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Volatility risk vs. longevity risk

Michael Nairne, Serious Money

It's a scary world. The threat of a bond default by Greece, a tiny country with an economy smaller than Ontario's, has sent tremors through the world's stock markets. With other Mediterranean countries sliding towards the fiscal abyss, fear has become contagious. Investors worry that even the trillion-euro loan package won't salvage the situation. Then, in the midst of this global drama, the Dow Jones plunges nearly 1,000 points, an intraday record.

No wonder a recent survey of high-net-worth Canadians found that the majority have become more cautious and that nearly two-thirds of them are re-evaluating their portfolio mix.

In my experience, however, many portfolio reviews are too narrow and focus solely on an investor's current appetite for risk. An investor's ability to sleep comfortably at night with the volatility of their portfolio is an important standard, but alone it is not a sufficient criterion for portfolio design.

This is particularly true when the decision is being made in a climate of anxiety in tumultuous markets.

Many investors face a second and potentially more devastating risk: longevity risk. This is the risk of outliving their assets in retirement. Portfolios that are exposed to too little risk may lack sufficient return potential to fund future expenditures over what are increasingly lengthy retirement horizons. A 65-year-old couple today has a 50% chance that the last survivor will reach 90 years of age. Nearly one in 10 couples will have the last survivor live into his or her late 90s.

Long-term living needs long-term funding.

Even affluent families can face substantial longevity risk. With money rolling in, many high-income earners fall into a pattern of high expenditures and inadequate savings and wake up late to the realization that the only solution to potential retirement shortfalls is to keep slugging away at work. As George Foreman said: "The question isn't at what age I want to retire, but at what income."

Unfortunately, even affluent investors with a handle on their expenses can underestimate their longevity risk. First, they focus on pre-inflation numbers, glossing over the fact that in all likelihood they will face constantly rising expenses over the coming decades. Real returns -- returns net of inflation -- are what fund retirement. Bond returns shrink to a paltry 2% to 3% when inflation is deducted. Proportionately, stocks do much better, but even here the real return is a modest 5% to 6%. Investors who are fleeing equities for bonds need to realize that they are cutting their prospective long-term real returns in half or more.

Investors can also overlook the fact that their tax bills may rise in retirement. Affluent investors who are relying on RRSPs and eventually, RRIFs as the bulwark of their retirement funding, need to appreciate that the balm of tax deferral during the years of RRSP contributions will be replaced by the pain of mandatory taxable RRIF withdrawals. Former business owners who need to withdraw capital from their holding companies can also confront unexpected dividend taxes.

At a time when nerves are frayed and confidence is fragile, investors must guard against being overly cautious when evaluating their portfolios. Otherwise, they could find themselves jumping from the "volatility-risk" frying pan into the "longevity-risk" fire. Designing a good portfolio is often a balancing act between "sleeping well today and eating well in the future."

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