THE IMPACT OF INFLATION AND LIVING LONGER...

PART 2 OF THE SERIES:

"Can you really afford to retire?"

MUIRFIELD

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Chapters covered in this series:

1. How big should your nest egg be?

2. The impact of inflation and living longer.

3. Reducing the risks of inflation and outliving your nest egg.

4. The SMSF Revolution: Why it might not be right for you.

5. Can you afford NOT to be an investor?

6. How to sack the tax man and live a tax-free retirement.

Letter from the author

Dear Reader,

I am glad you have chosen to receive our 6-part email series 'Can you really afford to retire?'.

We certainly live in interesting times, both financial and social, and the advance in technology and turmoil of investment markets have made long term decision making very difficult. This is especially the case as you embark on the transition from a stable and dependable employment income to the unknown realm of retirement.

We are hearing more and more from our clients that the most important and influential decision they have made in both the final stages of their working lives and into their retirement was finding someone they can trust. After all, you are relying on someone to guide you through the confusing maze of options and strategies available and not to mention you need to know that your superannuation investments are safe. Finding that person is becoming more difficult in Australia.

The aim of this 6 part email series is to provide you with the knowledge of what strategies are available, how much super is enough to retire comfortably, how to replace your income in retirement and much more. We hope that after reading the complete series you are better armed to make the important decisions that will shape your retirement.

It is important to note that this guide is for general illustrative purposes only and for personal advice you should find a trusted adviser and work with them to develop a plan specific to your own situation.

Hopefully we get a chance to meet at some stage so I can outline why our clients have trusted Muirfield Financial Services with their retirement plans since 1989.

Regards

Melinda Planken
CERTIFIED FINANCIAL PLANNER®
Employee Representative
Partner

The impact of inflation and living longer

Although we will be examining this later, suffice to say that your nest egg starts depleting the minute you make withdrawals from it. One of the great mysteries of retirement income streams is that you can actually make your income last forever, provided you withdraw at an appropriate and consistent level. Unfortunately there are a number of snags in the way, not the least of which is our squandering spending patterns.

To make your nest egg last, you should conservatively plan to withdraw about 5% of your account balance per year in retirement. But even a modest $1,500 a month would require a capital sum of approximately $300,000 which is far more than the average super fund balance.

That's $1,500 a month / $18,000 per year. Will that be enough? Not even close.

According to the RBA inflation calculator, what cost $1 twenty years ago will be the equivalent of about $1.66 today. Assuming the same rate going forward, your $18,000 in 2028 will buy you what you can get for $12,000 today. So that $1,500 a month will feel more like $1,000. Startling, isn't it?

Don’t believe me? Consider this:

It is said that Demography is destiny. There is no debating our demographic clustering or its cost to the people who have to pay for it. One way or another, Australians are going to have to pay for the fact that not only is there a “pig in the python” in terms of the bulge moving through the aging process but that also they (and proceeding generations) will live longer.

There are fewer than 500,000 Australians aged 85 and over now and there will be 1.8 million by 2050. The average 60-year old woman today will live to 88 and when you factor in the advances of medical science, a large proportion of these women will live to 90. Men will only be a few years behind in the longevity stages. The destiny issue is compelling: old Australians will continue to be income poor, until those with a lifetime of superannuation contributions start to retire; although a good proportion will be asset rich, relatively speaking. At present, the median household of people aged 75-plus holds 90% of its net worth in the home. But imminent retirees know they need to invest outside of their family home.

The Association of Superannuation Funds of Australia, in a paper which examines the spending requirements and financial needs of the very old, that is, those in their late 80s and early 90s found that over the next 40 years, the number of Australians

aged 85 and over is projected to more than quadruple, from around 400,000 in 2010 to 1.8 million by 2050 (Treasury 2010).

The ageing of our population is largely in response to improvements in life expectancy. In 1983, an Australian female reaching the age of 65 could expect to live on average for another 18 years, while an Australian male could expect to live for a further 14 years. By 2002, these figures had risen to 21 years for females and 18 years for males. The future number of those aged 90 or more will also reflect the impact of the ageing of the cohort of baby boomers. Even without an increase in life expectancy, older Australians can be expected because of this cohort effect.

The ASFA Retirement Standard focuses on the spending requirements of those aged about 70 who are in relatively good health for their age and are still resident in their owner occupied home. The prospective increase in the number of retirees aged 90 raises the question whether a retirement standard more suited to them is required. While the majority of retirees would not make it to this age, a significant minority will be alive.

The salient feature of the study is the 'realistic' cost of living for a typical single person and couple. The findings were based on people living in their own home and found that even the more modest budget would, for a single person, require over $21,000 a year of income and for a reasonably comfortable lifestyle a couple would need over $56,500 a year. That needs to be put into context of the longevity factors noted above.

In practice, in retirement, it is not unusual for the retiree to draw down on capital, so expenditure can exceed income. This would be expected as, for households that contain individuals who have been in retirement for periods of 25 to 30 years (or even more), there can be a developing deficit in terms of repairs and maintenance and home improvements (kitchen and bathroom remodeling for instance).

The conclusion drawn is that there are not sound grounds for decreasing the expenditures on housing for older retirees in budgetary terms, not are there strong grounds for reducing the amount of expenditure on food for older retirees. No boomer today would be satisfied with surviving on tea and toast! Nor is there any reason why it should be assumed that older retirees do not wish to remain smart and fashionable in their appearance.

The question is what is the right investment strategy for the retirement years to ensure a suitable standard of living in retirement? The answer, inevitably, depends on the individual, their account balance, their risk profile and their lifestyle.

There is little doubt that a majority of imminent retirees would wish;

- to retire without financial shocks and be independent in retirement – eg. A self-funded retiree
- have certainty of income
- generate sufficient earnings to keep pace with expenditure needs
- be able to access funds for emergencies
- not have their investments subject to market volatility

All of this will depend almost entirely on the super fund member's balance at the time of retirement as to how many of those boxes they can tick. The reality is most people – based on average account balances - will have to compromise and accept limitations.

To be realistic in a post GFC world might also mean being flexible about retirement age. Nobody would have been all that pleased to retire in 2008-2009 after a 40% fall in stock markets. The new thinking is to be working longer – just in case.

The point here is to illustrate cost inflation and its effect on retirement savings.

Another way to look at it is to realise that the 5% withdrawal rate should include inflation-indexed increases, so if you're taking out $18,000 in the first year of retirement (and inflation that year is 3%), the next withdrawal will be 1.03 times $18,000, or $18,540. Can you imagine how quickly your money will go? Think of the 'headless fish chart' from the first report of this series.

If you want to live off the current equivalent of say, $40,000 per year (and that's less than the average Australian couple needing $57,665 pa to live comfortably) in 20 years time, you can estimate that you'll have to withdraw $70,000 annually in 2014 dollar terms. If that's 5% of your nest egg, then that nest egg will need to be $1.4 million! Still unruffled?

This is, of course, just one (hypothetical) example. The intention here, once again is to kick start the awareness factor, not to frighten you into submission. There are plenty of options. **There's hope…. So read on.**

Many of us will have home equity to access, if need be, in retirement. Some of us will also receive at least something from Centrelink (see www.centrelink.gov.au), and perhaps a little from an investment fund or a rental property.

What is happening is that we have become aware. Now that we have reached a mid-point in our lives, suddenly we are looking at stock market averages and hoping that markets power on and deliver 10% a year or more of growth for our super fund nest eggs. Boomers will have been watching their superannuation fund balances grow very nicely over the past three years, but the stock market's return over the next 10, 20, and 30 years isn't going to match the more recent averages of 12% a year. It could be lower, and certainly more volatile in this post GFC era; meaning you can end up with a considerably smaller nest egg than you may have expected if you have been extrapolating from last year's figures.

But if you take some action now, you can begin to set yourself up for a more comfortable retirement. So get going! But first let's do some spring-cleaning and clear out the belief closet of those old notions of what retirement should or shouldn't look like. There are a myriad of ways our lives could unfold as we move into this next stage of our lives.

Longevity risk

A.k.a. - the worry that boomers will live 'too long' and run out of money. The reality is that financial institutions are not yet adept at managing longevity risk. In short, annuities, which have been a mainstay of retirement planning, where a nest egg is converted into a financial product, run down over a defined period of time, and in so doing, provide an income stream adequate for one's needs, are not going to meet the needs of boomers. **If you're 45 years old you have a near 40% chance of living to 90. For those over 60 this is more like a 50% chance.** So annuities would need to be sizeable as they stand at present. Indeed more sizeable than most of us could presently manage.

Apart from specific longevity risk other risks associated with living 'too long" are that in the intervening period, a retiree's capital is subject to other major risks such as inflation and investment risk.

By 2026, when the last of the baby boomer generation turns 65, old age will have started later because people will live longer. There were almost 2.4 million Australians aged 65 and over in 2000. By 2031, there will be almost twice as many: 5.2 million. Old age will be morphing this generation's desire for greater creative expression and independence and physical activity into a picture of 'lifestyle' villages and places where we may choose to live out our years beyond 85. There will be choirs, sports, concerts (acting, musical and singing), as well as writing and publishing, and pursuit of social ventures of all shapes and sizes.

According to the work of Susan Jacoby, author of *Never Say Die: The Myth and Marketing of the New Old Age (Pantheon)*, almost half of America living past the age of 85 will suffer from Alzheimer's. Jacoby who is program director of the Centre for Inquiry-New York City, a rationalist think tank, and a member of the advisory boards of the Secular Coalition for America and the Freedom from Religion Foundation says at least 50% will wind up in a nursing home and only 25% of Americans living past age 65 have annual incomes of over $US 33,667. Jacoby is neither an economist nor a medical expert but her points will resonate with many sectors of the financial services sector.

Eminent Australian scientist Gustav Nossel writes in Death to Disease that we will benefit from new, sophisticated treatments for heart disease, strokes, cancer diabetes and arthritis during the next 20 years. But the revolution will not come cheaply.

He predicts that by the middle of this century, human life spans could have leapt 40 years thanks to advanced drugs and the conquest of the most infectious and degenerative diseases. By then the current debate about the morality of stem-cell science will seem antiquated.

Thanks to advances in medicine, we are living longer and better – up to point. We may be blessed by good genes too but unless we have made all the right moves, financially, many are destined to run out of money at a time when their medical costs are soaring.

Paul Zane Pilzer, renowned US economist says we are entering a "Wellness Revolution" where, collectively, we will move from a mindset of dis-ease to one of wellness and wellbeing. You can already see the evidence of the first wave of semi-retired baby boomers elbowing out their younger counterparts on the yoga mats, the adrenaline adventure tours and the complementary health therapy couches. Mind, body, soul + money are the new mantra for this health-conscious generation. But there are unintended consequences.

Yet, many retirees plan their retirement lifestyle around the idea that they won't live much past 85. Allocated pensions are often structured around social security benefits to give a retirement income until about 85. Accordingly, many people fail to plan for a life after age 85. They will often have to rely on government benefits alone in the later years of retirement - an income that can only sustain a lifestyle well below their expectations.

Current realities

Even current retirees are finding their retirement spending is declining less than they expected, limiting the opportunities open to them. The message for boomers and Gen X'ers is that you will need to assert greater responsibility for your income needs in retirement as existing templates for how much you will need are steeped in old rules and paradigms. New sources of income and new ways of managing your financial assets need to become part of your life. Ultimately, the reality is that you will need to find other sources of income that give you the flexibility you need to plan for your post-career life, your way.

Living a longer, healthier and a more active life will mean a greater risk of you outliving your income. This is the new reality facing baby boomers and Gen-X. After a lifetime of pursuing their interests and being importunate savers, there is a yawning gap between what their experience has been and what is available to them in real hard cash terms. We need to consider the chances of your nest egg lasting through a 25-30 year retirement, something which is almost certain to be a reality for a majority of today's baby boomers.

Consider the facts:

- Life expectancy improves with time: by 1 year every 6
- A male today aged 60 has a 50% chance of living to 90
- 30 years at 3% inflation: $48,200 (minimum living standard for a couple) would have the equivalent purchasing power of $19,857.

About the author:

Melinda Planken is a Certified Financial Planner® with Muirfield Financial Services, AFSL 243287. Muirfield have been the trusted finance professionals in Geelong since 1989 with specialist knowledge of retirement planning strategies and advice. As a Partner of the firm, Melinda is well positioned to guide you through the process of retirement and into the next phase of your lives.

This guide is one section out of the 6-part series 'Can you really afford to retire?' We wrote this series to outline the most important issues facing retirees in Australia and how you can avoid the most common mistakes made by many retirees before you. It is intended to get you thinking more pro-actively about your retirement.

I encourage you to book your complimentary retirement strategy session with me to discuss your specific retirement goals. The best way to take advantage of the information you have learned so far is to speak with a CERTIFIED FINANCIAL PLANNER® practitioner about strategies specific to your personal situation. This guide has armed you with the knowledge to know what questions to ask so please click here to book your free appointment and I look forward to meeting with you.

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We also have clients all over Australia and the world who prefer to conduct appointments via Skype in the comfort of their homes.