering a 3% matching employer contribution, and delay Social Security and withdrawals until the stated retirement age. However, the three have chosen to retire at different ages—62, 66, and 70, respectively. The chart below shows the results of their individual choices: The cumulative amount of pretax money each is projected to be able to spend in his or her 60s; the amount of annual pretax income (Social Security benefits and portfolio withdrawals) each retiree is estimated to be able to spend at age 70; and each retiree's tax-deferred nest egg at age 70.



Sources: T. Rowe Price and ssa.gov.

This example is for illustrative purposes only and does not represent the performance of any particular investment.

All figures are shown pretax in today's dollars, discounted to age 60 at 3% annually. Preretirees are assumed to be age 60 with an annual salary of $50,000 and five times salary saved ($250,000) in their tax-deferred retirement accounts. All continue contributions from age 60 until the stated retirement ages, at which time they initiate Social Security and savings withdrawals. Employee contributions are 6% of gross pretax salary, plus 3% matching employer contributions, for a total of 9% contributed annually. Retirement asset growth is assumed to be 7% annually, preretirement. Inflation is assumed at 3% annually, applying to salary until retirement as well as to savings withdrawals and Social Security benefits beginning after the initial year of retirement. Assumed first-year savings withdrawal rates are based on the age retiring: 3.7% at age 62 through 4.5% at age 70, each year of delay adding 0.1% to the withdrawal amount; initial amounts increase 3% each year thereafter for inflation. Social Security benefits are estimated in "inflated (future) dollars" on the Social Security Administration's website at, ssa.gov (using the Quick Calculator, assuming a 0% Relative Growth Factor) and then discounted 3% annually to age 60.

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* Society of Actuaries and the National Association of Personal Financial Advisors (NAPFA), 2011.