

Has The GFC Changed Retirement Forever?

A Snelleman Tom Whitepaper.

Printed January 13, 2012

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Consulting Accountants and Financial Planners



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Has The GFC Changed Retirement Forever?

We are now three years on from the Global Financial Crisis (GFC), with markets still 30% down from their highs in 2007.

People are beginning to ask whether these are short-term bumps or structural changes in the global landscape. Whatever happened to the 'economic nirvana' of the past twenty years? Will we see the boom times again or will we have lower rates of returns for the next twenty years?

In this paper, we address the changed environment we live in post-GFC. We discuss how it has created the very important and real issue of a lower standard of living in retirement, and examine the actions that need to be taken to ensure, that the quality of life we want for our family is maintained.

Background

Over the last 3 decades, for very sound reasons most financial forecasters, economists, stockbrokers, banks etc have predicated their financial modelling on share markets producing average returns between 10 – 12%. They have taken the average dividend from the share market, being 4.1% since 1945, and coupled this with the value of investments doubling every 9 (8% return) to 12 years (6% return). A simple and quick reference point for most people is their home. Most Australians could testify to their home's value doubling roughly between 9 – 12 years from when they bought it. The 1980's and 1990's certainly support this reasoning, but importantly the last decade does not. The numbers are below.

	1980's	1990's	2000's	Long Term Average 1980 - 2010
Australian Shares	17.7%	11.1%	8.7%	12.4%
Balanced portfolio (50% defensive / 50% growth)	18.2%	11.0%	5.3%	11.3%
Growth portfolio (30% defensive / 70% growth)	19%	11.9%	4.9%	11.7%

Defensive is a combination of Cash and Fixed interest investments (local and international). Growth is a combination of Property and Share investments (local and international).

The importance of these numbers lies in the following fact:

With people being told over the last 30 years they can expect 10 – 12% returns, they naturally have incorporated these returns into determining what they need to do to achieve the retirement they want.

Is this a realistic expectation anymore? The simple truth is that nobody knows! What this Whitepaper sets out to consider is "What if it *doesn't* happen?" What if we don't achieve the returns above? Far better to be informed and overly diligent in our saving, than to arrive at the finish line (retirement) and then be told "you should have done more"

That is a big risk to take with your retirement.

Long term returns are not the only things that have changed. There are two more crucial ingredients to getting your retirement plan right. These are:

1. Retirement Age and Life Expectancy; and
2. Inflation.

Retirement Age and Life Expectancy

Over the last forty years our world has changed vastly. These changes have made substantial impacts on how we live our lives. Most notably, improvements in health services have resulted in significant increases in life expectancy for younger people. In 1909, the average male life expectancy at birth was 55 years, compared with 84 years today.

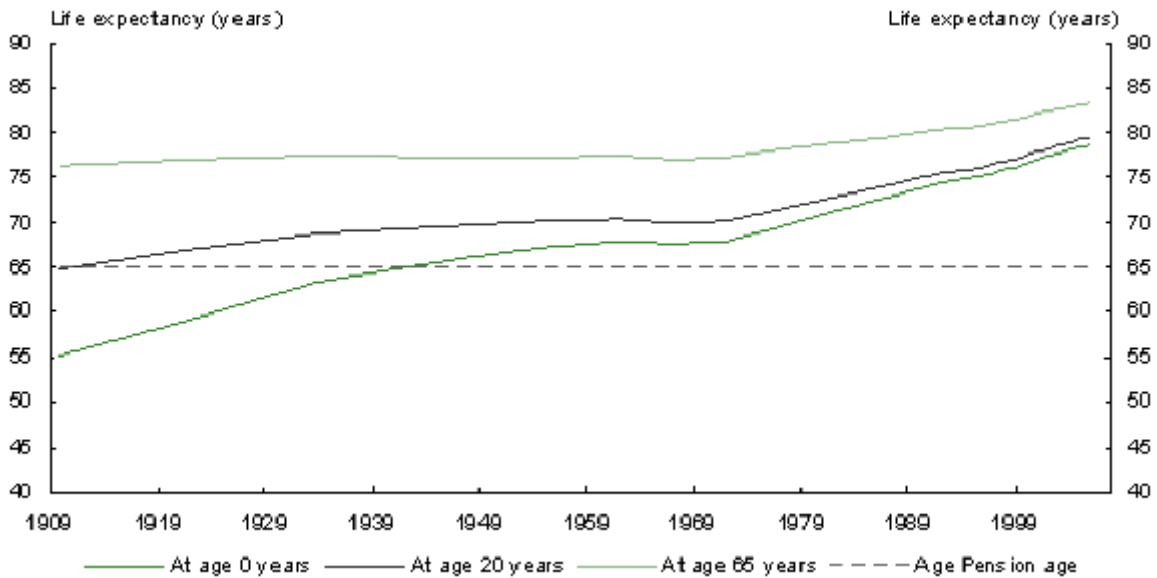
It is also interesting to note that many people after the age 55 during the early 1900's kept working up until the time they died. With no superannuation or social security system to fall back on, it was considered normal to work till you drop.

Now, not only are people generally living longer, but their retirement savings have to last longer as well. Proof of this is that (average) retirement savings now have to fund 19 years of pension and retirement income, whereas in 1970 retirement savings only had to fund the equivalent of 3 years retirement income.

It was not uncommon for baby boomers to starting work at age 20, after university or a trade is completed. The goal was **early retirement** at the age of 55, leaving most people 30 years in retirement. Could we ever afford this system?

Many expect to spend an equal amount of time in retirement as they do working. Put simply, you have only 35 years to save enough in order to spend the next 35 years doing what you dreamed of!

Male life expectancy



While the graph above shows the increase in life expectancy over the last century the chart below puts this phenomenon into context when planning your retirement

Age	Male	Female	A Couple Both Alive	At Least One Alive
Life expectancy	19.5	22.9	15.7	25.7
65	100%	100%	100%	100%
80	68%	80%	54%	90%
85	49%	65%	32%	78%
90	29%	44%	13%	56%
95	13%	23%	3%	30%
100	5%	9%	1%	12%

We think the numbers you need to focus on are age 90 and 85. At age 90 there is a 56% chance of one partner in a couple being alive; at age 85 it is 78%.

Inflation

Inflation affects the cost of living - how much money it costs you to eat, drink and be merry! The higher the rate of inflation the more money you need each and every year to maintain your lifestyle.

To illustrate the effect that inflation has on costs, consider for example a \$5,000 holiday taken during the 1980's when inflation was running at 8.3%. To take this same holiday in 1988 would have cost \$9,462 – almost double.

Year	Cost
1980	\$5,000
1982	\$5,864
1984	\$6,878
1986	\$8,068
1988	\$9,462

Inflation as a Measure

Mid-1993, the RBA introduced a stated goal of keeping inflation in the range of 2 – 3%. Because CPI is a measure of many goods, it includes items that have been both inflationary and deflationary, e.g. petrol has risen in price while TVs have come down in price. The net result is quite a benign CPI number over the last 20 years. While inflation as a measurement has been low in the past two decades, the fact is that household expenditure has increased significantly over the last 5 years.

Year	CPI
1980's	8.3%
1990's	2.3%
2000's	3.2%

Think about how the prices of the following items have increased, and the impact this has had on your family budget:

- Groceries (milk, meat and vegetables);
- Petrol in 2005 was \$0.92 now \$1.34 / L;
- School fees (up by 40% in many private schools over the last 4 years);
- Rates;
- Electricity (after deregulation);
- Gas (after deregulation); and
- Private Health Insurance (up 10% per year for most).

All of these yearly expenses make up a large part of the family budget and they have risen substantially in the last 5 years, many between 40 – 50%.

What has come down in price are one-off expenses that occur every 5 years or so, such as electronic equipment (TV's, stereo, DVD players), whitegoods and cars.

What this means is while the RBA might be reporting benign inflation numbers, the real cost of living has increased significantly. Unfortunately, at this point in time these increases in expenses do not appear to be abating.

This affects two important things:

1. The ability of people to save money for retirement.

As a result people need to start saving earlier, be more disciplined savers and keep focused on their retirement goals.

2. It certainly is no longer a case of needing less in retirement but more and more the case of needing more!

In our business the average increase in our clients' income requirement in retirement due to inflation over the last 5 years is 25%. As a result people need to revise upwards what they think they will need in retirement.

A Case Study - The Impact on Retirement



Meet Sam

- 45 years old
 - Earns \$85,000 p.a. (about \$65,000 after tax) and expects to stay at a similar level of income with pay rises matching inflation
 - He owns his own home with \$250,000 debt (expects to own outright when he retires)
 - \$130,000 in super with \$8,100 being contributed by his employer each year
 - Superfund is invested in the growth portfolio option, targeting high returns
 - Intends to retire no later than age 65 with enough assets to replace his net income
- Will reduce his investment risk at retirement and move from the Growth Portfolio option to the Balanced Portfolio option
 - Expects to live 10 years longer than the average life expectancy as he believes that healthcare will continue to improve and he will have enough money to be able to afford excellent medical treatment (Therefore his goal is to have his money last to age 95)
 - At 95 he expects to have consumed all his investment and only own his home

If the returns on Sam's investments continue at the same level as the last 30 years, Sam will need \$798,634 in today's terms to provide him with \$65,000 net income (indexed to inflation) each year after he has retired, until age 95. To achieve this Sam will need to keep working until age 63.

What If Returns Are Lower?

However, if we expect the reduced returns of the last 10 years to continue what is the impact on Sam? With all investment markets just starting their respective recoveries from the GFC it is too soon and thus too hard to believe that a long term return of 4.9% for a Growth portfolio and 5.3% for a Balanced Portfolio is realistic. We believe an 8% return is achievable. This comes as 5% income whether that is cash returns or dividends plus franking credits from Australian shares. Since the RBA introduced its inflation range of 2 – 3% the cash rate has averaged 5.33%, while the dividend paid by Australian shares has averaged 4.1% since 1945. We also believe any good quality asset should at least grow at the rate of inflation. This gets us to our 8%.

If Sam achieves an average return of 8% over the next 18 years he will have accumulated \$490,656 by age 63, instead of the required \$798,634 that he needs by retirement. As a result Sam will have a dilemma.

Not only will he have to make up for the gap between the \$490,656 he is now on track to accumulate and the \$798,634 he wants, but Sam will also have to make up for the lower return his portfolio will deliver while retired. Therefore, Sam will now need to accumulate \$1,095,966, a massive \$297,332 or 37% more than the \$798,634 previously required to provide him his \$65,000 income in retirement.

This scenario would present Sam with three choices:

1. He could take on the work ethic of 1909 and just keep working past retirement (63 for Sam) to age 75 to accumulate the required assets; or
2. He could leave work at 63 as intended with his \$490,656. He could then take \$65,000 income for as long as it would last, which would be 8 years. He would then be forced to live off Centrelink's Age Pension of \$18,228.60 p.a. for an expected 25 years.
3. Sam could leave work at 63 as intended with his \$490,656 and live off \$29,100 for the next 32 years until he reaches age 95 when his money will run out.

Please note we have not included Centrelink benefits in any of our calculations.

Conclusion

The fact is that while many things remain the same after the GFC, many things have also changed;

- Returns over the last decade are half those of the previous decade and one-third of the decade before that;
- Life expectancy has increased threefold the length of time most of us expect to be retired;
- At the same time we strive to retire earlier and earlier;
- Giving us the double conundrum of having less time to save and more savings required;
- Lastly, just to make it that bit harder, inflation is increasing the cost of living.

The question everyone needs to ask themselves is what is the risk to their future, their lifestyle, their retirement and their family of not changing too?

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About Snelleman Tom

Snelleman Tom challenges the way you have been advised for years.

Using an integrated approach of combining accountants, business consultants, financial planners and insurance experts, you or your business will achieve the future you've always dreamed. Snelleman Tom, allows the creativity of wealth creation or the focus of building businesses to be as important as making sure you pay the least amount of tax possible.

About Our Directors

Martin Kerrigan

Martin Kerrigan is a Director and CEO of Snelleman Tom Consulting Accountants and Financial Services. Prior to joining the firm in 1994, Martin owned a diverse range of businesses including waste paper contracting, limousines and wholesale nurseries. He holds a Bachelor of Commerce from University of Queensland and is a qualified CPA and Financial Planner. Martin is the chairman of the Snelleman Tom investment committee and a regular contributor to industry forums and parliamentary submissions.

Greg Tom

Greg established Snelleman Tom Consulting Accountants (1990-1997), working with Small Business Clients, offering business advice which helped clients create stronger businesses that was also aligned with their wealth creation, and protection objectives. Prior to joining the firm Greg worked in a diverse range of roles with businesses such as Price Waterhouse Audit, Colgate-Palmolive, Burton Group, Ernst & Young.

In 1997 Greg established the Palace Backpackers Pty Ltd, and over the next 11 years developed and operated businesses with operations in Brisbane, Mooloolaba, Hervey Bay, and Cairns. Greg holds a Bachelor of Financial Administration from University of New England and is a qualified chartered accountant with over twenty years experience.

In 2011 Greg returned to Snelleman Tom. His primary role is to focus on Practice Management, Client Advisory and Management Consulting. Greg is an expert in providing professional advice to business clients and assisting them to profitably grow their businesses.

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