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CASHING OUT

YOUR RETIRING CLIENTS NEED YOU TO DEVELOP INCOME SOLUTIONS.

One of the longest anticipated, and planned for, retirement waves **HAS ARRIVED.**

The first of the baby boomers have left the workforce; and that means retirement income planning is becoming a prominent issue. As with everything else they have touched, the boomers will change the face of retirement.

There are many challenges facing a planner who must balance the needs of this demographic with the realities of influencing factors such as inflation rates, stock market risk and healthcare costs. Underpinning this list of challenges is the fact that most Canadians will need a significant portion of their investment capital to fund their desired retirement income levels for the rest of their lives. While capital

preservation is always an important objective, in many client situations it isn't feasible. Besides, it's no longer safe to assume that interest or earnings generated from an investment will be sufficient to maintain a client's retirement income.

A more comprehensive strategy for retirement income planning must come into play and it needs to let clients systematically dig into their capital. When push comes to shove, few baby boomers will voluntarily downgrade their lifestyles when inflation reduces purchasing power. The primary source of income for most clients entering retirement will be their RRIFs and pension entitlements, so you'll want to incorporate enough safeguards to maintain income levels without being so cautious that a

client's standard of living is needlessly reduced. Succeeding here will require constant maintenance and monitoring of a client's personal situation and portfolio.

Life Expectancy

Longevity risk presents planners with a major challenge. If we knew with certainty how long clients would live, our jobs would be simple. And life expectancy is one of the most misunderstood aspects of retirement income planning. Most people assume life expectancy is the same as lifespan. Not true. Life expectancy is a median number of years a particular group will reach. Roughly half will die before and half after.

In other words, a man who is 65 today has a life **continued on page 20**

continued from page 19 expectancy of 19 years, but there's a 50% chance he'll live longer. And, interestingly, there's a 30% chance he'll live to see his 90th birthday. Meanwhile, a 65-year-old female is expected to live for another 21.5 years (86.5). But she has a 50% chance of living longer, and a 41% chance she'll see her 90th birthday.

The results for a couple, both aged 65, are even more interesting—now there's a 58% chance that one of the two will survive to see his or her 90th birthday.

In addition, advances in medical science mean historical numbers are probably understated. The risk of your clients outliving their funds is huge, so you need to deal with this issue proactively.

Rate of Return

In producing any long-term financial illustrations, you need to make certain rate-of-return assumptions. While investing is more art than science, it's still far from being guesswork. Use some fundamental historic relationships to help guide investment decisions, and set more realistic return expectations. Over the past 57 years (ending June 30, 2007), the compound annual rates of return for the following indices were:

Inflation rate (CPI)	3.9%
5-year GIC	7.2%
S&P/TSX	10.9%
S&P 500 (Canadian \$)	12.0%

Do these figures mean a person invested in the S&P/TSX index should expect to earn 10.9% every year? No. Instead, when setting return expectations, it's important to examine the historic relationships between these indices:

- The 5-year GIC should outperform the inflation rate by between 2.5% and 3.0%. This relationship almost always holds, even in the short term.

- The S&P/TSX should, over time, outperform the inflation rate by approximately 6%.

When running retirement-income illustrations, you should only use a real rate of return (return over the inflation rate) assumption of 4% or lower. If you use a higher number, there's a good chance you're overestimating your client's ability to maintain that income over a lifetime. Also, give your clients an after-tax, after-inflation income number (net spendable income).

Retirement-income illustrations should be updated, and your client's situation re-analyzed, every two years at minimum. If you continue to tweak and adjust your client's portfolio, as required, you should be able to help your clients achieve sufficient retirement income over time.

Inflation Rate

The inflation rate is usually measured by the year-over-year change in the Consumer Price Index (CPI).

Since there is high probability a client's retirement could last more than 30 years, it's important to understand how the inflation rate can affect his or her ability to maintain a desired lifestyle (see "Dollar Maintenance," page 21). Based on a 4% inflation rate (the historical long-term average), in 20 years an advisor would need to generate \$109,556 to buy the same basket of goods that costs the client \$50,000 today.

Another issue with inflation rates is they mean one thing to a retired client, and another to a 40-year-old working couple. The baskets of goods purchased by each one could be vastly different and not correspond accurately to the CPI. Inflation planning is not generic. It needs to match up with the goods and services your clients consume.

There's a generally held principle that

To mitigate correction risk, set aside three years' worth of retirement income.

a retiree will need 60% to 70% of his or her pre-retirement income in order to maintain the same standard of living during retirement. And it's a good starting point. In retirement, a person is no longer saving, but he or she also no longer has employment-related expenses.

Ultimately, however, the income requirements depend on what a client intends to do with life in retirement.

Stock Market Risk

During employment years, stock market volatility isn't a great concern, provided the portfolio is properly diversified.

But what if there's a sharp stock market drop just before or just after retirement? Proper diversification alone won't offset this problem. Instead, while generating income during retirement, it's important not to withdraw funds from declining assets.

If your client is unlucky enough to retire when the stock market is performing poorly (and the portfolio must generate income), capital can be depleted at an alarming rate. This further harms the ability of the portfolio to generate the required net-spendable income. But, here's the thing: Your clients should be prepared for a stock market correction every single day in retirement.

Let's say Bob invested \$100,000 in a portfolio diversified with stocks, bonds, GICs, term deposits, and mutual funds. And assume he withdrew \$450 per month, and the stock market corrected, causing his portfolio to lose 7% of its value. His account would only be worth \$87,600 a year later. So Bob would need

to earn 14.16% the following year to restore his portfolio, assuming he stopped further withdrawals. If he continued to take out \$450 per month, he'd need a return of 19.56% to restore his portfolio.

Between August 1995 and August 2005, the average Canadian balanced fund earned 7.4%. If Bob invested \$100,000 in such a fund in August 1995, and started a withdrawal rate of 7% (\$583 per month), his account would have been worth approximately \$107,700 in August 2005. So, one would assume withdrawing 7% from a balanced portfolio would still maintain his capital. However, if Bob had invested \$100,000 in the same average fund in August 2000 and withdrew at a rate of 7% (\$583 per month), his account would have been worth \$75,600 in August 2005.

Why the difference? In the first scenario, where Bob retired in August 1995, the market performed very well for the first five years, so a cushion built up in his portfolio. When the negative-return-years started, his portfolio was able to weather the storm. In the second scenario, in which Bob retired in August 2000, his portfolio would have taken an immediate hit.

To mitigate market correction risk, set aside at least three years' worth of retirement income in some type of guaranteed, fixed-income vehicle. That way if the market plunges, your client can weather the correction.

Retirement Lifestyle

It takes at least two years for an average client to develop a retirement lifestyle, and standardize his or her spending patterns. Until that happens, it's difficult to create a longer-term retirement income strategy to match the actual lifestyle. I've also noticed most clients are healthier and more energetic in the first 10 to 15 years of retirement, and so require more

Dollar Maintenance

To produce an income of \$50,000 per year during retirement (in today's dollars), a client must increase income each year to maintain the same standard of living.

INFLATION RATE	10 YEARS	20 YEARS	30 YEARS
2%	\$60,950	\$74,297	\$90,568
3%	67,196	90,306	121,363
4%	74,012	109,556	162,170
5%	81,445	132,665	216,097

Annuity Example

CPI Indexed (\$100,000)

	AGE	A	B	C
Male	65	\$455	5.5%	\$611
Female	65	413	5.0%	555
Joint	65	371	4.5%	497

A - Monthly income with a 10-year guarantee

B - Initial withdrawal rate equivalent

C - Monthly payment after 10 years (assuming a 3% inflation rate)

income during those years.

Fortunately, there are quite a few options for generating that income:

Indexed Annuity—This investment vehicle guarantees a certain income for the remainder of the recipient's lifetime, and as the name suggests, is indexed either at a set percentage or to inflation. Income increases every year by a set amount (i.e. 3%) or by the inflation rate as measured by the CPI. However, the more features added to an annuity, the lower the monthly income.

Let's say a couple—both aged 65—can purchase an indexed annuity for \$100,000 that will generate approximately \$371 per month (indexed to inflation) for the remainder of their lifetimes. This annuity would pay as long as

either spouse is alive or for at least 10 years. The estate is somewhat protected because there will be at least 10 years' worth of payments under any circumstances (see "Annuity Example," this page). This means that if the inflation rate were on average 3% over the next 10 years, the monthly income from this annuity would be \$497.25 at the end of that 10-year period.

Buying an indexed annuity is very similar to setting up a diversified portfolio (a combination of stocks, bonds, GICs, mutual funds, etc.), starting with an initial withdrawal rate of 4.5% and increasing the payment each year by the rate of inflation (as measured by the CPI). The initial withdrawal rate equivalent varies, however, depending **continued on page 22**

continued from page 21 on the age and sex of the annuitant(s).

Government Entitlements—Your clients may qualify for certain government-income entitlements, which are typically indexed to inflation. So, if you had a client who was 65 and entitled to full OAS and CPP payments, it would cost approximately \$300,000 to buy these pension entitlements personally. For a 65-year-old female, it would cost approximately \$320,000 to purchase these benefits. For many Canadians, this will make up a significant portion of their pension incomes.

Life Annuity—One of the strategies I use to ensure funds last the remainder of the clients' lifetimes is to transfer registered funds into a life annuity when they reach their late 70s or early 80s. You can always transfer funds from a RRIF or LIF into a life annuity at any time. However, once you purchase the annuity, you can never transfer back into a RRIF or LIF.

It's important to point out that registered funds are not tax-efficient for the estate because they're fully taxed on death. Non-registered funds are tax-efficient because most of the balance will pass on to beneficiaries tax-free. Therefore, later in life it may make sense to maximize your client's income with longevity protection (using an annuity) and leave any non-registered investments they have to accumulate.

Variable Annuity—These products are new in Canada but their use is widespread in the U.S. They allow for the combination of guarantees (protecting against longevity risk) and let clients enjoy some stock-market-based returns.

A client who buys them is guaranteed to get 5% of the initial deposit for life. And, if the underlying investments increase in value, your client can receive a higher income. The benefits reset approximately every three years.

It's important to realize if your income is not within these parameters (e.g. you withdraw more than 5% or you withdraw more than the RRIF minimum) you may lose the benefits of these products.

Unsustainable Withdrawal

A popular way of generating retirement income is to set up a diversified portfolio and take monthly withdrawal from the capital. It lets clients adjust income at any time and gives full control of capital so a client's estate gets the full benefit of the account value on death.

However, it's imprudent to dismiss stock market volatility in designing these strategies. Markets eventually correct and so it's important to prepare. Many studies suggest only taking approximately a 4% starting withdrawal from a client's capital in order to maintain the ability to generate an indexed income over his or her lifetime. These studies are flawed at worst and misleading at best. They assume there is nothing you can do about the market even though we do know it will correct approximately two times out of 10.

In addition, this withdrawal rate is not feasible in many client situations, and this is especially so for clients who typically spend more income during the first 10 to 15 years of retirement.

So, what's an advisor to do? Well, this strategy has worked well for my clients and allowed me to secure an income stream despite wobbles in the equity markets. It's got four simple steps:

1. Invest one year's income in a money market account that will be used for the first year's income.
2. Invest one year's income in a one-year bond or GIC.
3. Invest one year's income in a two-year bond or GIC. It's important that the client own the fixed income (bond or GIC) directly as you don't want the

current market to influence them and thus you'll know how much they will be worth on a specific future date. A bond fund or mortgage fund is not suitable for this purpose because both of them can fluctuate alongside changes in interest rates—as interest rates rise, bond and mortgage fund market values decline.

4. Invest the balance in a fixed income and equity portfolio based on the results of the client's personal Investment Policy Statement.

How it Works

The rationale behind this strategy is that the money market account will deplete itself over the first year. After the first year, if the growth part of the account has gained value, then you take the following year's income from that account to replenish the money market fund. If, however, the stock market performs poorly and the growth account slips, then you use the maturing GIC (a vehicle for which the maturity value is known) to replenish the money market fund. If the GIC isn't used for income, it will be re-invested for a guaranteed period of two years.

This strategy only works if the client avoids taking income from any part of the portfolio that is declining in value.

There is no magic bullet to retirement income planning but you need to know the various strategies that are available. The retirement income strategy portion of the client's financial lifecycle is dramatically different. In the early years, you were helping clients accumulate funds but their day-to-day income was coming from another source. In retirement, you need to change your thinking dramatically in order to properly prepare your retired clients to successfully generate their required income. ^{AE}

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