The Unexpected Risk to Your Retirement Nest Egg

Are you in danger of outliving your money?

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Planning for retirement is an important element of everyone's financial strategy. To avoid the damage that could result from a mistake being made—and then compounded over a thirty-year period—many physicians employ the services of professional planners. These doctors are looking to avoid risks that could cause them to fall short of their goals. In spite of the professional advice that many receive, however, the investment strategies being employed by many doctors accomplish the exact opposite of what they are trying to achieve—actually exposing them to financial risk in retirement. As you will see, "risk" can come from where you least expect it.

Let us take a look at four possible scenarios faced by a doctor at sixty five, the typical target age for retirement: 1) s/he may not live to sixty five, 2) s/he may live only a few years beyond sixty five, 3) s/he may become disabled, with the worst case scenario being the development of an incapacitating mental disability such as Alzheimer's, or 4) s/he may live a long and healthy life. Of these four possibilities, it is the fourth that presents a retiree with the most significant financial risk. Imagine a long and healthy life being the worst-case scenario! While the first two possibilities are certainly undesirable, neither presents significant financial risk because, under either of these circumstances, the doctor is unlikely to outlive his/her financial resources; however, to protect a spouse should either of these possibilities occur, a financial plan should include life insurance. The third risk can be addressed through the purchase of long-term care insurance.

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Outliving one's money is the greatest "risk" to be addressed when developing a financial plan. Let us look at two serious mistakes that, if avoided, can help us decrease this risk. The first mistake made by many physicians strategizing for retirement is being too conservative and protective of their invested capital. This is especially evident in years such as 2022 when the inflation rate is increasing and stock markets are highly volatile. While an extremely conservative investment approach might guarantee that a plan will not lose much principal in any given year, it also virtually *guarantees* that the investment's growth rate will be insufficient to build resources great enough to protect against the "risk" of living a long and healthy life. The outcome of "extreme protection" is that the doctor will probably need to continue working for far more years than s/he had planned.

As an example, assume that a practitioner takes home $150,000 a year, sets aside $30,000 each year in a retirement account (starting at age 35), and retires at 65. Placing this money in "safe" investments might return about 4% a year, and continuing this strategy until age 65 would result in a portfolio worth about $1.7 million "at retirement." Withdrawing 4% a year from this account in retirement years (the amount recommended by most financial planners) would yield an annual income of $67,000. If, instead, this same amount had been invested in a diversified stock portfolio earning an average annual return rate of 8%, 10%, or even 12%, the portfolio value at age 65 would have reached approximately $3.4 mil-

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lion, $4.9 million, or $7.2 million, respectively.

These amounts would have produced incomes (at the same 4% withdrawal rate) of $136,000, $196,000 or $290,000 annually. When we include the additional money the doctor would receive from social security, his/her current income would be fully replaced at retirement, even at the "low" 8% return rate. This "riskier" strategy protects against inflation because it produces a portfolio that will be growing at a faster rate than the rate of withdrawal. Equally important, if the doctor using the "riskier" strategy so chooses, at retirement, s/he could withdraw at a rate higher than 4% because portfolios invested in this way are less likely to be depleted, even when withdrawing percentages of more than 4% a year.

The stock market has had its ups and downs over the years; yet, depending on which index you follow, it has historically yielded a 10% to 12% average annual rate of return. While this level of return is not "guaranteed" in any given year, the odds are low that this rate will average less than 4% over the next 30 years. In this unlikely event, it really would not matter whether one had invested "safely" (protecting principal) or "smartly" (investing principal at an acceptable level of risk) because the outcomes of the two strategies would be about the same… in order to generate enough income in retirement, the doctor would need to continue working beyond his/her projected retirement age. In this case, the two strategies have the same downside—one that is *guaranteed* when using the "safe" strategy but highly unlikely for those who embrace the "risky" one. Significantly, only the "risky" strategy has the potential upside of providing financial security regardless of how many years one lives.

Being cognizant of the potential outcomes of the two scenarios discussed above leads us to the realization that the option of working past sixty-five should be an integral part of everyone's financial plan. As part of this strategy, a physician who owns a practice, is approaching retirement age, and is considering the sale of his/her practice should consider including a clause which allows him/her the option of continuing to work in the practice (at least part-time) following any sale. While this might reduce the ultimate sale price, this option is "priceless" should it ever become necessary—whether for personal or financial reasons. Fortunately, if we are lucky enough to be healthy and live well beyond the age of sixty-five, we will, by definition, also have the option of—and ability to—continue working. Keeping this option open is a way of reducing the risks associated with longevity and/or inflation. It offers us more assurance that our money will "last" as long as we do.

Working part time as an "employee" upon the sale of one's practice allows a physician the opportunity to shed the responsibility of management and reduce his/her hours to the point of being "semi-retired"—a status that offers the best of both worlds—especially to the doctor for whom full retirement turns out to be less fulfilling than envisioned. How much is this option worth? Consider that a doctor working two days a week in a busy practice should be able to produce a "take home salary" of at least $80,000, even if s/he is no longer performing surgery. For the conservative investor, this $80,000 annual income is the equivalent of the earnings that would be produced by drawing an annual percentage of 4% from a $2.0 million nest egg.

It is not only doctors who "fear longevity." Profiting from this worry, enterprising companies are now creating products that capitalize on future retirees' fears, with a few companies introducing longevity insurance. In some cases, purchasing insurance to protect against the possibility of outliving a nest egg makes sense. This type of insurance is basically a deferred annuity in which one deposits a lump sum in the insurance company and receives guaranteed payments once s/he reaches a designated age. What is really being bought with such a policy is the freedom to spend a greater percentage of one's savings in retirement than would otherwise be prudent—say, 7% a year instead of 4% – knowing that this safety net is going to fall into place at, say, age 85.

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This type of policy might be a good strategy for an individual who is healthy, active, and has a significantly large nest egg. This retiree could work out a plan whereby both the principal and interest of his/her nest egg could be spent down over the twenty-year period between the age of 65 and 85, providing the retiree with greater income than s/he would have otherwise had during those twenty years. Even if the entire nest egg were totally depleted over this 20-year period, this insurance's "safety net" would kick in at age 85 and, along with social security, provide an adequate "forever" income.

It is never too early or too late, for that matter, to analyze your goals and make a strategic plan for retirement. At what age would you ideally want to retire, and at that time what level of income would you consider to be adequate? After determining these two targets, you will have the relevant information you need to design a financial plan that meets your goals. **PM**

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