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# How should retirees manage risk in a DC world?

Angela Ashton | PortfolioConstruction Forum | 10 March 2015

"How should retirees manage investment and longevity risk in a Defined Contribution world?" by Don Ezra, Rotman International Journal of Pension Management, Vol 4, Issue 1, Spring 2011

Don Ezra is considered a global expert on financial strategy issues, including defined contribution funds. He's won lots of awards, published lots of books and contributed to many summits and conferences in the US on issues related to retirement.

I found myself reading and re-reading parts of this paper. There is a surprising amount of information and interesting ways of framing investment problems in retirement. Some of this is not fully applicable in Australia - there are few choices for annuities, for example - but it doesn't lessen its value.

Ezra sets up two important - but simple - ideas and then explores the options these ideas present retirees, and the way ways we can frame discussions to help investors make choices that will ultimately work in their best interests. Some of the conclusions are seriously counter-intuitive.

Let's start with a summary of the two central ideas. The first you have probably seen before - it's not that impressive on its own. Ezra basically outlines that most people are unlikely to have sufficient resources to retire really well, so they have three dials to turn in their quest to make their money last - the spending dial, the longevity protection dial and the investment policy dial. Where each dial is set and how each is moved will depend on the person, their resources and their needs. Nothing new there.

But Ezra then talks about what he calls Wealth Zones - the idea that wealth should be thought of like a house with many levels. The levels he suggests are:

- The Basement - he is a Canadian living in the US, after all, but we can think of it as the garage or man shed. This can be thought of as "Pre-annuitised Wealth" or wealth generated from government benefits and, say, defined benefit schemes. For Australians, it will most likely be the value of the age pension and concessions. The value as a lump sum is difficult to calculate, but it has one and should be seen as a safety net.
- The Ground Floor - this is the Essentials Zone, and its ceiling is the amount needed to annuitise essentials only, those which must be catered for to maintain the minimum acceptable standard of living. In Australia, the pension will account for at least a good part of this, so the Essentials Zone is likely to be comparatively small

(but clearly growing). Nonetheless, a great many retirees find themselves within this zone, rather than above it. So choices need to be made.

- The First Floor – this is the Lifestyle Zone. Its ceiling is the amount that will annuitise the income the retiree wants to fulfil their retirement lifestyle ambitions. It is the minimum amount that practitioners would generally aim to accumulate for clients looking to retire.
- The Bequest Zone – in this zone, retirees are decumulating but there will be funds left for bequests.
- The Endowed Zone – in this zone, the retiree does not use all the income and growth generated by their portfolio. Their nest egg actually grows throughout retirement.

Ezra then uses these ideas to start thinking about the choices people need to make in the various zones. For me, some of the more interesting analysis is the reason why people don't like annuities and what that actually means for their retirement lifestyle.

For a 60 year old, an annuity generating $1 per annum will cost about $12.30 (using 6% bond yields). However, the cost of self-annuitising with a 95% success rate (or investing your own money to generate the same income stream) will cost an average of around $14.50 (this uses today's life expectancies). Why do people not annuitise? Often, it is because they lose control, the ability to leave a bequest, or they don't have enough to annuitise the total of their lifestyle zone. So instead of locking in a sub-optimal lifestyle, they opt to manage their dials – spending, investment risk – to hopefully engineer a better outcome. This is risky, particularly if they live for longer than their life expectancy.

From here, the paper offers some good analysis of longevity versus investment risk and its implications for retirees.

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