The Biggest Risk For Most Retirees

Risk is a tricky concept to grasp because most people don't really understand what their true risks are. We tend to worry about things that are readily available in our memories while spending little time worrying about problems that could be years or decades out into the future. For the majority of investors, their biggest risk is not meeting their goals, or worse, running out of money. This piece I wrote for Bloomberg looks at a study that sheds some light on another risk associated with longevity.

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Investors are constantly reminded that it's impossible to avoid risk in their portfolio. People are worried about geopolitical risk, interest rate risk, liquidity risk, losing money, volatility, uncertainty and the permanent impairment of capital. The list could go on forever.

For the tens of millions of baby boomers who have retired or will be retiring in the years ahead, there is another risk that could prove far more important. The biggest threat to the majority of retirees will be outliving their nest egg. As life expectancies continue to climb, managing longevity risk will be a key input in the portfolio management and planning for the 10,000 or so baby boomers retiring every day for the next 19 years or so.

Getting older is a double-edged sword when it comes to your investment abilities. On the positive side of the ledger, as you age you gain valuable experience in the markets, your assets should be growing and you should have learned to avoid costly mistakes. On the other hand, these longer life expectancies lead to a higher chance for cognitive decline in your later years that could prove to be a huge risk to your assets and ability to manage money effectively.

A recent research paper, Risks in Advanced Age, by Michael Guillemette, a professor of financial planning at Texas Tech University, outlines why it makes sense for older investors to pay attention to the risk of cognitive deterioration.

Guillemette found people exhibit a decline in cognitive abilities over time that leads to a decrease in investment performance and financial literacy skills as they age. Older investors also prefer more certainty, meaning lower equity exposure, which could be a problem with increased time horizons and the need to keep up with inflation over the long haul. It's also difficult for older people to see their own decline in financial skills and abilities. Finally, wealthy people have been shown to have longer life spans than less wealthy people, meaning they will have to invest for a longer period of time.

So in some cases, retirees could prove to be their own worst enemies when trying to navigate the financial markets. Here are some ways baby boomers can protect themselves from the risk of cognitive decline as they age.

Simplify your portfolio and finances: The financial markets can be a complex system to deal with, and retirement planning is no walk in the park, either. You must consider taxes, Social Security, current income and future growth needs, distributions, health care expenses, sequence of return risk and much more. The best way to deal with this complexity to combat the effects of old age is to streamline your approach to money management. This could include taking steps such as consolidating the number of accounts and holdings you have, creating a written investment policy statement, automating bill payments and documenting your investment process. You don't want to get to the point where things are too hard to manage or understand.

Try generational financial planning: One of the best ways to lighten the cognitive load as you age is to bring others into the retirement-planning process. Intelligent portfolio management should always plan for a wide range of future possibilities in the markets ahead of time. The same should be done when preparing for old age and longevity risk. Retirees need to ensure their children and spouses understand exactly what the investment plans are so they can take over if the need arises. Money is often a taboo subject for families, but getting ahead of these risks can lead to a much smoother transition if and when your investment abilities begin to fade.

Hire a trusted adviser: Another option is to outsource the money management function to an investment adviser. Handing over investment management or financial planning to the right person or firm can be a great way to lower cognitive risks that can be difficult to accept on your own. An unbiased third party can provide an honest assessment to help with difficult decisions when the time comes.

Risk and reward are entwined when investing for the future, but the risks aren't always exclusive to the financial markets. Investors are constantly looking for the biggest risk in the markets at any given time. For most investors, however, the biggest risk is almost always themselves. Mitigating that will be more important than ever as life expectancies continue to climb.

Originally published on Bloomberg View in 2017. Reprinted with permission. The opinions expressed are those of the author.

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