ADVANTAGE COMPENDIUM

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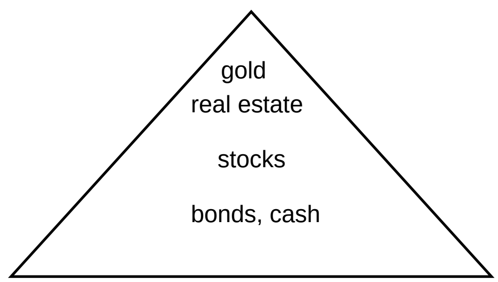
The New Retirement Income Pyramid

Old Retirement Pyramid

You've all seen the old Wall Street financial pyramid. The broad bottom level usually held things such as bonds, the middle levels contained diversified portfolios of equity mutual funds and stocks, and the top had assets like real estate or gold or tech stocks. It was a pyramid based on risk and it was supposed to show that you should put most of your assets in lower risk investments and less in high risk ones when planning for retirement. The pyramid steps were often adjusted by age, so the lowest ones were fattest for seniors and thinnest for juniors. The problem is the pyramid doesn't work well for retirement planning in the new normal financial world.

The pyramid did okay in limiting exposure to perceived high risk assets – real estate and gold are excellent examples of the potential gains and losses of high risk exposure – but it has occasionally failed over the years on the low risk side. The reasons the Wall Street pyramid fails are because...



The Old Pyramid Confuses Low Risk & No-Risk

Two investments generally touted as super-low risk are mortgage-backed bonds and target date funds. However, more than 90% of mortgage backed securities rated "AAA" when issued in 2006 and 2007 were rated as junk bonds three years later (CFO, June 2010) and the SEC proposed new disclosure rules for target-date funds because some funds lost an average of 25% of their value in 2008 (AP, June 2010). The problem is Wall Street's pyramid treats an asset with low probability of loss the same as one with no probability of loss. The post-crash market redefined what low risk meant in retirement planning.

The Old Pyramid Ignores Fixed Annuities

Where are fixed annuities in the pyramid? Part of the argument used against fixed annuities is they are illiquid. This is true when it refers to immediate annuities, where an asset is used to purchase an income, but it does not apply to deferred annuities.

Deferred annuities are often considered illiquid because they have surrender charges, but fees and illiquidity are not the same thing. If you sell a stock, you get your money, net of the commission charged to sell the stock. If I assess a 7% annuity surrender charge and give someone back 93% of their account value, they still get their money, net of fees. I submit that if a consumer was offered the choice between Asset One that on any given day gave them liquidity with a predetermined maximum liquidity cost or Asset Two where the maximum cost is unknown and could be as much as 100% of their investment, that the consumer would say Asset One is more liquid.

And Tax Deferral Isn't An Add-On

Annuity tax deferral is either ignored or treated as a negative by Wall Street. If the money is nonqualified, the argument is tax deferral results in ordinary income and not lower taxed capital gains. The argument doesn't make sense with fixed annuities. Fixed annuities produce interest. Interest, whether from a bank or annuity, is always taxed as ordinary income.

If an annuity is inside a qualified plan, the argument is made that you have wasted the annuity tax deferral. This would only be a waste if there was a distinct charge for it. However, neither the insurance company nor consumer incurs any additional expense because of the annuity tax deferral, the deferral is a result of the tax code and not an option the consumer is paying for.

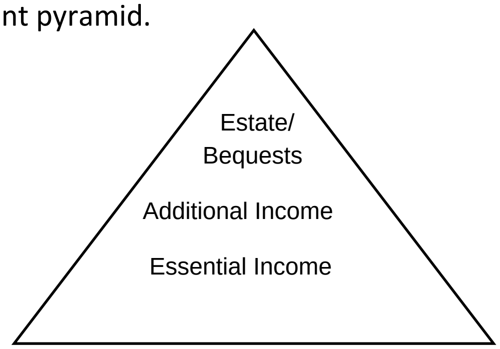
Finally, the Old Pyramid Assumes Rational Investors

The final problem is the biggest, and that is Wall Street's assumption that people make all financial decisions as if they are little computers possessing perfect information. It shouldn't come as a surprise that people do not make completely rational decisions with their money and therefore violate the rules of the pyramid. In reality, what this often means is consumers move too much money to the high-risk level when the market is soaring and keep too much in the bottom level after the market has bottomed and is moving up, and consumers also confuse no-risk and low-risk. It also means the real-world financial decisions made by consumers do not reflect the computer-created formulas of the old pyramid. Consumers do not put all their money in a pile and then divide up the money into least risky, risky, and most risky levels. Instead money is divvied up based on what the money is designed to do, and this is why a new pyramid is needed.

New Financial Retirement Pyramid

We tend to think of retirement in terms of dollars of investable assets because this is how Wall Street has trained the media to teach us about retirement. Since Wall Street doesn't guarantee a lifetime income, or guarantee growth of the assets to produce this income, they instead use retirement planning "rules of thumb" and since there is still a significant risk that the assets can disappear before the retiree does, their rules of thumb tend to require a very large pool of assets. This is the old pyramid. Consumers need to think of the new retirement pyramid.

The new pyramid is based on an awareness of Behavioral Retirement Principles. What it says is consumers are not simply conservative or moderate or aggressive when it comes to risk, but instead our aversion to risk depends on the context we are using.



Consumers divide up financial decisions into different sub-accounts with each having its own level of acceptable risk, and risk is defined as failing to provide the money needed in the sub-account. Our risk tolerance and the returns we will accept are the sum total of these sub-accounts.

It's Income, Not Assets

Most retirees do not need a million dollars; they need the income that the million dollars can produce. Granted, there are people who want the maximum estate possible and will starve to do it, but demographics and surveys show the main retirement goal is to not outlive your money. What this means is people should be thinking of how much retirement income they need.

Wall Street often says count on using 80% of your working income in retirement. Why 80%? There is reasoning behind the ratio, but the real answer to why use 80% is why not. With the Wall Street pyramid the income is simply a factor in getting the final answer which is total assets required.

The new financial pyramid believes getting the needed retirement income is the reason you save for retirement, so the consumer needs to figure out what they'll need by creating a retirement budget. Creating the budget accomplishes two things. First, it provides more realistic numbers about expenses so that real planning can begin. Second, it makes the concept of retirement tangible. During your working years, retirement is an abstract thing that happens in the future and we tend to think of retirement assets as game pieces. However, when you sit down and put on paper that you'll need $8,000 for housing, $7,000 for utilities, $5,000 for uncovered medical expenses and such, retirement becomes very real. Instead of treating it as a game you become focused on the reality of retirement, which means thinking about the source of the income you can count on.

Essential Income

The retirement budget is usually a bit of a wish list because it is designed to maintain the working lifestyle in retirement, but you also need to determine which expenses are essential because this is the income that needs to be protected. The budget may be $50,000, but if pushed the $4,000 January vacation can be eliminated next year as well as the weekly dinner out. Maybe, if you had to, you could get by on $36,000, and since Social Security provides $24,000 this means the essential income needed from your retirement assets is not $26,000 but $12,000. Guaranteeing that $12,000 is the bottom level of the pyramid.

What if the couple has an age 70 retirement goal and is age 65 today? If you could find an annuity with a guaranteed lifetime withdrawal benefit (GLWB) where the income benefit was guaranteed to grow at 6% a year, a premium of $169,190 today guarantees $12,000 is there in 6 years with a guaranteed payout factor of 5%.

Additional Income

What hurts the old Wall Street plan is treating low risk assets as no risk assets and taking money out when the value of the assets is going down. With the new financial pyramid, there is no market risk on the essential assets and withdrawals do not need to be taken from the high risk assets in bad years. Annuity Issuer risk on the essential assets is mitigated by using multiple carriers and the existence of state guarantee funds.

The additional income level is used to create income above the essential income. This could be done with a diversified portfolio of securities. The top level is designed for bequest needs. This could be also be accomplished using securities or – to bring in a new element – life insurance.

The key point here is using the annuity at the base creates a retirement where the retiree is much less likely to react poorly to a market crisis and make bad decisions about managing their investments, because they know their essential expenses are covered. The new financial pyramid approach readily lends itself to securities. The essential income is always provided by an annuity, but the additional income and bequests can be met through investments.

More Retirement Income Is Created

The old Wall Street pyramid usually assumes a low portfolio withdrawal rate of 2% to 4% because taking withdrawals in bear markets tends to deplete portfolios. The new pyramid uses annuities to cover the essential income so the investment assets would only need to be tapped when their value is not falling. This would permit a withdrawal of 5%, possibly, 6% on these invested assets, increasing the likelihood that the investment assets will be able to provide inflation adjusting income until death.

Wall Street's definition of "low risk" doesn't work in the new normal market. Essential income needs to be protected from both market risk and longevity risk. Immediate annuities and fixed annuity GLWBs guarantee the primary level of the new financial pyramid.

Sequence of Retirement Risk (Retirement Roulette)

Let's start with a couple of givens. If the stock market steadily went up and up, there wouldn't be a need to protect our assets from a stock market drop. If stock market drops happened on a predictable cycle or lasted a predictable period, we could simply sit out the bad parts. The problem is, except for knowing that the market goes up and down, the magnitude and length of either side are unpredictable.

Sadly, we can't say "The Bear Market is scheduled to start [fill in the date]"

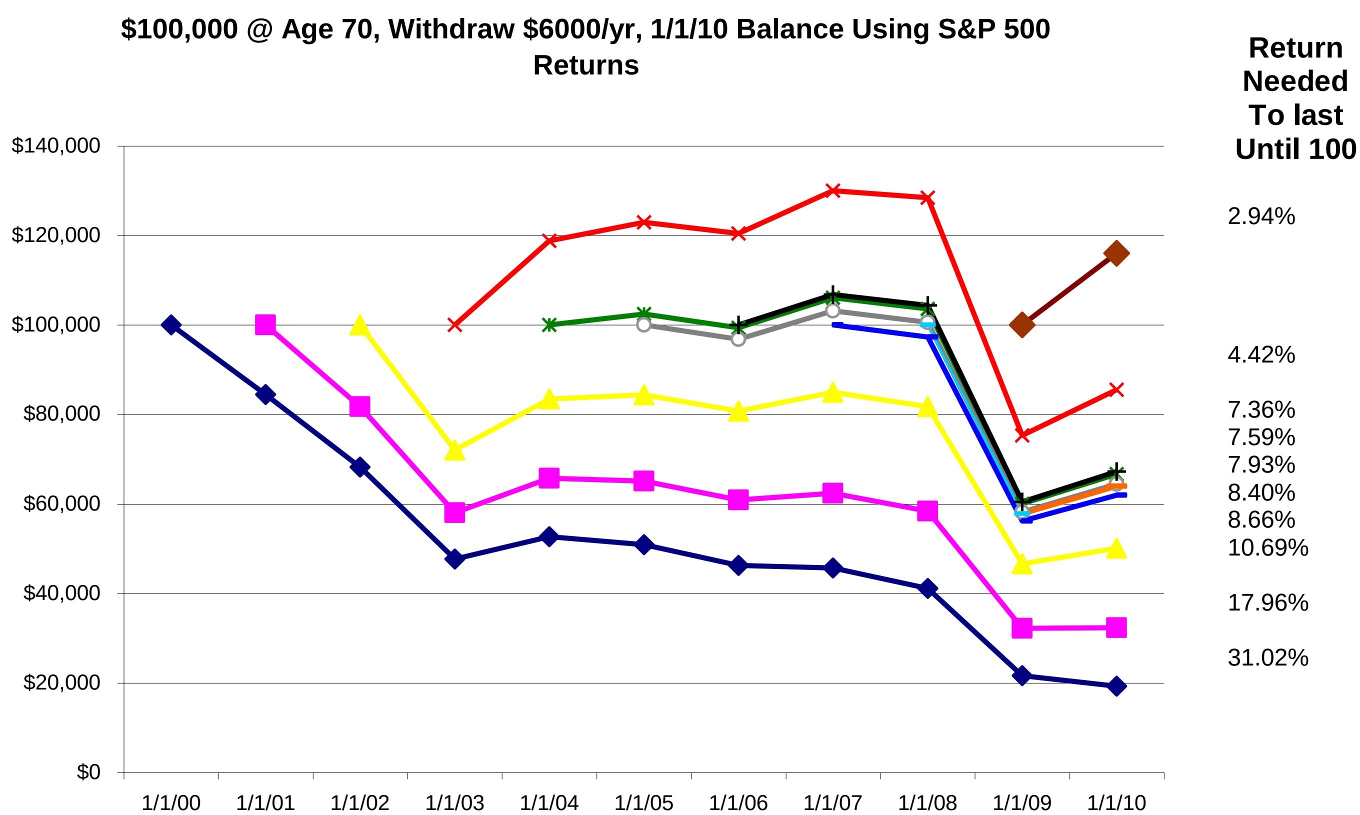
This makes planning on the cusp of retirement difficult. We know most of the time, the next 20 years will work out for a retiree withdrawing a prudent sum from their securities portfolio; but most of the time is not all of the time. If you type "sequence of return risk" into a search engine looking for its mention before 2008, you find very few articles; if you do the same looking since New Year's Day 2009, you find over twenty thousand articles. Clearly there is merit in attempting to protect the sequence of retirement.

Sequences

Each line of the chart below represents a row of 70-year-olds, all born on New Year's Day in sequential years, retiring with $100,000, withdrawing $6,000 a year on their 70th birthday.

The first to turn 70 (the blue line) began withdrawals January 1st, 2000, the second to turn 70 (the pink line) began in 2001, the third (the yellow line) in 2002, and so on. The right side of the chart shows how much each has left in their account on January 1st, 2010 based on movements of the S&P 500. The final column states the return they would need to earn each year from that day forward to be able to continue to withdraw $6,000 a year until age 100.

Explanation: If you started withdrawing $6,000 on January 1st, 2009 at age 70, and it is now January 1st, 2010 (you are now age 71), your account is worth $116,043. If you earn 2.94% a year, you can keep taking $6,000 for 29 more years. If you began withdrawals in the middle of the last decade ('04 to '07) you now have $60,000 to $70,000 remaining of your $100,000, meaning you need to earn roughly 8% a year from now on for your remaining funds to keep paying out $6,000 a year until age 100. But if you retired in 2000, you're now 80 with $19,258 left. You'd need to earn 31.02% annually to make it to 100.



What this shows is the average return earned may be far less important than the sequence in which the returns occur. If a bear market happens at the start of retirement, the retiree's portfolio may be unable to recover and this may result in insufficient funds in later years. Using immediate annuities or annuities with guaranteed lifetime withdrawal benefits can allow the retiree to avoid tapping into their investment portfolio during bear markets, thus giving them time to recover.

Spending the Principal

We are taught not to spend the principal of our assets. We can spend the interest, spend the dividend, but not the asset itself. After all, granddad said there won't be any eggs tomorrow if you eat the chicken today. This is a powerful belief and it runs contrary to the way annuity lifetime income is created. The result is often confusion that causes a reluctance to purchase and use an annuity with a guaranteed lifetime withdrawal benefit (GLWB). However, spending the principal is the basis of retirement income planning.

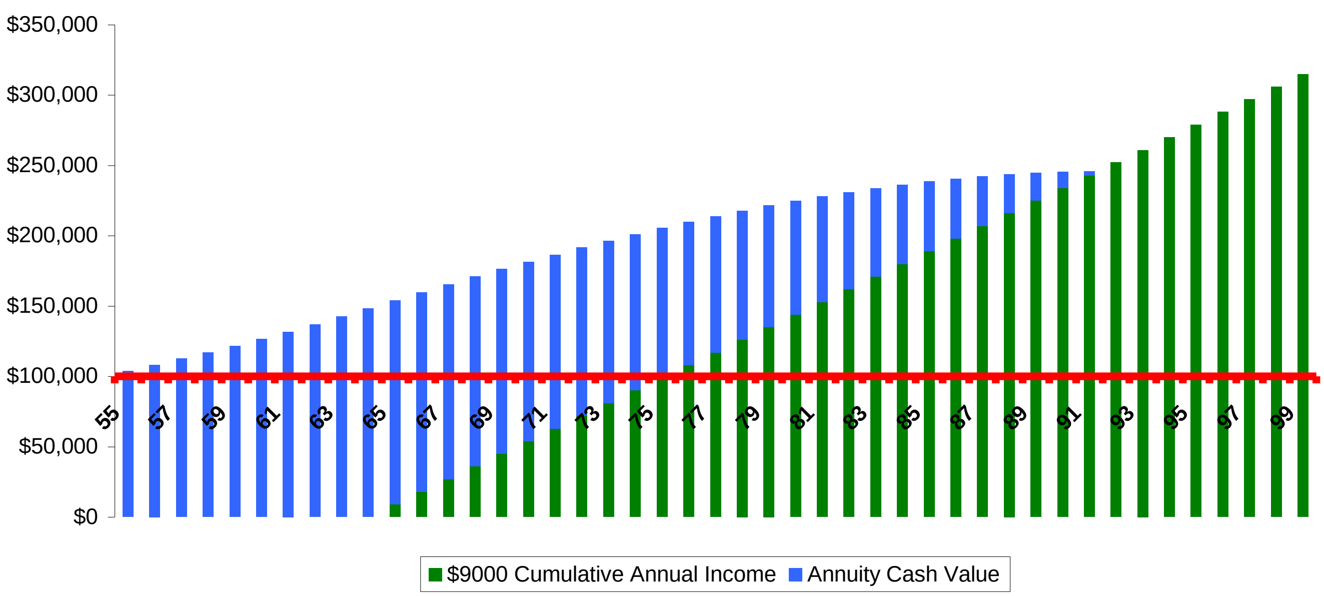
Whether it is a "safe" withdrawal method or a target date fund or a GLWB, the only goal of these methods is to have income that lasts as long as the retiree does. After legacy wishes are taken care of, if additional money remains at death that essentially means one did a poor job of planning because retirement income wasn't maximized. Even so, coming to grips with this reality is a difficult mental transition.

New retirees may see this as a win/lose situation. Either they go for income – and possibly run out of assets, or they preserve the assets – and settle for self-induced penury. There is another answer. Use part of the assets to build an income and set aside other assets to be held for emergencies or to leave a bequest. This changes the using principal for income dialogue from "keep or spend" to "how much".

Stable Income

Study after study finds retirees want a stable income in retirement. A strong argument can be made that at least the essential expenses – however those are defined by the retiree – should be covered by an income source that is not subject to interest rate fluctuations, longevity risk, market risk or other uncertainties. The primary objective should be providing this stable income. The solutions are thus narrowed to Social Security, pensions, and annuities with life income. The only solution that solves the stable income quandary and allows the retiree keep control of the asset is an annuity with a GLWB.

$100,000 Premium @ Age 55 in Deferred Annuity with GLWB income starting at Age 65



This does not mean the account value of the annuity with a GLWB will not go down; it should. After all, most GLWBs base the payout on an income account value that is far higher than the actual accumulated value. It's typically not a case of taking out 5% and earning, say, 4% each year – which by itself causes the account value to go down.

It's more often a case where the 5% payout is based on the $100,000 income account value, but the 4% is being earned on the actual cash value of $80,000. In other words, you're earning $3,200 (4%), but taking out $5,000 (6.25% of the actual cash). The annuity is designed to pay out principal; the difference is with this stable income choice, the retiree maintains control over the asset until the principal is used up. The difference between an annuity with a GLWB and uncertain income alternatives is the income level is guaranteed to both be stable and last until death, even if the principal is used up.

Uncertain Income
If the retiree wants to maintain a "don't touch the principal" philosophy, they should be made aware of the income trade-offs and retained risks.

Fixed Annuity Life Income Risk Management

Risks Transferred Away	Risks Partially Hedged	Risks Retained
longevity risk market risk	behavioral risks cognitive risk health costs risks inflation risk liquidity risk principal risk provider failure sequence of return risk yield risk agent/advisor risks (the risk of fraud; making mistakes; receiving poor, expensive, and/or biased advice)	bounded rationality voluntary risks

<u>Dividends</u>
Dividends are a time-tested way to generate a retirement income and many companies have a history of increasing their dividend, allowing dividends to also work as an inflation hedge. Granted, the value of the underlying stocks is fully exposed to market risk, but as long as the dividend is unaffected, life is good from an income perspective. The problem is sometimes it is affected.

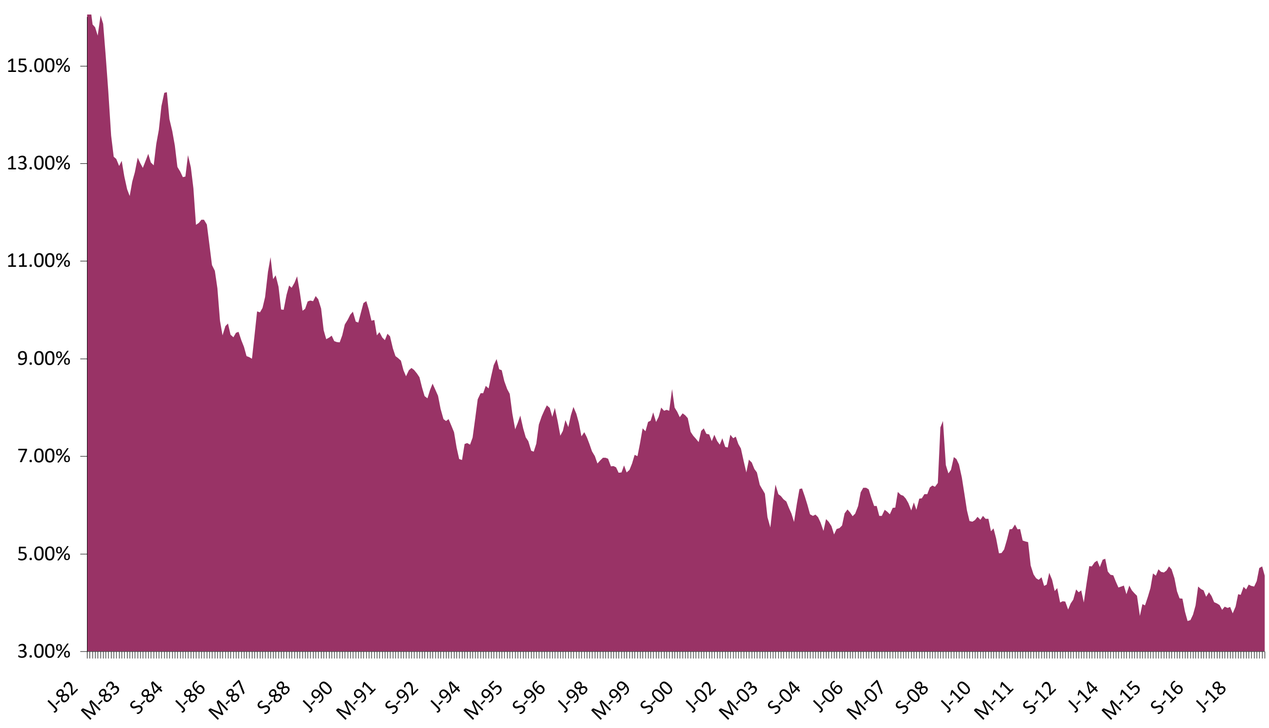
Eastman Kodak and General Motors were often mentioned as time-tested dividend stocks you could hold forever. Both companies went bankrupt a decade ago, not only ending the dividend, but causing the loss of the investment. General Electric didn't pay a great dividend, but the stock was touted as one of the blue chippiest and sure to increase in value. However, in recent years, the stock has lost value and its dividend was cut in 2018 to a penny a share. Even utilities are not immune. Ameren cut its dividend by 40% during the 2008 financial crisis. The reality is dividends, even from companies with a long history, are not sacrosanct.

The other issue is dividends usually yield far less than one could get from a GLWB. The current dividend yield on S&P 500 stocks works out to less than 2%. If you narrow the field to value stocks, you can average almost a 3% dividend yield. Contrast that to the 5% to 7% effective payout one can get from a GLWB. If the concern is growth of income, you can find GLWBs that guarantee the income will increase each year by a certain amount. Compared to dividends, annuities with lifetime income are more efficient, less expensive, and have guarantees that no stock dividend can offer.

Bond Ladders

The big problem with bond ladders is not the risk of default. Based on history, if you stick with investment grade bonds, the risk of the bond not paying is extremely low. The problem is that in the real-world bond ladders haven't worked very well.

The concept is nice. Assuming the yield curve is not upside down, longer maturity bonds will pay more interest than shorter term ones. If you initially buy bonds with a variety of maturities and then replace the matured ones with long maturity bonds, you wind up with a higher overall yield than only short-term ones provide and some principal freeing up on a regular basis. Wonderful theory; however, they forgot to take into account the possibility of a long declining rate cycle.



Yield of a mix of investment grade bonds and 10 Yr U.S. T-Notes

The *Advantage Insurer Bond Yield Index* shows the new yield of a mix of long term corporate and government bonds. Let's look at a bond ladder constructed in the summer of 1995. If you had simply purchased a portfolio of long maturity bonds, you'd have enjoyed a long-term yield of 7.7%. But say you built a bond ladder instead. I don't know exactly what comprised your ladder, but I do know five-year U.S. Treasury Notes were yielding 6% back in '95, so a good guess is the initial bond ladder was paying less than 7.7%.

Interest rates were heading down over the next several years. If, by the summer of 2005, you'd managed to replace all of your bonds with long maturity ones, you were then earning 5.5% - rather than the 7.7% you could have kept by simply buying the long-term bonds a decade earlier.

A Mix of Stable & Uncertain

For nonessential expenses, income uncertainty may be tolerable and even worth the risk. Letting financial markets decide whether you vacation this year in Paris, France or Paris, Texas may be acceptable, since, hopefully, the extra risk will result in higher returns and more assets in the future. As mentioned, the better approach for many will be to split assets and keep whatever is not required to safeguard essential income in whichever investments the retiree feels comfortable.

We are taught not to spend the principal, but the teachers forgot to finish the sentence which ends …until you enter retirement. Even so, it is difficult for many people to do this. Using an annuity with a lifetime income benefit helps because the retiree remains in control and the GLWB produces a regular check that, in our minds, quickly becomes appreciated as a stable essential income rather than the spending down of an asset.

For many people the real issue is not spending the principal, but maintaining a pot of money they can get to in an emergency. The solution here is to discuss what dollar amount of money would make the retiree feel comfortable and then work on producing the stable income with what remains.

The GLWB Dividend

A dollar derived from a capital gain spends the same as a dollar received as a dividend, but we treat them differently and hold the dollars in separate mental accounts. As Meir Statman of the University of Santa Clara has said, "We give ourselves permission to spend income dollars from dividends, interest, and wages on rent, groceries, and movies. But we are reluctant to give ourselves permission to dip into capital by selling stocks or bonds and spending that money on the same." An immediate annuity poses the same mental dilemma because it involves spending capital to generate income, and this perception is a reason immediate annuities have been flat for years. However, guaranteed lifetime withdrawal benefits (GLWB) may avoid this "accounting problem."

A GLWB dollar is unique in that its origin may be that of interest, capital, both, or insurance company guaranteed payments. Although the likely scenario is that the GLWB dollar consists of both interest and a long and steady dip into capital, the consumer is also aware that this dip may not happen, and that they have control to prevent the capital dip if desired. Because of this, the consumer may well place GLWB income dollars in the same mental account they place dividends, and essentially picture the annuity as paying a guaranteed 5%, 6% or 7% dividend that can't be lowered or stopped.

The Crash of '08 caused many companies to lower or stop dividends. Today, bank CD yields are lower than they ever have been. Fixed annuities with GLWBs offer an income that cannot be lowered, is controlled by the consumer, and offers the possibility that capital can be preserved. As Meir points out, "We want to spread our saving and spending over our lifetimes so we do not live as if we are rich when we are young only to live as poor when we are old; what we really want is to be rich throughout our lifetimes." GLWBs offer a lifetime of riches.

Goldilocks and Modern Portfolio Theory

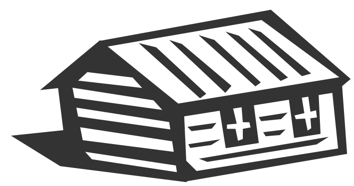
Once upon a time

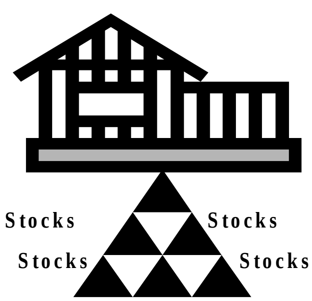
there were three bears that dreamed of a honey-filled retirement. Year after year, they contributed to their Bear Retirement Accounts with each utilizing a different investment vehicle from the other.

One day after saving for a number of years, the three bears decided to ask a financial consultant if they were on track for retirement.

The people at Goldilocks Financial Advisors reviewed the portfolios of the three bears and came back with these projections.

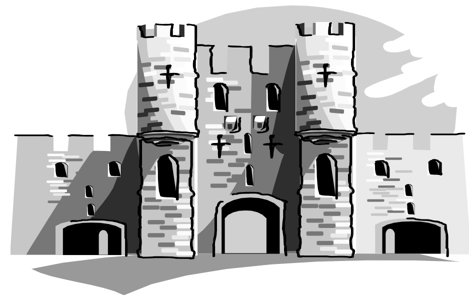
The first bear had gone to the Treasury for retirement advice and so the money was deposited in treasury bills, and although the principal was very safe from loss, it wasn't earning very much. Goldilocks projected that at the current rate of return, the first bear's retirement would be spent sitting in a cabin on the Red River near Fargo.





The second bear used the internet for financial advice and was invested 100% in stocks. Although the second bear's portfolio had certainly outperformed the first bear's, it was subject to the full risk of the stock market and in fact it had dropped over 35% in the last year and a half. Goldilocks was unable to make a projection due to the extreme volatility of the portfolio. Goldilocks told the second bear that with the lack of safeguards in the portfolio, retirement could be relaxing on a yacht on the Riviera or a twilight career greeting people at the local discount store.

The third bear was a prudent bear. This bear wanted the opportunity for more than the Treasury would allow and yet protection of the principal and credited gains from market loss. The third bear had used fixed indexed annuities to plan for retirement. Goldilocks congratulated the third bear and projected a retirement filled with sweetness and light due to the potential and safety of fixed indexed annuities.



The moral of the story is even bears benefit from fixed index annuities.

Advantage Compendium Ltd. (www.advantagecompendium.com)

is led by Jack Marrion, providing research and consulting services to financial firms in a variety of areas. He has conducted a broad scope of research ranging from the behavioral economic reasons why consumers buy or don't buy financial products to future industry impact models. He also served as Director of Research for the National Association for Fixed Annuities and as a Research Fellow for Webster University.

His insights on the annuity and retirement income world have appeared in hundreds of publications including *Best's Review*, *Business Week, Kiplinger, The New York Times*, and *The Wall Street Journal*. He has thrice been asked to address the National Association of Insurance Commissioners, most recently about the evaluating volatility control indices and previously on the effects of aging on senior decision-making. *Best's Review* said he was likely to affect the course of the industry. *Best's Review* said he was likely to affect the course of the industry.

Prior to forming Advantage Compendium Dr. Marrion was president and owner of an NASD broker/dealer with offices in nine states, and formerly vice president of a life insurance company and previously vice president of an NYSE investment banking firm. He has a BBA from the University of Iowa, an MBA from the University of Missouri and his doctorate from Webster University in the area of cognitive bias in decision-making formed a new paradigm in the marketing and development of retirement income products. Neither Jack Marrion nor Advantage Compendium sell or endorse any financial product.