

DREAMING BIG

CAP sponsors and retiring plan members face the downside of economic and market cycles—but there is hope.

BY CHRISTOPHER CARTWRIGHT

IMAGINE that you are about to retire under the capital accumulation plan (CAP) where you work, and that the conditions for your retirement are ideal. For most plan members, this scenario would include good health, a paid-off mortgage and a comfortable nest egg generating a secure personal income. And, since this is an imaginary scenario, add in strong government pensions, minimal taxes, and a sunny outlook for the markets and the economy in general

(i.e., low inflation). In short, you are feeling healthy, wealthy and wise—and fully in control of your destiny. Remember, this is the dream you've been working toward for your entire life.

Not everyone expects this dream to come true, but it is reasonable to expect that plan members are most likely to retire when they feel their nest eggs have hit their target levels and they are confident that they will be able to sustain positive market returns. On the contrary, they are less likely to rush into retirement when their portfolios are being hammered by negative results and the market outlook is less than rosy.

None of this is terribly startling or illogical, but there seems to be an ironic symmetry in the way CAPs work over time. The irony comes into focus when looking at the perspective of the other partner in the CAP deal: the sponsoring employer.

For the plan sponsor, a benefits program serves to attract and retain the talent needed for the organization to succeed. This means hanging on to valued staffers when

the demand for the product or service they produce is strong and growing. By definition, for most enterprises, this occurs when the economy is in its growth phase. Conversely, an employer will be looking to cut payroll when business demand is sluggish or declining (i.e., when the economy is slowing down).

Notice how the two perspectives line up: CAP members want to retire when conditions are rosy, yet that's when employers want them to stay on the job. Given the choice, members will want to postpone retirement at the same time as their employer is contemplating a downsizing.

If this theory is correct, a real-life demonstration of its effects could well be on its way as the current economic cycle progresses. The pieces are starting to fall into place.

In a CAP, the amount of retirement income depends on the size of the plan member's accumulated nest egg. This is based on just three factors: the member's contributions, the average net rate of return on investments, and the length of time that the contributions remain invested.

Plan members have some direct control over how much is contributed and how long it stays there, as well as indirect control of their investment earnings through the level of risk they are willing to assume. As the decision to stay or go draws near, it's rather late to make up contribution shortfalls, so the only real factor at play is timing.

When the retirement is voluntary, the timing will have much to do with the individual's outlook for the future. The decision to retire calls for careful consideration of many factors. How much money is on hand to convert to income? How much income will the current assets generate? What other sources of income are available? How much will be needed for a decent retirement? But in the end, it comes down to one simple question:

Do I have enough?

No one can guarantee the future, so each individual has to answer that question by making guesses about longevity, lifestyle, inflation and market performance. In short, the individual needs to paint a picture of what the future might look like. When the outlook is right, then the time to retire has arrived.

Wealth Effect

Another factor that can affect the right time to retire is the so-called "wealth effect," which has been observed to drive consumer spending. As people feel wealthier, they spend with greater confidence. This can occur, for instance, when rising house prices create the illusion of instant affluence. Without having to make any savvy investment decisions, average homeowners can suddenly discover that they are richer than they think—at least, on paper.

Of course, what goes up must come down. Overheated real estate values have a habit of cycling back down again, as we have seen in the subprime credit crunch in the U.S. housing market. As more and more buyers qualified for home ownership, the rise in demand pushed prices higher, confirming the inevitable increase in home values and adding impetus to the trend. As overextended buyers realized that they could not really afford the houses they had purchased, the trend reversed and a wave of defaults created a sudden increase in the supply

of houses, triggering the inevitable decline in prices.

The wealth effect, then, works in both directions. When people feel wealthier, they are full of confidence and keen to spend. When they feel less wealthy, they think twice before spending extravagantly or voluntarily saying goodbye to a steady paycheque.

So where do future retirees find themselves today? Are they making realistic guesses about the future? News headlines conjure up images of decline, not growth; turbulence, not stability; rising costs and falling market returns. It's tempting to reach for the old "perfect storm" cliché and apply it to the outlook for our CAP members: low interest rates (which make insuring the annuity income stream expensive and/or unattractive); the rising cost of living (which makes future income needs uncertain); turbulent capital markets (which make future rates of return doubtful); and an economic slowdown that may lead to job cuts and forced retirement.

Under these conditions, many plan members may find themselves revising their retirement plans, factoring in a few more years of accumulating assets before leaving the workplace and moving to the de-accumulation phase.

However, this scenario is based on the premise that the choice is not being made by someone else. Unfortunately, employers faced with difficult economic conditions may be pushed to downsize at an inopportune time for plan members.

As a CAP member or sponsor, what can you do? Here are three possible options to consider.

Phased retirement: This can work for both partners in the CAP deal. When times are tough, employees can transition gradually into retirement, supplementing their retirement income with at least a partial paycheque to help bridge the gap before full government pensions and supplements can kick in. On the other hand, when times are good, employers can keep knowledgeable staff around a little longer—at least long enough to ensure an orderly transfer of knowledge to the next generation entering the workforce.

A variation on this idea is the arrangement in which an employee retires but is hired back as a consultant, which serves the same function of smoothing the transition for both parties.

A tried-and-true risk-controlling financial instrument: No one knows for sure where the economic cycle is headed, so timing is never easy. But retirement need not be a complicated process of market and economic analysis, calculations and projections, and complex simulations. If there is a shortcut to retirement security, it's a simple, proven alternative: the insured life annuity.

Insured annuities are the epitome of the dull, safe and boring products of the past. In recent years, they have fallen out of favour as low nominal interest rates make them seem unduly expensive. They are also criticized for lacking the flexibility and inflation protection associated with registered retirement income funds (RRIFs) and life income funds (LIFs). Indexing options are available, but at a significant cost. Banks are not authorized to sell life annuities, limiting how they are distributed to those with a licence to sell insurance.

An annuity will lock in the current fixed income rates, which may be perceived as quite low at present. However, it is important to remember that the rate is positive and guaranteed. This becomes a real plus when the returns of market-based RRIFs and LIFs go south.

Real education: Another long-term solution to consider is an active and sustained campaign to address the financial literacy of employees. Financial education can change employees' attitudes about retirement, improve their understanding of the consequences of their decisions and help them to have realistic expectations. Real education comes from a source that has no

conflict of interest in the subject—in other words, an organization that does not make money from the decisions that employees will ultimately make.

How can you use education to influence behaviour? Let's look at the situation objectively. Although it sounds counterintuitive to retire just as an economic recession is confirmed, this may, in fact, be the best time to retire—for those who are prepared.

Crucial Exit Strategy

Multiple simulations using historical data illustrate the important impact of timing the transition from accumulation to de-accumulation. The first few years after contributions cease and withdrawals commence can make a critical difference to the long-term sustainability of a retirement portfolio. Making withdrawals during a few negative years can seriously damage the nest egg that was slowly built up over decades. When answering the question, Do I have enough?, it's vital to consider the timing of the market's cycles.

No one can predict with 100% accuracy when the market is at its peak or its trough, but it's fair to say that the chances of a decline are much greater when the market has experienced a long run of positive results. Just as everyone begins convincing themselves that the bull market will never end, savvy investors are preparing for the inevitable bear market.

The point is that retirees leaving the workforce when things could not look rosier are actually begging to be disappointed early in their golden years when their portfolios suddenly shrink, the values of their homes fall and widespread turmoil undermines all of the assumptions supporting their new lifestyle.

The good news is that the opposite is equally true. If they can retire comfortably after their portfolios have been beaten up by a nasty bear market, the surprises are likely to be on the positive side as conditions improve. In such a case, the portfolio can rebound nicely and can sustain a higher withdrawal rate and a more generous standard of living than initially planned.

Perhaps the pre-retiree's question should be rephrased. Instead of, Do I have enough?, perhaps it would be better to ask, Do I have *more* than enough? A retirement nest egg should be robust enough to support the desired standard of living through all phases of the economic cycle.

With real education, plan members can appreciate how the other tactics—such as buying an annuity or phasing in retirement—can fit into an overall financial

and lifestyle strategy. Too often, they feel they are faced with an all-or-nothing, either/or choice that lacks the subtlety and sophistication to truly meet their needs. In fact, a combination of instruments may be the answer. This may include an annuity for basic living costs, a RRIF for those big discretionary purchases, such as the trip of a lifetime or a new car, and insurance for the legacy to the grandchildren or that favourite charity. Without adequate financial literacy, CAP members are unable to ask the right questions and confidently take charge of their own destinies.

Whether or not your CAP has matured enough to produce the hoped-for outcomes may soon be tested. You'll know if the retirement dreams of your employees don't come true when your phone starts ringing. **BC**

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