INCOME

~~ASSET~~ ALLOCATION

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RETIREMENT SECURITY:
It's NOT About Your LUMP SUM, It's About Your INCOME

DAVID GAYLOR

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Income Allocation

"It's not about your lump sum. It's about your income."

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by

David L. Gaylor

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Any mention within the pages that follow regarding any particular product or strategy as a means of addressing retirement income concerns, is not meant to be construed as the definitive, only, or best available option for that purpose. For *any* given financial concern, there can be multiple solutions that might utilize a number of different investment and/or insurance products. If I demonstrate any bias toward a given product, strategy or security, it is because I feel strongly about the merits of that vehicle in this application. As always, you are strongly encouraged to weigh all of your options and meet with a qualified, licensed individual in your area to assist you in determining your best option(s).

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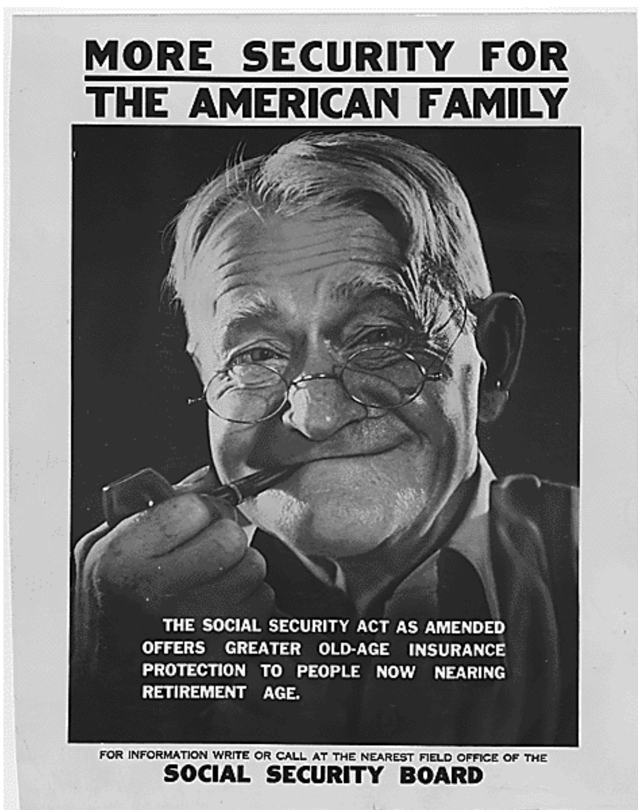
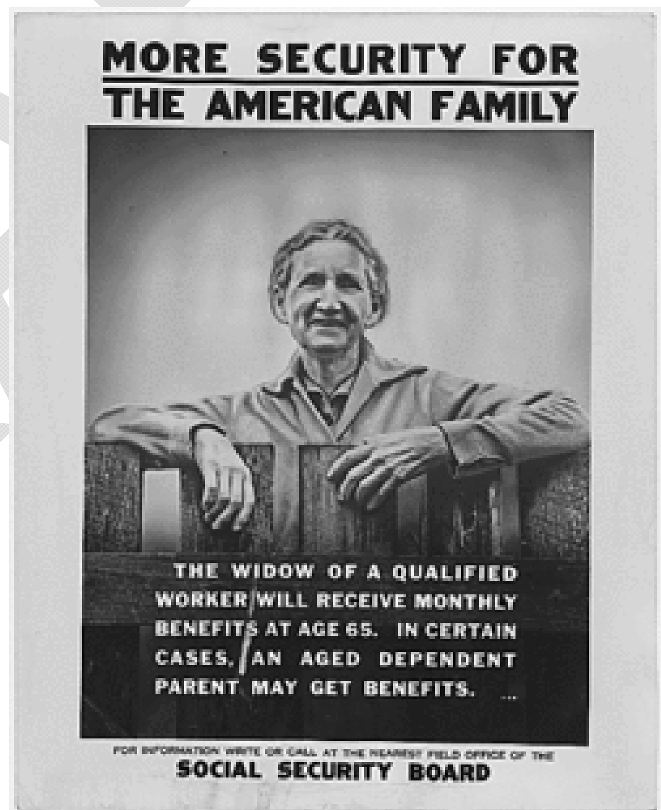
Introduction

SURVIVING YOUR RESOURCES

On the day I sit down to write the beginning pages of this book, statistically 10,000 baby boomers are turning age 66: full retirement age now, for Social Security benefits. On the day you read the opening pages of this book, another 10,000 or so are turning retirement age. It really doesn't matter when you're reading these pages as long as it's before the year 2031, because that's the year the last of the baby boomers, those born in 1964, will reach full retirement age (then 67) and will be able to claim their full Social Security benefits. I'm one of those people—I was born in 1964—so what I'm writing about in this book is of extreme importance to me, my friends and my family members.

As thousands of boomers become retirees, a question comes to mind. No, not the politically charged "How will the Federal Government and The Social Security Administration (The SSA) address the long-term solvency issues of Social Security," when according to each of the five previous Social Security and Medicare Trust Fund Reports by The SSA's Chief Actuary, *"Social Security's OASDI Trust Fund reserves would become depleted between 2033 and 2037 under the intermediate set of economic and demographic assumptions provided in each report. If no legislative change is enacted, scheduled tax revenues will be sufficient to pay only about three fourths of the scheduled benefits after trust fund depletion."*





The answer to that question would require another book and a different author. However, it is a genuine social issue and one that must be addressed. It is certain to be among the top debated issues during the next several elections.

No, the question on my mind this Saturday night is this: "How many of those people are facing the likelihood of living beyond the exhaustion of their retirement resources?"

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Have you ever heard anyone say, "I anticipate a retirement that endures long after the resources I've worked my entire adult life to accumulate have been exhausted?" Not one person has said that to me ever, and I suspect that no one reading this book has ever heard anything like this either. I *have* heard many goals for retirement over the years as an investment advisor: traveling the world, reinvention of self, starting an entirely different career, spending time as a volunteer for the causes that are close to my heart, playing golf seven days a week, enjoying a second home in a different place, going back to college and learning something new, spending the winters somewhere warm, spending the summers somewhere cool, you name it, I've heard it. Yet no one has ever indicated to me that they are anticipating depletion of savings before the end of their days. If that's not the case, then why are so many facing this exact peril during retirement?

As a United States citizen, a financial advisor, a fiduciary, and as a human being, I am highly concerned about the possibility that millions of people retiring over the next 20 to 30 years will face making lifestyle adjustments, versus enjoying their long planned and diligently worked for retirement.

WHY THE WELLS RUN DRY

When I ask myself why it is that many retirees are facing the possibility of outliving their resources, many answers came to mind. Thanks to advances in medicine, people today are living longer, much longer in fact than their parents and grandparents. Lifetime pensions have seen a steep decline within the last 20 to 30 years, and their numbers dwindle each year. Yields on traditional savings vehicles are negligible in the low interest rate environment we have been in for some time now. We've endured now two vicious bear markets already this century that have devastated portfolios and even compelled many to exit the market entirely or in part, essentially forgoing the subsequent recoveries. Those answers are all true, and you probably can think of many more.

To me though, one of the biggest if not *the* biggest factors contributing to the portfolio depletion issue, is that so many people have been given erroneous guidance. Retirement income planning advice given with the best of intentions, but unbeknownst to the one giving the advice, was based on retirement planning theory that would later prove to have an inherent flaw, especially for those with the misfortune of entering retirement during certain periods in the economy. The flaw I speak of, is that these retirement planning doctrine fail to account for the very real peril known as "Sequence Risk."

Sequence Risk is defined as:
The risk of receiving lower or negative returns early in a period when withdrawals are made from the underlying investments. The order or the sequence of investment returns is a primary concern for those individuals who are retired and living off the income and capital of their investments.

It's all about timing. Asset Allocation and The 4% Rule, The prevalent retirement income planning methodologies of recent history, do not account for the important variable, *order (timing) of returns*. These models are based solely on *average returns* over time. We now know that this is a very dangerous assumption to make, particularly for those with the misfortune of experiencing severe, numerous, and/or prolonged recessionary market cycles in the earlier years of retirement. William Bengen, the Financial Planner that developed *The 4% Rule* in 1994, now refutes the practicality of his own theory. In a May 2012 article in Financial Advisor Magazine, Bengen states "Research has confirmed that the 'sequence of investment returns' is crucial for portfolio longevity; a retiree with low returns early in retirement will probably have trouble later in retirement."

Some would say that Mr. Bengen's partial repudiation downplays still (or at least underestimates) the potential for some considerable shortfalls. Regardless, think about that for a moment. Two identically constructed portfolios, designed for the same purpose of generating retirement income and experiencing

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both the same exact yearly and average returns, might have lifecycles that differ significantly, depending on the timing and severity of losses in the one that realizes them early on. Potentially, one portfolio falls several years short of reaching its primary goal of generating income for a 30 year retirement, while the other not only accomplishes this goal, but actually leaves an *appreciated* value for beneficiaries.

In other words, Asset Allocation and The 4% Rule may have well worked as prescribed for many, those fortunate enough to retire and then experience an extended period of economic growth, but as I said before it's all about timing and personally, I am constitutionally incapable of leaving that much to chance, not for myself, not for my family, and certainly not for those whom have entrusted me as their fiduciary, with the honor of guiding them as they prepare financially for the final stage of their journey.

SET FOR LIFE

The good news though, is that retirement at or below the poverty level is not a forgone conclusion. Many retirees live comfortably for decades after their paychecks stop, and rarely is it because they've managed to accumulate or inherit a small fortune, or had the vision to buy Apple's common stock at less than a buck-fifty, back in 1982.

Let me introduce you to a married couple who are clients of mine. Let's call them "Adam and Beth Walker**"** They are 61 and 59 years old respectively. 'Adam' is planning to retire in five years, while 'Beth' is slightly more than six years from her planned workforce exit.*

The Walkers calculate that in addition to their Social Security benefits, they will need $40,000 per year in order to support the retirement that they have planned. Their accumulated retirement savings totaled right at $1 million. I introduced the Walkers to a strategy utilizing a Fixed Index Annuity (FIA), from a very well known, established, and financially sound U.S. insurance company, one that was established well over a century ago.

The consideration that the Walkers will receive for placing only half of those liquid assets, or $500,000, is that they are guaranteed by the financial strength and claims paying ability of the insurance company that not only is their principal and credited interest protected, but once they retire and for the rest of both of their lives, they will receive $40,000 per year, every year. Fixed Index Annuities are actually designed for this very purpose. They are intended to meet long-term needs for retirement income and they provide guarantees against loss of principal and any credited interest. They also offer the reassurance of a death benefit for the contract owner(s) beneficiaries.

So now the Walkers have locked-in a lifetime income stream that equals their projected needs, and they did so by utilizing just half of their retirement savings. The other half, $500,000, can now be used in any way they want: traveling, discretionary spending, buying a vacation home, investing in potentially high-return ventures, anything and everything will be on their menu. Indeed, with savvy investing that $500,000 could become $1 million again. Meanwhile, the Walkers will still have the annual income stream needed to cover their living expenses from the first part of their savings, each and every year of retirement.

The primary concession that the Walkers agree to comes in the form of a commitment to what is known as a 'surrender schedule,' meaning that in the earliest years of the contract (typically the first 5 to 10), should any of the committed funds be accessed early (prior to annuitization), the amount withdrawn that is in excess of the yearly allowable or 'free withdrawal' amount (currently averaging 10%), would incur a surrender fee that is calculated as a percentage of (and *only* on) the excess amount.

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A current seven year surrender schedule on a typical product might look a lot like this:

Year One: 8%
Year Two: 7%
Year Three: 6%
Year Four: 5%
Year Five: 4%
Year Six: 3%
Year Seven: 2%

Now let's take a wild turn and for the sake of this demonstration, flash forward in time three and a half years and we will pretend that the Walkers somehow managed to part ways with the first $500k already. Remember, $500k of the $1M that they accumulated for retirement, was essentially made accessible to them to use as they wish, just by way of employing this strategy in the first place. It is now three and a half years since the Walkers agreed to and executed on this plan and now they need to access $60,000.

This particular contract has a 10% per year (*after* the first year) free-withdrawal allowance, so after the first year $50,000 is off the table, leaving $10,000 of the $60,000 for assessment of the early surrender charge. The schedule calls for a 6% charge in the third year of the contract, therefore this unplanned emergency need to access $60,000 in cash only cost $600 ($10,000 x .06= $600) in surrender charges. I doubt there would be lower transaction costs involved in any other alternative format, venue, or vehicle established or utilized for the same purpose, had the Walker's gone a different route in their retirement planning.

In Chapter Two I'll go into more detail about this plan that I employed with the Walkers, which I call "Income Allocation." For now, keep in mind that it is possible to get the reliable, steady income you require to meet your needs over an extended retirement, and without having to employ 100% of your life savings in order to generate this income. It is my hope that you will see the wisdom in a plan such as this. I'm going to show you that an individual or a couple of average (even above average) means that intends to fund an entire 30 year retirement's income needs by using the more customary methods, will generally need to utilize their entire retirement savings in order to have the best chance of doing so. Either that, or they will need to realize some amazing investment returns in the future.

Want to make a major purchase? If you do, you'll be depleting your income base! Spend too much early on in retirement, or suffer a multi-year market correction while doing so, and you could face a significant increase in the risk of outliving your resources.

ADVISOR AGENDAS

The question I have for you and for everyone else currently in, or planning for retirement is this: with such a strategy available, one that can provide a predictable stream of retirement income and doesn't require 100% of your life savings, why aren't more people directed to this strategy? This strategy that could potentially free up part of your savings for those special things--the trip of a lifetime, that beach condo or motor home or dream car—without depleting your income base. I'll explain this strategy to you in the pages of this book.

In my opinion, the answer to why many people aren't advised of this strategy is apparent: the advisors and brokers that they are working with are still practicing the aforementioned doctrine, even though these are now widely considered to be inherently flawed. Those advisors may try to discredit this book and the underlying theory, but ask yourself, why they would do that? Why would they cling to a model that has the potential to elevate one's risk of outliving retirement resources?

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Most likely, the answer lies in where they work. The unfortunate reality is that, many if not most financial services firms dictate the products that their advisors have access to, and thus are able to offer to their clients, by way of the contractual relationships they choose to pursue (or not to pursue), or are prevented from pursuing, due to their size, nature of business, etc. This creates a dilemma, whereby an advisor with the best of intentions to honor his or her fiduciary responsibility to act in the best interest of his or her clients, simply cannot offer a certain product if their firm does not have the requisite selling agreement in place with the product's sponsor, even though the advisor considers that particular product to be better suited to meet the objectives of a certain client, more so than what he or she currently has access to within the firm that they are currently registered with.

Here's a quick preview into the power of my favored strategy, which will be thoroughly explained later on. If I invest $500,000 into a 'typical' portfolio, in 10 years how much income can I take from it without violating basic financial planning fundamentals and therefore increasing my risk of eventually depleting my resources? The answer is, I have no idea! Past performance isn't going to guarantee some future value. I work with some outstanding private wealth managers who invest my clients' growth money, so I'm not against using financial markets, and I do not have a bias in favor of a particular product. In fact, I love the financial markets and the way my own money and my clients' money is managed!

Nevertheless, I have no certainty about what will happen with the markets over the next 10 years. If clients double their money, that $500,000 will become $1,000,000. Current fundamentals show that if a client retires at age 66, he or she can prudently withdraw about $30,000 in the first year. With the strategy I'm going to explain to you, one of today's favored products in particular would allow a married couple to invest $500,000 at age 56 and then withdraw a minimum of $38,500 at age 66, in the first year of their retirement. That's assuming that over those 10 years, their money in this product doesn't earn even one single penny of growth.

COMPARATIVE ADVANTAGE

Think about that for a moment: 100% growth over an entire decade in the 'typical' portfolio, from $500,000 to $1 million, would provide less income from a fundamental standpoint than a single product could, even if it didn't earn a penny. With that in mind, where do you think you have the greater likelihood of getting the income you need in retirement? The 'typical' portfolio, if we are to apply The 4% Rule, would need to grow by 92.5% ($462,500) to $962,500.

What if the income product I'll describe earned an average of 3% during those ten years? The income for this married couple would then be over $51,000 in the first year of retirement, even with this modest growth rate assumption. Under the 4% Rule they'd need over $1,250,000 to provide that much cash flow, and under a more realistic 3% Rule, this couple would need $1,700,000.

So I pose the question again: where do you have the greater likelihood to attain the income you'll need in retirement?

Keep in mind, products change over time and the versions described here may be better or worse by the time you're reading this book. The basics however, will likely remain the same which is why I intend to present an alternative idea and concept to you, to potentially enhance your well-being in retirement.

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Chapter One: *Grasping The Generation Gap*

If you're a relatively young retiree or a pre-retiree, you might wonder what all the fuss is about. After all, your parents may have lived very comfortably in retirement (and might still be doing so), without concerns about running out of money. That's true, but things have changed. The circumstances faced by your parents are very different than those facing today's retirees.

ROUGH BEGINNINGS, HAPPIER ENDINGS

If you're in the Baby Boomer generation (born in the late 1940s through the early 1960s), your parents probably were born in the first four decades of the 20th century. People born then are typically thought to belong to the "Greatest Generation" (grew up during World War I and fought or provided homeland support during World War II) or the "Silent Generation" (grew up during the Great Depression and World War II).

Many members of those generations went to work after finishing school, then spent most or all of their working careers with one employer. As a result, they often received pensions at retirement. In technical lingo, those pensions were and still are the fruits of defined benefit plans. In these plans, pensions are funded by employer contributions. The payouts last for a lifetime, no matter how long that might be, and there's usually a pension for a surviving spouse.

For people born from 1900 to 1940, the husband generally was the family breadwinner while the wife was the homemaker. If the husband earned a pension and died first, which typically was the case, the widow often continued to collect a survivor's lifetime benefit.

Don't forget, retirees started to receive Social Security payments in 1940. Thus, many members of preceding generations received lifelong benefits from the federal government as well as from a former employer.

Together, Social Security and a pension might have equaled most or even all of the amount a retired couple earned during their years of employment. No wonder many people from that generation didn't (and still don't) worry about running out of money.

LOW SPENDING, HIGH YIELDS

Other factors contributed to the relative comfort previous generations have enjoyed in retirement. Having lived through the Great Depression, many members of those generations developed frugal spending habits.

What's more, there weren't as many things to spend money on. When people retired in, say, the 1960s or 1970s, they weren't concerned about how to keep up with the latest smartphone plans.
Obviously, there were exceptions. However, many members of the Greatest Generation and the Silent Generation spent carefully during their working years and saved significant amounts. Often, savings went into bank accounts and U.S. Savings Bonds, where yields usually were decent and sometimes extraordinary. Any stock market investments probably were helped by the bull market that lasted, with few setbacks, from 1982 until 2000, and saw the Dow Jones Industrial Average increase by over 1,400%, from 777 to 11,723! Obviously, even if you had to spend from your portfolio during this time period it wasn't much of a challenge. It was during this remarkable period of investment growth that the 4% Rule was established.

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AGE-OLD ASSURANCE

As an example of the Greatest Generation, consider Charlie Thomson, now age 94. He served in World War, worked as a successful executive with a moderate income, and retired at age 62---just in time to put his savings into the bull markets of the 1980s and 1990s.

Charlie and his wife Debbie***** have lived comfortably for decades on their Social Security checks and Charlie's pension. (As an additional benefit, Charlie's former employer also provides retiree health coverage, which combines with Medicare to cover medical bills.)

Charlie has some money in an IRA, and he reluctantly has taken the required minimum distribution (RMD) each year, paying the resulting income tax. Besides these RMDs, Charlie and Debbie have never needed to withdraw a penny from their savings for basic lifestyle needs. When I asked Charlie how they managed to live for 32 years on his pension and their Social Security checks alone, he told me that they actually save money from those income sources!

Charlie still plays golf, mows his lawn, and enjoys freedom from financial fears. He'll always have his pension and his Social Security, and that income will be more than adequate for him. Knowing that their bills will be covered by those guaranteed income sources; Charlie and Debbie have gone and are still going through their extended retirement with no concerns over their finances.

Think about that for a moment: retired for 32 years, waking up every day of every month knowing the bills are sure to be paid! This is an example of why I think the Greatest Generation has been and continues to be the most financially secure generation I will ever see. Indeed, one of my personal financial goals is to have the same comfort level for my wife and myself. Similarly, that's the goal I have for as many of my clients as possible and is the sole purpose of this book.

If you think Charlie's story is unusual, consider a representative of the Silent Generation: Ed Samuels*****, now age 76. He worked in a machine shop in a small town and took early retirement at 56. Again, Ed received a pension that has served him well for 20 years, as well as the Social Security benefits he now receives. Ed and his wife Florence live the same lifestyle as they always had, from these sources of cash flow, without needing to tap their savings at all. Now that he is older than age 70-1/2, Ed must take RMDs from his IRA. Ed doesn't like doing so—he hates the idea of paying more tax than necessary—so he withdraws no more than the amount he must take out, in order to avoid a 50% IRS penalty.

For retirees such as Charlie and Ed, Social Security benefits plus pension income have provided more than enough cash flow to cover their living expenses. Indeed, for all retirees—present and future—having adequate assured income provides a certain degree of security.

Once you have secured your income, savings now become a luxury: you can spend those funds, or pass them on to your loved ones. However, as we'll see in future chapters, many baby boomers lack their parents' guaranteed income, so they may not have similar stories of retirement security to relate.

PRESENT IMPERFECT

Compared with previous generations, today's younger retirees and pre-retirees are less likely to have worked for decades with the same employer. Moreover, very few companies provide the same sort of pension that Charlie and Ed were able to earn. Companies now have "defined contribution" plans such as 401(k) s. With these plans, the payout in retirement is determined by the amount contributed to the plan as well as the investment performance after the contribution. The 2000-2002 and the 2008-2009 bear markets have reduced the amounts in such accounts considerably. Therefore, today's defined contribution plans have uncertain payouts—the amounts can be disappointing. By comparison, yesterday's defined benefit plans that covered Charlie and Ed were designed to pay retired workers a given amount, no matter how markets performed.

***The experiences of these clients may not be representative of your experience and is no guarantee of future success.**

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Moreover, defined contribution plans are largely funded by employees themselves. Employers may make matching contributions but such contributions are modest—and, in many cases, nonexistent. Savings yields are low now and likely to stay there for the foreseeable future. With unpredictable retirement plans and scant savings yields, baby boomers who maintain a familiar lifestyle in retirement might well run short of money if they live into their 80s, 90s, and beyond.

This book is intended to present an alternative strategy, using a different approach to solving the retirement challenge, rather than rely upon flawed theories that have been presented as facts to so many retirees.

Please spend some time with me inside the pages of this book and see if a different path is appropriate for you, a friend, or a family member. This path, or strategy, is intended to provide those who follow it with a more financially certain retirement, one where their income needs are anticipated and met each month by using only a portion of lifelong savings.

The portion necessary to meet those income needs could be as much as 70% or even 80% of investable assets. Even if it is that much—and it usually isn't—once retirees' income needs are met they can spend freely from the remainder of their assets or continue to invest the balance. With enough time and sufficient growth, retirees can generate the income they need in retirement from a reliable source while potentially replenishing their portfolios to their former levels.

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