# Turn Clients' Savings Into Retirement Income

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The oldest baby boomers are beginning to retire, steadily growing the number of new retirees for the next decade until leveling off at four million each year. As a result, advisors are carrying increasingly large retired client lists. Astute advisors know that investing alone does not ensure their clients' retirement goals will be met. Instead, advisors should ascertain what their clients' goals are, determine what resources are available and develop plans to reach them. For many clients, deriving income from their investments will be central to their retirement income plans.

There is tremendous opportunity today for advisors to get involved in income planning. In a recent survey of near and recent retirees, just one in four has a formal written plan for managing income, assets and expenses in retirement, and less than half (47%) has a personal financial advisor.* Left to their own devices, many retirees may make withdrawals as desired, unaware of the ramifications.

The industry consensus holds that an initial withdrawal rate of 4% is sustainable, assuming future years' withdrawals increase by the rate of inflation. Table 1 shows that, under a variety of asset allocations, the likelihood that an initial 4% withdrawal will last 25 years or more is at least 85%. Under different withdrawal systems, discussed later, withdrawal rates of 5% or higher may also be sustainable.

Retirement income planning can be simplified into four basic steps: setting retirement goals, determining income needed, creating an inventory of existing income sources and filling any gaps in income.

**Table 1 – Probability of Meeting Income Needs: 25-Year Retirement**

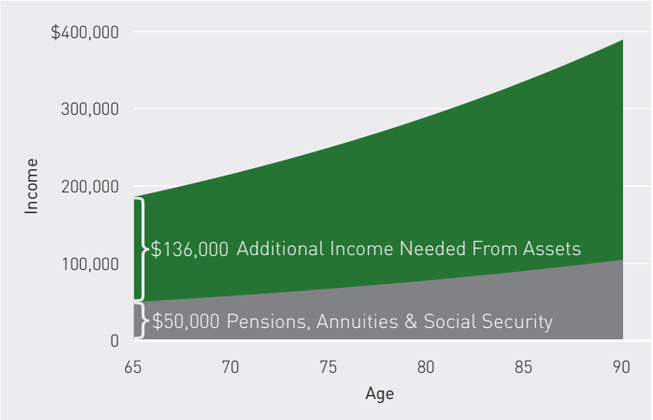
| Inflation-Adjusted Withdrawal Rate (%) | Stock/Bond Allocation (%) | | | | |
|---|---|---|---|---|---|
| | 20/80 | 40/60 | 60/40 | 80/20 | 100/0 |
| 4 | 94.5 | 95.5 | 93.6 | 89.9 | 85.8 |
| 5 | 68.0 | 75.2 | 77.2 | 75.2 | 73.1 |
| 6 | 32.7 | 45.8 | 53.9 | 57.2 | 58.8 |
| 7 | 10.1 | 21.6 | 31.5 | 39.9 | 44.5 |
| 8 | 2.9 | 7.5 | 16.0 | 23.5 | 33.4 |

Sources: BlackRock®; Financeware. The projections or other information generated by Financeware regarding the likelihood of various investment outcomes are hypothetical, do not reflect actual investment results and are not guaranteed for future results. The results generated by Financeware are based on the assumed asset allocation strategy indicated and do not reflect performance results for any particular investment. Key to the analysis are the rates of return and risk assumptions for the index data used to represent the various asset classes.

* Source: LIMRA International, "Advisor Impact on Retirement," 2007.

If you assume each client will need a steady, inflation-adjusted income stream, retirement income planning is very simple. After determining the income needed, simply divide that amount by the initial withdrawal rate. Take the example from Figure 1: If a client needs to generate $136,000 per year from investments, he or she must have $3,400,000 (using a 4% initial withdrawal rate) to afford to retire. Alternatively, a client with a given asset level can multiply the asset value by 4% to determine how much he or she could "safely" withdraw and then decide if that amount is enough.

**Figure 1 – Inflation-Adjusted Income**



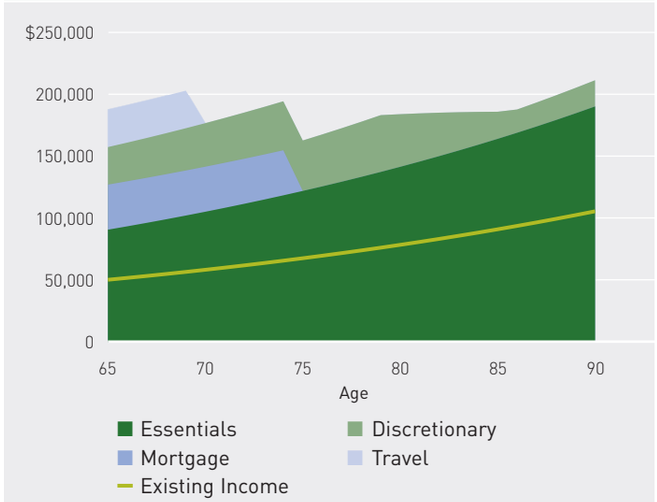

| Initial Withdrawal Rate | Assets Needed to Fund $136,000 Inflation-Adjusted Annual Income |
|---|---|
| 4% | $3,400,000 |
| 5 | 2,720,000 |
| 6 | 2,266,667 |

For illustrative purposes only. Assumes $186,000 total pre-tax, inflation-adjusted income needed; pensions, annuities and Social Security total $50,000 in the first year and increase with 3% annual inflation.

Unfortunately, retirement income planning is rarely this simple. Few clients have an income need that is constant in real terms throughout retirement. Early in retirement, they may have more active (and expensive) lifestyles. They may have fixed expenses that do not increase with inflation and that may last for a specific number of years. More importantly, their assets may not be sufficient to fund the desired income. If, in the above example, the client has $2 million in investable assets, then the $136,000 income needed is equivalent to a 6.8% initial withdrawal rate, a rate most would agree is not sustainable.

After further analysis, the financial professional determines the client in our example needs $186,000 in the first year of retirement but will not need that much every year. In fact, the client has a fixed mortgage with 10 years of payments remaining, plans to spend a relatively fixed amount on travel for the first five years of retirement and recognizes that discretionary spending may scale back with age (see Figure 2).

**Figure 2 – Anticipated Retirement Spending**




| Purpose | Annual Income Needed | For How Long? | Increase With Inflation? |
|---|---|---|---|
| Essential | $90,000 | For life | Yes |
| Mortgage | 36,000 | 10 years | No |
| Discretionary | 30,000 | For life | Yes |
| Travel | 30,000 | 5 years | No |
| Total | $186,000 | | |

For illustrative purposes only.

The most straightforward way to fund this income need would be to make the required withdrawals from one overall investment portfolio. Although this method of retirement income planning is a marked improvement over assuming that the income need is constant (in real terms) throughout retirement, there are disadvantages to this approach, including:

- Each expense may have different levels of importance to the client and/or different timeframes, yet the assets are invested identically.
- The client still may not have enough assets to be confident that he or she will meet his or her anticipated spending needs.

Consider investing separately for each income need for greater success. In determining the right approach to meet each client's unique goals, financial professionals must carefully consider a variety of factors, including the client's age, health status, net worth, income goals, bequest motives and risk profile. It is also important to understand the client's priority for each income goal, as well as any additional goals.

## Portfolio Withdrawal Methods

Following are several methods advisors may employ in creating income for their retired and retiring clients, with suggestions on how to combine the methods to meet a client's unique income goals.

### Fixed-Dollar Withdrawals

Among the simplest withdrawal methods is to withdraw a fixed dollar amount each year, usually for a specific number of years. This approach can be useful for clients entering retirement with a particular expense that is anticipated to be level for a specified time period (e.g., a mortgage payment) or for the rest of their lives.

### Fixed-Percentage Withdrawals

Using the fixed-percentage withdrawal method, the client withdraws a specific percentage of assets each year. Normally the percentage selected is less than the anticipated rate of return on the investment to increase the chance the investment—and the resultant cash flow—will increase over time. An ideal use of fixed-percentage withdrawals is to fund discretionary spending. Under this method, discretionary spending can increase in times of good investment performance and decrease somewhat when investment performance is worse than expected (as shown in Year 4 of Table 2). As a secondary benefit, when a retiree's lifestyle slows down as he or she ages, the investment can continue to grow and be available to fund unforeseen medical expenses or an estate.

### Withdrawals of Investment Earnings

The client withdraws the yield (dividends and/or coupons), and possibly capital gains on the investment, leaving the principal intact (as illustrated in Table 3). Similar to fixed-percentage withdrawals, withdrawing investment earnings is an ideal method for funding discretionary spending. For investors with sufficient savings, yield-only withdrawals can also be used to fund essential expenses, allowing for potential growth in the income stream over time.

**Table 2 – Fixed-Percentage (4%) Withdrawals Illustration**

| Year | Portfolio Return (%) | End of Year Value ($) | Withdrawals ($) | % Change of Withdrawal |
|---|---|---|---|---|
| 0 | | 1,000,000 | | |
| 1 | 12.0 | 1,080,000 | 40,000 | |
| 2 | 7.0 | 1,112,400 | 43,200 | 8.0 |
| 3 | -8.0 | 978,912 | 44,496 | 3.0 |
| 4 | 16.0 | 1,096,381 | 39,156 | -12.0 |
| 5 | 5.0 | 1,107,345 | 43,855 | 12.0 |
| Total | 6.0% | | $210,707 | 2.0% |

For illustrative purposes only. Withdrawals occur at the end of each year and are calculated on the ending portfolio value for the previous year.

**Table 3 – Withdrawals of Investment Earnings Illustration**

| Year | Portfolio Return (%) | Portfolio Yield (%) | End of Year Value ($) | Withdrawals | % Change of Withdrawal |
|---|---|---|---|---|---|
| 0 | | | 1,000,000 | | |
| 1 | 12.0 | 4.0 | 1,080,000 | 40,000 | |
| 2 | 7.0 | 4.5 | 1,107,000 | 48,600 | 21.5 |
| 3 | -8.0 | 3.5 | 979,695 | 38,745 | -20.3 |
| 4 | 16.0 | 4.0 | 1,097,258 | 39,188 | 1.1 |
| 5 | 5.0 | 4.0 | 1,108,231 | 43,890 | 12.0 |
| Total | 6.0% | | | $210,423 | 2.3% |

For illustrative purposes only. Withdrawals occur at the end of each year and are calculated on the ending portfolio value for the previous year.

### Inflation-Adjusted Withdrawals

As mentioned earlier, inflation-adjusted withdrawals usually start with applying a percentage (e.g., 4%, 5%) to the initial portfolio value to determine the withdrawal in the first year. In subsequent years, the withdrawal is increased for inflation either using the Consumer Price Index (CPI) or assuming an average inflation rate (e.g., 3%). This method (illustrated in Table 4) is often assumed to cover a retiree's complete income need — an unrealistic assumption for many clients.

### Comparing Withdrawal Methods

One key advantage to using fixed-percentage instead of inflation-adjusted withdrawals is that, theoretically, the client's portfolio will not run out of money. On the other hand, inflation-adjusted withdrawals offer a smoother income stream. The income streams generated by both of these strategies are illustrated in Figure 3 below. The inflation-adjusted withdrawals offered a steady income stream until the account depleted entirely 19 years into retirement. On the other hand, the fixed-percentage withdrawals were somewhat lower in the beginning while poor performance was affecting account values but allowed the account value to reach $1.8 million even after 25 years of withdrawals.

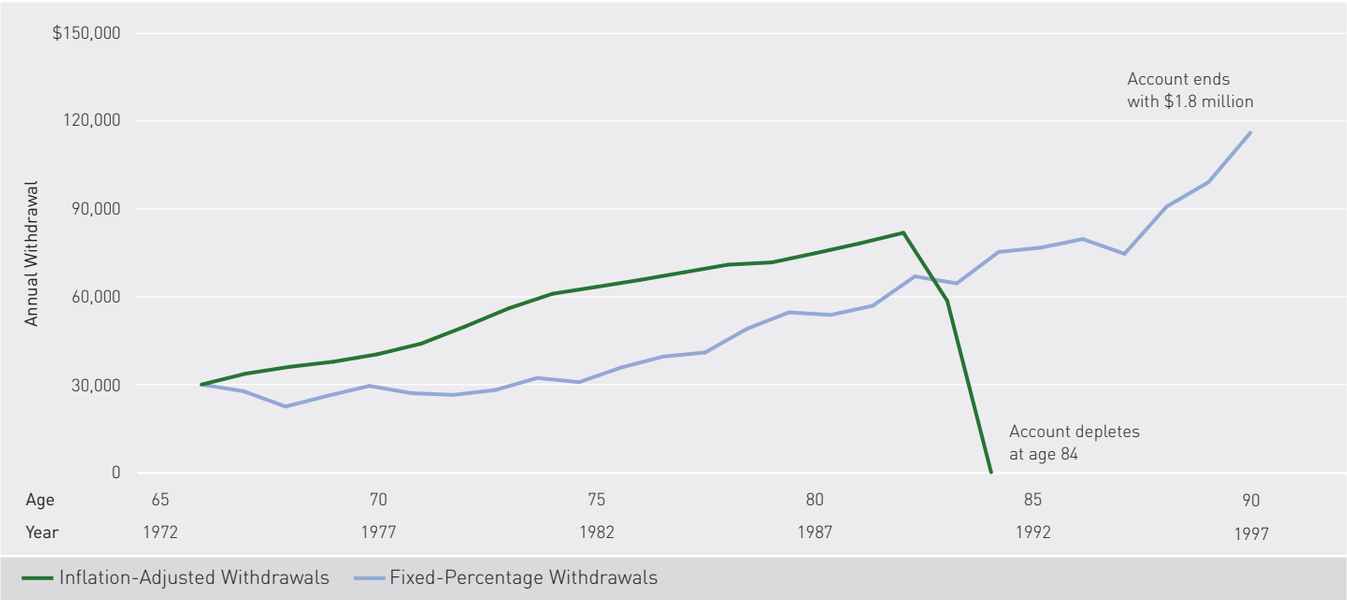
You should help clients weigh the benefits of both of these strategies in light of their anticipated expenses. The best option may be to combine both strategies: Use an inflation-adjusted withdrawal for essential expenses and a fixed-percentage withdrawal for discretionary expenses.

**Table 4 – Inflation-Adjusted Withdrawals Illustration (4% initial withdrawal)**

| Year | Portfolio Return (%) | End of Year Value ($) | Withdrawals ($) | % Change of Withdrawal |
|---|---|---|---|---|
| 0 | | 1,000,000 | | |
| 1 | 12.0 | 1,080,000 | 40,000 | |
| 2 | 7.0 | 1,114,400 | 41,200 | 3.0 |
| 3 | -8.0 | 982,812 | 42,436 | 3.0 |
| 4 | 16.0 | 1,096,353 | 43,709 | 3.0 |
| 5 | 5.0 | 1,106,150 | 45,020 | 3.0 |
| Total | 6.0% | | $212,365 | 3.0% |

For illustrative purposes only. Inflation assumed to be 3% in all years.

**Figure 3 – Withdrawals of 6% From a Hypothetical Investment of $500,000**




Sources: BlackRock; PSN Enterprise. Assumes money is invested in a portfolio of 60% S&P 500 Index and 40% Barclays Capital Government Bond Index on 12/31/72; the portfolio is subsequently rebalanced annually; withdrawals occur at the end of each year; and fixed percentage withdrawals are calculated on the beginning portfolio value for the year. Inflation-adjusted withdrawals increase by the actual rate of inflation (as measured by the CPI) each year. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

### Buckets by Time

Another way to consider retirement needs is to group cash flow needs by time period. For example, a three bucket approach could consist of: income needed for the first 10 years, income needed beyond 10 years and legacy needs.

The assets are invested more conservatively for the first bucket and more aggressively for the third bucket. Based on assumed rates of return or through simulation methods, determine the present value of each of the first two buckets and put the remainder in the third bucket, which can also be used to fund emergencies. Because of the presence of a legacy bucket, this method is more appropriate for high net worth investors who are more likely to have wealth transfer goals.

## Guaranteed Income

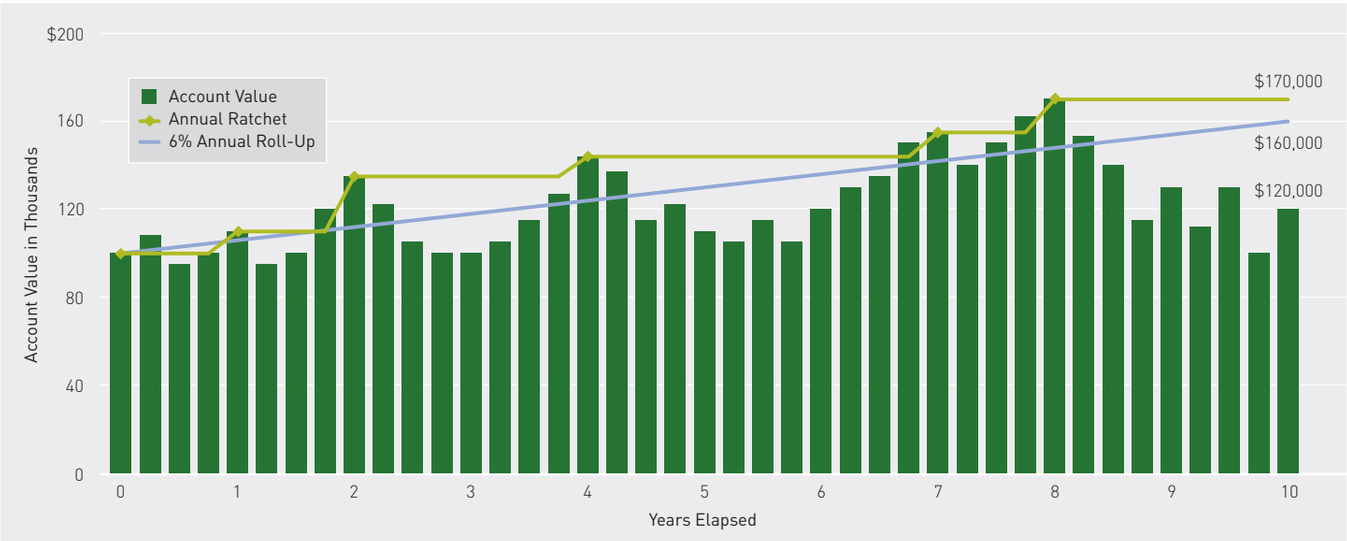
The life insurance industry offers a variety of products that provide guaranteed income for retirees. Incorporating insurance into a retirement income plan can be beneficial for many retirees, especially those with more modest asset levels. There are two main types of products that offer retirement income: immediate annuities and variable annuities. Immediate annuities provide guaranteed income with payments that begin within one year of purchase. Variable annuities, on the other hand, usually have a longer period of time between purchase and commencement of payments.

Variable annuities may be useful retirement planning tools for clients who have not begun to take income from their assets. This may include clients who are a few years away from retiring or those already retired but with a pool of assets not currently used for income purposes. Although annuities are often thought of as income solutions, variable annuities also offer many accumulation benefits that may help grow clients' assets more than ordinary investments. Variable annuities are tax-deferred vehicles with no contribution limits and investment options across equities and fixed income. A unique advantage of variable annuities is that, after a specified period of time, they guarantee the income base will be at least the principal paid in. Therefore, if your client's account value has fallen below the original principal value when he or she begins to take income, the withdrawal base would be the principal rather than the account value. Variable annuities also offer two benefits that may help grow your clients' assets regardless of market performance:

- Annual Ratchet:* This benefit guarantees a floor on the investment that can reset by periodically locking in higher values due to market performance.
- Annual Roll-Up:* This benefit provides a constant, non-compounded growth rate on the principal regardless of market performance.

The chart below illustrates a client's hypothetical $100,000 investment in a variable annuity with an annual ratchet benefit and a step-up benefit over a 10-year period. At the end of this period, the client has the option to begin taking income based on the highest of either of the benefit values or the account value (in this case, the annual ratchet).

**Figure 4 – Annuity Living Benefits Can Help Investors in Volatile Markets***




This information is hypothetical and is for illustrative purposes only. It is not intended to represent the performance of any particular investment. Annual ratchet benefits and step-up benefits are illustrated based on the hypothetical account values shown.

* Living and death benefits and riders illustrated here are optional features of the annuity contract available for additional fees. Guarantees are backed by the financial strength and claims-paying ability of the insurance product sponsor and do not apply to the performance of the variable sub-accounts. The return and principal value of a sub-account will fluctuate and, when redeemed, may be worth more or less than the original cost.

Once a client decides to take income, variable annuities offer several methods depending on the client's needs. Regardless of which income option best suits the client's needs, the withdrawal rate will be based on the highest of either the account value or any of the accumulation benefits previously mentioned. Income can be taken in three ways:

- Guaranteed Minimum Income Benefit (GMIB): This benefit allows the client to annuitize the assets (or, if higher, the living benefit) into an income stream, usually for life.
- Guaranteed Minimum Withdrawal Benefit (GMWB): This benefit allows the client to take systematic withdrawals from the account until the benefit amount is depleted.
- Guaranteed Lifetime Withdrawal Benefit (GLWB): This benefit works like a GMWB; however, it will continue to pay the annual withdrawal rate for life even after the highest benefit value is fully depleted.

Although variable annuities may appear complex due to the variety of options available, they offer the freedom to tailor the benefits to your client's needs. In addition to the living and withdrawal options, variable annuities also provide growth and protection opportunities for clients with legacy needs.

**Table 5 – Withdrawal Strategies for Investment Assets**

| Method | Description | Advantages | Disadvantages | Investment Considerations |
|---|---|---|---|---|
| Fixed-dollar withdrawals | Withdraw a fixed dollar amount for a specified time period. | • Simple to implement. | • Does not grow with inflation.<br>• Could erode principal if dollar amount is high. | • Fixed income funds<br>• Target date funds<br>• Target risk funds |
| Fixed-percentage withdrawals | Withdraw a fixed percentage of assets each year for a specific time period or for life. | • The account is never fully depleted, increasing chances overall plan will be successful.<br>• Can provide growth in income and account value if percentage chosen is below anticipated rate of return. | • Amount varies year to year.<br>• Assets could become depleted over time if percentage is too high.<br>• Growth in income is not guaranteed. | • Asset allocation funds |
| Withdrawals of investment earnings | Withdraw only the income created by the underlying investments. This includes dividends from equities and coupons from bonds. Capital gains can also be included. | • Prevents running out of money since principal investment remains intact.<br>• Potential for investment to grow while providing income. | • Amount varies year to year.<br>• Withdrawals may not keep up with inflation. | • Income-oriented funds |
| Inflation-adjusted withdrawals | Withdraw an amount that is 4% to 5% of the portfolio value in the first year. Increase the dollar amount withdrawn by the rate of inflation in subsequent years. | • Provides growing income stream.<br>• Allows client to maintain standard of living throughout retirement. | • Requires annual calculation.<br>• Can erode principal and eventually become fully depleted.<br>• CPI may not be good indicator of a given client's spending needs over time. | • Asset allocation funds |
| Time-based approaches | Invest separately for short-, medium- and long-term expenses. For example, cash can be used to fund the first several years, intermediate bonds the next several years and equities for later years. | • Simplifies income planning.<br>• Can align time frames with anticipated lifestyle stages.<br>• Reduces impact of poor investment performance in early years of retirement.<br>• Can invest more aggressively for longer term needs. | • Less efficient way to fund ongoing expenses.<br>• Requires ongoing monitoring. | • Cash-equivalents<br>• Intermediate bond funds<br>• Equity mutual funds<br>• Target date funds<br>• Target risk funds |

| Table 6 – Guaranteed Income Products | | | |
|---|---|---|---|
| Product | Description | Advantages | Disadvantages |
| Fixed immediate annuities | Provide income guaranteed over a specified period or for life. Can include inflation adjustments or a fixed rate of growth and can cover one or two lives. | • Increases amount of guaranteed income.<br>• Improves chances of not running out of money.<br>• Tax-advantaged payments in nonqualified accounts.<br>• Can be structured for inflation and/or growth. | • Reduces available liquidity in the portfolio.<br>• Lose control of money. |
| Variable annuities with GMIB | Allows the client to annuitize into an income stream. | • Increases amount of guaranteed lifetime income.<br>• Improves chances of not running out of money.<br>• Tax-advantaged payments in nonqualified accounts. | • Additional fees paid for some guarantees.<br>• Must annuitize, reducing available liquidity in the portfolio. |
| Variable annuities with GMWB | Allows the client to take systematic withdrawals from the highest of either the account or benefit value. | • Can control and grow assets in a tax-deferred account.<br>• Potential for income growth.<br>• Provides income protection on the downside if account loses value. | • Additional fees paid for some guarantees.<br>• Excess withdrawals can limit future benefits. |
| Variable annuities with GLWB | Similar to variable annuities with GMWB; however, it will continue to pay the annual withdrawal rate for life even if the account value is fully depleted. | • Increases amount of guaranteed lifetime income.<br>• Potential for income growth.<br>• Can control and grow assets in a tax-deferred account. | • Additional fees paid for some guarantees.<br>• Excess withdrawals can limit future benefits. |

## The Need for Ongoing Monitoring

Successful retirement income planning does not end with the initial plan creation. All retirement plans are built on a variety of assumptions, and chances are one or more of these assumptions will not hold over the entire duration of a client's retirement. For example, investment income is not likely to be constant throughout retirement, and there will likely be some years when the client earns more or less than planned. Additionally, unexpected expenses can pop up and use assets earmarked for other purposes. Therefore, regular monitoring is vitally important to the success of a retirement income plan.

One way to monitor an income plan is to calculate your client's current Monte Carlo outcome and compare it to the previous outcome. If the chances of success increased, you most likely will not need to change anything at this time. If the chances of success decreased, however, you may need to make modifications to the plan going forward. Do not let your clients perceive this change as an increased chance of failure of their retirement plan. Position it, instead, as a mid-course correction. An unexpected outcome has pushed your clients off course. As long as you reposition the income plan, your clients should enjoy success throughout retirement.

## Putting It All Together

Consider a hypothetical couple about to retire. They estimate that their essential expenses will be approximately $40,000 per year, over and above the amounts they expect to receive from Social Security, a pension and a retirement annuity. In addition, they would like to be able to spend $30,000 on their lifestyle each year plus $30,000 for travel during the first five years of their retirement. Like a growing number of new retirees, they have a mortgage with 10 remaining years of $3,000 monthly payments. Their goals are to be able to maintain their chosen lifestyle, have funds available for emergencies and leave whatever is left to their heirs upon their deaths. To help them reach these goals, they have combined investable assets of $2 million.

Their financial professional advises them to keep the mortgage to benefit from the interest deduction rather than paying off the loan and to invest their assets as follows:

- $1,000,000 to pay for their essential expenses and take inflation-adjusted withdrawals. The first year's withdrawal of $40,000 is 4% of their investment and is sufficient to cover their essential expenses remaining after guaranteed income sources.

- $600,000 to fund their discretionary expenses and take fixed-percentage withdrawals from an income fund with an anticipated yield of 5%. This fund is expected to offer growth potential, which means their lifestyle spending should be able to grow over time. The fund can also double as an emergency fund, especially later in retirement as their lifestyle slows down and the likelihood of having major health issues increases.
- $400,000 in a relatively conservative fund with an anticipated return of approximately 6%. They will take $3,000 in monthly withdrawals to make their mortgage payments and withdraw $30,000 each year for five years to fund their travel. Combined, these withdrawals are expected to fully deplete this investment over 10 years.

The 4% initial withdrawal rate to fund their essential expenses results in a 85% or higher level of confidence that the assets will fund their essential expenses over a 25-year period. When incorporating all three buckets and the associated withdrawals, the success rate will be even higher.

## Conclusion

While the previous example may be simplistic, it illustrates important concepts. In reality, client situations are more complex, and financial professionals do not always have the luxury of numbers that fit together nicely. Nevertheless, there are many benefits to incorporating multiple withdrawal strategies within an income plan.

1. Assets are invested more efficiently since each investment is tied to a particular need.
2. Incorporating fixed-percentage withdrawals, withdrawals of investment earnings and/or annuities into a retirement income plan can have a significant favorable impact on the probability of success in retirement.
3. Investments backing discretionary spending, if held separately, can fund unforeseen healthcare expenses without sacrificing the ability to meet essential expenses.

At the same time, implementing this approach is not always straightforward. Clients often have multiple accounts. It is not uncommon for a married couple to have at least three accounts: two tax-deferred accounts — one in each of their names — and a taxable account. Additionally, the amounts needed to fund each income need may not align with the amounts in the various accounts. While in some cases creating additional accounts may be the solution, keeping the number of accounts to a small, managable number is often desirable.

The methods discussed here may appear to challenge traditional retirement income planning methods. However, this needs-based framework is most helpful when viewed as a compliment, rather than a substitute, to traditional income planning. It may be beneficial for a client's retirement plan to match assets to liabilities and then implement an appropriate withdrawal strategy for each set of assets.

If you decide to invest a client's assets separately for different income goals, there is less of a need to focus on the priority of withdrawals, which can help make a client's income plan easier to implement and, therefore, more effective.

*Annuities are long-term investment vehicles designed for retirement purposes. Early withdrawals are subject to surrender charges. Withdrawals are subject to ordinary income tax, and if taken prior to age 59½, a 10% IRS penalty may also apply. Withdrawals have the effect of reducing the death benefit and cash surrender value. Annuities are not insured or guaranteed by the FDIC.*

*Please ask your clients to consider the investment objectives, risks, charges and expenses of a variable annuity and its underlying funds carefully before investing. This and other information is contained in the prospectus for a variable insurance product and is available from the insurance product sponsor. The prospectus should be read carefully before investing.*

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AC2856-2/2010
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