POWER POINT

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3 FINANCIAL RISKS TO PLAN FOR BEFORE RETIRING

As with corporate strategy, the essence of personal finance strategy is to identify the one or two most important problems, and to find a solution to them. These issues could be visible, immediate and relatively simple, or they could be almost invisible, long-term and relatively complex. Both types of issues require attention.

To be able to focus one's limited attention on complex issues firstly requires that we stop over-complicating simple issues. For example, to get equity exposure, one can simply buy a low-cost (10-15 basis points per annum) NSE NIFTY 50 index fund (direct plan). Also, complex real-world issues typically do not have an optimal solution and one must accept a satisficing solution i.e. a good enough solution.

Several top personal finance risks cannot be mitigated by financial products in India because such products almost do not exist. That makes these problems complex and amenable only to satisficing solutions. There are three such risks.

LONGEVITY RISK

Longevity risk is the risk of living much longer than average and, hence, exhausting one's savings during one's lifetime. Say, a couple, Mr X and Ms Y, are both currently 60 years old and have just retired. They calculate that their average life expectancy is 80 and 83 years, respectively. Spreading their savings over roughly 23 years seems just about doable. But they also know that the average (50% probability) is deceptive. They find that the probability of X, Y, X and/or Y living beyond the age of 95 is 5%, 10% and 14%, respectively. Spreading their savings across 35 years and still having a 14% probability of failure naturally feels disheartening to them. For most people, the only financial product that can mitigate longevity risk is a life annuity which pools the longevity risk of many people. However, in India, life annuities do not sufficiently keep pace with inflation and they are extremely tax inefficient for a retired person in a high tax bracket. One out of several satisficing solutions for them is to put half of their net worth into sub-optimal life annuities. And with the other half, try to synthetically approximate a life annuity which starts at the age of 80 to compensate for inflation. This is complex because, if X and Y are still alive at the age of 80 and they check again, they are likely to find that the compound probability of X and/or Y living beyond the age of 95 has now crept up from 14% to 25%.

To mitigate this non-intuitive aspect of probability, they will most likely have to gradually cut down expenses during retirement.

DISABILITY AND CRITICAL ILLNESS RISK

Pure term life insurance makes it possible to protect against the mortality risk of a primary breadwinner. But it is extremely difficult to protect against disability and critical illness risk which can also end the salary/business income. For various reasons, disability and critical illness insurance products cover only a small sum insured or an extremely small range of issues. For example, both kidneys functioning at one-ninth of normal or loss of 99% of vision in both eyes may not qualify as an issue. Accordingly, the premium to cover such risks is also very low.

A very limited financial solution is to start saving as much as one can when one is in his/her 20s or 30s, and reduce risk as much as possible—using many small non-financial solutions like closely monitoring one's health and wearing a seat belt even while travelling in the rear seat of a car.

RISK OF UNEXPECTED HIGH INFLATION

Unexpected high inflation will devastate the real value of one's long duration bond portfolio (for example, 10-year government securities or G-secs).

> Some risks can't be mitigated by products as such products almost don't exist in India

In the US, this is a lower risk, but individuals mitigate this by holding Treasury Inflation-Protected Securities (TIPS). However, in India, so far only a tiny amount of CPI inflation-protected bonds have been issued by the government and it was not tax efficient.

The partial mitigation is to own a suitable set of assets classes which have their own drawbacks but offset drawbacks of other asset classes. The assets classes that partially mitigate against unexpected high inflation, with their main drawbacks mentioned in parenthesis, are: equity (risky), real estate (illiquid and risky), short-duration fixed income such as overnight debt mutual funds (lower expected returns) and possibly, international investments such as a US S&P500 index fund (higher logistical overheads and risky).

Being a competent co-CEO of one's family's finances requires one to additionally grapple with the long-term complex problems that seem unsolvable and to find a good enough solution to them. And being a competent investor of one's family's finances requires that one be willing to wrestle with problems and solutions that most people will consider to be ridiculous.

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