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THIS IS HOW YOU CAN STRESS TEST YOUR RETIREMENT SAVINGS BEFORE IT'S TOO LATE

By: Chris Carosa - July 24, 2020

It might make sense to treat your retirement savings like the government treats banks. Your savings will, after all, become your bank when you retire.

Historically, banks' internal procedures periodically called for accounting "stress tests." Similar to what your doctor might order you to take to test the strength of your heart, bank stress tests measure the strength of their finances.

"In general, a stress test is any kind of test that pushes the limits on the subject using extreme scenarios," says Tim Bain, President of Spark Asset Management Group, LLC in Statesville, North Carolina. "Specifically, the bank stress test applies what-if scenarios to determine if the bank has sufficient assets to survive during periods of economic stress. These could be high unemployment, low GDP, periods of significant inflation or deflation, a stock market crash, etc…"

When the credit markets seized up in 2008/2009, many banks teetered on the brink of disaster. What had been merely "best practice" for financial institutions soon became law.

"Bank stress tests are now required to be performed for banks with at least $10 billion in assets," says Mark J. Alaimo, a member of the AICPA Personal Financial Specialist Committee based in Lawrence, Massachusetts. "This was because if these banks failed, it would impose a meaningful strain on the FDIC insurance fund and would likely require governmental intervention to ensure the depositors were not harmed by the loss."

But you can let the government worry about the "too big to fail" banks. You need to worry about your own retirement savings "bank." Still, what you learn from the lessons of these mega banks may help protect you in retirement.

"Bank stress tests were created in response to the 2008 financial crisis," says Macedon, New York-based Richard Barrington, a senior financial analyst for MoneyRates.com. "They are designed to show what would happen to bank finances should they experience some business setbacks. The idea is to find out how close to the edge the banking system would be in a bad economy. People can apply the same approach to their retirement plans."

This isn't just an academic exercise. If you can judge from history, stress testing your retirement savings has real practical implications.

"Today's retirees may experience three or more major market declines during retirement," says Sheryl O'Connor, Founder and CEO of IncomeConductor in Hartford. "Since retirees today depend on their savings as the primary source of income, they simply do not have the luxury of 'riding out' these times of crisis as those accumulating assets can. Therefore, retirees need to utilize strategies that protect their savings and income during times of economic crisis or high market volatility."

Just look at what has happened in the last twenty years. In the early 2000s you saw the dot-com bubble implode. In the late 2000s you saw real estate prices collapse and credit freeze. Just this year you, along with everyone else, are living through a once-in-a-century pandemic event. Imagine if you had to experience these crises during retirement.

Banks have learned to live with this possibility. You should, too.

"Stress testing one's retirement savings is very similar to stress testing a bank," says Alaimo. "If a bigger bank were to fail, it would impose a significant hardship on the economic safety nets in place. Likewise, if your retirement savings endure a meaningful hit that isn't provided for at an inopportune time, it could cause significant harm to the retirement lifestyle one expects."

You shouldn't confuse this kind of retirement savings stress test with a different kind of risk analysis tool used by many financial planners. Called a "Monte Carlo" simulation, it's used primarily to test various investment portfolio strategies. This computer-generated series of random outcomes tests the odds your investment will yield the results you need.

"Simulation analyses, such as a Monte Carlo simulation, can model various economic conditions over a long period of time," says James Ciprich, Partner & Wealth Advisor at RegentAtlantic in Morristown, New Jersey. "It will incorporate sequence of return risk, and provide a probability of success. A positive result may be a plan that works 80% of the time or more, whereas a failing plan may have a probability of success below 75%."

While incorporating many of the same variables, Monte Carlo simulations offer only a narrow risk assessment as it pertains to the range of likely returns on your investments.

You need to conduct a more thorough stress test. Although your financial status is relevant, a proper comprehensive analysis will introduce elements that further test the viability of your retirement savings.

Before you begin, you need to establish a baseline. This is similar to what a doctor does when you undergo a heart stress test. First, you take a measurement of your heartrate before you get on the treadmill. It's the same idea with your retirement savings stress test.

Here's what this baseline entails and why it's important.

"Many financial professionals take a probability-based approach to income distribution where it is difficult to demonstrate the impact of economic crises, hyper-inflationary periods, and/or unforeseen medical events," says O'Connor. "It's critical to use a strategy and technology that creates a written plan that is customized to an individual's retirement goals. Once you have a 'base plan', these negative events can then be modeled to determine their impact on the plan. For example, if the crisis analysis results in the individual's savings running out before they die, or a reduction of income that is unacceptable, they can then consider their options to address these impacts."

With that foundation in place, you can now proceed to examine various worst-case scenarios to test their impact on your retirement. Here's one that you'd be surprised to know many people ignore (at their own peril).

"Given that we are all living longer, a long-term healthcare event test helps to give you peace of mind," says Clari Nolet, Senior Financial Advisor at Team Hewins in Redwood City, California. "If an event of needing nursing home or in-home care lasts 2-3 years (average from data) at age 75 and/or 80, will your savings/investments take care of your living expenses for the rest of your lives or the lives of the people you are responsible for? If not, and you are young enough for it to make sense and you can qualify, you can look into long term care insurance (LTCi) to ensure you do not run out of money. If you do not run out of money, then you are able to be what is called 'self-insured' to weather this type of event."

If this example applies to you, what kind of practical mid-course corrections are available to you should LTCi not be an option? Nolet suggests you "leave less to your children, reduce expenses to save more, look at reverse mortgages and finally look at part-time work after you planned to retire, or working longer."

It's not just this specific need (long-term care), in general, there are other stress inducing factors that arise with advanced age. How can you test this?

"One easy stress test to conduct on your retirement savings is to add five years to your life expectancy," says Marc Labadie, Partner of The R.O.W. Group in Nashville. "This is probably the most telling because the longer you live, the more susceptible you are to inflation, market volatility, health care costs, etc. Do you run out of money? Of course, if you reduce the dollar amount of assets you have, this too, will have a huge impact. Take your March 2020 values and re-do your assessment. I assure you that assessment varies greatly from your December 31, 2019 assessment."

More likely to stress your retirement but no less ignored (especially since it really hasn't been an issue in this low interest rate environment) is inflation.

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