

The Retirement Iceberg no one talks about

Or,

(Why good news can upset the retirement apple cart)

Medical science is on the verge of extending life significantly, and that is good news!

A decade ago, when I was Chairman of the Board of the University of Massachusetts Medical Center, it was thought the maximum possible lifespan was 130 years. In April, I watched as Barbara Walters hosted a show entitled “150 years”. During her show she talked about developments that would extend life and create replacement body parts. A lot has happened in the last decade!

Authors like Andy Kessler “The End of Medicine” and Ray Kurzweil “Fantastic Voyage” predict the end of heart disease, stroke and cancer from the developments in imaging, nanotech, viral and protein science, and genetics. These developments, they predict, will create a major increase in lifespan and health and an eventual reversal of the aging process within the next five to ten years.

From my own personal experience I have seen the development of replacement ears, the birth of the CT scanner and imaging that can pinpoint Alzheimer’s and Parkinson’s diseases.

The pace of medical discovery is quickening geometrically.

The implications of medical improvements in treatment of the major diseases that cause infirmity and death will have significant implications on the longevity of the “boomers” reaching retirement and the population at large.

This increase in longevity will change how we think of retirement and the way we plan for it. Yet few are talking about the implications.

Social Security in its 2008 annual report of the Board of Trustees reports life expectancy for those reaching age 65 of 16.7 years for males and 19.2 years for females. The solvency of our social network is predicated on the accuracy of these actuarial assumptions.

Interestingly, the Center for Disease Control National Center of Health Statistics in 2004, published four years earlier than the Social Security report of 2008, predicted longer expectancy at age 65 than did Social Security four years later. Could politics have an influence?

The CDC also reported life expectancy for the group had risen 5 years since 1950. Even with the great medical breakthroughs predicted, Social Security in 2008 only projects an added life expectancy of 2 years by 2055. Thus, if one is to believe the assumptions upon which our retirements are based, the increase in

age longevity will slow dramatically in the next 50 years to a rate only 40% of what it was in the previous half century before polio, small pox and other scourges were eradicated.

What if Kessler and Kurzweil are right and longevity over the next 20 years is extended by another 5 years beyond the assumptions? (They actually predict greater life extensions than 5 years)

Demographics is a straightforward formula since the population and its age stratification are known, an extension of longevity of five years over the Social Security estimate of 19 years at age 65 raises estimated liabilities by 25%. The only way to make up the shortfall would be to lower benefits or increase funding by raising taxes. This reality is not discussed in Washington and is referred to as “the third rail” of politics since it is too hot to touch. Despite a spirited election in 2008, none of the candidates have made this a primary issue of their campaign.

Retirement asset allocation formulas provided by financial advisors assume similar life expectancies, and allocate fixed income assets a time of retirement for a 65 year-old to 50% to 60%. As the retiree ages, the asset allocation percentage increases for fixed income in their current models.

Historically, this asset allocation accomplished two purposes: principal preservation and a provision for a planned withdrawal process from the generated interest income.

Inflation is a concern. Ten year bonds now pay 3.5%. An investor can get a higher return by assuming more risk, but needs to balance this decision with the knowledge that bond market cycles have periodic wash outs of higher yielding securities that destroy principle similar to the one we are now experiencing with the subprime fiasco.

Long term inflation in the US is 3%. Thus, ten year bonds roughly cover expected inflation.

The income from ten year bonds will roughly cover expected inflation if the investor can reinvest all of the income received in comparably returning bonds. Unfortunately, that income is meant for living expenses and is only available after payment of any investment management fees and taxes the investor incurs. Expenses growing faster than the average inflation rate such as medical costs, future cost shifts and reduction of social security benefits, added taxes and any unforeseen expense will further reduce future income.

Thus, if the plan at retirement includes only living expenses after income taxes, there will be little re-investment to the portfolio to keep pace with inflation and a retiree will over time lose purchasing power. This is the law of compounding in reverse and will result in an income loss of 50% to 60% of purchasing power in a 25 to 30 year period.

As more of the portfolio is committed to fixed income, the retirees become less and less able to maintain their standard of living. This is not a reasonable solution!

So today, we have a retirement system that is not prepared to adequately provide a retiree for the possible longevity he or she should expect. We also have an “industry standard” investment management approach that fails to protect the current purchasing power of a retiree over an extended retirement period.

The consequences of these two failures, until corrected, will create a social and economic dislocation none of our political leaders are preparing us for. Members of Congress are secure with their own Federally funded pension plan that assures retirement income after 20 years of service, a plan few of the rest of the population can expect to have. We need to focus the discussion on the consequences of these two failures to provide answers.

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