

Retirement income planning: Can we have our cake and eat it too?

Executive summary

Retirement income planning is a compromise. As Canadian baby boomers enter retirement, there is considerable concern, anxiety and confusion as to how to plan their retirement income. As with so many things regarding personal finances, there are many different and conflicting possible courses of action.

Canadians who are in retirement or close to retirement want to have the ability and flexibility to react to unexpected events. They also want to maintain their lifestyle, they want to have a guaranteed income, and they are worried about outliving their money. As for their investments, they want to participate in asset growth during boom times, but they also want to be insulated from bear markets.

In deciding on their personal retirement income strategy, Canadians must above all recognize that they cannot have their cake and eat it too. In this report, the BMO Retirement Institute identifies what Canadians believe are important elements of a retirement income plan and examines why it will be difficult, if not impossible, to attain all of them without making some concessions.

The BMO Retirement Institute was established in 2008 to provide thought-provoking insight and financial strategies for those individuals planning for, or currently in, their retirement years.

Tina Di Vito, CA, CFP, TEP
Head, BMO Retirement Institute
Director, Retirement Strategies
BMO Financial Group

Contact the Institute at
bmo.retirementinstitute@bmo.com

I'm ready to retire. Now what?

In the past decade, much of the discussion around retirement planning focused on the accumulation stage: How much will I need? How much should I be saving each year? What kind of investments should I be making to reach my goals? But now, as many Canadians approach retirement, attention is shifting to the next stage, “decumulation”: How will I receive my retirement income? How can I ensure that I can maintain my lifestyle?

As Canadian baby boomers enter retirement, there is a lot of concern, anxiety and confusion as to how to plan their retirement income. As with so many things regarding personal finances, there are many different and conflicting possible courses of action.

In a survey commissioned by the BMO Retirement Institute in December 2010, 604 retired Canadians and 523 Canadians who plan to retire in the next five years were asked to express their main concerns about retiring and the strategies they are adopting to address those concerns.

Although survey respondents were concerned about remaining in good health and about enjoying the rest of their lives, the biggest concern was having enough money to survive on a fixed income, with 39% of retirees and 45% of pre-retirees citing this as their main concern; the next highest concern — health — was cited by only 13%–14% of respondents. When asked about considerations important to them in retirement planning, 93% of all survey respondents said that having enough money to maintain their current lifestyle is important.

If having enough money to survive on a fixed income and maintaining their lifestyle during retirement were the only concerns, there are a number of solutions that could address this. However, these solutions may conflict with other considerations equally important to them, such as the ability to pay for emergency cash needs (which an overwhelming 95% of all survey respondents cited as an important consideration in retirement planning).

In this report, we identify the main goals of Canadians who are in retirement or close to retirement — having the ability and flexibility to react to unexpected events, maintaining lifestyle, having a guaranteed income and not outliving their money — and examine why it will be difficult, if not impossible, to attain all of them without making some concessions.

Of all survey respondents, 93% said that “having enough money to maintain my current lifestyle” is important in retirement planning.

Breakdown of respondents:

Already retired95%
 Planning to retire
 in next five years91%

Those who think that “having the ability to pay for emergency cash needs” is important in retirement planning.

Breakdown of respondents:

Already retired95%
 Planning to retire
 in next five years96%

Retirement income planning has taken on a certain urgency, not only because the baby boom generation is reaching retirement age, but also because a number of developments have changed the situation for them.

Happy 90th birthday

Notable among these developments is the steady improvement in life expectancy. Many more people will be around to celebrate their 90th birthdays than in the past — but will they still have enough retirement income to afford the cake? Nobody knows how long they will live, nor, therefore, how long they will need to rely on their retirement savings. According to Statistics Canada, a 65-year-old man can expect to live an additional 18.1 years (to age 83), while a 65-year-old woman can expect to live an additional 21.3 years and celebrate her 86th birthday.¹ But people forget that, by definition, 50 per cent of them will live longer than the median life expectancy. People therefore tend to underestimate the likelihood that they will survive 25 — or perhaps 30 or more — years after retirement. In fact, when a healthy couple enters retirement at age 65, there is a 50 per cent chance that one of them will live to be 92, and a one-in-four chance that one will live beyond 97.²

Bulls vs. Bears

Another uncertainty is the timing of returns (or sequence of returns) — the possibility that the market will have poor or negative returns about the time one is starting to draw down one's retirement savings. A bad year or two in the early years of the retirement phase can have a major impact on how long the retirement savings will last. That is because one has to draw down the capital in an already shrunken asset.

For instance, the recent market downturn of 2008 put a major dent in the retirement savings of many Canadians. For those in the accumulation stage and for whom there is still time before retirement to recoup losses, the market decline may even have represented an investment opportunity. Indeed, the market has essentially returned to pre-2008 levels already. But for those who were on the verge of retirement, the downturn may have altered their retirement plans significantly. The experience may have shaken their faith in the market's ability to provide sustainable earnings, causing them either to resign themselves to living with less or, in some cases, to postpone their retirements.

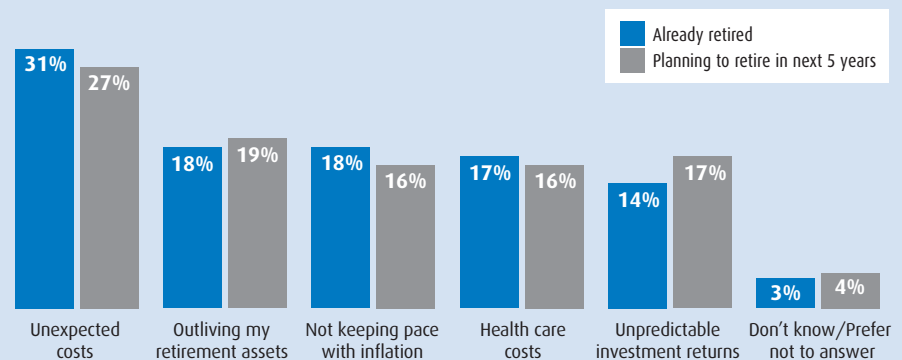
Decline of DB pension coverage

The third development is the trend away from defined benefit (DB) pension plans towards defined contribution (DC) plans. Recipients of DB pensions need only to choose when to begin receiving their benefit; the amount they receive, by definition, is already known, and will be payable for life. By contrast, the holder of a DC pension plan needs to consider not only the timing but also the manner in which the accumulated funds will be invested and distributed: how much, and for how long?

What will tomorrow bring?

No matter how long one lives, there is the ever-present uncertainty about health care expenses at some point — expenses that exceed the basic day-to-day expenditures that figure in most retirement plans. Indeed, when asked to rank a number of risks when planning their retirement, our survey respondents overwhelmingly selected unexpected costs as the biggest risk, ahead of outliving their retirement assets, not keeping pace with inflation or unpredictable investment returns. Paying for these expenses may require drawing down capital, which, in turn, will have an impact on how long one's retirement savings will last.

When asked, what do you consider to be the biggest risk when planning your retirement?



Guaranteed income for life — but at what price?

Given the concern about having enough money to survive on a fixed income, people without defined benefit pensions — the majority of Canadians — may feel a certain envy of those who have them.

Lower-income Canadians may find their retirement income needs largely met through government pension plans, which provide a predictable, indexed monthly benefit for the remainder of their

Those who agree with the statement “I prefer a guaranteed retirement income stream each month, even if I have to give up the potential for future growth of my money.”

Breakdown of respondents:

Already retired65%
 Planning to retire in next five years69%

Of all survey respondents, 67% agree with the statement “Having flexibility to deal with contingencies (such as home repairs, family emergencies or health care expenses that may arise in later life) is more important to me than ensuring a predictable retirement income for life.”

Breakdown of respondents:

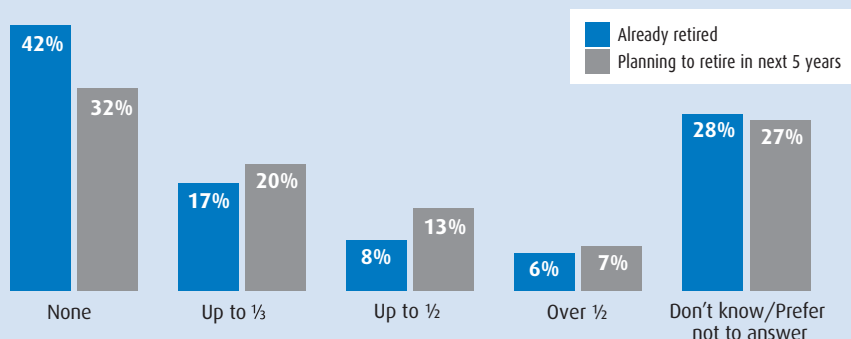
Already retired69%
 Planning to retire in next five years65%

lives.³ At the other end of the spectrum, people who have amassed a vast enough fortune to be able to live off investment returns alone will probably not have to worry about how much they can spend in retirement either: by definition, they will never run out of capital. To be able to do this, however, entails building up a large capital base, and may be out of the reach of the average person. For the rest of us, how can we be sure that our accumulated savings over a lifetime of work — our RRSPs, TFSAs, other investments and the equity in our homes — will be enough to enable us to lead a comfortable life in retirement, as well as meet any unexpected expenses along the way (emergencies, home, repairs, health care expenses, etc.)?

There is always a trade-off between risk and return, and in order to ensure a predictable income stream, one may have to give up some return in order to achieve stability. Indeed, in exchange for not having to worry about how market ups and downs will affect their retirement income, over 70% of all the survey respondents are prepared to give up opportunities to increase their income if the market goes up. Over 65% also prefer a guaranteed retirement income stream each month, even if they have to give up the potential for the future growth of their money.

In achieving predictability, however, one may also have to sacrifice some control and flexibility. It is here that Canadians want to have their cake and eat it too. Of all the survey respondents, 67% considered having the flexibility to deal with contingencies, (such as home repairs, family emergencies or health care expenses that may arise in later life) to be more important than ensuring a predictable retirement income for life. Nearly 40% of all survey respondents, when asked what they are prepared to give up control over in order to receive guaranteed income for life, said they would not give up any of their retirement savings. Only 18% are prepared to give up no more than one-third of their retirement savings.

In order to receive guaranteed income for life, what percentage of your retirement savings are you prepared to give up control over?



Perhaps this is why traditional life annuities, which are designed to provide one with a guaranteed, predictable, lifetime income stream, have not met with greater popularity. In the Institute's survey, even among those who view outliving their assets as the biggest risk they face, only about one in ten chose annuities to address their concerns. Research in the U.S. also indicates that annuities attract only five per cent of the potential market for annuitization.⁴ A 2009 survey conducted in the U.S. also found that people are generally unfamiliar with annuities or have no opinion of them. Of those who do have an opinion, many found them too complex or expensive.⁵

Aside from lack of understanding, one of the major objections to annuities is that one has to give up control. One gives up investment decisions, as well as the opportunity to benefit from potentially superior market performance. One also gives up control over one's capital (in exchange for a reliable income stream), which severely hampers one's ability to deal with unexpected expenses that may arise in future. There is also the lurking risk that if one dies early, one will not have received the hoped-for return, and meanwhile one's heirs will receive nothing. This concern about legacy is not insignificant: more than one-half of our survey respondents feel it is important to be able to leave money to their heirs, so for them annuities probably have little appeal. It is worth noting that the lack of liquidity and inability to leave a legacy also apply to those who receive a defined benefit pension.

In the next section of this report, we will take a look how some additional features of annuities, as well as newer guaranteed lifetime income products that the financial services industry has introduced in recent years, seek to address these concerns. First, however, we will examine alternative strategies that have been widely adopted in the quest to create a sustainable retirement income stream.

Hedging your bets — keeping your options open

We have seen that the overwhelming majority of our survey respondents consider having enough money to maintain their current lifestyle as important.

For those who rely on their own retirement savings, in order to ensure that their lifestyle can be maintained throughout retirement, their retirement assets must not be depleted during their lifetime. We have already discussed how market performance and life expectancy can affect how long one's retirement assets will last. There is, however, another factor that cannot be overlooked: inflation.

How much for a latte in 2036?

For people reaching age 65 in 2011, inflation over their lifetime has averaged about four per cent per year.⁶ The basket of goods that cost their parents \$100 in 1946 would cost more than \$1,200 today. While inflation has slowed somewhat in recent years, it has still averaged more than two per cent for the past 25 years.

If inflation averages four per cent annually over the next 25 years, an annual income of \$50,000 today will need to grow to over \$130,000 in 2036, 25 years from now, for the recipient to maintain his or her living standard. Even if inflation is at the lower rate of two per cent annually, the income will need to grow to over \$80,000 in 2036 for the recipient to maintain his or her living standard.

Assuming an inflation rate of 4%, what income will you need in future to match today's purchasing power?

INCOME	10 YEARS	15 YEARS	20 YEARS	25 YEARS	30 YEARS
\$30,000	\$44,407	\$54,028	\$65,734	\$79,975	\$97,302
\$40,000	\$59,210	\$72,038	\$87,645	\$106,633	\$129,736
\$50,000	\$74,012	\$90,047	\$109,556	\$133,292	\$162,170
\$60,000	\$88,815	\$108,057	\$131,467	\$159,950	\$194,604
\$70,000	\$103,617	\$126,066	\$153,379	\$186,609	\$227,038
\$80,000	\$118,420	\$144,075	\$175,290	\$213,267	\$259,472

Assuming an inflation rate of 2%, what income will you need in future to match today's purchasing power?

INCOME	10 YEARS	15 YEARS	20 YEARS	25 YEARS	30 YEARS
\$30,000	\$36,570	\$40,376	\$44,578	\$49,218	\$54,341
\$40,000	\$48,760	\$53,835	\$59,438	\$65,624	\$72,454
\$50,000	\$60,950	\$67,293	\$74,297	\$82,030	\$90,568
\$60,000	\$73,140	\$80,752	\$89,157	\$98,436	\$108,682
\$70,000	\$85,330	\$94,211	\$104,016	\$114,842	\$126,795
\$80,000	\$97,520	\$107,669	\$118,876	\$131,248	\$144,909

Since inflation increases the amount of money that you will need to withdraw in order to maintain your lifestyle, even those who can rely on a fixed lifetime income stream, whether from a DB pension or other guaranteed-income product, may find their spending power eroded by inflation, unless the pension benefit/

income is fully indexed to inflation. Moreover, even fully indexed pension benefits tend to peg their increases on general consumer price indices, which may not fully reflect the price changes that affect seniors (e.g., medical expenses may have a higher inflation rate than general inflation rate).

The potentially devastating effect of inflation on retirement income is recognized by a majority of our survey respondents: 56% considered not keeping pace with inflation as one of the top three risks when planning their retirement, and 17% cited it as the top risk.

In order to reduce the eroding effect of inflation on one’s purchasing power, it is important to include investments with growth potential. Here again the risk-reward conundrum comes into play: to keep pace with inflation, one needs equity investments to retain growth potential in a retirement portfolio, but growth investments will be subject to market fluctuations. So how can one ensure that market fluctuations — a fact of life — will not jeopardize the sustainability of one’s diversified retirement portfolio?

Sustainable withdrawals

One spend-down strategy designed to prevent outliving one’s assets, and at the same time maintain a diversified asset allocation that includes growth potential, is to adhere to a sustainable withdrawal rate. William Bengen concluded from his research that retirees could withdraw about four per cent of their portfolio in the initial year, and similar amounts adjusted for inflation in subsequent years, and stand a reasonable chance of having their portfolios outlive them.⁷ In his calculations, Bengen assumed a tax-deferred baseline portfolio consisting of stocks and bonds, with investment returns and inflation based on historical data, and a portfolio time horizon of 30 years (carrying a person through from age 65 to 95).

This strategy has, however, two potential shortcomings.

From a behavioural point of view, people often respond to challenging market conditions with impulsive, emotional actions (e.g., selling off all equities in a bear market). About half of all our survey respondents indicated that they would be extremely concerned if their retirement savings were to drop 15%–20% in a year due to difficult market conditions, and that they would make drastic changes to their asset allocation to reduce their exposure to equities. Such precipitate decisions may have adverse consequences for the long-term sustainability of a portfolio.

Those who agree with the statement “If my retirement savings drop by 15%–20% in a year due to difficult market conditions, I will be/would be extremely concerned and will/would make drastic change to my asset allocation to significantly reduce the equity component.”

Breakdown of respondents:

Already retired 48%
 Planning to retire
 in next five years56%

In addition, since the withdrawal rate is determined by a preset formula, it may not adequately address the concern about unexpected costs, which our survey respondents identify as the top risk when planning for their retirement (ahead of outliving their assets and unpredictable investment returns). An unexpected expense could mean that a significant withdrawal must be made that exceeds the 4 per cent threshold, throwing into doubt the continued sustainability of the portfolio.

Asset dedication

An alternative retirement spend-down strategy that specifically addresses contingency needs is the asset dedication or “bucketing” strategy, which involves the creation of separate pools of assets for different objectives. For example, one pool could be set up to handle the most immediate short-term income needs (e.g., basic living expenses for the next three to five years); a second pool could be set up for longer-term basic lifetime income; a third for discretionary expenses (travel, home improvements, gifts to family or charity); yet another for emergencies and future health expenses, and so on. The pools earmarked for short-term needs and basic lifetime income would be invested conservatively, while those geared toward longer-term objectives could be more aggressively invested. With the peace of mind that comes from having assurance that one’s short-term cash needs, basic long-term needs and unforeseen needs are covered, one should find it easier to remain committed to investing for growth (for a portion of one’s portfolio) in the face of market volatility.

Guaranteed lifetime income products

Despite the merits of the asset dedication approach, it does require discipline and regular monitoring. For people who prefer a less hands-on approach, and yet are not yet prepared to hand over complete control, the financial industry has introduced new guaranteed lifetime income products that combine a predictable and guaranteed income stream with added features such as participation in equity market performance and liquidity options that allow for lump sum withdrawals to deal with emergency expenses.

The original guaranteed lifetime income product, the life annuity, can also be enhanced with specific features to alleviate concerns about early death, purchasing power and unplanned-for cash needs. For people who are concerned about early death, life annuities can be purchased with guaranteed periods. Joint and survivor annuities

can be purchased to ensure payments are guaranteed for the life of a spouse or partner. Inflation adjustment can be purchased to deal with rising cost of living. More recently, liquidity options have also become available for people who are concerned about unexpected lump sum expenses that may arise in the future. Even the desire to leave a legacy can be addressed through the use of an insured annuity strategy.⁸

As with most things in life, there is give and take. All of these solutions come with their own price tags: adding enhanced features to guaranteed payout products will have an impact on the size of the payout; incorporating participation in market performance will translate into higher management fees (which will in turn limit the extent to which one actually shares in the market performance); and where withdrawing a higher amount than the contractual withdrawal amount is permitted, the guaranteed payout itself may be adjusted downward as a result.

Nonetheless, these hybrid products may have strong appeal for those who are prepared to give up some growth in return for guaranteed income, and those who are prepared to settle for a reduced guaranteed income in order to preserve flexibility and the ability to deal with unexpected needs.

To thine own self be true

In retirement income planning, is there a perfect formula that will work for everyone as a rule of thumb? Regrettably, there is not — although financial services professionals have been striving to find one.

Canadians entering retirement want guaranteed lifetime income. At the same time, they are unwilling to give up control and flexibility. They are also apprehensive about lack of liquidity and how they can cope with unexpected expenses that may arise. Last but not least, they are concerned that inflation can diminish their living standard. They are frustrated, because they want it all, but are facing the reality that no one investment solution will satisfy 100% of their needs, because while there are many possible strategies and options in retirement income planning, each is designed to address different considerations, and each has its own strengths and weaknesses.

In deciding on their personal retirement income strategy, Canadians must, above all, recognize that they cannot have their cake and eat it too. They should make an honest assessment of what they need and value most and what they are prepared to give up, and choose the appropriate product or strategy that will best enable them to achieve

those needs with a price tag that they are prepared to live with. One's individual situation (e.g., age, risk tolerance, wealth level and life expectancy), as well as one's individual goals (e.g., preserving flexibility and control, leaving an inheritance) will determine which solution — or combination of solutions — is best. It is also important to start thinking early, since the successful implementation of one's strategy may involve taking action well before retirement.

Finally, one should remember that there is no 100% certainty in life. No plan, however well thought out — based on the best information available, a realistic response to current conditions and reasonable assumptions about the future — can be guaranteed to protect against every single contingency. Just like people in other phases of their lives, people in retirement will need to stay flexible and be prepared to make adjustments to their retirement income plans in response to changing conditions.

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1. <http://www.statcan.gc.ca/daily-quotidien/100223/t100223a1-eng.htm>
2. Wharton Financial Institutions Center Policy Brief: *Personal Finance, Investing Your Lump Sum at Retirement*, by David F. Babbel and Craig B. Merrill. August 14, 2007.
3. S. LaRochelle-Côté, J. Myers and G. Picot (2010). "Replacing Family Income During the Retirement Years: How Are Canadians Doing?" Statistics Canada, Catalogue no. 11F0019M – No. 328.
4. James Mitchel and Matthew Drinkwater. *Behavioral Economics and Annuitization*. LIMRA International, 2006.
5. *Household Opinion of Annuities*, 2009. Sources: Cerulli Associates, Phoenix Marketing International.
6. Source: Based on data from Statistics Canada, Consumer Price Index, historical summaries from 1946 to 2010: <http://www40.statcan.gc.ca/l01/cst01/econ46a-eng.htm>
7. Bengen introduced his sustainable withdrawals theory in "Determining Withdrawal Rates Using Historical Data," an article that appeared in the October 1994 issue of *Journal of Financial Planning*.
8. The insured annuity strategy involves using funds to purchase a prescribed annuity contract as well as an exempt life insurance policy. The annuity generates a tax-advantaged payment stream that also covers the life insurance premiums. When the annuitant dies, the life insurance proceeds are paid out to their beneficiaries in a tax-efficient manner.