# WHY YOU NEED TO UNDERSTAND RISK AND UNCERTAINTY WHEN PLANNING FOR RETIREMENT

BY SIGHTLINE WEALTH MANAGEMENT

THE LONGER THE FORECAST PERIOD, THE LESS RELIABLE A FINANCIAL PLAN WILL BE. JUST ONE REASON NOT TO CREATE A SET-AND-FORGET SCENARIO.

The mathematics of retirement planning does not result in just a single solution. Much like meteorology, it is a forecast based on holding several factors constant, to try to help you make decisions today for tomorrow.

If a meteorologist suggests a high probability of precipitation, you might bring an umbrella to work or send the kids to school in rubber boots. You react, in advance, to a professional's perceived future risk of rain. Like a financial planner, the weather specialist is doing their best, but is not always right.

The Financial Planning Foundation wrote a paper entitled "The 'Risk' of Ignoring Risks in Retirement Financial Planning," authored by Bonnie-Jeanne MacDonald, Richard Morrison and Marvin Avery. Some of the risks and remedies may be of interest to retirees, those approaching retirement, and the advisors who advise them both.

In much the same way forecasting the weather more than 14 days from today is difficult — no offence, Farmer's Almanac — the longer the forecast period, the less reliable a financial planner's planning. "The relatively long time spans inherent in individual financial strategies offer major opportunity for these risks to generate significant, interacting, cumulative impacts on the financial outcomes that people will experience," according to the foundation's paper.

Several studies have identified the risk of so-called "one future" projections that attempt to give a once-and-for-all answer to how much you need to retire. This is a genuine risk of the commoditization of financial planning, whereby a financial plan has become a product like an insurance policy, to be purchased once, as opposed to a process like deciding whether you need to wear a scarf today. The media can be equally guilty: A generic one-liner about what your nest egg needs to be makes for a good headline, but a bad retirement plan.

A genuine risk throughout someone's career that may increase as retirement approaches is labour-market risk. Jobs are hardly guaranteed these days, and a late career job loss for someone counting on a few more years of accumulation during their prime earning years can be devastating. This is an important reason to plan for an early retirement but opt for a later one.
Other financial shocks like divorce, disability or death can result in unexpected costs, which are similarly detrimental. The latter two can be insured against with disability or life insurance, whereas the former — divorce — is harder to mitigate (though believe it or not, you can buy marriage insurance).

One of the key criticisms that the FP Foundation paper has of conventional financial planning is a deterministic projection that investment returns, inflation and retiree spending are consistent and linear, and that retirees conveniently die at 90, particularly if financial planning is completed as a set-and-forget exercise.

Financial planners sometimes use techniques like Monte Carlo analysis to evaluate a broad range of potential investment or inflation outcomes based on historical data, or stress testing to evaluate worst- or best-case scenarios. Even this can be risky, because it can lead to "extreme and improbable outcomes," causing under or overspending in retirement as a result.

Financial Planners can attest firsthand to the frequent inaccuracy of people's estimates of their annual spending as well. Without the assistance of budgeting software, which few people use, most tend to dramatically underestimate how much money they spend. Since bad input leads to bad output, even the most sophisticated financial modeling techniques may be all for naught if important and sometimes fluid inputs such as expenses are incorrect in the first place.

"The challenge, however, is that people who depend on financial planners may not return year after year to revisit their strategies," according to the FP Foundation; and rightly so. Financial planning has a cost, whether someone hires a fee-for-service financial planner or an investment firm offers planning as part of their investment management for a client. We would all have healthier teeth if we could visit the dentist every three months, but let's face it, that may not be practical for everyone either.

Two of the main recommendations in the paper include delaying Canada Pension Plan (CPP) uptake and adjusting investment withdrawals over time based on actual portfolio performance. A pensioner can begin their CPP retirement pension any time between age 60 and 70. Deferring past the typical "retirement" age of 65 results in an 8.4 per cent annual pension increase, or a 42 per cent higher pension at age 70. CPP deferral helps protect against inflation risk, given CPP is indexed to inflation, and longevity risk, as the pension keeps paying out even if you live to 110 (unlike an investment portfolio). Despite deferred CPP being a simple method to secure retirement annuity income, most Canadians not only do not delay their CPP, they start their pensions before even the "normal" retirement age of 65.

The variable spending recommendation based on portfolio returns in the paper is an interesting option, and it has been explored by other retirement experts, such as William Bengen (floor and ceiling withdrawals) and Michael Kitces (ratcheting rule). The main premise is that in years in which your investments perform poorly, you reduce spending, while in years in which investments perform well, you increase spending. This requires a degree of variable spending in a retirement budget, which may not be appealing to everyone.

Retirees who lack large pensions or those who have more volatile investment portfolios need to plan for the risk of more variable retirement outcomes. Defined benefit (DB) pensions are harder to come by these days, but deferral of CPP or Old Age Security (OAS) pensions may help maximize guaranteed income for those who do not have other pensions. More conservative retirement investment portfolios may result in more predictability in possible retirement spending, but perhaps at the expense of the potential of higher spending that may result from higher returns from taking more investment risk.

Retirement planning and weather forecasting techniques are both improving over time. The science of retirement planning is not unlike meteorology, given neither is 100 per cent accurate and both require a margin of error. We can frequently check the weather, but it's prudent to always have an umbrella in our cars. The best approach to financial planning may be much the same — hope for the best, plan for the worst and take any forecast with a grain of salt.

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