

Making Longevity a Gift, Not a Risk



William Hammer, Jr.

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“Inflation is taxation without legislation.”
-Milton Friedman

Imagine a couple coming to you for their first retirement planning meeting. For this couple, retirement is the financial equivalent of the World Series. They have waited their whole lives for this moment, but they still feel incredibly unprepared and nervous. Assuming that retirement is a short journey, they ask all of the wrong questions about the economy, the crisis du jour, and your firm’s 12-18 month outlook.

Without our help, most retirees will assume that (1) they won’t live very long and (2) their living expenses will not rise very much during the rest of their lives. They project the past into the future and imagine retiring like their parents did – fighting for a comfortable 10-year retirement with an army of bonds, Social Security, and a generous company pension.

But the retirement game has changed, so our approach must change. Most retirements will now last 20 or 30 years during which expenses can double or even triple. If you’re at, all skeptical, just look at a 15 cent 1980 stamp and a 44 cent 2010 stamp. Baby boomers also demand a higher retirement income than their parents did because they travel more, eat at restaurants more often, drive more expensive cars, have more financially dependent children and live in bigger homes. Add to that the equity markets of the last ten years and we have a perfect recipe for retirees outliving their wealth.

So, initial planning meetings present us with a tremendous responsibility: we can ultimately plant the seeds for this couple’s retirement success or failure. Allowing conversations to dwell on headline news is about as responsible as a personal trainer letting a client waste his/her first consultation worrying about sneakers and water bottles. After all, what happened within the last 24 hours has very little bearing, if any, on the next 24 years. While we cannot prevent our clients from worrying, we can help them to start worrying about the right things. **We need to constantly reinforce that the central issue of retirement planning is making sure that their longevity is a gift, not a risk.**

To protect against running out of money during retirement, many advisors turn to guaranteed insurance products that provide income for life. These products

are valuable as a core holding and pension replacement and they protect clients from longevity risk and market volatility. Conversely, they do very little to protect against rising living costs over a 20 or 30 year retirement.

Rising living costs demand a rising income if our clients want to maintain their dignity and independence throughout retirement. Here are three important weapons that we can use in the fight against rising living costs:

(1) A **sustainable withdrawal rate** may be the biggest factor in helping clients’ wealth to outlive them and it is something that we can control. The lower the withdrawal rate, the higher the probability of long-term success. The younger the retiree, the lower the withdrawal rate needs to be.

(2) **Emergency funds** with one or two years of expenses will protect clients from depleting their assets during bear markets, panicking during turbulent times and needing to liquidate assets for large, unusual expenses. Planning carefully during the last five years before retirement, not the week after retirement, is usually the difference between having an emergency fund and not having one.

(3) You can love them or hate them, but **equities** are the only asset class that has offered a significant historical premium over inflation. Most of us focus on the volatility of equity prices, but we should emphasize that stock dividend payments have grown at a rate of one and a half times inflation over the long-term. During the early years of retirement, dividend payments may need to be supplemented with capital gains, but over time these dividends can sustain a greater portion of annual income needs. Simple math tells us that if a client withdraws 4.5% per year and inflation averages 3% per year, we need a 7.5% **after-tax** return to avoid invading principal or compromising lifestyle. If you know another way to get this kind of return without an equity component, please call me!

As 21st century retirement planners, our clients need to understand the goal of our mission together—to make sure their wealth outlives them, not the other way around. **FA**

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