INVESTOR

Russell Investments

Understanding Longevity Risk

Helping you make informed investment decisions

russellinvestments.com/ca

All investors preparing for a future retirement face one common risk: that of outliving their savings.

Known as longevity risk, it is becoming one of the biggest issues in retirement planning as the world's population ages. Human lifespans are rapidly lengthening due to improved medical care, better nutrition, innovations in disease prevention and control, and a general increase in the standard of living. A child born in Canada today has a greater chance of living to 100 than ever before.

According to the 2016 census, life expectancy reached 79.6 years for men and 83.8 years for women, continuing the steady increase seen since the start of the previous century. But many of us live far longer. Indeed, the number of people in Canada aged 85 and older grew by more than 19% between 2011 and 2016 – nearly four times the rate of the overall Canadian population, while the number of centenarians (those aged 100 or older) grew by more than 41%.[1]

Living longer is great, but paying for increased longevity can exhaust your wealth if you don't plan ahead. That's especially true if you have unexpected cash demands or emergencies that deplete your savings.

Increased longevity means retirement planning now encompasses a wide range of issues related to getting older: higher health care costs over time, reduced mobility, the potential need for long-term care and/or a different type of housing as we age. All will impact the level of income you require.

While you can't predict how long you'll live, by planning for a longer retirement you can avoid running out of money when you need it most. Some of us could reasonably expect to spend as many (or even more!) years in retirement as we did working. More than ever, retirees need to consider portfolios that have the potential to produce steady income over an entire market cycle.

Moreover, the longer we live, the more vulnerable we are to two other risks: inflation risk and investment risk.

Inflation risk

Even a 2% inflation rate will reduce the purchasing power of your money over time. If you are concerned with maintaining the same anticipated lifestyle throughout your retirement, you'll need to build in inflation protection. A portfolio that provides an absolute return above inflation is one potential option.

Inflation can significantly erode a portfolio's returns, especially if markets are volatile. For example, if your portfolio returns 6% in one year, but inflation is 2%, then the "real" return you receive is only 4%. And if markets fall by 6% in a year, and inflation remains 2%, then the "real" return of your portfolio will be -8%.

This is a greater risk to those who rely on their portfolios to sustain their standard of living – such as retirees, who no longer have a salary that could increase over time.

Investment risk

Anyone who invests in the capital markets faces investment risk, but the concept of "sequence of returns" makes this a crucial concern in the years just preceding or just after the date of retirement.

While volatility is a fact of life in the markets, younger investors can have years or even decades to recover from downturns before they need to begin drawing income from their portfolios. Those nearing or just entered retirement don't have that option.

[1] Source: http://www12.statcan.gc.ca/census-recensement/2016/as-sa/98-200-x/2016004/98-200-x2016004-eng.cfm

As an investor, you face your maximum risk exposure the day you retire. That day marks the start of the longest period of time in which you will need your savings to provide income. Your assets have likely peaked and your ability to save further is limited. A downturn in investment returns during this period can have a significant impact on your portfolio. The risk in the "sequence of returns", or sequential risk, means poor returns early in retirement are much more harmful to your nest egg than poor returns later in retirement.

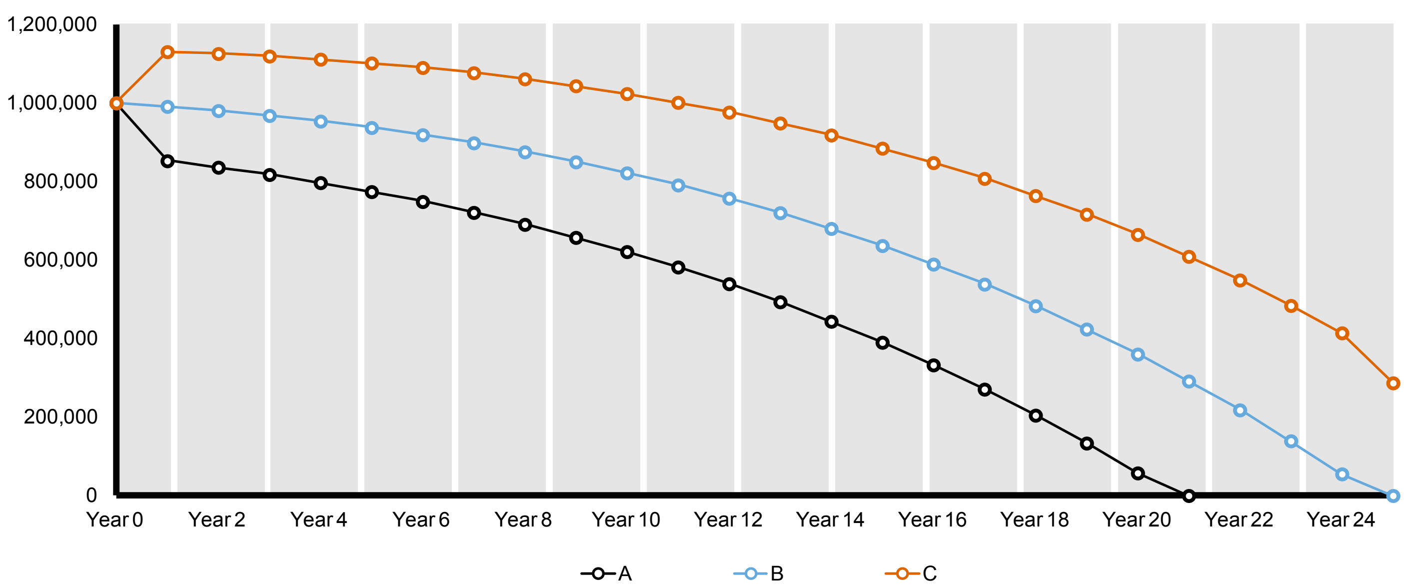
The chart below illustrates the concept using three portfolios (A, B and C), each with a starting balance of $1 million and an asset mix of 65% equities and 35% fixed income. The annual withdrawal from each portfolio is $50,000, indexed at 2.5% annually.

As you can see, its crucially important to avoid, or limit, drawdowns in your portfolio's value at the start of your retirement. Indeed, since you can't predict what markets will do, it seems prudent to consider the steady middle path (Portfolio B).

During your working career, your focus is to accumulate wealth. After retirement, the focus becomes on drawing income. How to drawdown income from your savings in a manner that ensures you always have some, is the only way to counter longevity risk.

	RETURN SEQUENCE		
PORTFOLIO	**A**	**B**	**C**
Starting Balance		$1,000,000	
Withdrawal amount (indexed at 2.5%)	$50,000	$50,000	$50,000
Return Year 1	-10.0%	4.2%	18.5%
Return Years 2-24	4.2%	4.2%	4.2%
Return Year 25	18.5%	4.2%	(10.0)%
Average return for 25 years	**4.2%**	**4.2%**	**4.2%**

RESULTS			
How long money lasted	21 years	At 25 years	At 25 years
Value at end	$0	$0	$286,904



INVESTOR is published quarterly by Russell Investments.
Please direct comments or questions to your financial advisor.

Date of first publication: July 2018

RETAIL-02282 [EXP-06-2020]