Plan to live to 100

Most of us have no idea how long we're going to live. This lack of foresight could allow our assets to run out before we do, if we don't plan properly, Andrew Barnett writes.

Death and taxes are the only two certainties in life, as Benjamin Franklin wrote, which is unfortunate for those of us saving for retirement. We're faced with two great uncertainties that have a profound impact on the amount of money we'll have to live on between retirement and death: the future returns on our investments and how long we'll live.

The first of these uncertainties is called market risk, the danger that we'll lose money in the sharemarket or on bonds. The second is longevity risk, the danger that we'll outlive our savings.

Investors became painfully aware of market risk through the global financial crisis. Many put their retirement on hold because plunging sharemarkets depleted their superannuation funds.

But investors can be somewhat insulated from market risk if they're fortunate enough to be in that group that has built up sufficient assets through their working lives; items that provide substantial returns they can live off, whether that's from interest, dividends, or rental yield from a property. Even if the value of the investment falls, the income is generally not as affected.

However, the category more representative of the population – where 90 per cent fall – includes those who will rely on their returns, but will also need to gradually sell some of their assets. Therefore, they will increasingly become exposed to market risk.

Avoiding the market's hazards altogether isn't necessarily the right answer because it will generally lower the amount of future returns.

Longevity risk is arguably more confronting than market risk but it's less understood, whether that's consciously or unconsciously. Even if markets are relatively benign and there isn't a correction, investors may consume all of their assets before their life is over.

Matching the rate of consumption of your assets to the rate of consumption of life – as it were – is tricky. The objective, assuming you don't have a bequest motive, is to write your last cheque to the funeral director, and have it bounce. Very few of us will manage to do this. Many of us will run out of money first.

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Australians have somewhat more longevity risk than people in many other countries. United Nations data shows that life expectancy in Australia is among the highest in the world.

Life expectancy at birth for Australian boys is exceeded only by boys in Iceland, Hong Kong and Switzerland. Life expectancy at birth for Australian girls is exceeded only by girls in Japan, Hong Kong, France, Italy, Switzerland and Spain.

And we're living an increasingly long time. In 1885, life expectancy at 65 was another 11 years for men and 12 for women; on average a 65-year-old male would live to 76, and a female to 77. Now, life expectancy at 65 is a further 19 years and 22 years for men and women, respectively. Based on this rate, life expectancy rises eight minutes for every hour we're alive.

Estimating how long we will live is critical for planning our retirement. However, if we plan based on life expectancy, we'll be wrong one way or the other almost all the time. By definition, half of us will stay around longer than average. Rather than plan to reach your life expectancy, you should plan to survive to beyond your life expectancy, particularly if you are concerned about running out of money, and in this you wouldn't be alone. In a survey conducted recently in the US, but which would resonate here, 77 per cent of individuals aged 44 – 49 years old feared running out of money more than they feared death.

The other consideration for longevity risk is that most of us have to account and plan for being in a couple. The way probability works is that 50 per cent of individuals will live past average life expectancy, but for a couple, the probability that either one lives past average life expectancy increases to 75 per cent. In fact, there is a one-in-10 chance one member of a couple will live to 100.

Most of us aren't planning to live to 100, or worrying about how to fund it if we do. Accumulators in their 40s and 50s expect to have about 20 years in retirement but this is still conservatively about two decades too short.

So why aren't we more worried about the longer term? This has puzzled the academics for years, and there are many theories. These are among them:

- Lack of awareness: in reading this, you've joined only a small population who understand how long your planning horizon might need to be.
- Hyperbolic discounting: things that are in the distant future have less relevance or importance. Related to this is consumption bias – we prefer to consume now rather than save for the future.
- The money illusion: a lump sum of, say, $100,000 seems like it should be able to generate at least $8000 in perpetuity, and anything less seems like a bad deal. In reality, that figure of $8000 is less likely these days.
- Fear of regret: some products that provide for longevity, such as lifetime annuities, are a bet on your own mortality, and if you die early you "lose".
- A preference for liquidity: lifetime annuities pay more if you relinquish access to your money but this is cash you therefore don't have for unforeseeable costs, such as medical care.

Longevity risk has traditionally been difficult to address when managing retirement finances.

The age pension provided the government provides is far and away the largest longevity "product"; 80 per cent of retirees receive the full or part pension. Unfortunately, the age pension in Australia is also one of the lowest public pensions in the developed world.

Our pension targets poverty alleviation instead of wage replacement. On average, equivalent schemes in other OECD countries are worth three times as much and in a survey of 25 countries, only Chile and Mexico had pensions that were worth less.

As a result, there is increasing interest in products that mitigate longevity risk. In a survey of Australians aged over 40 conducted by Investment Trends, 60 per cent of respondents haven't considered a retirement income product, of which 41 per cent agreed this was because they don't know what they are, but 22 per cent of respondents want advice on how to make their superannuation last however long they live. Above all else, it's clear that even some basic advice would go a long way for many individuals.

In data from the same Investment Trends report, 68 per cent of people over 40 were not aiming for a specific level of saving or income.

Advice can help form an objective for an income over a reasonable timeframe that will fund a comfortable retirement, something that is critical to good planning. ☒

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