Longevity Risk

When planning your retirement, perhaps the first and most important decision you should make is how many years you are going to spend in retirement.

What is longevity risk?

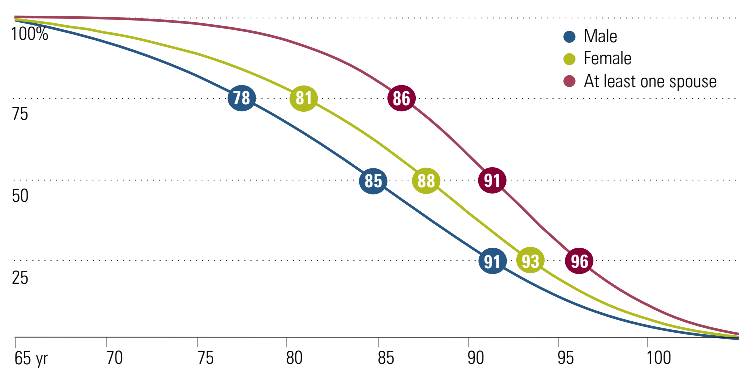
Longevity risk simply refers to the risk that you will outlive your assets. Longevity risk is perhaps the single biggest risk facing retirees. The decision on how long you should plan to live should be the first decision you make when planning your retirement. All subsequent decisions, such as when to retire, how much money to take from your portfolios each year, and how to invest your assets all flow from this longevity decision. It's great to be able to live a long and healthy life, but you'll need to plan carefully to make sure your money lasts as long as you do.

How long should we plan to live?

People often base their retirement plan upon their "life expectancy," which is the age at which someone is expected to die. Unfortunately, most investors underestimate how long they are likely to live. In the United States, the median life expectancy of a 65-year-old male and female is 85 and 88, respectively. But remember: half of the population will live longer, often much longer, than their life expectancies.

For retirement planning, you need to consider two things about how long you think you'll live. First, given the advances in medicine, diet, and technology, demographic trends suggest that many of today's retirees will live longer in retirement than any generation in history. Second, provided that there is a 50% chance of surpassing your life expectancy, it may be risky to base your retirement plan on that one figure.

Retirees should plan for a long retirement[1]
Probability of a 65-year-old living to various ages



The image above illustrates that for a couple aged 65 who is about to retire, there is a 50% chance that one of them will live to age 91, and a 25% chance that at least one of them will live to age 96—a 31-year retirement! Unless there is a specific medical reason to suggest otherwise, many financial planners think that retirees should plan for their investment assets to last for 30 to 40 years.

Questions to ask your advisor:

- What life expectancy should my spouse and I use in planning to minimize longevity risk?
- How does our health and our family's medical histories affect our retirement planning assumptions?
- Are there specific products we should consider to insure against longevity risk, such as immediate payout annuities?
- How do our longevity assumptions affect decisions such as when to retire, how much money we can take from our portfolios each year, and how we invest our assets?

These statistics reflect the life expectancies of your parents, who didn't have the same access to medical advances and diet that you enjoy, so there's a good chance your generation will live even longer than these statistics suggest. And as medicine continues to advance, longer life spans will put increasing pressure on retirement portfolios.

Your family medical history and lifestyle will have a big impact on how long you will live. Even then, there's no way to predict how long you'll live. The important thing for your retirement plan is to have an open discussion with your spouse and your financial advisor, and if possible, be generous in your planning assumptions regarding how long you might live. You want to give your investments a chance to survive as long as you do.

Are women more exposed to longevity risk?

Yes. Women have longer life expectancies and should plan to live longer than men. Many women's advocacy groups are concerned that women are particularly exposed to longevity risk, and it's not just because they have longer life expectancies. Many pension plans are tied to husbands and have substantially reduced spousal benefits.

How can we protect against longevity risk?

Living long is a financial risk simply because it can strain your investment assets. But there are things you can do to protect against that risk. Life insurance protects your spouse against longevity risk by paying him or her a financial benefit at your death. Other financial products, such as immediate payout annuities, can provide guaranteed income no matter how long you live. Most of all, be sure to use planning assumptions that help you steward your investment assets over a long period of time.

[1] Source: Annuity 2000 Mortality Tables—Transactions, Society of Actuaries, 1995–1996 Reports.