Practice Management:

Longevity Risk: Let's not Play Actuary

by By Jim C. Otar,
CFP, CMT, BASc, Eng.

Some advisors go to great lengths to figure out a client's life expectancy. While this exercise may be necessary for insurance companies, the health care profession, morticians and such, I find little use for it in my financial planning practice. I can best explain the reason by sharing a personal experience with you.

On my 50th birthday – over five years ago – I received a phone call from my family physician. As the phone was ringing, I saw his name on the call display. While I was reaching for the handset, I cheerfully mumbled to myself, "Such a thoughtful doctor. He remembers my birthday!"

His phone call was not about what I naively expected. He went on explaining that my PSA level was abnormally high and I needed to have a prostate biopsy right away. He further added, based on my PSA level, I had about 15% probability of prostate cancer.

It was not a happy day for me. Later on that day, I started thinking about this 15% probability. You see, this information may be useful for a urologist, a prostate clinic or a cancer treatment center. Probabilities and statistics are valuable for them in planning their business, the facilities and resources. However, it has no use for me whatsoever. You see, I cannot have 15% cancer. I either have it (100%) or I don't have it (0%). Statistics and averages do not apply to individuals, only to pools of people. Any attempt to do so, be it by an academic or by a financial planner, is just an abuse of the science of statistics.

Let me give you another analogy. I am 5'8" and I like to consider myself as "average tall." If by any chance I walk into a basketball player's convention, am I expected to grow taller, because the average height in that room is 6'4"?

I don't attempt to figure out my client's life expectancy by asking numerous questions. One such typical question is "Did you have any traffic violations in the last three years!" Who cares! The answer to this question may be significant for estimating one's life expectancy or his car insurance premiums. However, I just don't think we financial planners should turn into actuaries. The term "Life Expectancy" measures the age at which half of the people will die and the other half will survive. What if a seemingly incurable ailment becomes treatable in five years through a routine procedure? Would that create a sufficient excuse for running out of money "prematurely"?

One of my clients was told by a cancer specialist that he should prepare for the inevitable. Supposedly, he had only a few months left to live. That was 10 years ago. My client still exercises every day, eats well and enjoys his life to the fullest. He helps run men's prostate support groups all across Southern Ontario. He even gives me investment tips occasionally! Luckily, I did not design his retirement plan based on his life expectancy.

No, we the retirement planners are neither statisticians nor actuaries. We were taught not to guess tomorrow's market direction because in the long run we would be mostly wrong. By the same token, it is just as wrong to guess an individual's life expectancy for retirement planning. Of course, there are situations where one should use some judgment. However, when you do that, you must be cognisant of where the Ultimate Judgment comes from.

For someone who is ready to retire and does not appear to be sick, I am not going to waste my time trying to figure out whether his life expectancy is 83 or 86. As a rule of thumb, I use 95 as the age of death for most of my cases. If a client has visible signs of ill health, then I use age 90. If a client has or had parents with long life span, then I use age 100. If you don't want to play an actuary, or for that matter, if you don't want to play God, I recommend that you do the same.

The key to proper retirement planning is not trying to guess when exactly an individual might die, but to design a perpetual portfolio for that client. For that, you need to go through a "Needs Analysis" to determine if client needs life annuities for lifelong income, which will be the subject of my next article.

* * * * * *

About the Author

Jim Otar spoke at the 2006 CALU annual meeting. This is the first of two practice management articles which he has agreed to write for CALU. Jim may be reached by e-mail at jimotar@rogers.com or by phone at (905) 889-7170.

© Conference for Advanced Life Underwriting, September 2006