Stress testing your retirement plan

Until recently, stress tests were generally associated with medical exams in which patients run on a treadmill or pedal a bike to elevate their heart rate, so that doctors can observe how their heart works while under conditions of unusual strain.

In the past few months, stress testing has assumed a different meaning, as markets hung on the results of “stress tests” ordered by the Obama administration to ensure U.S. banks would remain solvent should the economy behave worse than projected and loan losses increase as a result.

This principle of conducting stress tests to ensure that we’ll survive unanticipated problems doesn’t just apply to the financial system … it’s also relevant for many Canadians contemplating retirement. After all, given the level of uncertainty today, many of us are unsure if we’ll be able to hit our long term goals and as a result feel out of control of our financial future.

Not that many years ago, doing the complex calculations to explore different scenarios and understand available tradeoffs leading to retirement would have been impossible. Today, sophisticated financial planning software is readily available that allows investors to run projections and test what-if scenarios. This is normally done with the assistance of a skilled financial advisor who takes a financial planning approach, although those who are technically proficient might try this on their own using planning software such as Quicken, the leader in the consumer marketplace.

In this process, you need to stress test three things - how much you’ll spend in retirement, how much you save for retirment and the risk you take in investing those savings along the way. For each of these you create a base case and then examine the impact of different scenarios.

The first step is to stress test how much you’ll need in retirement, adjusted for inflation.

Calculating your retirement needs is often done by taking a percentage of income before retiring   - 70% of preretirement income is the most common number used. It’s worth noting that this 70% number has come under attack as being both too high for many Canadians (actuary Malcolm Hamilton of Mercers is the most prominent proponent of this view) and as being too low for others (Fidelity Investments has issued a report making this case.)

A better way to forecast needs is develop line by line estimates of spending for each major budget category, adjusting for inflation each year and factoring in things like travel and spending winter in warmer climates that many Canadians have on their retirement wish list. To clarify your options, you could create low, middle and high spending scenarios for each type of expenditure. Something else to consider is the extent to which you want to set aside money to help family members or for charities you support.

Then conduct the first stress test: Consider the impact of higher than expected inflation (a growing concern among some economists due to the record levels of spending by Governments around the world) and unanticipated expenses such as an extended stay in a long term care facility or nursing home.

The second step is to stress test how much you'll save before retiring.

Last year's markets have caused many to cut back spending to increase saving levels and to rethink their retirement age. January surveys by Sun Life indicated that half of Americans have decided to postpone retirement by a year or more and a quarter are planning to work five more years; in Canada, half of those 30 to 65 expect to work past age 65. In fact, in the absence of a firm grip on where they stand, even some retirees who have nothing to worry about have panicked and made drastic spending cuts.

The age at which you plan to retire and whether you'll work part time afterwards are key variables in the cash you'll generate to live on. Another factor is the amount of home equity you'll free up by downsizing into smaller quarters.

Here's the second stress test: Look at the impact of being laid off - a recent survey reported that nearly 60% of Canadians are concerned about someone in their household losing their job. Also examine what happens if that consulting or other part time income you're expecting after you retire is less than you expect or if health issues make part time work impossible. You could also look at the effect of different scenarios around the price when it comes time to sell your house.

The final stress test is to look at the risk you take in investing your savings.

The expected return on your savings both before and after retirement is a critical factor in determining where you'll stand in retirement. This is primarily driven by the amount of risk you take. Given what's happened to markets, many Canadians would prefer to avoid risk entirely ... so you could start by stress testing your retirement plan for the impact of the 2% return currently available on GICs.

For most Canadians without guaranteed company pension plans, a risk free return means they're almost certain to run out of money in your 80s; that's especially true under the higher inflation scenario. If there's a shortfall at 2%, you can do further stress tests at 4%, 6% and 8% returns- looking at the greater volatility and risk that comes with each of those higher return levels. A capable financial advisor can be especially helpful in looking at the tradeoffs between risk and return.

Note that given longer life spans, it's not just before retirement that Canadians need to look at taking on more short term risk. If you're 65 and in reasonable health, chances are your money will need to last you twenty five years or more – and your investment time horizon needs to be pushed out to match.

For this stress testing process to be remain accurate, it needs to be updated every year or two. The underlying rationale behind stress testing our retirement is borrowed from the military axiom that in war you should hope for the best but prepare for the worst. By preparing a base case scenario and then looking at the impact of negative events, you can get a handle on where you stand, clarify the tradeoffs and options to close any gaps and create a buffer against unforeseen events, in the process ensuring you're in control of your financial future.