

Commentary

Investment Advice

Retirees Have Long Investment Horizons

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There exists a perception that as people approach retirement that they should be moving their investment portfolio towards a cash position. However, this is a false perception since those approaching retirement and those who are retired retain a long investment horizon; a person retiring might expect to live another 20 years or more, while 80 year olds might expect to live another 10 years.

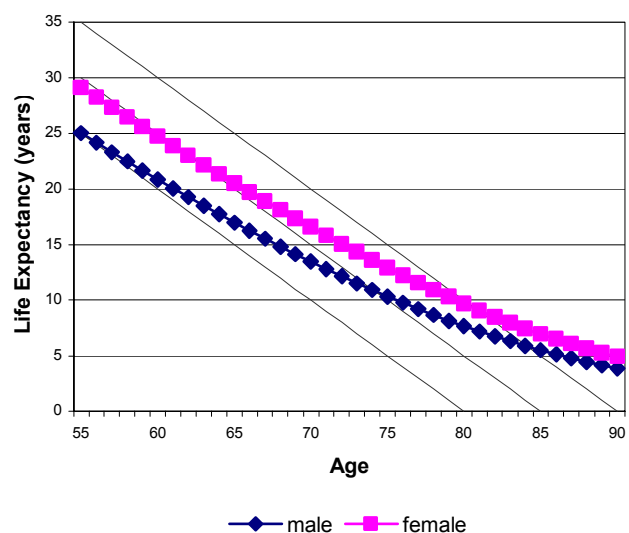
Moving towards a cash position as retirement nears makes sense if the person is intending to blow the nest egg on a big retirement party or on frivolous toys, otherwise, moving towards a cash position only makes sense if the person is bullish on interest rates rising or thinks that the stock market is ripe for a downturn; that is, they are engaging in market timing.

Life cycle funds are an investment style that benefits from this false notion that investment horizon dramatically shrinks as a person nears retirement or becomes older. Similarly, GIC-ladders in defined contribution pension plans or group savings plans can inappropriately encourage having the top-rung be retirement date.

Retirement savings are to provide retirement income (even if they are squirreled away to give to heirs). At ages 60 and 65, or even 75 and 80, there are typically many more years to live. Using Canadian population mortality rates, a 65 year-old male has a 17 year life expectancy and a 65 year-old female has a 20 year life expectancy. Reference Table 1 and Graph 1.

Age	Male	Female
60	20.8 years	24.7 years
65	17.0 years	20.5 years
70	13.5 years	16.6 years
75	10.3 years	12.9 years
80	7.7 years	9.7 years
85	5.5 years	7.0 years

Graph 1 - Population Life Expectancies



data source Table 1 and Graph 1: Statistics Canada Life Tables 2000-2002

Life isn't fair and neither is death. Healthy lives have longer life expectancies. Using mortality of lives that have passed underwriting tests for life insurance, a healthy 65 year-old male non-smoker has a life expectancy of 20 years and a healthy 65 year-old female non-smoker has a life expectancy of 23 years.

Age	Male	Female
60	23.4 years	26.8 years
65	20.0 years	23.1 years
70	16.7 years	19.6 years
75	13.9 years	16.1 years
80	10.7 years	12.8 years
85	7.7 years	9.6 years

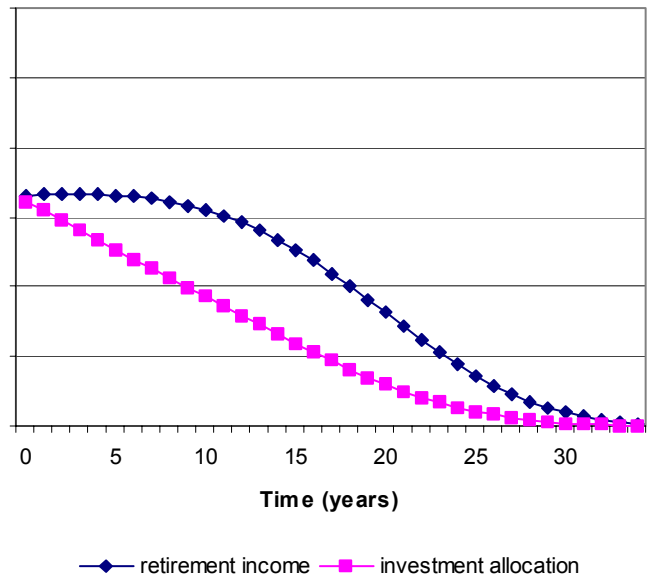
calculated from Society of Actuaries 2001 Valuation Basic Tables, developed from U.S.A. insured lives

Retirement income is needed throughout retirement, before and after a retiree's life expectancy. To give a sense of the portion of monies to be invested for different time periods, Table 3 presents, for sample retired lives, the periods over which a pot of retirement savings should be invested for. For example, the sample female 70 year-old, to meet her expected retirement income needs, would invest 35% of her retirement savings with a 0 – 5 year horizon and 7% of her retirement savings with a horizon of more than 20 years (see fifth column of Table 3). Graph 2 presents the female 70 year-olds expected retirement income needs as well as the corresponding allocation of her retirement savings.

Table 3 and Graph 2, as well as Table 4 and Graph 3, were prepared using current population mortality rates, a 5% investment return and delivering a retirement income that increases 2% per year.

If the mortality rates were that of healthy lives or if mortality rates were projected to decrease with time then the investment horizons would extend further than those presented. Similarly, unhealthy lives or increasing mortality rates would cause a shortening of investment horizons.

Graph 2 - Investment Horizon for Expected Retirement Income Needs (Female 70)

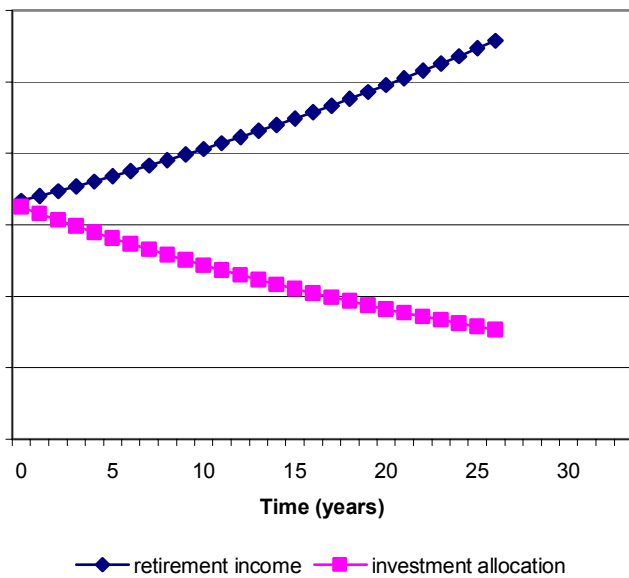


Of course, the expectation is never reality since life expectancies are averages (people don't die in parts). Any one of us could leave this world tomorrow, while others may become centenarians. In addition mortality rates may change (decreases in mortality rates have been the norm for North Americans for some time now). Any given person might live well beyond their life expectancy. To protect themselves against the risk of longevity, that is, outliving their retirement savings, a retiree acting as an individual may decide that they want to be 90% confident that their retirement savings won't run out before their time in this world runs out (i.e., 90% of people will not live beyond the period that they have provided for); if they die earlier, the remaining assets are left for their heirs and if they die later then they need other assets (e.g., sell house) or support (e.g., family, government, charity). Under this 90% confident criteria the investment periods in Table 3 are revised to those presented in Table 4 and likewise the presentation of Graph 2 is revised to that of Graph 3.

	Male 60	Female 60	Male 70	Female 70	Male 80	Female 80
0 - 5 years	30%	27%	41%	35%	59%	51%
5 - 10 years	24%	22%	29%	27%	29%	30%
10 - 15 years	19%	18%	18%	19%	10%	14%
15 - 20 years	13%	14%	9%	11%	2%	4%
+ 20 years	14%	19%	4%	7%	0%	1%

	Male 60	Female 60	Male 70	Female 70	Male 80	Female 80
0 - 5 years	22%	21%	28%	25%	38%	33%
5 - 10 years	19%	18%	24%	22%	33%	29%
10 - 15 years	17%	16%	21%	19%	29%	25%
15 - 20 years	14%	13%	18%	16%	0%	13%
+ 20 years	27%	32%	10%	19%	0%	0%

Graph 3 - Investment Horizon for 90% Confident Retirement Income Needs (Female 70)



By requiring 90% confidence the investment horizon lengthens. For example, a male 70 year-old goes from 31% of retirement savings with a horizon longer than 10 years to 49% longer than 10 years. A female 70 year-old goes from 37% longer than 10 years to 54% longer than 10 years.

The insertion of the 90% confident criteria will have a cost in terms of the retiree’s available retirement income. For example, the 90% confident criteria will cost a 70 year-old female about one-third of her potential retirement income. For a retiree that does not intend to spend all of their wealth on their retirement but rather pass on a large portion of it to their heirs, this cost is not real. However, for a retiree that will spend the vast portion of their wealth on their retirement this cost is a burden and for such a retiree annuitization, pension plans and government schemes can be useful.

If considering a married couple that needs its retirement income to continue while at least one spouse remains alive, the investment horizon extends beyond that of the life with the greater life expectancy. However, this extension is not necessarily large. For example, for a male and a female both 70 years old, the portion of retirement savings with a horizon longer than 10 years is 42% when examining the expectation, and 55% when examining with 90% confidence. This is a marginal increase from 37% and 54% respectively for just the female life (the increase was particular small for the examination with 90% confidence, going from 54% to 55%).

Regarding the wealth of a retiree that is not considered part of their retirement savings, that is, the wealth that the retiree intends to pass along to their heirs, the investment horizon is invariably long. Reviewing the life expectancies in Table 1 it is observed that even octogenarians will have a 5 to 10 year horizon for this event. And further, their heirs won’t necessarily be looking to consume their inheritance immediately upon receipt but will most likely invest the majority of it in their own or others enterprises.

There are many definitions of what is “long-term”. In investment parlance, “long-term” may mean more than 5 years or it may mean more than 10 years. Regardless, a large portion of retirement savings may be stuck in “long-term” throughout a retirement. □