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Financial security elusive in retirement

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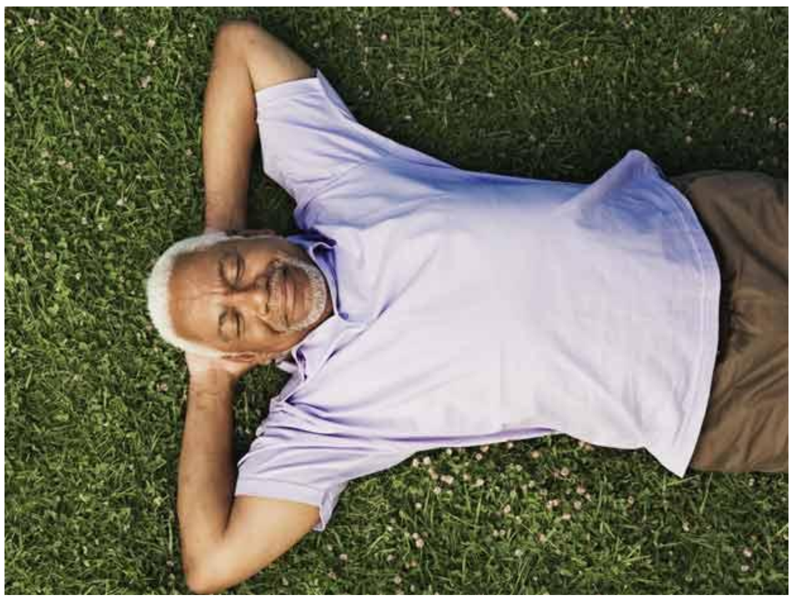

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Retirees facing serious capital depletion have hard choices but many simply hope the issue goes away.

Retiring today with financial security is challenging. Courtesy of central banks, interest rates are at levels not seen since World War II. Then, ultra-low interest rate policies abetted wartime funding needs. Today, central banks are promising a lengthy period of miniscule rates in a frantic effort to stave off the slumps and deflation that often follow on the heels of a credit crisis.

In this world of artificially low interest rates, the price of safety is enormous. Not only are nominal rates paltry, but net of inflation, Government of Canada bonds yield a negative real return. High net worth investors who hold bonds in non-registered accounts also face the bite of taxes.

A back-of-the envelope calculation illustrates how devastating this combination is for wealthy retirees withdrawing funds from their portfolios. Start with three million dollars. Assume a 2% nominal return less inflation of 2% and taxes of 1% and the portfolio will lose 1% per annum in real terms. Now assume a 4% withdrawal rate based on the original capital value, and by the end of year one the real value of the portfolio is $2,850,000. If ultra-low rates drag on for the next three years, a possibility, the real value of the capital will fall to $2,545,850. A stunning erosion of over 15% of capital in just three years.

It's not just the wealthy who are caught in this squeeze. Every conservatively invested RRIF holder faces escalating taxable distributions that virtually guarantee a spiral of ever-falling real wealth. In today's artificial world, the price of safety for many retirees is the heightened risk of outliving their money.

Retirees facing serious capital depletion have hard choices – accept more investment risk in the pursuit of higher returns, cut spending or both. In my experience, many retirees don't find these options very palatable and simply hope the issue goes away. Hope, however, is not a strategy. The prudent course of action is to develop both a diversified investment plan and a budget that reflects today's harsh reality.

On an investment front, an appropriate exposure to equities is critical. Fortunately, unlike the state of affairs a decade ago when ludicrous stock valuations offered little in the way of future returns, stock valuations are reasonable today. Our firm recently forecast a long-term, expected real return from global stocks of 6.3% per annum – only modestly below the 6.6% annual real return of U.S. stocks since 1926.

Adding equity exposure is just one way of improving a portfolio's expected return. Provincial government bonds yield more than Government of Canada bonds as do investment-grade corporate bonds. Bear in mind, though, that this return premium is not a free lunch – these bonds do have greater credit risk and are more volatile. Alberta, for example, defaulted on its bonds in the 1930's. Canadian investment grade corporate bonds lost over 4% in September and October 2008 when the financial tsunami hit.

Preferred shares are another option. Currently yielding over 5%, most preferred shares pay eligible dividends that have a lower tax bite due to the dividend tax credit. Due to their higher yield and lower taxes, preferred shares offer a real return opportunity to taxable investors. Investors need to keep their heads up on the risk front. Preferred shares, which have higher credit and liquidity risk than bonds, lost 16.9% in 2008. Still, this was about one-half the loss of common shares.

Investors can also diversify and seek higher returns through real estate investments. These include both mortgage investment corporations and real estate investment trusts. On the risk front, REIT's lost nearly 50% in 2008 while the shares of publicly traded mortgage investment corporations dropped over 20%.

Every financial storm ends; higher interest rates will eventually return. Until then, however, retirees face some hard choices.

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