Funds on FRIDAY

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by Sanlam

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## Living longer can be dangerous to your financial health

People all over the world are living longer. This is great news. The problem is that you might live too long for the amount of money you have saved. This risk is known as long life risk. In this article we will discuss some reasons for longevity and introduce some ways to handle this potential financial problem.

The phenomenon of an increased lifespan is almost universal. 500 years ago the life expectancy was not much more than 30 years. Today it is closer to 75 for most developed countries. The life expectancy in Switzerland today is over 80 years, while in Zimbabwe it is just 35. This substantial difference in life expectancy can largely be explained by socio-economic effects.

### Life expectancy 1950 – 2005

Source: World Policy Institute

The above graph illustrates how lives are being extended. Note, with the exception of Sub-Saharan Africa, the trends are converging. One of the biggest jumps in life expectancy coincided with the introduction of sewers, which greatly reduced the spread of disease. Also, in the last few centuries a strong statistical effect was caused by the near elimination of infant mortality in the Western world and elsewhere. A much larger percentage of children survive their birth and the numbers of infants that die in the first months have also drastically reduced. It has been suggested that life expectancy fell with the introduction of plant and animal domestication, but in recent centuries life expectancy has increased dramatically. These changes are the result of a combination of factors including nutrition, public health and medicine. These numbers show that this has not been the case in Sub-Saharan Africa.

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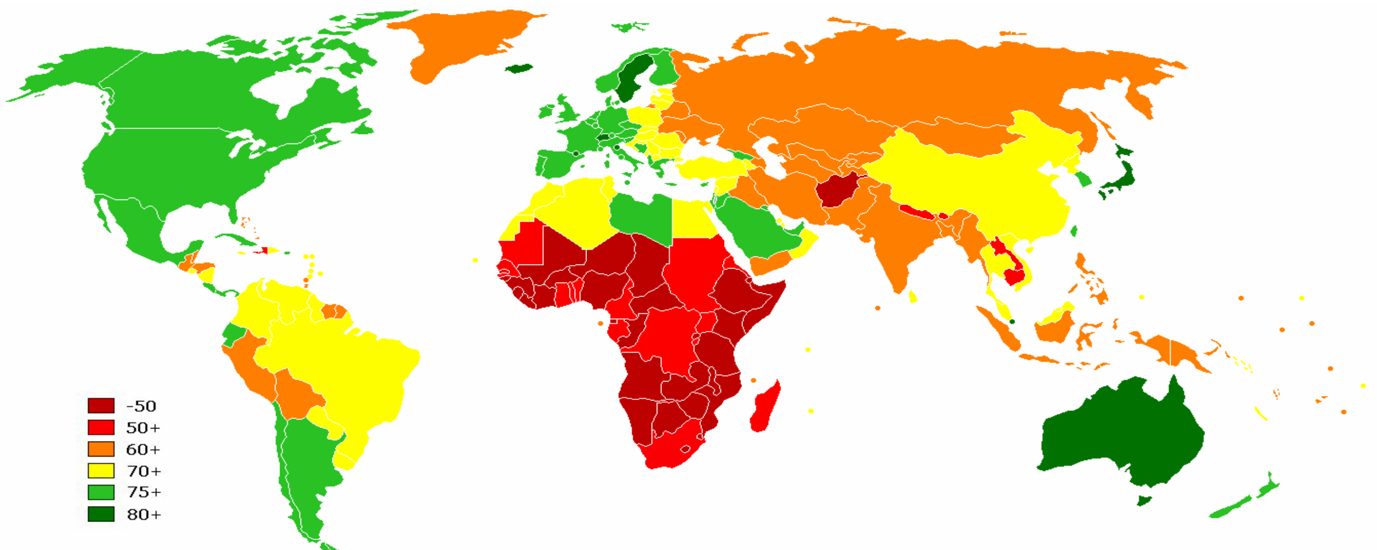
# Life expectancy and your location in the world




Source: World Policy Institute

At first glance it seems that a person's life expectancy is very dependant on where you live. There is indeed a high correlation between your location in the world and your life expectancy. But it is not about location so much as about wealth. What social class and income group you belong to play a much bigger role on your expected lifetime than your geographic location. Across counties people of the same social class tend to have the same pattern of mortality. People of means tend to live to a ripe old age, whether they find themselves in South Africa or Switzerland. There are several reasons for this; some more obvious than others. People with means tend to have better healthcare, eat better and have the ability to take better care of themselves. The effect of this is obvious. Healthier habits increase your lifespan by quite a margin, and better medical care decreases the risk of premature death from sickness. Even in old age it allows you to live more comfortably. Money may not be able to buy you happiness, but it can furnish you with a lot of other things.

A general level of education is usually required to become wealthy, or lacking that, these people are usually well informed. This makes them more aware of the risks they are exposed too. They also usually have the knowledge of how to mitigate these risks. But knowledge is only part of the solution. Sometimes there is a cost associated with the alleviation of risks and this cost might be unaffordable to the average person.

People with means usually live less risky lives. The life of a senior manager at a bank is a lot less dangerous than that of a miner. We also find that the incidence of murder and other violent crime is a lot lower in wealthy neighborhoods than in poor ones. Deep pockets can buy you high walls, dogs and an armed response service. Being wealthy also usually means you can afford an expensive car which is a lot safer to drive. Factors like race, sex, genetic health and family history you have no control over, but they also impact on how long you will live. Life insurers use all these factors to calculate your life expectancy.

All of this is excellent news. Surviving to your golden years and a long prosperous retirement would seem to be the ultimate goal. You can watch your children grow up. Share in their lives. You can spend more time playing with your grandchildren. Tour the world and play golf every week. Do all those things you never had time for while you were working. It sounds like an idyllic existence.

The problem is however that you may live a lot longer than you expected. What if you don't die at 75? What happens if you life to 85 or even 95? This is hardly strange anymore. Where a couple decades ago a person over the age of 85 was a rarity these days most people have a relative that is at least that old. What is the situation going to be like in 30 or 40 years? Is 90 going to be the new 70 or 60? Currently, if you are a person aged 65 and you want to retire, life insurance companies expect you to live to 84 on average. More than 1 in 4 women aged 65 will live to 90. Your retirement could last a long time.

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What does this mean for your finances? Firstly, it is important to realize that prevention is better than cure. It is crucial to start saving as early as possible. Save as much as you can and get your kids into the same habit. They will thank you for it later. Albert Einstein once said that the effects of compound interest could be seen as the eighth wonder of the world. Investing early is quite possibly the most effective solution to the problem, and one of the best habits to acquire early.

Secondly, it is important to invest your money properly. In past issues we have spoken about effective asset allocation and the diversification of your investment. These are important issues when you are investing your retirement monies.

The problem is however that a lot of people do not make adequate preparation for retirement. Few people expect that their lives will be so much longer than their father's. Or, which is more often the case, the saving for your retirement is always put off untill next year. No one wants to spend their last years in squalor or as a drain on their kids and family, so the issue now becomes, "How do I make the most of the money that I do have?"

So how do you combat long life risk? The most traditional method is to use life insurance. You can purchase a living annuity that provides you with an income that covers you for the rest of you life, regardless of whether you live to 70 or 110. There are many different types of annuities, and each one was designed to fulfill a specific need. They range from whole life annuities (for your whole life) and temporary annuities (for 5 or 10 years) to increasing or inflation-linked annuities.

Recently however, life companies have gone out of vogue and investments are all the rage. There are several advantages and disadvantages when solely using investments in your retirement plans. Possibly the biggest advantage is that the potential growth is a lot higher when investing in the stock market. The disadvantages are that your money may run out either because you live too long or because of adverse market movements. When you are investing with the intention of drawing an income you must consider both the percentage income you wish to draw along with what your risk profile is. These two issues will determine what your portfolio should look like.

One of the problems in the past was that people confined themselves to a single solution. This often had unintended results. It is important to remember that you don't have to choose a single option. By using both risk instruments and investments when planning your retirement you ensure peace of mind during your retirement. Combining an increasing whole life annuity with a living annuity is a possible solution. This will allow you to take more risk in your investments than you usually would, because you are not totally dependant on their continued capital growth.

How much money do you have? If you don't have a lot to invest, it makes some of your options unviable. On the other hand, if you have a lot of money it makes some of your options unnecessary. If you have R100m for example you don't need to reduce your risk by purchasing an annuity, but with R500 000 it would be unwise to invest all of your money in equities.

Analyzing your financial situation and weighing up the various scenarios is imperative. It is always a better idea to start of with a conservative assumption and prepare for the worst. In the next Funds on Friday we will tell you about some of the tools you have at your disposal to help reduce long life risk, and hopefully help you to be better prepared for your retirement.

*Sources:*

*Statistics South Africa*
*World Health Organization*
*Actuarial Society of South Africa*
*Faculty/Institute of Actuaries*
*World Policy Institute*

Next week we will discuss the various different forms annuities can take and what they were designed for.

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