Impact of Disability on Retirement Planning

Even the best designed retirement plans can backfire miserably if you do not carefully consider the effect of disability during working years on retirement

By Jim Otar, CFP, CMT, M. Eng.

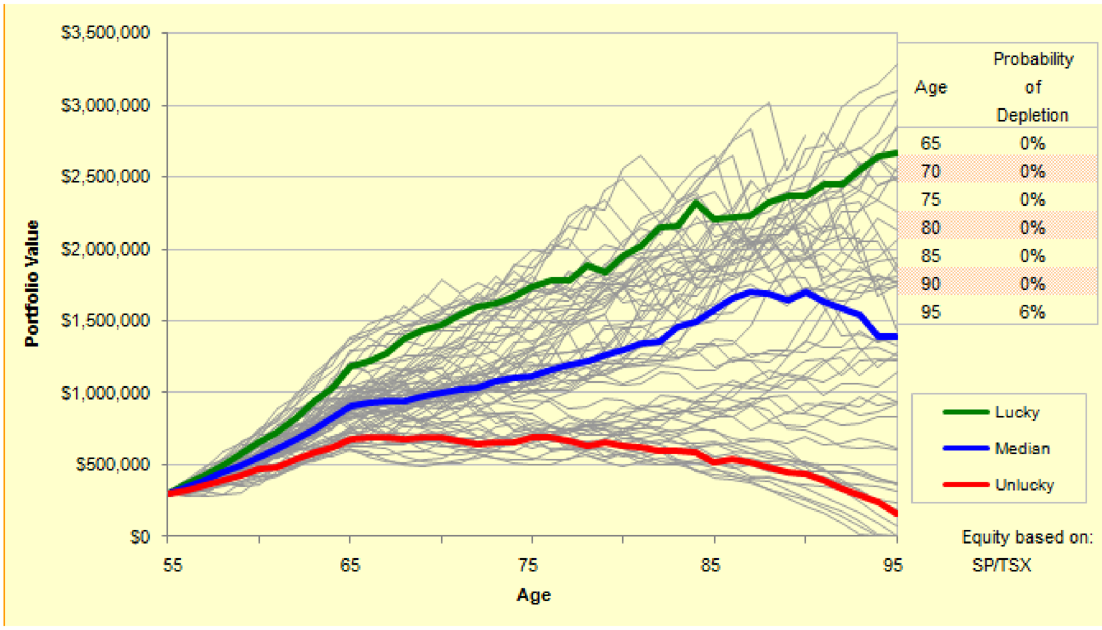
Picture this: You have a client who is ten years away from retirement. He comes to you for retirement advice. You spend several hours, maybe a full day with him. You go over many different retirement scenarios. At the end of this exercise, you prepare a plan for him that is as thick as a phone book. In your next meeting, you review it with your client. One of your suggestions is to buy disability (a.k.a. income replacement) insurance, in case he becomes unable to work and earn income. Your client says the company he works for already gives him a similar insurance. He is not interested at all in purchasing his own disability insurance. After some intense discussions, you fail to convince him to go with your suggestion. “Oh well” you say to yourself, “maybe he’ll come around soon”. After your meeting, you decide to hand over the plan to your client.

Perhaps, the client was being stubborn. Perhaps, he thinks you are going to make a lot of commission, and he does think you deserve it. Perhaps, he genuinely believes that his company hired him for life and the plan they have is good enough. It does not matter. The bottom line is, you were not able to show him clearly why he needs the disability insurance as an essential part of his overall retirement plan. You might have been more effective if you were to show the impact of loss of income to his retirement.

Let’s look at an example: Bob and Sue, both 55, married to each other, have about $300,000 in their retirement accounts. Their asset allocation is 40% equities and 60% fixed income. They are planning to save each year $25,000 (combined). They plan to retire in ten years, at age 65. After retirement, they figure that they need $50,000 annually -in current dollars-, indexed to inflation. They expect a total of $25,000 from their CPP and OAS benefits. They want to plan for income until age 95, a thirty-year withdrawal time horizon.

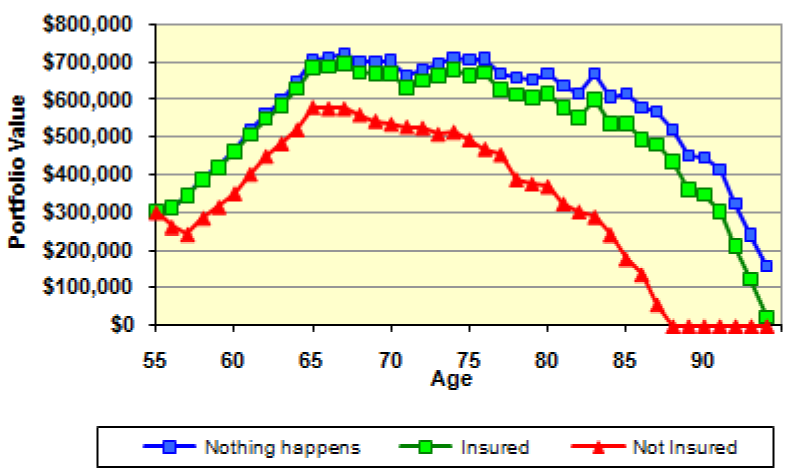
I take this information and run it through my retirement calculator that is based on actual market history. It tells me they have a good plan (Figure 1). If they are lucky (top decile of all historical outcomes) and catch a good, long-term market trend, they’ll have about $2.7 million in their portfolio at age 95. If they are unlucky (bottom decile of all historical outcomes) they have about $164,000 at age 95.

Figure 1: Bob and Sue's Retirement Assets over time



This sounds great doesn't it? Well, not so fast. What if Bob loses his job? In that case, he also loses his disability insurance coverage. Now, he is on his own. What if he experiences a health problem or an accident, and as a result he is unable to earn income for a while? Now, they can no longer save the $25,000 they were hoping to save annually. Worse, he may have to take out money from their retirement savings just to make ends meet. Their meticulously planned retirement finances go down the drain.

Figure 2 depicts the impact of a disability that lasts two years.



The blue line on the graph in Figure 2 indicates the portfolio value, if Bob has no disability insurance and no disability occurs. Bob earns income continuously until age 65. Everything looks great; their portfolio lasts at least until age 95.

The red line depicts the portfolio value if Bob has no disability coverage and he becomes disabled during ages 55 and 56. What do we see? The portfolio life is reduced by 7 years. If Bob were single that might be OK, because a disability lasting two years might also reduce his life expectancy. What about Sue? There is a 36% chance that she would be still alive when the money runs out at age 88. Not an acceptable retirement plan.

And finally, the green line on the chart indicates the portfolio value, if Bob has disability insurance and he is unable to earn income at ages 55 and 56. The portfolio value is slightly lower than the blue line because of the cost of the disability insurance. But, in this particular example; Bob and Sue still had income until age 95. Now, this is a good retirement plan.

The table below shows the impact of loss of income to portfolio life.

Duration of total loss of income:	Portfolio life is reduced by:
1 year	1 to 7 years
2 years	5 to 11 years
3 years	8 to 14 years
4 years	12 to 17 years

Keep in mind, these numbers are only approximate. There are many factors that affect the reduction of portfolio life. How much excess assets you might have in your portfolio, how much each spouse earns, when does the disability happen relative to retirement age, how much additional expenses you might have, whether or not one can collect CPP disability pension, are some of the different factors that will affect the size of the reduction of the portfolio life. However, the numbers in this table might help you convince your client that during the accumulation stage, disability insurance is not a luxury but a necessity for a proper retirement planning.

The bottom line: Don't call a retirement plan complete or comprehensive until the risk of disability is carefully examined and covered.

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