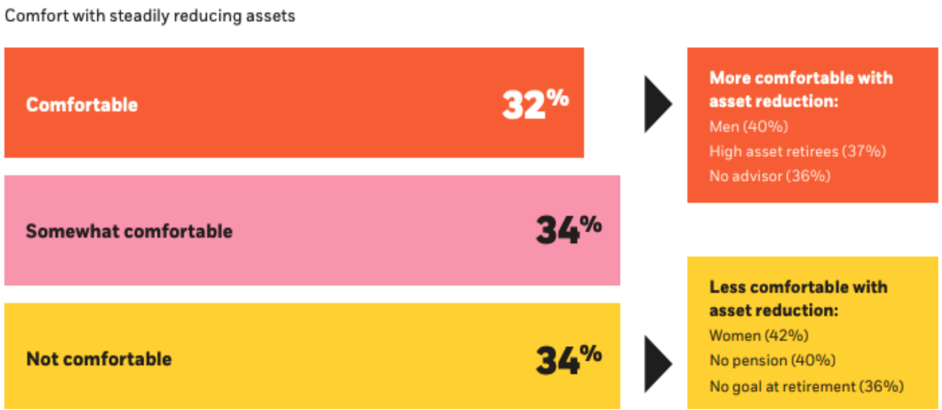
Fighting Longevity Risk in Retirement

Today's retiree is much different than yesterdays. Each year there are a variety of challenges that advisors and clients face as they plan for retirement income. Market volatility, political uncertainty, pandemics, tax management, and you name whatever else comes to mind. The fact is, no matter how hard you work and save – there will always be questions.

As we detailed in the summary page and will continue to through this series, we remain resolute to the fact that current market conditions have presented challenges for clients to navigate portfolios. When portfolio returns do not meet expectations, living costs increase, you live longer, or possibly your cash flows are different than projected – Longevity risk is something you must plan for.

Longevity risk for retirees refers to the possibility that one may outlive their money and may need to change their lifestyle in some form to continue to have adequate income.



Source: Greenwald & Associates, BlackRock Asset Retention Study, 2018

According to Blackrock's asset retention study, retirees hold mixed feelings about spending down their assets in retirement. It is only natural to have reservations about spending vs. saving, as a working American I struggle with finding that balance sometimes and I have a monthly paycheck still.

Let's dig more into types of retirement income and how each could have longevity risk associated with them. Topics to be covered:

1. What is Guaranteed Income and how is it different than Investment Income?
2. **How each fit into today's market?** *Guaranteed Income*; *Investment Income*

Fixed Payments/Guaranteed Income

First, let's dig into the guaranteed income category. You work a certain amount of time, contribute a certain dollar amount, and at retirement you receive a consistent payment. The timeline for how long that income is paid to you will vary from plan to plan and can be paid out in a variety of ways: the retiree's life only, for a specific period, and some may have spousal benefits as well.

Having a stable payment on a regular basis should help with one's concerns over economy issues or stock market performance. Social Security income being the most common type of guaranteed fixed payments to individuals. The guaranteed bucket generally is used to cover all or a portion of fixed expenses.

As it relates to fighting cost of living increases in this category… Some defined benefit or pension plans have inflation adjustments year to year and some do not. Adjustments are case by case and may even be at the discretion of your previous employer. Good news for folks eligible for social security, they do adjust benefits for inflation as seen in the COLA increase for 2022.

Take the good with the bad with fixed payments of any kind. You should know exactly the payment you are receiving (very good). Life and markets change quickly and whether it is an unexpected medical bill, cost of living increasing, or the stock market grows at a 20% clip which you miss out on – sometimes life moves faster than that fixed payment (not so good).

Variable Payments/Investment Income

401ks and IRAs are the most common savings vehicles you will find in this category for retirees. Trusts, real estate, royalties, brokerage accounts would also fit here. Within each of these account types there are different tax strategies to think through as you plan for retirement, but today we will not get into that. If you have the luxury of savings in both guaranteed income and investment income buckets, this category very likely would be for discretionary spending in retirement.

Two big differences with 401ks and IRAs to a Pension/guaranteed income plan… Your withdrawal cadence and dollar amounts will be much more flexible and you have full control over the underlying investments. That flexibility and control can be a nice compliment to the other bucket, just keep in mind that there are no guarantees that your accounts may grow and of future income.

The pro here is having that lever to shift your savings to portfolios that you and/or your advisor have built that fit your specific goals. More control and flexibility with less guarantees…

How each fit into today's market?

Fixed payments

Fixed and possibly guaranteed payments from pensions or social security are great, but you are limited to managing just one side of the equation: your costs if you are fighting longevity risk. You have safety of your principal with consistent repeatable income, but typically cannot make changes to your withdrawals or investing plan to adjust to market/lifestyle changes.

The biggest threat to fixed payments for retirees is unplanned or unexpected expenses. The cost of living increases in 2021 is a great example of this headwind. An uncontrollable factor that can deplete the value of your dollar.

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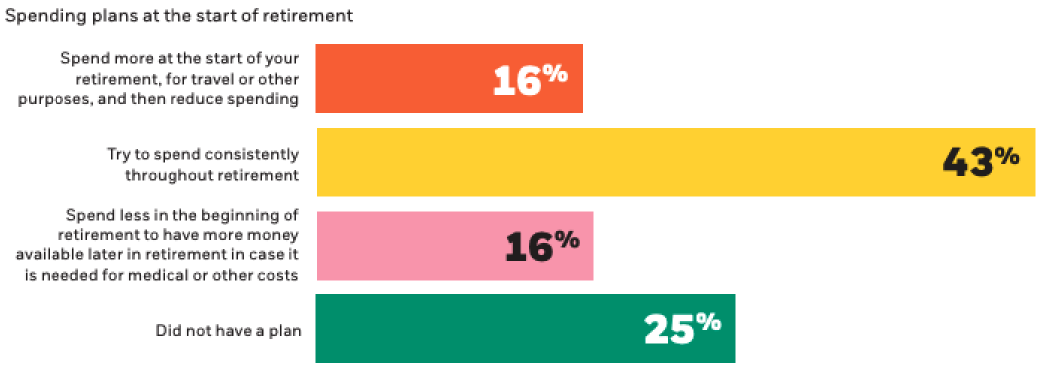


Source: Greenwald & Associates, BlackRock Asset Retention Study, 2018

Ultimately, what you the retiree care about are the factors you can control as you plan. A detailed budget and cash flow analysis is essential to understand where your money is going and what your inflation rate actually is. Please do not be one of the 25% who have no spending plan at the start of retirement! Average costs might be going up 5% for the everyday consumer but impacting you 10%. Either way understanding the outside changes that have impacted your budget will help you plan for what changes you will need to make going forward.

Second item that you have control over is where you allocate any of your excess income. We will get more into thinking through investments here next – but if you are only spending 80% of your fixed payment, let's put that 20% into something that makes sense and isn't depleting year over year.

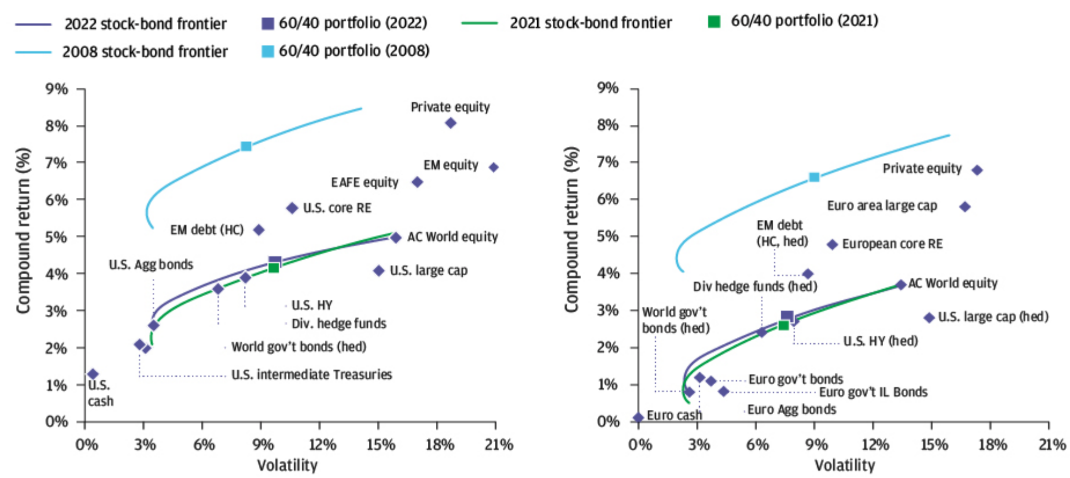
Investment Income

Related to investment income whether its royalties, rental payments, dividends from stocks, or interest on bonds – you have much more control in this category. You have control over both the growth and the withdrawal plan. Today we will stick to one side – the investments. For many Americans the investment decisions come down to allocations between stocks, bonds, and cash. The market landscape for investors today we believe certainly make these decisions challenging to navigate, especially for more conservative investors.

Cash and money market investments are yielding basically nothing today. Traditional bond allocations provided little juice to performance and even negative returns in certain cases as Investment Grade Bonds in 2021 were down -1.84%. In 2021 Equities were certainly the winners with the S&P finishing over 28%. The bottom line regardless of your risk appetite, future returns of portfolios going forward look very different than what we have seen over the past 10 years. It is our belief that the return outlook for both bonds and stocks will be lower going forward due to a combination of the low interest environment and valuations being so high.

The chart below illustrates JP Morgan's anticipated differences in the 60/40 portfolio for 2022 and how it compares to 2008. A lot going on in the chart, but an interesting visual to see similar volatility expectations with less expected return.

EXHIBIT 12A: USD STOCK-BOND FRONTIERS **EXHIBIT 12B: EUR STOCK-BOND FRONTIERS**



Source: J.P. Morgan Asset Management; data as of September 30, 2021.

Two challenges that can increase longevity risk here – negative or less than expected growth on your investments or increases in your costs. Possibly a combination of both? Bottom line is you have your investment, income, and a cash flow plan to consider making tweaks. Staying with our investment focus for today, let's look to address these two questions that we are often discussing with clients:

1. How should we address lower expected returns?
2. How do you manage risk along the way?

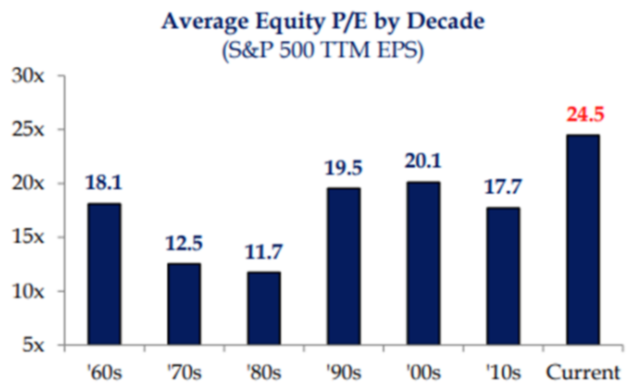
How to address lower expected returns?
Short answer is Asset allocation. Really one of the most powerful tools in any plan and we believe the current environment has put a bigger spotlight on decisions here. Our belief is that steady wins the race with client portfolios, but small shifts can make such a difference.

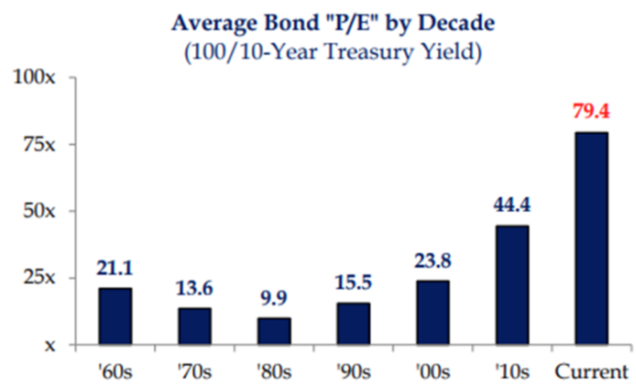
In terms of overall risk management and generating diversified income, we see that a material (even substantial) allocation to bonds has been a great solution for many investors over time. However, we believe the asset class faces many structural hurdles today. As an overview, bond returns are derived from the combination of Coupon (interest income) +/- Yield Curve (change in interest rates/shape of curve) +/- Credit Spreads.

Given the low interest rate environment, historical tight credits spreads, and no "earnings growth" potential in a fixed coupon asset, we think investors can limit their real return potential with the traditional bond allocation. If you were to maintain your bond allocation, it is our believe that there are only two ways to combat this reality – take duration risk and hope for interest rates to decline or take credit risk and hope for spreads to contract. In each case, we do not believe you are compensated enough for the additional risk you are taking on.

Source: Aptus Research 2021

What is one of the biggest differences between stock and bond ownership? Stock owners can participate in company's growth. We believe the more we can allocate to investments that have the potential to grow, you inheritably address longevity risk in your plan.





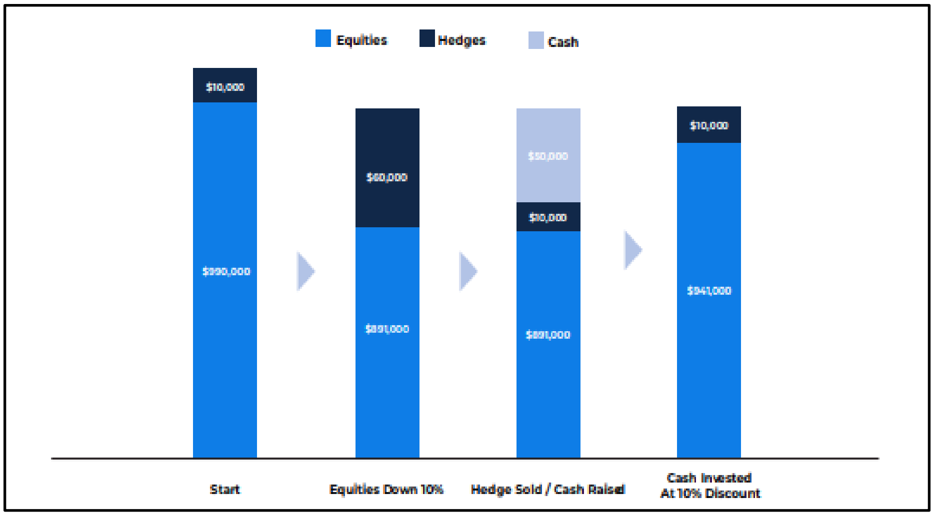
Source: Strategas Dec 2021

What about the narrative that stocks are expensive? Although, it is certainly fair to say this and we would agree with the statement, we think bonds are even more expensive. Shifting portfolios more to equities and less to bonds should in turn increase your expected returns.

But…What about risk?

Equity markets have more risk, so it can't be as simple as shifting from a 60/40 to a 70/30 - can it? This may work just fine if we look back in 10 years. Ultimately, we would argue it is counterproductive if you are addressing longevity risk by adding another risk, in this case the risk of your portfolio drawing down by adding a riskier asset.

Our solution is to incorporate an overlooked asset class: volatility. To us, including volatility means using option contracts to manage downside risk, provide income, and add return potential through a variety of market conditions. We believe a small allocation to volatility within your portfolios can allow you to allocate more to equities, less to bonds, and keep risk neutral. For this conversation let's just focus on the hedging that takes place in portfolios.



Source: Aptus Hypothetical Illustration

In the above example we have a small sliver of volatility exposure, in this case put options at 1% of the total portfolio value. Equities go down 10%, leading to your hedges being valued at 60k from 10k. Your portfolio which would have been down around 100k is down about 50k. Not preventing loss, but the protection mitigates the damage and provides capital to be deployed when markets are down.

The key component of an option is the convex payout potential. The ability to buy something that has the potential for asymmetric returns. Essentially the option holder would share in upside but would not incur those same losses on the downside. So, in our view, adding a small amount of protection and volatility exposure clients can comfortably allocate more to equities, less to bonds while not getting out of their comfort zone for risk.

Summary

As you approach retirement age and are actually living through your retirement years, the amount of levers you can pull for a successful retirement over time naturally become more and more limited. The fact of the matter is that whether you are referring to guaranteed income or investment income, your resources and choices change and are more limited as your start your retirement spending.

Not trying to scare you if you are retiring tomorrow, more trying to explain that waiting too long to make adjustments to your plan could lead to increasing the longevity risk factor in your overall plan.

With rates this low, and inflation reappearing after a long absence, we think investors should be really thoughtful about their use of fixed income in their investment income bucket. Stocks may seem expensive, but the ability of companies to raise prices and grow over time can at least give investors a built-in way to maintain their purchasing power. The fixed coupons of traditional bonds can’t do that, eroding real value for as long as inflation exceeds returns…a sneaky danger but a costly one for sure.

Stay tuned as we hit on sequence of returns risk and try to put it all together as we take a deeper dive into asset allocations impact on the plan in today’s market.

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