

# YOUR INVESTMENT PLAN

## Life Expectancy and Investment Risk

[by Jean Wolfe]

I am constantly challenged in investment design with the conundrum posed by “predicting” life expectancy. One of the largest risks we have as investors is to determine the wealth needs in a distribution phase that can be as short as 3 years or more than 30. An additional challenge is that today’s volatile investment climate has decreased investors’ taste for risk. In bull markets, investors tend to accept short-term risk with complacency, but the opposite occurs in bear market cycles. And a swing to “too conservative” can leave an investor out when markets recover.

A popular new approach to investing for the long term is the creation of multiple “buckets” to fund the retiree’s spending at various stages. This approach builds a “cash or spending reserve” and then a “bond reserve” and then ultimately the “stock reserve” for short-term, intermediate-term, and long-term horizons. Of course, the sum of these three buckets equals the simple balanced portfolio we design for most of our clients. We “stress test” the portfolio with return probabilities and Monte Carlo simulations, but we also recognize the limits of these tools and illustrations. In the miracle of modern-day computers, we can illustrate up to 10,000 hypothetical outcomes for the investor, but the largest challenge remains—the date of your death is still unknown.

Funding these stages of life and understanding a client’s view of mortality are part of the planner’s challenge. We discuss early mortality versus late mortality, lifestyle, current health, hereditary factors, support network, and ultimately, last wishes. All of these topics affect the quality and cost of our last years. When significant medical events occur, we need to estimate the impact on a client’s financial resources—and then revise that calculation if there is a surprising recovery.

I’ve shared the stories of my own family with many of my clients to illustrate the impact of excellent health care on significant illness. My brother and father-in-law both enjoyed many years of life in spite of debilitating and eventually terminal illnesses. My own parents continue to enjoy a high quality

and Social Security are facing underfunding and the possibility of default. As consumer responsibility grows, missteps could be costly and many elements of retirement seem more uncertain than ever before.

So how can we manage the risk that we may well live to be 95 years old while still



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of life after cancer surgery and near fatal illnesses. So how do we manage longevity when we may need to stretch out our life savings for 30 years?

As traditional investors, we invest in bonds, CDs, and savings accounts for their certainty of payouts and low risk. We invest our “risky” money in stocks and portfolios through mutual funds or index funds (ETFs). And we invest a certain amount in concentrated risk areas such as individual stocks or international stocks. There are many studies that support this approach, and we have been successful in tailoring this approach to the individual needs of our clients.

However, I have observed with increased concern the “consumer responsibility” trend influencing many issues related to retirement. One example is the shift from corporate fiduciary plans (e.g., the old defined benefit pension plan) to “self-funded” 401(k) plans. Self-funded health savings accounts and long-term care insurance to support late-in-life care needs are also gaining in popularity. The number of options and the level of complexity in all aspects of health insurance coverage and income replacement are increasing at a time when Medicare

expanding funds? Insurance vehicles have always been used to diversify individual life expectancy into “pools” to reduce risk. As an investor, this sharing of risk seems appropriate to explore. The use of variable annuities and immediate or fixed annuities in combination with appropriate investment diversity has proven effective in several studies. The volatility of short-term equity markets demonstrates the importance of using investment vehicles that increase the certainty of payment. The use of annuities is another strategy to explore in a time of financial turbulence.

Even with these latest investment alternatives, the big variable will always be unknown. Though there are no guarantees of a long, leisurely retirement, we are always seeking creative strategies that will help our clients enjoy the rest of their years—whether retirement lasts 3 years or 30. ●

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