Understanding Retirement Income Planning

When it comes to planning for retirement, most Canadians may not be as familiar with the term “wealth deaccumulation” as they are with the term “wealth accumulation”. This may be attributable to the fact that the past three decades have been the prime earning years for the largest and most influential portion of the Canadian population – the baby boomers (people born between 1946 and 1965[1]). Therefore, much of the focus around retirement planning in the past has been centred on wealth accumulation – the first stage of retirement planning. As Canadian baby boomers edge towards retirement, we are expecting to see the focus of retirement planning shift from wealth accumulation to wealth deaccumulation – the second stage of retirement planning, also referred to as “Retirement Income Planning”.

The planning strategies and considerations with respect to retirement income planning are very different from those employed during accumulation planning. Whether your own retirement is decades away or in the next couple of years, it is important to have your objectives established so that you can take full advantage of the time you have to prepare for a smooth transition to retirement.

To help you gain a better understanding of the wealth deaccumulation phase of retirement planning, this paper will discuss the following:

- What is retirement income planning?
- What are the five most significant risk factors to consider when building a retirement income plan?

What is retirement income planning?

Retirement Income Planning is about understanding whether or not a retiree is able to maintain a sustainable source of retirement income, while living the lifestyle they desire. Retirement income security is perhaps the most important financial goal for most retirees, and having a proper retirement income plan in place may provide peace of mind and allow retirees to live out their retirement dreams.

What are the five most significant risk factors to consider when building a retirement income plan?

Retirees in the deaccumulation stage face different risks than those who are accumulating wealth. When building a retirement income plan, it is important to take into account the following five risks factors.

1) Longevity Risk:

One of the key retirement planning risks for retirees is the risk of outliving their retirement savings. In general, Canadians are retiring earlier and living longer. Retirees need to consider the fact that they may live longer than they expected and thus need to ensure that sufficient income is available to fund these additional years in retirement. If retirees plan to save just enough money for retirement based on published life expectancies provided by agencies such as Statistics Canada, there is a chance that they could outlive their retirement savings.

Although we cannot control how long we are going to live, we can certainly mitigate longevity risk through proper retirement income planning. When building a retirement income plan and determining the appropriate life expectancy assumption, retirees should consider personal circumstances such as physical health condition, applicable hereditary diseases, and the level of longevity risk that they are willing to tolerate.

2) Inflation Risk

The loss of purchasing power over time due to rising consumer prices is known as inflation risk. In general terms, as time goes on goods and services become

[1] Defined by Statistics Canada, “The Daily: 2006 Census: Age and Sex,” July 17, 2007

more expensive. For example, if you purchase $1,000 worth of goods today, you would need about $1,486 to buy the same goods 20 years from now[2]. Hence, retirement income plans must factor in the erosion of purchasing power created by inflation.

If the effect of inflation is not considered during retirement income planning, it may undermine the retirees' ability to maintain their lifestyle and long-term financial security. Therefore, investment portfolios should be structured to generate an income stream that is able to outperform the rate of inflation, in order for retirees to minimize the erosion of their purchasing power over time

3) Asset Allocation Risk

Asset allocation refers to the process of diversifying investments within an investment portfolio among the major asset classes, such as cash, bonds, and domestic and foreign stocks. Asset allocation is considered the cornerstone of prudent investing and ensures that the structure and content of a portfolio accurately reflects investors' circumstances, objectives, risk tolerances and constraints. By diversifying investments across different asset classes, investors may reduce overall risk against market volatility while providing an opportunity for growth.

It is important to note that the asset allocation strategies and risks applicable to the wealth accumulation and deaccumulation phases of retirement are significantly different. In the wealth accumulation phase, we are often working with a relatively long investment time horizon which may allow investors' to recover from portfolio losses. On the other hand, when investors' are in retirement and drawing down on their assets during the wealth deaccumulation phase, they may not have the ability to fully recover their portfolio losses. This is mainly due to the erosion of capital caused by the withdrawals required to fund their retirement during periods of poor market returns. To minimize this risk, retirees generally seek lower-risk investments during retirement, and shortfall management becomes extremely important in ensuring that they do not outlive their retirement savings.

When determining an appropriate asset allocation for a retirement income plan, retirees should consider having an asset mix that is capable of providing the level of income necessary to meet their lifestyle needs, with the potential for growth. Investors may also turn to product allocation strategies to help maximize their retirement income, while minimizing financial risks. There are many products available that may be used to mitigate asset allocation risks, such as annuities and guaranteed minimum withdrawal benefits (GMWBs). Some of the important product features common to these types of products are:

- Principal protection
- Guaranteed lifetime income
- A wide range of investment options
- Protection from interest rate fluctuations
- Protection against market volatility
- Control over asset allocation
- Flexibility and access to cash
- Cost-effective and tax-effective transfer of assets upon death

4) Withdrawal Rate Risk

While an overly aggressive withdrawal rate may lead to the risk of depleting investment assets prematurely, an overly conservative withdrawal rate may also lead to unfavourable scenarios, such as greater estate tax liability at death, or insufficient income to fund retirement goals.

A commonly-used strategy to mitigate withdrawal rate risk is to determine the sustainable withdrawal rate (SWR). Essentially, SWR estimates the maximum periodic amount that can be withdrawn from an investment portfolio without depleting it prior to the end of the investor's investment time horizon.

For investors who are risk adverse, the determination of SWR can help illustrate what their retirement income may look like based on worst case historical returns. In addition, investors who believe their retirement is underfunded based on their SWR may want to consider incorporating alternative investment vehicles in their investment portfolio to generate greater retirement income.

5) Health Care Risk

Health and long-term care costs have been steadily increasing over the past number of years, and this has quickly become one of the key retirement planning concerns for Canadian retirees.

To mitigate health care risk, retirees may consider income protection under critical illness and/or long-term care insurance. Critical illness insurance provides a lump-sum payout in the event of a critical illness (e.g.

[2] Assuming a modest annual inflation rate of 2 percent.

stroke, heart attack, cancer, etc). Most policies cover a variety of major illnesses, and there is no restriction on how the money may be used. Long-term care insurance generally provides two types of policies – either to receive a pre-determined monthly amount or to be reimbursed for expenses.

As part of retirement planning, retirees must understand the coverage available under government programs and private insurance. Without adequate planning, unforeseen out-of-pocket health care costs may deplete retirees' retirement assets and impact their overall quality of life.

Final Thoughts

Retirement planning is a process that doesn't necessarily stop at retirement. As you transition from your working years and into retirement, proper planning becomes even more critical, as you will experience many different life events, needs and challenges throughout this time period.

If you are retired or soon to be retired, and would like to learn more about retirement income planning strategies, contact your TD Waterhouse advisor today.

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