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Longevity Complicates Retirement

Americans often underestimate needs

Americans are living longer. Life expectancy for Baby Boomers (born between 1946 and 1965) is greater than for any previous generation. National Center for Health Statistics tables show that life expectancy increased by 30 years during the 20th century – from 47 in 1900 to 77 at the millennium. And, figures compiled in the Society of Actuaries' 2000 Annuity Table estimate the life expectancy of men 65 years old to be another 15.9 years. At the same age, women can expect to live an additional 19.2 years.

What do these numbers mean to you? The good news is that your retirement may be years longer than you thought it would be. That could also be the bad news. It all depends on how well you have planned and saved for your retirement. Longevity is, increasingly, becoming a major factor in retirement planning.

Recent surveys have sought to determine whether Americans are aware of the implications of longer lives in relation to future sources of income. Questions concerning Social Security, pensions and individual savings – referred to as a "three-legged stool" in the traditional paradigm of retirement income – were included in the surveys.

These surveys have found major misperceptions regarding these three important retirement issues. Let's look at a few of these misperceptions and their potential impact over longer lifespans.

Social Security

The Employment Benefit Research Institute (EBRI) *2005 Retirement Confidence Survey* found that the average retirement age is 62. When EBRI asked respondents when they thought they could receive full Social Security Benefits, 52% believed that they could claim full benefits at a younger age than is actually the case.

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Most people working today won't be eligible for full benefits until age 67. Not being aware of this fact can adversely impact plans about when to retire, how much Social Security income to expect and how much more money will be needed in retirement income – especially since, according to the Social Security Administration (2005), Social Security payments account for 39% of the average retiree's income.

Pensions

Defined benefit plans are traditional employer-funded retirement plans that provide income for life. These plans are funded by private companies and guaranteed (up to certain limits) by a federal agency. According to figures released by the Department of Labor in 2005, the number of these plans has dropped from 139,000 in 1979 to 48,000 in 2000. The number of plans and workers covered continues to decline.

Defined contribution plans (401(k)s), on the other hand, are mainly employee-funded. Between 1979 and 2000, the number of these plans increased from 331,000 to 687,000, according to the Department of Labor. Here, the individual employees are totally responsible for deciding how much to contribute, where to invest, and how the money will be distributed at and through retirement. They assume all the risks and bear all losses.

According to Merrill Lynch's *2004 Retirement Survey*, 58% of Americans believe that these plans are guaranteed by law up to certain limits.

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Savings

According to the *2005 Fidelity Retirement Index*, the typical working American household (average age 43) has typically saved $18,750 toward retirement. Sixteen percent have not yet started to save. For midlife households (ages 41-54), the average retirement savings reported is $30,000. In that age group, 14% are not saving yet. Among pre-retirees (ages 55 and older), the average amount saved is $60,000. Eleven percent of pre-retirees reporting have not begun to save.

How long would these typical nest eggs last? People often use 85 as an assumed life expectancy when calculating retirement needs. Remember the life expectancies mentioned earlier? Those actuarial figures are *averages.* So, half of those 65-year-old males will live past 80, while half of the 65-year-old females can expect to live past 85.

According to the Census Bureau, there are presently more than 60,000 Americans over 100 years old. What if you are one of the estimated 600,000 centenarians in 2040 and you had used age 85 in planning? For 15 or more years you might find yourself totally dependent solely on Social Security and perhaps a small pension income.

This is what's known as longevity risk – the real possibility that you might very well outlive your money.

Planning needed to avoid shortfall - How much money should you save?

Now let's look at planning for the "distribution phase," when you will depend on your nest egg for income.

Many financial professionals believe that people should plan to replace at least 70% of pre-retirement income when they stop working. According to the Employment Benefit Research Institute (EBRI) *2005 Retirement Confidence Survey*, a majority of workers (59%) expect they will need less than that amount during retirement, with about one in five (18%) of those surveyed expressing the opinion that they would need less than half of their pre-retirement income after they stop working.

Furthermore, only 42% of EBRI's respondents said they had actually attempted to calculate how much they would need to save. Of those who reported that they had tried to make this determination, 37% used their own methods of calculation and 10% admitted to guessing.

The calculation is complex. It is not simply a matter of adding up projected expenses and multiplying it by a number of years. Factors to consider include market volatility, inflation and now, longevity. The effect of recent stock market volatility on retirement savings demonstrates the seriousness of this risk. Asset allocation strategies, a topic beyond the scope of this article, can help manage that risk.

Inflation – compounding in a bad way.

What makes inflation so potent a threat is the fact that it compounds over time. Perhaps you decide to retire at 65 and estimate that you need $50,000 a year to support your lifestyle. At 3% inflation (the average over the last 20 years), by age 89 you would need $100,000 a year to maintain the same standard of living. At 6% inflation, you would need $100,000 per year by the time you turn 77. The longer you live, the more inflation will consume the value of your retirement dollars.

The Downside of Longevity

Simply living longer can add significant expenses. Medical advances may have reduced the incidence of fatal illnesses, but longer lives are often beset with chronic health problems requiring prescription drugs, medical treatments or periodic hospitalizations – sometimes all three. In its Guide to Long-Term Care Insurance (2004), America's Health Insurance Plans (AHIP) states that people now 65 years old face a 40% lifetime risk of entering a nursing home sometime

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during their lives. AHIP also notes that the likelihood of entering a home, and staying for longer periods of time, increases as people age.

In the field of health care, inflation and longevity combine in an especially insidious way. The costs of medical care, prescriptions and long-term care are rising faster than the general inflation rate. The longer you live, the more you could be affected.

Distribution choices

When discussing retirement, emphasis is usually placed on saving and accumulating assets. In fact, when people reach retirement, key decisions must be made about how to distribute funds accumulated in retirement accounts. Choices made at this time may determine whether those assets will provide lifelong income.

A U.S. Government Accountability Office (GAO) report issued in 2003 noted that defined benefit plans and defined contribution plans offer markedly different distribution choices. Defined benefit plans tend to offer annuities that provide guaranteed income for life – no matter how long that life is (guarantees are based on the claims-paying ability of the issuer). Defined contribution plans, on the other hand, tend to offer lump sum distributions or the option to keep assets in the plan.

The GAO further reported that a growing number of plan participants who have a choice of benefit payouts take lump sums or leave their money in the plan rather than receive an annuity. On what basis do they make those decisions?

Plan sponsors usually provide ample information about investing, but surprisingly little information about taking distributions. Prospective retirees often are not given the assistance needed to assess the advantages and risks of different distribution options.

Develop a Retirement Resource Plan

When developing a retirement resource plan, you should consider a number of factors. First and foremost, do not underestimate your life expectancy. Other considerations include: your housing needs, health and long-term care insurance; provisions for dependent care, funding a child's education, perhaps travel expenses.