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Designing Retirement Cash Flows In the 21St Century

Most Canadians work hard during their career years, often raising a family, putting the kids through college, paying off a mortgage and saving enough money to retire in a lifestyle they deserve – a retirement full of vacations, cottage time, golf courses, playing with grandchildren and other goals you had dreamed of for thirty or more years while you were working.

All of this can be ruined however, if you don't get your retirement money planning done early and done right.

No one wants to be 75 years old and fighting with a spouse because there isn't enough money for a new car or a vacation this year. And no one wants to be 88 years old and face a low quality, government run nursing home where you share a room with three strangers.

Why Retirement Is Different Today

Several key factors have come together in recent years to make retirement financial planning different from when our Fathers and Mothers retired 30 years ago. Ignore these factors, and your retirement money planning could be a disaster:

- We are all living longer – health care advancements could add 20 years to your life – that doubles the amount of retirement time you have to pay for costs compared to your ancestors. And, if you spend the last ten years in a care facility in old age, at $40,000 a year per spouse, it could be a far more expensive retirement than envisioned.
- We want nice things always. So often I hear "Kurt, I don't want to retire the way my parents did. They sat on a park bench for 30 years after retiring, never bought new clothes, never bought a new car and never took a vacation. Kurt I work hard and I want to have nice things always." Today's baby boomers have grown up with a silver spoon in their mouths, many driving luxury cars, carrying Iphones, kids in private school, big vacations every few months and eating at restaurants four days a week. Few want to give all this up in retirement and live off far less. In today's world Canadians want to maintain their standard of living always – this could mean twice as much money for retirement as originally thought.
- No one downsizes their real estate anymore in retirement so there is no money added to retirement cash flow from the sale. Or, if Canadians downsize, they sell their $500,000 house and buy a $450,000 condo. That's not downsizing – it doesn't add squat to one's retirement finances to help with annual cash flow.

- Children are living at home longer, going to university longer, returning to live at home if they get divorced and generally burdening the parents much longer – resulting in less money for the parents to save for their retirement.
- No one has juicy pensions anymore – they say that only 1/3rd of Canadians still have a defined benefit guaranteed pension like the kind that teachers and police officers still have. The rest of us have a defined contribution plan, a group RRSP or nothing. It used to be that you could count on your employer to take care of you with a big, fat pension waiting for you when you retire. Not any more: I haven't seen one of these latter types of pension plans be in a position to take care of anyone. Couple this with the fact that folks change careers far more frequently now, and no one stays anywhere long enough to build up enough savings. If you aren't doing a lot of extra savings yourself, you're likely in trouble with retirement savings.
- The average person is finding that retirement savings is at the bottom of a long list of essentials. So many Canadians are torn between what to do with their dollars when it comes to financial goals: save for children, save for retirement, pay down mortgages, buy a new car, purchase more life insurance, disability insurance, upgrade the kitchen and so on. It's all important – so what to do first? As financial planners, this is one of the most important assessments we can help with, so give us a call. On your own, you may feel lost, or helpless that you won't be able to accomplish it all. So many Canadians wake up one morning at age 50, realizing there is only 10 years (or so) until retirement and feel they are hopelessly behind. You might be if you don't have a plan. And you might be if you leave this kind of planning to age 50. So often the answer we hear is "I'll keep working". This is not a safe response because a health condition (e.g. stroke) can end your career and really leave you and the family in dire straits.

How The Stock Market Correction of 2009 Changed Everything
Greed is powerful. It causes people to put 80% of their savings in the stock market to chase bigger and bigger returns at age 70. So quickly a few weeks or months of up stock markets can cause us to forget a stock market can fall 30% quickly as well. And, if you are retired and no longer capable of returning to a career, you cannot afford a significant loss – you have no time to recoup this lost money if you are already in late retirement.

In 2008, for the second time in the decade and the tenth time since 1950, we experienced a gut wrenching massive drop in portfolio values. Knowing that you can expect such declines approximately every five years during your retirement, and no one knows when they will occur, reflect on two comments right now:

- Will you ever be able to relax in your retirement if you live in constant fear of a stock market decline? How is that an enjoyable retirement? Is this you: you are constantly checking your portfolio online or watching Business News TV? Are you able to totally relax and not think about your portfolio for weeks on end? If you are addicted to investing due to fear, I am worried about you. I am worried about what this stress will do to your health. Retirement is not supposed to be stressful.
- Do you want to have to think about every dollar you spend in retirement, fight with a spouse about spending, limit your goals and more because you are worried you won't have enough? Never, ever retire until you can 100% say you have enough money saved up, you can withstand a variety of negative consequences along the way, and you have a cushion for unexpected and occasional costs. Oh yes, and we have factored in inflation – more on that below.

If you are retired, you cannot afford a large stock market decline. So, you should never have a large amount of your savings in the stock market. Period. Sure there are exceptions to the rule (e.g. independently wealthy, large pensions to supporting your cost of living). But for the rest of us, where retirement will consist of living off our accumulated RRSP and other savings, you must be careful with your asset base – investing all of your savings in the stock market at age 70 is not being careful!!!

How Retirement Cash Flow Planning Starts
We are finding that the old standard of living out your retirement with 60% of your pre-retirement cash flow is rarely the case. Specifically, we see three phases to retirement:

Phase One: Active Retirement – age 60 (or whatever age you start retirement) to age 75. This phase is characterized by high cost travel and socializing, interacting with children, grandchildren and parents. For these reasons, this is often the most expensive phase – travel is expensive today, you may still be paying for children's education in your 60's while also helping out with your own parent's advanced health care costs in old age. This fifteen year period may be as expensive, or more expensive than when you were working – but now you have no new money coming in. It is absolutely critical that you have cost control limits during this phase – if you blow the budget now, you can set yourself up for a very poor quality later retirement if there is no money left. Remember, you may live 40 years in retirement or almost half a century. That's a long time to live with no new salary earnings coming in!

Phase Two: Passive Retirement – age 75 to 85 – often this is when the first serious health issues creep into your life. Sadly, one spouse, usually the male, will die in this phase. But as you age often you slow down and stay closer to home. Cottages get sold off, fewer vacations out of the country and possibly giving up the country club membership. Your costs decline in this phase.

Phase Three: Eldercare Years – age 85 and beyond. This phase may be characterized by life in an assisted living facility or a nursing home or perhaps just hired support in your own home. This phase can see your costs rise again, as health care in Canada is expensive. Whether it is drug costs that are not covered by provincial health plans or nursing homes that range from $30,000 / year to $60,000 a year per spouse, once again you want to ensure that your savings and incomes are managed to last the entire period.

And then there is inflation. In the last 50 years, inflation or the rising cost of living (e.g. cost of milk or stamps) has averaged as high as 5% per year. Today inflation is closer to 2% per year. Ignore inflation and you will face a damaging erosion of your purchasing power and standard of living over your retirement. One dollar will buy far less over time. A general rule of thumb is that your cost of living will double every 20 years. So if one of you lives 40 years or more, you could face your cost of living doubling twice. You absolutely need to have some income sources that factor in the inflation impact.

No one should retire until they have a strong handle on their expected spending levels in retirement – not only when they start retirement, but also when they finish retirement at age 100. Yes, age 100 – it is foolhardy to plan to the median age of death (something around 80). We need to ensure that if you beat the odds that you don't run out of money.

So, before you retire, we need to estimate retirement costs. This is best done if you take a year's worth of credit card statements and cancelled cheques, sit down one weekend and summarize your costs as follows:
Category A: Core, fixed costs – expenses such as utility bills that are fixed, essential to your lifestyle and must be paid, no matter what.

Category B: Core, variable costs – fixed costs that vary in amount. An example is a birthday gift – you must buy something, but you can decide whether you spend $20, $200 or $2000.

Category C: Discretionary costs – costs that you are choosing to make, are optional, but do matter to your quality of life. Examples are restaurant meals once a week, reasonably priced vacations, small financial gifts to the kids, practical new cars and gardening costs.

Category D: Luxury costs – non-essential, feel good expenses like high end cars, elaborate parties, wine, vacations and more.

It is important as you compile these costs to factor in future costs that are not yet part of your life but will be in the future: health care costs being the biggest one. And it will be a core, fixed essential cost.

If you start to examine these costs at around age 55, at least 5 years ahead of retirement, take note that you will need to deduct some costs that you are incurring today that will not be part of your retirement costs:
- Mortgage and other debt payments – you should be clear of all debt before you retire.
- Life and disability insurance – when you retire you no longer need this.
- New savings – few people create new savings once retired.
- Kids – a huge cost that should largely be done before you retire. Don't retire if your kids are still in university as you will likely be involved in paying for this high cost.

As well, when you add up your retirement costs, don't forget to factor in the following occasional costs:

- Real estate repairs (e.g. roof shingles every 15 years and other costs)
- New vehicle purchases
- Big vacations
- Costs of children's weddings and new home purchases you want to help out with.

Note that even once you are retired it is important to periodically review your expense levels to ensure you are still on plan and living within your means. We call this "life style parameters and it applies to everyone regardless of wealth level. Folks with more money typically spend more. Some Canadians who admit that money is not their bag, need strict coaching to avoid overspending. This is one of the most essential roles we provide as your advisor in retirement.

Income Matching

This is arguably the most important step of this exercise and ironically the one step that many overlook to complete.

In 2008, when retirees lost a fortune in the stock market, many lost even their money for basic groceries when losses went so deep they impacted right down to the fixed, core costs.

So here is the point about income matching: your fixed core costs and your variable core costs should never be provided from a variable income source like the stock market. These essential costs, necessary for basic life, should be provided from the following sources only.

- Canada Pension Plan pension – if you paid CPP premiums when you were working then you are guaranteed to get some level of pension starting as young as age 60. This is guaranteed for life and benefits will periodically be increased for an inflation factor by the government.

- Old Age Security pension – paid after age 65, you get it by virtue of being a Canadian resident for a long enough period of time. This government pension has a catch to it however – the government can cancel your annual pension if your total income is too high. So we cannot count on this one. Generally however, anyone over age 64 earning less than $60,000 a year in total income will get a full Old Age pension.

- Defined benefit pensions from strong companies with paid up pension plans – Nortel and Abitibi Bowater, both longtime Canadian corporate goliaths are now in bankruptcy. Pensioners from both companies are waiting to see if they will have their pension benefits reduced. In the 21st century, this new fear is causing many retiring employees to take their pension benefits away from the company when they retire so they don't have to worry about the strength of the company long term. If however the company will be a survivor, or you will get a government pension (e.g. teacher), then you can also count on this money as part of your "guaranteed" income sources for life. Note however that many company pensions no longer offer inflation indexing, meaning your monthly payments won't be raised over time. If this is the case you'll need to build an inflation adjusting component into another part of your retirement cash flow.

So let's stop here and do an example: perhaps your monthly pre-tax CPP pension is $600, Old Age Security is $500 a month and your company pension is $1800 a month. The total of these three "guaranteed cheques in the mail" is $3,200 per month, pre-tax.

Let's assume your annual income tax is $12,000 a year, or $1,000 per month. So your after-tax pension cheques amount to $2,200.

But perhaps your core fixed costs and core variable costs are $3,000 per month.

We have a shortage of $800 a month.

This shortage of $800 per month or $800 x 12 equals $9,600 per year should be filled by another source of guaranteed revenue – a source that can adjust for inflation and be guaranteed for what can be more than 40 years of retirement. In my opinion, you only have two choices to fill this gap: an indexed annuity and a guaranteed withdrawal product. Both are discussed below.

While bonds and GICs are safe and guaranteed, market interest rates are not. We are seeing that currently in 2009 and 2010: the lowest interest rates in 50 years are seeing long-time retirees having to live off far less interest income than they received five years ago. This is bad planning and an over reliance on bonds and GICs because they incorrectly appear to be "safe". They make up far too much of many older retirees' portfolios. Newer retirees have to learn that to rely on bonds for the lion's share of retirement costs could leave the retirees savings ravaged by inflation over time and subject to the volatility of interest rates year to year. This can mean you are left with not enough money to live off long term.

So where should you invest in stocks and bonds? The stock and bond portfolio, or the mutual funds and etf portfolio, should be of a size that they provide your income for the remaining two types of optional and flexible expenses: discretionary and luxury expenses only. Since you cannot count on them to maintain stable values, you need to limit their contribution to your cash flow to only the expenses that can flex. This means that in bad stock and bond market years, you resist incurring your typically discretionary and luxury costs. And in good stock and bond market years, you spend a bit extra when you have the growth and earnings.

This is where so many Canadians went wrong in 2008 and 2009. They had based almost all of their retirement cash flows on the stock and bond market. When the stock market fell 50% or more and rates for bond interest fell below 1%, a retiree that used this investment mix saw their entire cash flow base collapse. And because the retiree didn't segment their cash flows according to the types of expenses I identify above, their bond and stock market losses penetrated right down to the core expenses. I talked to more than a few 70 year olds that were out looking for work last year because of this. Not the retirement anyone envisioned. If you let us help you design your retirement cash flows, we will work with you to design your retirement income streams, pre-tax and after-tax, and match this up with the right types of investment and insurance products. We will then review this with you each year to ensure you stay on track and have the peace of mind everyone wants.

Investment Products Suitable for Retirees
Products to Provide Guaranteed Income for Life with Inflation Indexing Built In

Indexed annuity – an annuity is an insurance product. You provide a one-time lump sum amount of money (as little as $25,000) to the insurance company in exchange for a life long pension or stream of payments paid to you each month. The indexing feature is an add-on that you purchase whereby the payments will rise over time to adjust for the impact of inflation.

Annuities are permanent products – once you purchase one, it cannot be reversed. They are offered by all the big insurance companies in Canada and further insured by Assuris. If you die prematurely, you can include a nifty feature called a guarantee feature that will pay the benefits to your estate or your spouse for many years to come. Annuities can be purchased with either RRSP, RRIF or non-registered money. With non-registered money the tax rates applicable to your annuity cash flow are lower than other forms of investment income, resulting a tax advantaged form of cash flow. The annuity payment you will get is based on age and features attached to the annuity. Recently, a joint annuity provided to a couple in Toronto, age 62, offered more than a 6% guaranteed income stream for life. This was more than six times the best GIC and bond rate of the day when we quoted the annuity. This rate is guaranteed for life and will actually rise when the inflation adjustments kick in.

The older you are, the higher the cash flow yield on the annuity. Generally we recommend that one third of your savings should be considered for an annuity. More specifically, it should be based on your essential expense needs.

Guaranteed withdrawal products -products such as CI Sunwise, Desjardin Helios and Manulife IncomePlus have combined the benefits of an annuity with the benefits of a segregated fund product. Different versions of these competing products in Canada offer guaranteed incomes up to 5% of the invested amount payable for life, the potential for increased guaranteed income over time, protection against loss of your original capital and a simplified and potentially less costly estate inheritance for your heirs. These products have been very popular in Canada in the last few years, offering peace of mind in retirement through a guaranteed income stream for investors fearing the stock market but needing more than GIC returns to live off.

Products to Provide Liquidity or Growth
This is where traditional stocks and bonds fit in – as a source of cash flow for the non-essential costs of retirement.

Government bonds, GICs, corporate bonds, bond mutual funds and bond exchange traded funds (ETFs) – all of these are fixed income investments offering various degrees of cash flow, risk, liquidity and volatility. They offer stability to your investment portfolio, some amounts of cash flow that depend on the interest rates of the day, heavy taxation and a useful source of liquidity for lump sum needs. The best source of fixed income tends to be a series of high quality bonds with staggered maturities ranging from one to ten years. Each year in retirement you spend the interest earned and reinvest the matured bond into a new ten year bond to extend the bond maturities.

Stocks, stock mutual funds and exchanged traded funds, invested in the Canadian and foreign stock markets. Even dividend paying blue chip stocks can cut their dividend and the stock prices can fall significantly as we saw in the fall of 2009. If you are retired and face a nasty correction, this can be unnerving. Any stock market product can be extremely volatile and cannot be counted on for essential income. As your wealth grows, stocks and etfs should become the dominant form of product utilized. If you have a smaller amount in the stock market, the diversification offered by etfs and mutual funds offers more stability for a higher fee. In the end, a mix of blue chip dividend paying stocks, global etfs and sector mutual funds is a blended mix that offers good performance, reasonable cost, tax efficiency, and a risk managed approach to investing.

Next Steps

Retirement planning is complicated. The thinking and brainstorming of your issues needs to start around age 50 and stop around age 100. It must consider your various income sources and expenses of course, but it also must consider a tremendous amount of income tax planning, risk assessment and personal gut preferences.

It starts with a lot of talking. As always, we are at your side, ready to help. Call us when you are ready. We are not ordinary financial advisors.

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