Optimizing your decumulation plan

For a worry-free retirement

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As retirement approaches, decumulation is a key element of an investor's financial planning process. While accumulation is the main goal during your working life, it's equally important to carefully plan for the decumulation phase. Thoughtful planning can help you ensure that you maintain a comfortable standard of living and financial security, all while no longer earning a pay cheque. In this article, we explore the role of retirement decumulation in financial planning as well as the challenges that retirees face in today's environment. We also discuss the solutions and opportunities offered by sound investment management.

What is decumulation?

It's simple. Decumulation is the conversion of accumulated savings into regular income streams once you reach retirement or stop earning a pay cheque. During the accumulation phase, when the focus is on capital growth, up to 70% of an investor's portfolio consists of securities that are growth-oriented, typically stocks. However, because the value of these securities may fluctuate significantly, it's traditionally recommended that you transfer assets to less volatile investments once you reach retirement.

Optimizing your decumulation plan over time is vital to ensure maximum efficiency of your assets in the long term. This approach ensures that your investments remain tailored to your needs as a retiree and generate a sustainable return.

Another essential element of an effective decumulation plan is tax management. The main objectives of tax planning are two-fold. First, to minimize the taxes you pay on withdrawals and, second, to design your estate so that it may reduce tax obligations and maximize the transfer of wealth to the next generation, if you plan to do so.

Assessing the financial landscape and its challenges

With the largest intergenerational wealth transfers in history quickly approaching, effective decumulation management is more important than ever. The ever-changing investment landscape presents many challenges and financial risks, including inflation. Adding to these challenges is the increase in life expectancy, which requires careful financial planning to ensure your long-term financial security.

Navigating the current context

The investment horizon emerging today is quite different from what the retirees of the 1990s and 2000s experienced. Future retirees face expectations of lower returns, interest rates that remain historically low, the decline of defined-benefit pension plans, the risk of government changes to pension plans (such as increases in the age of eligibility) and heightened volatility in financial markets.

These factors, combined with increasing longevity, rising costs for home and health care, and investors' unconscious behavioural biases, make managing retirement savings more complex than ever and call for sophisticated strategies that help ensure stable retirement income. Although many current retirees have been able to hang on to their nest eggs after decades of retirement, future retirees may not benefit from the same luxury.

A study by the BlackRock Retirement Institute highlighted a trend among many recent retirees: they have opted to keep most of their retirement savings intact, preferring to live on regular sources of income rather than dip into their capital. Some of these sources of income include pension plans, social security, or rental income. In fact, more than a third of current retirees report having increased their assets. In stark contrast, the study forecasts that future generations of retirees may need to spend their capital in order to support themselves.

The importance of sound planning

The growth equation is essential for retirees once the regular streams of employment income come to an end, especially if their capital is limited. The search for returns and yield, however, comes with its share of volatility and risk; in the current environment, preserving capital while earning adequate returns is becoming increasingly difficult, especially with the imminent return of a downward interest rate environment. Many financial products, such as GICs and government bonds, offer a return that is too low to keep pace with inflation over the long term; thus, leaving money locked in for long periods could make an investor poorer, not richer, over time.

Moreover, it's important not to overestimate the periodic income generated from our investments, keeping in mind that market performance can influence the value of your portfolio. One of the major hurdles to overcome is market cycles and their related uncertainty, particularly during times of withdrawal. One potential solution is combining guaranteed income from annuities with continued investment in growth-oriented assets.

Coping with the demographic transition

Increasing life expectancy means that health care costs and longevity are major financial planning challenges you must address. Above all, it's imperative to manage the increasingly higher risk that you will outlive your capital. Investment management plays a critical role in managing this risk. Portfolios must be constructed and optimized to meet long-term needs, provide financial security and maintain enough flexibility to cover unforeseen expenses.

The art of balancing safety and returns

Given all the aforementioned challenges, effective investment management can offer solutions that maximize the potential return of your assets and, importantly, optimize your decumulation plan. Your plan, above all, has to be flexible enough to adapt to changing circumstances.

Assessing the different strategies

During the decumulation phase, it's generally recommended that you rebalance your investment portfolio in favour of less volatile and safer investments, such as government bonds, GICs or life annuities. Although this strategy provides a guaranteed income for life in exchange for initial capital, you must avoid moving too much capital into products that are guaranteed but whose net returns are lower after inflation is accounted for. After all, this only answers part of the decumulation equation; security. What about rising costs?

A study by the Stanford Center on Longevity[1] looked at how investors can assess and combine different types of investments and insurance products to achieve their retirement-income goals. The researchers analyzed systematic decumulation plans for investment portfolios as well as basic annuities, taking into account criteria such as income, access to savings, pre- and post-retirement protection, inflation protection and lifetime guarantees. One of the study's key findings is that, from a strictly financial perspective, annuities can often provide a higher annual income than systematic withdrawals of investment assets.

[1] Stanford Center on Longevity, Optimizing Income Solutions in DC Retirement Plans, May 2016.

Even so, from a behavioural standpoint, a 100% annuity (or even a high proportion of annuity) would be suboptimal for most people. Instead, the report suggests a balanced approach whereby a portion of retirement assets is used to purchase an annuity that provides guaranteed income, while the remainder is used to cover discretionary expenses through a systematic withdrawal plan.

Broadening your investment horizon

Managing assets in order to optimize retirement income requires a reassessment of preconceived notions about long-term investments, income generation and risk management. An approach based on diversification and asset allocation can help mitigate risk and generate sustainable returns over the long term. With the structural increase in financial needs in retirement, it's now recommended that you maintain a diversified portfolio, that includes up to 50% of more volatile securities for a better long-term return potential. The remainder should be allocated to safer investments to ensure stable disbursements. This approach takes into account a longer retirement period and considers volatility as an ally for capital growth. It's thus vital to revisit the concept of risk and to avoid lower-return products that could deplete your capital too quickly.

To diversify the growth portion of a retirement portfolio, several solutions are available to investors who venture outside of Canada. Foreign corporate bonds, for example, offer attractive yields with manageable volatility over a relatively short period. Emerging market government bonds present an attractive risk/reward trade-off. Finally, preferred shares provide a balance between potential growth and stability suitable for retirees who are looking for higher returns but want to minimize the risk and volatility associated with common shares.

Exploring other solutions

As part of a strategy that combines guaranteed retirement income and investment, insurance products can offer an attractive way to manage your expenses, whether they involve essential needs or discretionary spending. Incorporating them into your retirement income planning allows for better optimization of accumulated savings and provides greater certainty for future spending.

Capitalizing on the benefits of active management

As part of your decumulation strategy, opting for active portfolio management can be especially relevant. In addition to adjusting your asset allocation to your investment horizon, active management can adjust the composition of your portfolio to ever-changing market conditions. Active management can also incorporate inflation-hedging or currency-management strategies, which are particularly important for preserving a retiree's purchasing power in their home country. In addition, the use of sophisticated quantitative models for tactical asset allocation helps optimize risk exposure according to your changing liquidity needs. To get the most out of active management, strong macroeconomic and data-analysis skills are required, along with the ability to assess the characteristics of the many financial instruments available.

Despite the fees associated with active management that are generally higher than passive management, the potential benefits in terms of both capital preservation and income optimization can more than offset such costs.

Conclusion

The strategic and tactical asset allocation expertise of a major institution such as iA Global Asset Management can be a relevant tool for your accumulation and decumulation phases alike. With more than $21 billion under management in our balanced investment mandates, we offer a full range of diversified solutions, leveraging our team's expertise to select the best managers from more than 150 funds and 40 management firms. Our experts employ an approach based on human talent and technology, offering sophisticated portfolio construction combined with robust risk management.

Whether you're on the verge of retirement or looking to optimize your decumulation strategy, your financial advisor can help design a judicious plan adapted to your needs and can guide you toward the solution that is best suited to your profile.

About iA Global Asset Management (iAGAM)

A magnet for top investment talent, iAGAM is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAGAM's unifying commitment to strong risk management, analytical rigour and a disciplined, process-driven approach to asset allocation and security selection.

Rooted in history. Innovating for the future.

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