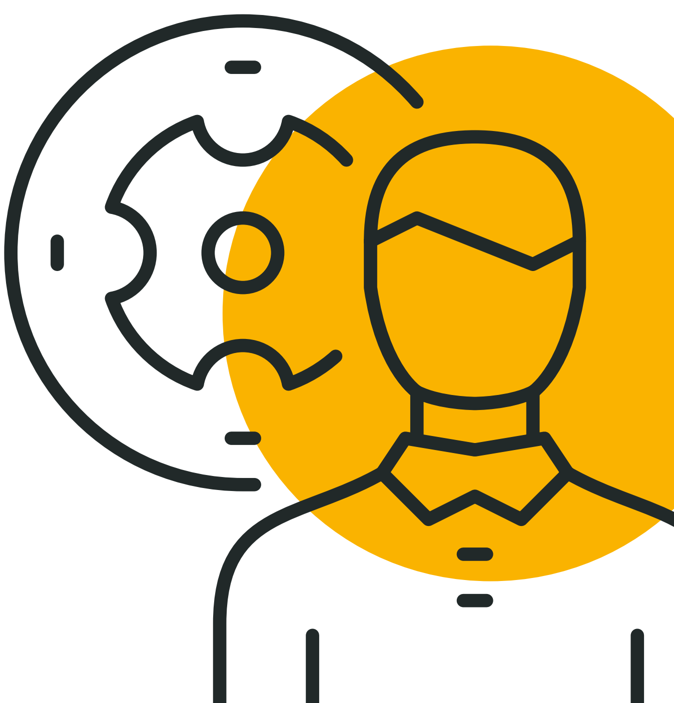
7 RISKS OF RETIREMENT PLANNING



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7 RISKS OF RETIREMENT PLANNING

By Wade Pfau, Ph.D., CFA

Retirement income planning has emerged as a distinct field in the financial services profession. While it suffers from many growing pains as it gains recognition, increased research and brainpower in the field have benefited retirees and those planning for retirement. One matter has become even clearer than before: The financial circumstances facing retirees differ dramatically from pre-retirees. For this reason, traditional wealth management approaches do not sufficiently address a retiree's needs.

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Below, I have outlined what I see to be seven financial challenges unique to retirees that must be taken into account when planning for retirement.

1 REDUCED EARNINGS CAPACITY

Retirees have a harder time making money. Whether it's because of physical limitations or limited job compatibility, it's simply not as easy to find an extra job and create a financial cushion against poor market returns.

2 VISIBLE SPENDING CONSTRAINT

While investments were once a place for saving and accumulation, retirees must turn that around and create an income stream from existing assets. Where investment risk was previously just a part of the financial picture along with salary and other income, it takes center stage, severely limiting spending.

3 HEIGHTENED INVESTMENT RISK

Retirees experience heightened vulnerability to sequence-of-returns risk once they are spending from their investment portfolio.

Poor returns early in retirement can force the sustainable withdrawal rate well below what is implied by long-term average market returns.

The returns experienced near your retirement date matter a lot more than most people realize. Retiring at the start of a bear market is incredibly dangerous. You might enjoy positive average market returns over 30 years of investing, but if negative returns are experienced in the early stages when you start spending from your portfolio, wealth can deplete rapidly through withdrawals, leaving a much smaller nest egg to benefit from any market recovery, even with the same average returns over a long period of time.

4 UNKNOWN LONGEVITY

The fundamental risk for retirement lies in this question: How long will your retirement plan need to generate income? Retirement can be much shorter or longer than a person's statistical life expectancy. Half of the population will outlive their statistical life expectancy, and some will live much longer. A long life is wonderful, but it costs more and is a bigger drain on a retiree's resources.

5 SPENDING SHOCKS

Unexpected expenses could relate to any number of matters: health and long-term care needs, fraud and/or theft, an unforeseen need to help other family members, changes in public policy, divorce, changing housing needs, home repairs, rising prescription costs... The list goes on and on. While contending with the other six risks mentioned here, retirees must maintain financial flexibility and liquidity to manage unplanned expenses. When budgeting for retirement, it is important to include a "rainy day fund" of sorts for surprises such as these.

6 COMPOUNDING INFLATION

Retirees face the risk that inflation will erode the purchasing power of their savings as they progress through retirement. While it may not be noticeable in the short term, even low inflation can have a big impact over a lengthy retirement. With just three percent average annual inflation, the purchasing power of a dollar will fall by more than half after 25 years. This is why it is so important that a portfolio be adjusted to account for inflation from year to year.

7 DECLINING COGNITIVE ABILITIES

Finally, a retirement income plan must take into account that a retiree will experience declining cognitive abilities, hampering portfolio management and other financial decision-making skills.

It will become increasingly difficult to make sound portfolio investment and withdrawal decisions as one enters advanced ages.

In addition, many couples don't share management of personal finances equally. When the spouse who knows what's going on financially dies first, the surviving spouse can run into serious problems without a clear plan in place. He or she can be left vulnerable to financial predators and other financial mistakes.

But there is still hope, as retirement plans can be built to manage these varying risks, hence retirement income planning's emergence as a distinct field.

To discuss your retirement plan, contact McLean online or call (866) 827-0636.

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