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A tough time to retire

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Illustration by Chloe Cushman

Imminent retirement often evokes a feeling of joyful anticipation as liberation from the daily grind beckons. However, for Baby Boomers hoping to retire in relative comfort, the prospect of no more paycheques provokes apprehension instead of delight. The massive market meltdowns of 2008-2009 and 2000-2002 have permanently scarred investor psyches. A daily diet of worrisome economic news, punctuated by repeated flare-ups in the Eurozone debt crisis and violent market swings, has dulled any lingering appetite for risk.

Of course, excessive stock market exposure can be a trap for retirees. For individuals building wealth, bear markets allow them to accumulate more shares for the same dollar investment. That is why dollar cost averaging, investing the same amount every month, works so well over the long term – it capitalizes on bear markets. For retirees who are regularly withdrawing funds from their portfolios, the opposite is true. Constant dollar withdrawals from a declining portfolio will accelerate its descent.

Harold Evensky, a leading wealth manager in the U.S., calls this “black hole” risk. This aptly describes the predicament of aggressive investors who have the misfortune to begin drawing on their portfolios just as a major bear market hits. The early erosion of principal, a consequence of the relentless downhill pull of withdrawals on top of falling values, leaves the portfolio so depleted that it cannot adequately partake in the eventual market recovery.

Many retirees sensing this risk have flocked to government bonds. Unfortunately, in their zeal to avoid the "black hole" of bear markets, they may get caught in the "quicksand" of low real (inflation-adjusted) interest rates. Quicksand can also submerge a portfolio – it just takes longer than a black hole. Let me explain.

Historically, nice, safe government bonds have been a source of moderate real return to investors – 2.2% per annum since 1900 according to the Credit Suisse Global Investment Returns Yearbook. This real return has been critical in funding retirement needs, especially for conservative investors.

For example, consider a retiree who plans to withdraw 4% of their portfolio in the first year of retirement and to increase withdrawals by the level of inflation every year. In normal circumstances, such a retiree would either be depleting their bond portfolio by the difference between their withdrawal rate of 4% and their real annual return of 2.2% – about 1.8% per annum on average or, more typically, would be balancing their portfolio with some stocks with a view to boosting long-term potential returns to offset this depletion.

Unfortunately, the word "normal" doesn't apply to interest rates today. Unconventional monetary policy has driven interest rates to dismal levels not seen since World War II. In fact, at current inflation levels, real 10-year Canadian government bond yields are about nil. In our example, the retiree is facing depletion of 4% per annum given the absence of any real return. In just three short years, his bonds will lose 12% of their purchasing power.

And don't overlook the fact that, for simplicity sake, I've left taxes out. Throw in the erosive impact of taxes, especially when mandatory RRIF payments begin, and the downward spiral accelerates.

It is a tough time to retire. Today's highly indebted economies are more susceptible to frequent recessions and bear markets. At the same time, negligible interest rates are likely to persist for several years. Although it is expected that rates will eventually rise — Vanguard's research team has estimated this will occur in about 80% of their future simulations — bonds will take a hit before real returns are restored.

Thoughtful retirees need to chart a path between the "black hole" of excessive aggressiveness and the "quicksand" of undue conservatism. Fortunately, there are new investment and insurance vehicles, as well as more sophisticated analytic tools, that can assist in finding a solution. One thing is certain – you don't want to be out in the retirement minefield without a map to safety.

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