Penguin Bitesize Guides to Better Money Management

Guide #11

Six Big Risks to Your Retirement – and How to Manage Them

1. Inflation

Inflation can upset any retirement plan, and it is surprising how even lower rates of inflation can bite.

Look at this table to see how an income of £24,000 per year devalues over a 20- and 30-year period:

	3% per year	5% per year	7% per year
20 years	£13,288	£9,045	£6,202
30 years	£9,888	£5,553	£3,153

So, imagine your position if your income dropped to these levels in the future, later in retirement?

Every part of your retirement plan or strategy must be tested against inflation risk.

You should plan to grow your income in retirement. You cannot simply aim for an income figure when you first retire and assume this will be enough to carry you through the next couple of decades or longer.

Aim to use investments or financial products which provide for your income to increase year on year.

2. Sequence of returns

Not enough people know about or understand this risk.

The current trend, a good one, is for people to keep their savings and pensions intact in retirement, and to draw an income from these areas. This is commonly called drawdown.

For example, if your savings/pensions are a total of £200,000 and you draw down 4% each year, you generate an income of £8,000 per year.

The problem is that to make this work over a long period, you need to grow the £8,000 figure, if possible, to cater for the inflationary aspects referred to above.

This means you need to invest your £200,000 in higher risk funds or asset areas, such as shares and property.

These are higher risk because they can fall in value.

This is where sequence of returns risk comes into play, as we can evidence with this simple example:

£100,000 portfolio | £10,000 annual withdrawal each year

	Portfolio Gain/Loss	Portfolio Value (end of year)
Year One	-50%	£40,000
Year Two	+100%	£70,000
Year Three	-50%	£25,000
Year Four	+100%	£40,000

This may be an extreme example, but it illustrates the effect.

The portfolio gain/loss is zero, the price of the investments has not changed, for an investor taking no withdrawals, they would still have £100,000 in value.

The value for the drawdown investor is £40,000 - a 60% loss of capital. They have had £40,000 in withdrawals in total.

(Incidentally, if you carried on this fluctuating picture year five, six, seven, eight – your Portfolio Value you would run out of money in year seven……)

This is the sequence of returns effect – if you draw from your savings/pensions and get early year losses of any significance (a very real risk) it could upend your retirement plans.

The risk of sequence of returns is heightened during the first period of your retirement. Some experts say that if you have a poor first period (say ten years out of thirty) then your entire retirement plan can be ruined. This means you could run out of money or must except much lower income later down the line.

3. Retirement calculators

This may not be the most obvious risk. This is closely related to point two above, and to other risks we cover in this short guide.

Many calculators freely available online perform a simple mathematical function based on cashflow projections. Expert Dr William Bernstein refers to these as 'retirement calculators from hell'. This is because they make a dangerous assumption – that your expected rate of investment return is the same every year. However, as described in point two, this doesn't work in the real world.

In addition, multiple pieces of research relating to typical retirement income and expenditure needs – based on studying actual retirees and their spending patterns – show that retirement expenditure is rarely level. Most people need variable sums at different times.
It's not just the sequence of returns which matters, but also the pattern of your retirement expenditure.

Both are likely to fluctuate considerably, and these mixed patterns create a completely different outcome to those predicted by a typical retirement calculator which assumes everything is level and even.

4. Longevity

Living a long time might be positive in many ways, but financially it can prove troublesome.

Longevity risk is a way of saying that if you live to a ripe old age, you will need your savings, pensions etc. to provide for you, for a much longer period – and you may not have enough provision to cope.

The risk is that you set out your spending plans to be adequate to cope with a typical life expectancy, but if you live to 100, you run out of money or – more likely – you have to live off a much-reduced income.

Another factor, important to many people, is that the longevity involves depleting wealth to such an extent that a legacy is heavily reduced or lost.

You cannot plan to be "OK" if you live to age 86, but financially destroyed if you live to 100.

5. Health and care needs

However resilient the NHS is proving to be, the fact is that there are a range of health care needs which can prove very expensive in retirement. The most extreme being a need to go into residential care. Privately funded care home costs can easily run into hundreds of thousands within a few years.

Many health problems can incur costs, some are often hidden or secondary costs, such as needing to travel regularly to appointments or having to adapt a property.

The risk to health seems to increase the older one gets, so the expensive aspects to this can come later in retirement.

In the worst cases, healthcare can be an enormous strain on finances and present a real risk that must be factored in when planning ahead.

6. Investment and asset prices

Many retirees continue to invest and rely on investments and assets in retirement. Despite some volatility in the past 40 years, this has largely been a period where investment and asset prices have gone up, and in some decades by a decent amount.

One of the key behavioural finance biases is something known as recency bias. This describes a decision-making approach influenced by the most recent experiences or outcomes taking precedence over past ones.

Investors can therefore be fooled into thinking "more of the same". History tends to show the opposite, that the experiences from generation to generation are very different.

Someone retiring in the 1970s, for example, would have been faced with a completely different financial situation to someone in the 1990s and so on.

The danger of multiplying your risk

One aspect of considering your risks in retirement, which is often neglected, is the dual risk or worse effect.

For many retirees they can cope with one risk, but it is when two or more combine, serious problems arise.

If you have large market falls and high inflation and you need care, then it is very easy to see how a situation can become untenable.

Many risks are linked, so this is quite a problem.

How to manage the risks you face

Too many retirees set their plans on a course where they are hoping for the best. Generally, the period 2000-2020 produced the right conditions to support a standard retirement strategy.

There was very little inflation, investment markets, despite two volatile periods, generally performed in line with targets, especially post 2010. Government provided good support to state pensions and health care, albeit at a high cost to overall public deficits and debt.

The next 20-year period may not be so kind.

The six risks referenced in this guide are not the only risks you face.

With nearly all risks you face in managing your finances through retirement, you are unable to remove them as a threat, but you can take steps to protect yourself.

What is the best way of doing this?

There are several steps.

- Be aware of them. For example, many people, who invest in volatile assets to draw an income, are not conversant with sequence of returns risk.
- Work through them by scenario planning. Look at all the risks you can think of and then test what happens to your finances if they manifest. Use cash flow forecasting software to help you do this.
- Explore insurance and safeguarding options. Insurance doesn't necessarily mean taking out an insurance policy (although it could do, Private Medical Insurance as an example). It could mean building in downside protection to an investment portfolio, or using guaranteed income products, or instigating a Power of Attorney arrangement to help with financial care decisions.
- Have a financial plan. It's easy to think of a plan as something you have as you work towards retirement, and then when you get there you put your feet up. Arguably, the risks in retirement are higher than they are before retirement. A plan is crucial.
- Work with a great adviser, a firm or an individual who understands the retirement risks and how to dynamically manage the changing nature of a typical retirement period.

About Penguin Wealth

We are a Cardiff-based Financial Planning firm formed in 2010 by a group of Financial Planners who share the same vision and love for what we do. Our processes, support team and the accreditation we have achieved all reflect our principles and prove that we are best placed to help you live the life you deserve with peace of mind.

Our Mission Statement

Helping People Live their Best Lives, by Making Smarter Financial Decisions.

Core Values

- At Penguin we Commit to our Words, Actions and Results
- Clients' Needs 1st – Always
- Communication is key
- Have Penguin Positivity

Providing the highest standard of advice is at the heart of what we do, and we are always extremely excited to see what we can help you to achieve in the future!

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