The Crescent Group

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Wealth Management
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February 2023 Crescent Commentary

During February, we saw the release of the January inflation report showing inflation increased more than expected to start the year. As a result, financial markets returned their attention to the realities of elevated inflation and rising interest rates. That reality essentially consists of the Fed continuing to raise interest rates and holding rates at higher levels for longer, with the goal of bringing down inflation. Interest rates act as gravity in relation to asset values, which explains why financial markets declined in February.(1)

Given the current environment of elevated inflation and rising interest rates, we continue to recommend that investors own a mix of assets: (1) We recommend investors own a substantial allocation to dividend paying investments with strong cash flows and a demonstrated track record of increasing dividends annually; such investments showed strength during the last major cycle of elevated inflation and rising interest rates in the 1970s; (2) We recommend measured allocations to certain "growth" assets that have substantially declined and where we find long-term, durable value. (Individual recommendations are based on suitability.) (2)

The topic of elevated inflation has led many investors to wonder about inflation's impact on their retirement planning. Many wonder about the sustainability of the lifestyle they've planned for. The good news is that even with the double-digit inflation of the 1970s, U.S. inflation has only averaged about 3% a year over the past 100 years. We use the long-term average inflation rate in our wealth plan assumptions, so we have already taken into account inflation at far worse levels than we're seeing today. But thinking about the sustainability of one's retirement lifestyle does bring to mind a topic that's often not carefully considered: life expectancy and longevity.(3)

For the time period 1900 to 2018, average U.S. life expectancy increased from 47 years to 79 years. That's great news! And while the rate of increase in life expectancy is expected to slow substantially, continued long-term gains are expected.(4)

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The continual increase in life expectancy presents a wealth planning challenge: people tend to underestimate how long they'll live. Even professional forecasters have "consistently underestimated how long people will live". According to Olivia Mitchel of The University of Pennsylvania, "the chance you might live a very long time in retirement and run out of money is something we haven't focused enough on at all". One factor that isn't widely understood is that life expectancy is a statistical average. That means there's a 50% chance you could live for many more years than your life expectancy.(4)(5)(6)

Given the one-two punch of elevated inflation and increasing lifespans, how should investors prepare for the future? The first step is to have a carefully constructed wealth plan. A wealth plan is only as good as the assumptions used to create it. It's important to use conservative and reasonable assumptions when it comes to life expectancy, inflation, and expected future returns. We've already seen that many people underestimate how long they'll live. Another challenge our Group has seen is a tendency for investors to overestimate what returns they'll achieve in the future. The experience of the 12 years leading up to 2022 was very good, but also exceeded the long-term average. We expect a reversion to long-term average returns, and use these conservative return assumptions when creating wealth plans.(7)

Your asset allocation is another critical component of your wealth plan. The higher your equity allocation, the higher your expected returns. Obviously, higher returns means more protection against living longer. There are limits to this, however. If your equity allocation doesn't align with your tolerance for volatility, you might decide to lower your equity exposure in the middle of a correction. And that could work against your returns in a big way. Your reaction to last year's stock market decline is a good indication of your risk tolerance. 2022 was the 7th worst year on record for stocks over the past 94 years. That made it a once every 13 year event.(8)(9)

There are some other steps investors can take to help manage the impact of a longer life. For married couples, two people means you have twice the chance of one person living an above-average life span. Delaying Social Security until age 70 maximizes the benefit for the surviving spouse. Another step you can take is to work in some reduced capacity rather than fully retiring. Finally, a rather blunt instrument approach to preparing for a longer life is simply increasing your savings rate prior to retirement.

If you have any questions about what we've discussed, please contact us today to set up a conversation.

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Sources:
(1) CNBC
(2) Roger Thomas
(3) Bureau of Labor Statistics
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(5) The Wall Street Journal
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(8) Invesco
(9) A Wealth of Common Sense

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