

MDRT: Fighting Retirement's Foe – Inflation

BY MARK NOBLE

The fear of inflation among boomers heading toward retirement is a well-founded one, says a well-known retirement expert. At its current rate, inflation could wipe out two-thirds of the value of a boomer's portfolio just halfway through retirement.

"A very interesting survey that we've done with individual clients asked them, 'What worries

you in retirement? What risks do you fear in retirement?' Over and over again, the answer is inflation," Moshe Milevsky, executive director of the Individual Finance and Insurance Decision Centre, told a packed audience at the Million Dollar Round Table's annual meeting in Toronto.

Milevsky, who is also an associate professor of finance at York

University's Schulich School of Business, says the fear is very well grounded. He says roughly half of boomers can expect to live to the age of 90, so 25 years from now, many will be only at the halfway mark in their retirement. Meanwhile, if the consumer price index of U.S. inflation were to persist at its current 4% level, the value of \$1,000 in today's money would erode to just \$375 in 25 years.

Unfortunately, Milevsky notes the 4% number is probably too conservative for the reality boomers may face.

NOT FOR EVERYONE

"Right now there is a problem with the inflation index because it doesn't measure inflation for everyone; it measures for an average," Milevsky says. "In the U.S. the Bureau of Labor statistics has released a new index. For many years, the consumer price index for wage earners, which is 32% of the population, was the de facto most important index for inflation calculations.

Continued on page 11

ADVISORNEWS

MDRT: Fighting Retirement's Foe – Inflation

Continued from page 1

“A couple of years ago, they decided to launch a special index, CPI-E, the consumer price index for the elderly, since 17% of the U.S. population is considered elderly.”

Milevsky says the CPI-E was higher than the other indexes, and when the Bureau of Labor back-tested it for the last 25 years, the CPI-E regularly exceeded the CPI.

“What does this mean? As you talk to baby boomers as they get closer to retirement, you have to show them that \$100 decays after 25 years to \$50 for a wage earner,” he said. “If you're elderly or retired... that \$100 decays to \$44. The elderly have to concern themselves with risk management for inflation in a very different way.”

MOST EFFECTIVE SOLUTION

The most effective way to combat this substantial erosion is to ensure clients hold a broadly diversified portfolio of equities well into retirement because heightened

longevity risk is as much a factor as market risk, Milevsky said. But, it's imperative that volatility is controlled during the first few years the retiree enters the draw-down phase.

Milevsky explained that during the accumulation phase, it doesn't matter when positive or negative returns on a portfolio happen. For example, he says if an investor put \$100,000 into a fund that returned 27% in year one, 7% in year two and -13% in year three, the three-year return would be \$118,224. The fund's three-year return would be exactly the same regardless of whether the sequence of negative and positive years were changed up so that the fund lost 13% in year one and gained the next two years.

The funds have different consequences for retired investors, based on the sequence in which they are experienced negative and positive return years.

“It does not matter if I get the bull market before the bear market or the bear market before the bull. Give me all of them because I'll end up in the same place,” he said. “This is why we tell people to buy and hold and stay invested and not try to market time.”

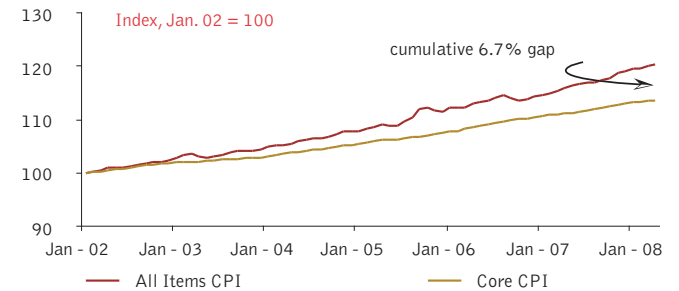
INVESTMENT LOGIC BREAKS DOWN

But this logic breaks down in retirement. When the client starts to withdraw from his or her savings, an early bear market can be devastating.

Milevsky showed how \$100,000 invested in two existing funds yielded the exact same 20-year return, so that both funds earned the investor \$370,000. The funds had different consequences for retired investors, based on the sequence in which they experienced negative and positive return years.

If the investor withdrew \$10,000 a year, the fund that experienced losses early on was completely depleted in 15 years, while the other fund lasted the full 20 years and was still worth more than the initial principal investment.

“CORE” MISSES US INFLATION TREND



Source: CIBC World Markets Report, May 27, 2008

“It is what happens in the first few years of retirement that matters. If you lost money early on as you were withdrawing money, the funds don't last as long, which means the traditional metrics of investment which we've been teaching our finance students for 30 years – mean and variance, risk and return, and accumulation and volatility – are the wrong metrics to look at,” he said. “[They] work great in the accumulation phase, but when it comes down to the distribution and income, it will not tell you which fund will last longer. There could be a 10- to 15-year gap in the fund's lifespan.”

STICK TO EQUITIES

Milevsky suggested advisors look at keeping their clients in equities in retirement to outperform inflation, but when the client nears or transitions to retirement, they should consider using the newer breed of variable annuities and guaranteed withdrawal products that will protect a client's retirement portfolio from the impact of early losses.

“You don't want to have a bear market early in retirement, so instruments and vehicles that help us remove that until further into retirement are going to be at a premium,” he said.