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By Dario Fusato, PhD

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A FRESH APPROACH TO LONGEVITY RISK

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Insurance companies and retirement plan sponsors constantly evaluate the financial impact of people living longer than expected. They call this longevity risk.

Regardless of their income or net worth, many individuals also come face to face with their own version of managing longevity risk. However, they may just be thinking, "Will I ever run out of money after I retire?" They know they may live past their 70s and into their 80s—or even their 90s. So they ponder what they can do to ensure having enough funds to meet basic retirement expenses, but they also are interested in maintaining the lifestyle they enjoy during retirement.

New products that work in innovative ways to pool longevity risk are now becoming available to help investors deal with some of the uncertainties of living longer in retirement.

Conventional thinking once dictated that people could meet their financial obligations during at least a 30-year retirement by withdrawing 4 percent of their available funds annually adjusted for inflation and any change in their financial resources.[1] The assumptions behind that approach may no longer be valid. Many people will now be retired for more than 30 years. They may spend more or less than inflation, and their investment portfolios might evolve beyond the mix of 60-percent stocks and 40-percent bonds on which the 4-percent guideline was based.

People must be proactive today to counter longevity risk. The first step is knowing how much their retirement plans will contribute to their retirement goals. Thanks to the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, annuity holders and members of retirement plans covered by the Employee Retirement Income Security Act of 1974 will receive annual reports showing how much monthly income their current account balances will produce during retirement.

Those with self-directed 401(k) plans and individual retirement accounts (IRAs) should make the effort to determine how much income such accounts will provide. They also need to consider Social Security payments, savings, income from real estate, and perhaps other investments. This process should no doubt be undertaken with a financial advisor, and undoubtedly it will raise the questions covered below.

When should protecting against longevity risk become a priority?

The concept of longevity risk should be introduced to young adults when they begin earning income and perhaps either participate in a company retirement plan or open a retirement account. For many, it may remain a consideration left for the distant future, but the earlier in life the concept is grasped the better.

By their late 30s or early 40s, when they have a reasonable income, some funds built up in their retirement plans, and perhaps a comprehensive investment portfolio or other assets, it's time to start seriously recognizing the need to offset longevity risk. Assuming a planned retirement at age 65, they should begin to take advantage of the decades before that to prepare financially for the decades that follow.

This age range is the time to sit down with a financial advisor and identify a savings and investment strategy to build up retirement assets without sacrificing lifestyle.

What type of investment options should individuals consider?

Although retirement products such as annuities, 401(k) plans, and IRAs have a place in retirement planning, none by themselves are designed to cover estimated expenses and maintain a lifestyle during retirement, however long someone lives. For example, annuities contracts provide periodic payments, but they may have drawbacks in periods with high inflation such as today.

Some have revisited tontines, typically closed-end funds in which you and others pay a lump sum upfront into a shared pool. A tontine pays income for as long as you live. But when you die, you are not replaced with a new investor. Instead, your share of the payout is re-allocated among the remaining tontine members. Retirement researcher Moshe Milevsky sees them as a vehicle that includes both a return on capital and mortality credits.[2]

Tontines have a long history; they funded European wars as far back as the 1600s. They reached their American heyday in the early 1900s when these popular investments became part of embezzlement scandals by the insurance companies behind them, ending their popularity. Blockchain technology might overcome the concerns for accountability and transparency.

Meanwhile, some retirement professionals are developing a fresh approach based on private risk pooling to help people cover expenses and maintain a lifestyle during retirement regardless of lifespan. Risk pooling means the sharing of common financial risks among many people. It's the same concept on which life insurance is based. Life insurance companies charge premiums to clients to be sure they will always have sufficient funds to pay benefits when any client dies.

With a risk-pooled retirement plan, multiple individuals could purchase shares in the plan with a recognized stock market index fund as the underlying investment. The shares would be under the control of a qualified custodian. Each investor selects a payout date and receives a share of the pool's value at that time. Participants agree that if they die before their individual payout dates, their beneficiaries receive a portion of their investment value, and the remainder stays in the pool. Participants who live to reach their payout dates receive their full share of the pool based on the value of their original index-fund investments and their share of the total amount in the risk pool.

Couples wishing to take advantage of the opportunity may invest in the plan separately. It's also possible to select multiple payout dates stretching further into the future. When making the initial purchase, a participant can name an individual, a business, or a trust as the beneficiary.

The earlier someone invests in a risk pool, the longer the investment has for its value to increase. For example, if someone invests at age 40 with a payout date of age 78, the total payout will represent 38 years of pool growth. Even if the individual dies before the payout date, beneficiaries still receive their minimum distributions.

What percent of an individual's assets could deliver protection and still leave a suitable portion of income and net worth available for lifestyle spending?

Allocating 5–10 percent of the assets designated for retirement to a risk pool in an investor's 50s or 60s should be sufficient to provide longevity protection by the time the investor is in their mid-70s or 80s. Certainly, the amount anyone chooses to invest will depend on age, selected payout date, and preferred lifestyle.

How will a plan accommodate the required recordkeeping, account transaction data, and participant confidentiality?

A plan must incorporate technology that provides accuracy, security, transparency, immutability, and fairness in terms of transaction data. Duplicate records of each participant's transactions should be stored separately and securely for an extended period. State-of-the-art data protection from a cyberattack should be expected.

The reality is that some participants will die before their payout dates. In such cases, the amount returned to their beneficiaries and the funds remaining in their accounts that revert to the risk pool must be accurate as of the date of death. At the same time, the death must be verified before any funds are transferred. When someone dies, numerous circumstances may cause a delay in the time it takes the family or its representatives to notify the plan of the participant's death. Fortunately, multiple sources are at a plan's disposal to help alert them, including access to the Social Security Death Index and the National Death Index maintained by the Centers for Disease Control. However, because these are not always accurate or may have a backlog, the plan may have developed a method relying on artificial intelligence technology to monitor online media, obituaries, social media, court records, and genealogy sites.

Could an investor withdraw from a plan?

Investors can withdraw if they choose. The withdrawing investor would receive an amount equal to a minimum percentage of the initial investment for withdrawing early.

Are these plans suitable for 401(k) plans or IRAs?

This is a question to ask the plan sponsor when considering an investment. These plans may or may not be structured to accept investments from 401(k) plans or IRAs. The plan sponsor also should be queried about whether account beneficiaries can be businesses or other organizations in addition to individuals.

What advantages would financial advisors recognize in the availability of a plan?

Unlike annuities, the initial investment plus the accrued value of the shares in the risk pool may remain under the advisor's assets under management. Thus, advisors can continue to serve their clients throughout their lives, even after retirement.

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ENDNOTES

1. William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning* (October 1994): 14–24.
2. See, for example, "Moshe A. Milevsky, PhD: Planning for Retirement Income," *Retirement Management Journal* 10, no. 1 (2021): 8–17, https://papers.ssrn.com/abstract=4011317.

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