Biggest risk during retirement? Running out of money

BY TERRY MCBRIDE, SPECIAL TO THE STARPHEONIX FEBRUARY 27, 2012

"Do we have enough money saved for retirement?" That was the question Jim Otar's wife asked him 16 years ago. Having been trained as an engineer, Otar decided to analyze the numbers scientifically.

He was skeptical of the conventional rules for planning retirement cash flow. Otar decided to develop his own set of rules, which he calls The Zone Strategy.

Running out of money

Otar says the biggest risk that retirees face during retirement is running out of money. We can go broke from living too long. A burst of double-digit inflation can eat up the purchasing power of our savings. We could also go broke through bad luck, especially if there is a stock market downturn during the first few years of retirement.

How long should you expect your savings to last?

Do not plan your retirement based on average life expectancy. If you only accumulate enough savings to last until your average life expectancy, there is a 50-50 chance that you will outlive your savings. To be more certain of success, Otar recommends making your savings last until age 95.

Otar says too many people focus exclusively on choosing investments - deciding how much to allocate to cash, bonds and equities.

Sustainable withdrawal rate

Because of his research, Otar believes that the annual withdrawal rate, as a percentage of your savings, is the most important factor in determining whether you will go broke in retirement. Otar feels strongly that the rate of withdrawals from your retirement savings should not exceed what a life annuity would pay.

If a 65-year-old wants savings to last to age 95, a safe withdrawal rate is 3.7 per cent per year. A 75-year-old can safely withdraw 5.2 per cent. The goal is to make sure that you do not run out of money by age 95.

Zone strategy

As a financial adviser, Otar has developed a threecolour graph to determine how to withdraw retirement income to make sure savings last to 95. Based on your retirement age, your savings and your desired retirement income spending level, he would place you in one of three zones - green, red or grey.

Green zone

You are in the green zone if you have abundant savings because of your careful spending habits. You have enough savings to maintain your lifestyle throughout your retirement. You can invest in a portfolio that includes equities.

Red zone

If you have big spending plans but modest savings, you are in the red zone. You have a high probability of running out of money by 95. You cannot afford to take risks. Don't expect your financial adviser to work miracles.

Otar recommends you buy a life annuity that guarantees lifelong income. Share the risks by pooling your savings with other retirees.

You will need to trim your lifestyle expenses but that is a better outcome than holding a potentially volatile investment portfolio with a high probability of running out of money.

Grey zone

For some people who are in the grey zone, in between the green and red zones, the best strategy is to allocate some savings to buy a life annuity and keep the rest in an investment portfolio.

Not enough savings

What if you do not have enough savings to sustain the spending level you need for a comfortable retirement? In other words, how can you move from the red zone to the green zone?

You could, for example, delay your retirement, spend less, work part-time during retirement, rent part of your home, downsize your home or sell and rent.

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Jim Otar is the author of Unveiling the Retirement Myth: Advanced Retirement Planning based on Market History.

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