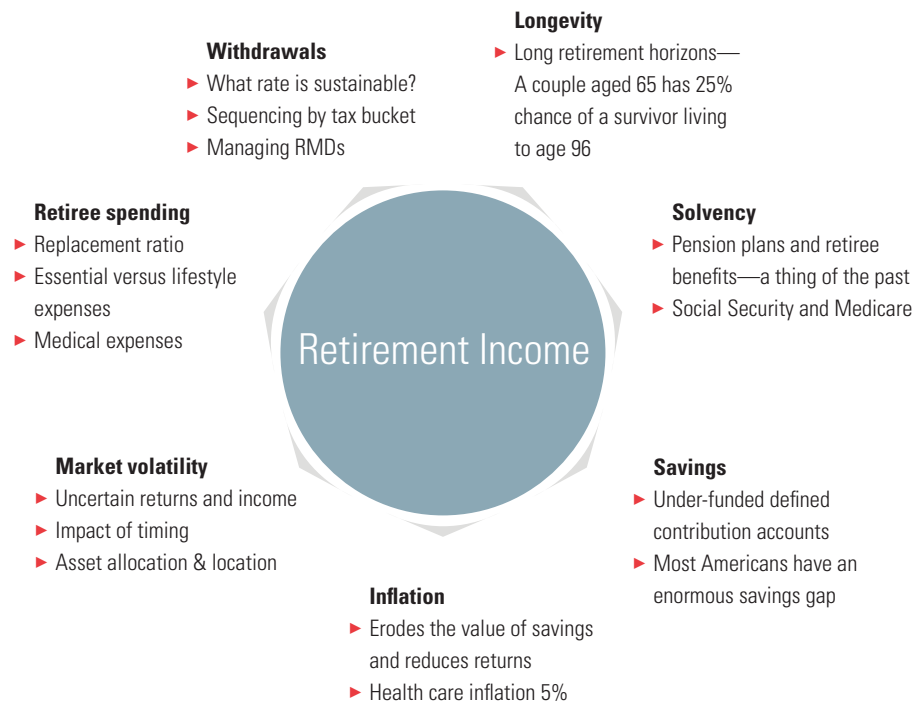


Risks in Retirement

Retirement has changed dramatically over the past few decades. People are retiring earlier, living longer, and staying healthier than ever before. At the same time, Social Security and traditional defined benefit pension plans are predicted to play a considerably smaller role in providing retirement income in the future. How well your portfolio provides for your retirement not only depends on how well you save before retirement, but how you manage funds during retirement. Are investors making the necessary adjustments in their financial planning to compensate for longer life in retirement? Are financial advisors adequately preparing investors with the proper asset allocations and products to meet the longer retirement window? Tackling these questions begins with learning about and understanding the risks you'll face during retirement.



Longevity Risk

What is longevity risk?

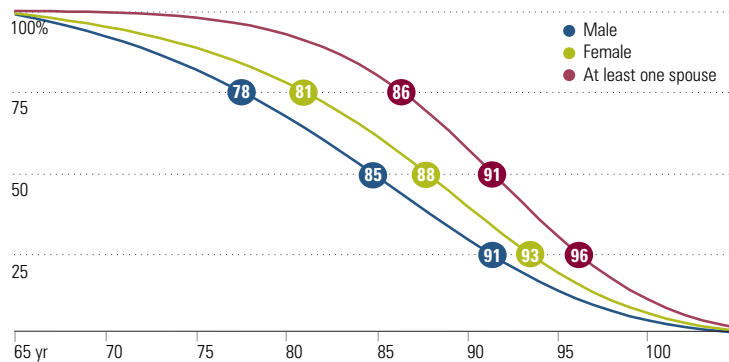
Longevity risk simply refers to the risk that you will outlive your assets. Longevity risk is perhaps the single biggest risk facing retirees. That said, life expectancy plays a critical role when planning for retirement. All subsequent decisions, such as when to retire, how much money to take from your portfolios each year, and how to invest your assets, all flow from this longevity decision. It's great to be able to live a long and healthy life, but you'll need to plan carefully to make sure your money lasts as long as you do.

How long should we plan to live?

People often base their retirement plan upon their "life expectancy," which is the age at which someone is expected to die. Unfortunately, most investors underestimate how long they are likely to live. In the United States, the median life expectancy of a 65-year-old male and female is 85 and 88, respectively. But remember: half of the population will live longer, often much longer, than their life expectancies.

Retirees should plan for a long retirement¹

Probability of a 65-year-old living to various ages



The image above illustrates that for a couple aged 65 who is about to retire, there is a 50% chance that one of them will live to age 91, and a 25% chance that at least one of them will live to age 96—a 31-year retirement! Unless there is a specific medical reason to suggest otherwise, many financial planners think that retirees should plan for their investment assets to last for 30 to 40 years.

When planning for retirement, it is important to have an open discussion with your spouse and your financial advisor, and if possible, be generous in your planning assumptions regarding how long you might live. You want to give your investments a chance to survive as long as you do.

Solvency Risk

Are you counting on the government or your employer to take care of you in retirement?

Many investors nearing retirement depend on Social Security, Medicare, and defined-benefit pension plans to meet the majority of their retirement needs. However, demographic and economic forces are placing these systems under extreme stress.

Social Security benefits could be cut

Contrary to popular belief, Social Security is not a “trust fund,” but rather a “pay-as-you-go” system that depends upon a healthy balance of money being paid into it relative to money being paid out. The image below shows the number of people receiving benefits per 100 workers paying into the system. The number of beneficiaries per 100 workers has increased from 20 in 1960 to 32 in 2009. In the face of such demographic pressure, the Social Security system may eventually collapse unless Congress acts to increase payroll taxes, reduce benefits, or push back the eligibility date for benefits.

Social Security is under strain²

Number of beneficiaries per 100 covered workers



Will Medicare cover all your medical needs in retirement?

In the past, Medicare provided all the medical insurance coverage necessary for retirees. Today, as retirees are living longer and striving for healthier lifestyles, Medicare may fall short in meeting your needs. Many experts believe that the solvency risk of Medicare is even more severe than that of Social Security. While both programs face similar demographic challenges, Medicare is also impacted by the rate of health-care inflation, which recently has run about 2% higher than the overall rate of inflation over the past 20 years. As with Social Security, Medicare will require some combination of higher taxes and lower benefits to resolve this solvency issue.

Traditional pension plans are a thing of the past

Traditional defined benefit pension plans offered by corporations are also subject to demographic pressures. Because corporations are under enormous pressure each quarter to deliver profits, they are cleaning up their balance sheets by reducing their pension and health care liabilities. Many are replacing traditional defined-benefit pension plans that pay a benefit for life with a defined contribution plan in which the responsibility for saving for retirement falls squarely on the employee. Other companies are reducing or eliminating benefits for employees who are near or in retirement.

Savings Risk

Saving enough for retirement is up to you

Today, people are increasingly responsible for building their own retirement accounts. They need to make their own decisions on how much to save each month, how to allocate savings, and how to take disbursements in retirement. This is a dramatic change from their parents' generation, who relied heavily on defined-benefit pension plans, which guaranteed them income for life once they retired.

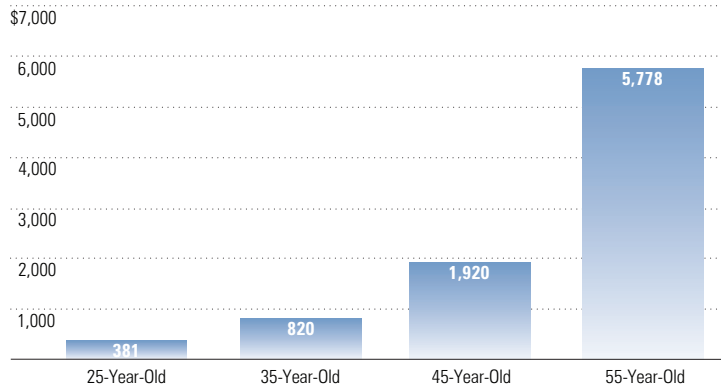
The sad reality is that most Americans aren't saving enough for retirement. The U.S. savings rate has been generally falling for more than 20 years.³ However, this trend has recently reversed, as credit markets remain tight and consumers are uncertain about the future.

You need to save a lot more than you think

Many financial advisors believe their clients can safely withdraw between 4%-5% each year from their portfolios in retirement. If you have a \$1 million portfolio, a 4% withdrawal rate would produce only \$40,000 in income in the first year. If you're trying to replace \$100,000 in income and estimate you'll get \$20,000 from Social Security, you'll probably need to save \$2 million before you retire.

The earlier you start investing, the easier it is to reach your goals*

Monthly savings needed to accumulate \$1 million by age 65



The image above illustrates roughly how much monthly savings an investor needs to save at various ages to reach \$1 million at retirement. Clearly, the earlier you start saving, the easier it will be to attain your retirement goals. If you haven't saved enough, you may need to start an aggressive savings plan or postpone your retirement.

Once you're ready to save and invest regularly, consider programs that "pay yourself first," such as payroll deductions or automatic monthly debits from your checking account. These provide savings discipline, which is half the battle.

*Image represents monthly savings necessary using a 7% hypothetical rate of return. This is for illustrative purposes only and not indicative of any investment. The data assumes reinvestment of all income and does not account for taxes or transaction costs. Your results will vary as investing involves risk, fluctuating returns, and the possibility of loss.

Inflation Risk

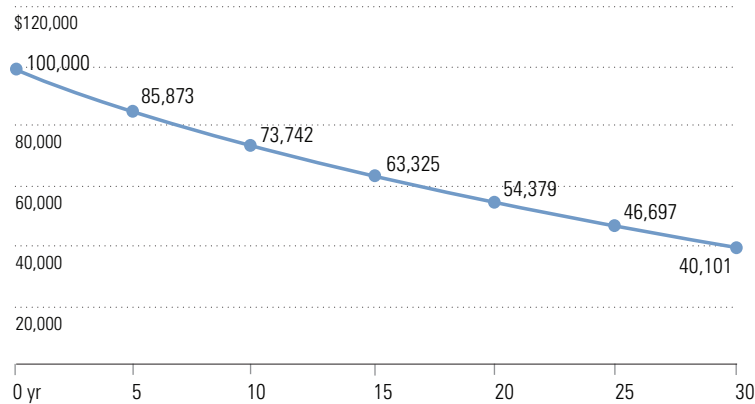
How does inflation erode purchasing power?

Most consumers don't understand how inflation can damage purchasing power over long periods of time. One dollar today simply doesn't buy as much as it did in 1970, and it will buy even less 30 years from now.

Inflation has averaged about 3% annually from 1926–2009. Three percent may not seem like much, but it can significantly erode your purchasing power over long time horizons. Take for example the impact a 3% inflation rate can have on a fixed annual income of \$100,000 over a typical 30-year retirement. As the image below demonstrates, your money would be worth 14% less in five years. In 30 years, the purchasing power of your income would be reduced by nearly 60% to \$40,101.

Inflation significantly erodes purchasing power over time⁴

Effects of 3% inflation on purchasing power



There's a good chance that the rate of inflation you will experience in retirement will exceed the long-term 3% average, simply because the goods and services that you will be purchasing won't resemble what the typical consumer is buying. Medical expenses in particular are likely to be a significantly higher portion of your overall spending.

Despite the risk inflation can pose to retirement savings, the natural tendency for many retirees is to protect their investment assets by investing conservatively. As a result, many retirees' portfolios are largely allocated to bonds and cash with minimal exposure to stocks. History shows, however, that of these three asset classes, stocks were the only one to provide significant growth after accounting for inflation.

A long-term horizon can cushion the impact of short-term volatility and extra risk associated with stocks. The payoff for accepting this extra risk is a portfolio that has a better chance of keeping pace with inflation and protecting your purchasing power. Given this, you should consider some exposure to stocks.

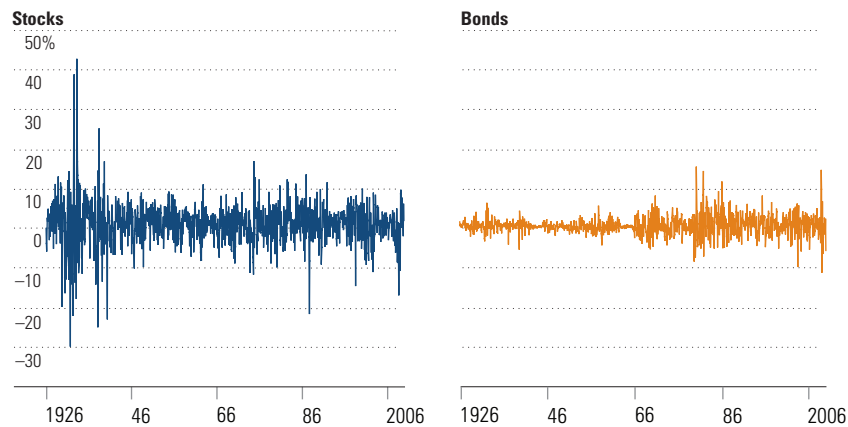
Market Volatility Risk

How volatile are stocks and bonds?

Market volatility risk refers to how much the capital markets, and more specifically, the value of your investment assets, fluctuate up and down. Every investment has some level of risk or volatility, as returns tend to weave and wind over time. You can think of the jaggedness of returns over time as market volatility risk.

Historically, stocks have been riskier than bonds⁵

Volatility of stock and bond monthly returns 1926–2009



The illustration above contrasts the historical monthly volatility in returns of stocks and bonds. While stocks are more volatile than bonds, over long holding periods, stock investors have been rewarded with higher returns for assuming greater risk. In fact, stock returns outperformed those of bonds from 1926–2009, averaging 9.8% and 5.4%, respectively.

How can I manage downside risk?

Another important concept is managing downside risk. Consider an investor who invests \$1,000 and suffers a 25% loss in the first year, followed by a 25% gain in the next year. Many people would assume the investor ended up where he or she started, but that isn't the case. After two years, the investor would have \$937.50, a loss of 6.25%. This is because the 25% gains are applied to a smaller asset base at the end of year one. The larger the downside returns, the longer it will take to recover.

Many retirees traditionally have invested most of their assets in bonds, perceiving them to be safer than stocks. That may no longer be prudent. Because asset classes such as stocks and bonds react differently to economic events, it pays to spread out your investments among multiple asset classes. Effective diversification can reduce portfolio volatility and downside risk during all types of market conditions. How much to allocate to each asset class depends on factors such as your goals, investment horizon, and risk tolerance.

Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The data assumes reinvestment of all income and does not account for taxes or transaction costs. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. Diversification does not eliminate the risk of experiencing investment losses.

Retiree Spending Risk

Retirees are living longer, healthier lives, and are spending more money on entertainment, travel, and health care. Many financial planners believe one of the biggest risks retirees face is the prospect of spending too much, raising the risk of outliving their money.

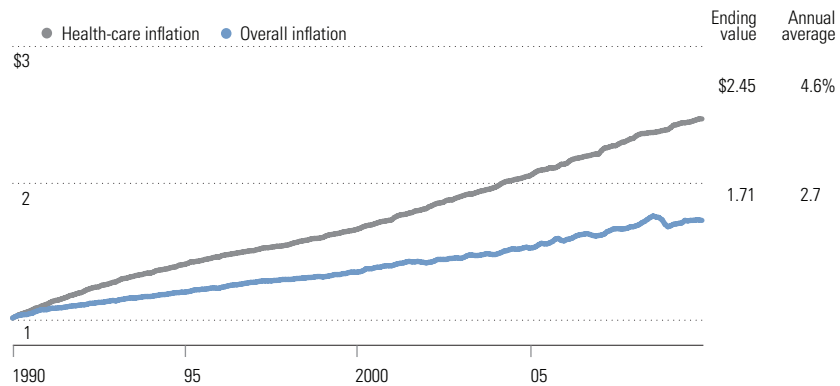
How much income do you need in retirement?

When discussing retirement expenses with clients, many financial planners use the concept of a replacement ratio, or the percentage of pre-retirement gross income needed in retirement to cover expenses and preserve their pre-retirement standard of living. Many financial planners suggest a replacement ratio of 70% to 90%. However, it is important to think about the lifestyle you would like to lead in retirement. You should distinguish between essential expenses (e.g., mortgage, insurance payments, basic food, and utilities), and lifestyle expenses (e.g., entertainment, dining out, and travel). If you desire an active lifestyle with expensive activities such as golf or travel, you might actually spend more in retirement.

How much should we expect to spend on health care in retirement?

One of the major concerns facing a retiree is rapidly rising health-care costs, or health-care inflation, which is significantly higher than the overall rate of inflation, as shown in the graph below. So as you age, not only may you need more medical care, but the cost of medical care will become increasingly expensive and you're likely to cover a greater portion of each bill out of your own pocket.

Health-care inflation has far outpaced overall inflation⁶
1990–2009



How much does long-term care cost?

In addition to typical medical expenses in retirement, you should also consider the cost of long-term care arrangements should you need professional care in your later years. According to the 2009 MetLife Market Survey of Nursing Homes, Assisted Living, Adult Day Services, and Home Care Costs, the average annual cost for a private room at a nursing home in 2009 was \$79,935. In most cases, long-term care health insurance coverage provides benefits for nursing homes, assisted living facilities, and home care. If you can afford the premiums, you may want to consider purchasing long-term care insurance.

Withdrawal Risk

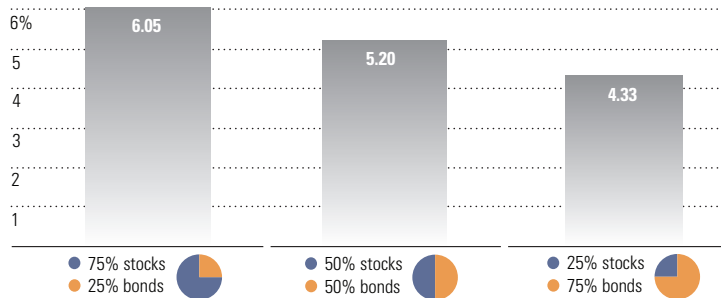
When you reach retirement, you face a lot of changes. Perhaps the biggest financial challenge is the transition from earning money and accumulating assets to spending them down. Developing a plan for spending your assets can be challenging, especially since you won't know how long you'll live.

What is a reasonable withdrawal rate?

The first question many retirees ask is how much money they can safely extract from their portfolio each year. A simplistic way of looking at this is a withdrawal rate, expressed as a percentage of your investment assets. Historically, as shown below, withdrawal rates that could support an investor over a 30-year retirement have varied from 4.33% to 6.05%, depending on the asset allocation of the portfolio.

The withdrawal rate you can sustain may be lower than you think*

Average: 1926–2009



Many optimistic investors hope to withdraw 10% of their portfolio annually, while more conservative investors only withdraw interest and dividends. Unfortunately, there is no magical formula or simple solution. The optimal withdrawal rate will vary from investor to investor, and may vary over time.

How does the timing of portfolio returns affect planned withdrawals?

Market returns affect how long your retirement portfolio can sustain your desired withdrawals. When poor returns occur early in retirement, the risk that your portfolio will run out of money during retirement dramatically increases. Financial planners call this "point in time" risk. Many financial planners suggest that you adjust your withdrawal rate and spending each year based on the returns you earned in the previous year. If you face poor returns early in retirement, you might want to lower your withdrawal amounts for a while. Conversely, in years when you earn good returns, you can maintain, or perhaps increase your withdrawal amounts.

Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The data assumes reinvestment of all income and does not account for taxes or transaction costs. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. Each portfolio is rebalanced monthly.

*Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Bonds—5-year U.S. Government Bond; Inflation—Consumer Price Index.

All withdrawal rates are represented by an inflation-adjusted percentage of the initial portfolio balance that, if withdrawn in each of the 30 years of the hypothetical retirement horizon, would have resulted in an ending portfolio balance of \$0. Annual fees of 0.88% for stocks and 0.74% for bonds were assumed. This is the percentage of fund assets paid for operating expenses and management fees.

Summary

What next?

Retirement risks such as longer life expectancies, inflation, market risk, withdrawal rates, and unfortunate timing can create an unpredictable retirement scenario. Preparing for your future begins with an understanding of these risks and the amount of income that might be available to you going forward. Though many people believe they have adequate resources for retirement, few actually do. Be proactive and establish a foundation for retirement using reasonable expectations and adjust periodically to boost your chances of enjoying those golden years.

Questions to ask your advisor:

- ▶ What life expectancy estimate should my spouse and I use to manage longevity risk?
- ▶ How much do I need to be saving to fund a comfortable retirement?
- ▶ Should I set aside additional savings for unexpected expenses and events in retirement?
- ▶ How should my investments be allocated to minimize inflation risk?
- ▶ What is a reasonable withdrawal rate and how much income might that generate each year?
- ▶ How will poor market performance affect my ability to meet my needs and goals?
- ▶ What are some retirement strategies for late savers?

¹Source: Annuity 2000 Mortality Tables—Transactions, Society of Actuaries, 1995–1996 Reports.

²Source: Social Security Administration. Scenario assumptions are as follows: Low-cost—assumes relatively rapid economic growth, low inflation, and favorable (from the standpoint of program financing) demographic and program-specific conditions; Intermediate—represents the Trustees' best estimates of likely future demographic, economic, and program-specific conditions; High-cost—assumes relatively slow economic growth, high inflation, and unfavorable demographic and program-specific conditions.

³The personal savings rate is defined as a percentage of disposable personal income. Source: Bureau of Economic Analysis.

⁴Source: Inflation—Consumer Price Index.

⁵Source: Stocks—Standard & Poor's 500[®], which is an unmanaged group of securities and considered to be representative of the stock market in general; Bonds—20-year U.S. Government Bond.

⁶Source: Overall Inflation—Consumer Price Index; Health-care Inflation—Consumer Price Index-Medical Care Inflation, Bureau of Labor Statistics.