“Life’s tragedy is that we get old too soon and wise too late.”
—Benjamin Franklin

Highlights

• With average life expectancy on the rise, generating enough income to live comfortably for an extended period of time has become a complex undertaking. Increasingly, finding sources of retirement income is left to the individual and society’s track record for self-management of savings and investments has been decidedly mixed.

• Stock market volatility, combined with 30 years of falling interest rates, have left many people unable to meet their investment goals. Guidance from a financial professional, preferably someone with special expertise in retirement planning, is advised.

• Meeting income requirements throughout a lengthy retirement may require looking beyond traditional short-term and fixed income assets and considering equities, global investments and specific strategies such as product allocation to broaden income sources and match sources of income to expenses.

It’s Complicated

With average life expectancy on the rise, generating enough income to live comfortably for an extended period of time can be a complex and somewhat daunting undertaking. Recognizing that a growing percentage of the population will have to provide for themselves financially to age 90, governments and the financial industry have stepped in to provide a flood of retirement investment tools and programs.

For highly sophisticated investors, this proliferation of investment choices may represent a “golden age” of retirement planning possibilities. More often than not, however, people are simply overwhelmed.

Guidance from a financial professional—ideally someone with special expertise in retirement planning—can be invaluable in both the planning and implementation stages of a disciplined retirement savings and investment program. Services typically include:

• Creation of a retirement strategy
• Development of a written plan
• Selection of investments
• Monitoring and reporting on a regular basis
• Rebalancing investments or revising the plan over time to ensure best results

Advisors may also act as gatekeepers, coordinating the various components of a retirement plan. Since investors are frontline participants in the process throughout their retirement, becoming familiar with the issues and challenges surrounding the financial aspects of retirement income planning may increase the effectiveness of the partnership.

The Issue: Funding Longer Lives

When social security was introduced in 1935, average life expectancy in the United States was only 61.7 years. By 2008, the average 62-year old could expect to live a further 21.1 years\(^1\). Today, a growing cohort of centenarians testifies to the very real possibility that significant numbers of those entering retirement in the years ahead will spend more of their adult lives outside the workforce than in it. Given the rapid pace of advances in geriatric medicine and other age-related research, prudent retirement planning for tomorrow’s retirees should include a strategy to generate income for 30 years or more.

The proliferation of registered and non-registered savings vehicles over the past decade is sending a powerful message that finding the sources of that income increasingly will be up to the individual. So far, however, society’s track record for self-management of savings and investments has been decidedly mixed. Figure 1 compares the changing face of retirement income sources over a 48-year period\(^2\) between 1962 and 2010. While private pensions (401k and others) showed solid growth, personal savings (represented by “other”) and asset income actually declined during this period. More recently,
Even so, limiting the focus of investing to the years preceding retirement may not be enough, especially for those entering retirement with insufficient assets and, increasingly, household debt. Investing throughout retirement, to preserve capital, generate income and perhaps even obtain a measure of growth, will be a necessity for many if they are to address the most pervasive fear about growing old: outliving their retirement savings.

**Figure 1: Past Imperfect:**
Swelling Private Pensions, Diminished Savings and Asset Income

<table>
<thead>
<tr>
<th>Year</th>
<th>Social Security</th>
<th>Earnings</th>
<th>Asset income</th>
<th>Government employee pensions</th>
<th>Private pensions</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1962</td>
<td>30%</td>
<td>28%</td>
<td>15%</td>
<td>6%</td>
<td>3%</td>
<td>16%</td>
</tr>
<tr>
<td>2010</td>
<td>37%</td>
<td>30%</td>
<td>11%</td>
<td>9%</td>
<td>9%</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: ssa.gov U.S. Social Security Administration, Office of Retirement and Disability Policy

Nevertheless, signs of a change for the better are beginning to emerge. A recent survey commissioned by Franklin Templeton Investments examined individual retirement strategies and expectations4 (RISE survey). The survey revealed that when ranking their top three primary retirement vehicles, use varies by age (Figure 2).

**Figure 2: A Diversified Future**

<table>
<thead>
<tr>
<th>Retirement savings</th>
<th>18-54 years of age</th>
<th>55-64 years of age</th>
<th>65-74 years of age</th>
<th>75+ years of age</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workplace retirement plan respondent funds through salary deferral (i.e. 401(k), 403(b), etc.)</td>
<td>76%</td>
<td>63%</td>
<td>58%</td>
<td>47%</td>
</tr>
<tr>
<td>An employer-provided pension benefit (i.e. Defined Benefit, STRS, PERS, etc.)</td>
<td>49%</td>
<td>55%</td>
<td>68%</td>
<td>68%</td>
</tr>
<tr>
<td>A traditional IRA or direct Roth IRA respondent funds</td>
<td>41%</td>
<td>41%</td>
<td>34%</td>
<td>33%</td>
</tr>
<tr>
<td>Mutual funds, stocks, bonds or exchange trade funds (ETFs) NOT held in a retirement account</td>
<td>25%</td>
<td>33%</td>
<td>25%</td>
<td>44%</td>
</tr>
<tr>
<td>Life insurance, annuities</td>
<td>23%</td>
<td>25%</td>
<td>16%</td>
<td>28%</td>
</tr>
<tr>
<td>Money market account, checking account, savings account</td>
<td>29%</td>
<td>12%</td>
<td>15%</td>
<td>12%</td>
</tr>
<tr>
<td>Certificates of deposit (CDs)</td>
<td>15%</td>
<td>7%</td>
<td>14%</td>
<td>29%</td>
</tr>
</tbody>
</table>

Percentages for each row are based off of those who have included the particular retirement savings vehicle as part of their current retirement savings plan.

4 The Franklin Templeton Retirement Income Strategies and Expectations (RISE) survey was conducted online among a sample of 2,011 adults comprising 1,008 men and 1,003 women 18 years of age or older. The survey was administered between January 2-16, 2014 by ORC International’s Online CARAVAN®.
This approach requires grouping expenses into three categories, or buckets:

- **Fixed** – Basic expenses that are less likely to be affected by inflation, but more so by income volatility, such as fixed mortgages and life insurance premiums.
- **Rising** – Basic expenses that are likely to be affected by inflation and income volatility, including costs for health care, food, and utilities.
- **Discretionary** – Expenses that are more likely to be affected by inflation but less affected by income volatility, including such “nice to haves” as hobbies, travel, and dining out.

The next step is to determine which income sources most closely mirror the income need. Generally, fixed expenses such as shelter (mortgage payments, property taxes, rent, etc.) should be matched to a stable income source that is protected as far as possible from the effects of volatility. Indexed government programs like social security, survivor benefits and disability payments are suitable sources, but may be inadequate on their own.

Stability options can be customized to meet specific needs. For those looking for high levels of stability, guaranteed income choices such as annuities and bank products may be appropriate. If a guaranteed amount is not critical—as in the case of a grandparent helping to fund a grandchild’s education—systematic withdrawals from an investment portfolio can be considered; however, in situations where a guarantee of the same payment at regular intervals over the long term is essential, product allocation may be a more suitable strategy.

**The Issue: 30 Years of Falling Income**

In response to stock market volatility, investors often tend to shift into cash and the perceived stability of traditional fixed income investments. Unfortunately, over the past 30 years the movement into fixed income investments has coincided with a steady drop in interest rates, which for many has resulted in less income than may have been anticipated (Figure 4).
What's Next: Rethinking Asset Allocation

Asset allocation refers to the percentage of a portfolio devoted to asset classes such as equities, fixed income and cash; it is arguably the most important influence on the growth of an investment portfolio’s value.

As retirement approaches, assets are typically rebalanced to reduce the proportion of higher-risk investments in favor of income-generating investments; but asset allocation does not cease upon reaching retirement. Income investments may also need to be rebalanced with the passage of time. Moreover, no one can be absolutely certain what will happen over a 20- or 30-year period. Even investors who entered retirement in relatively solid financial shape could find living to a ripe old age more expensive than expected.

Depending on individual needs, creation of a strategy capable of meeting income requirements through a lengthy retirement may require looking beyond short-term and fixed income assets to a portfolio that includes a component of equities and global investments. Equity investments such as preferred shares, which provide both income and potential for an increase in value, may help retirees avoid being trapped in a downward spiral of diminishing returns and allow them to maintain assets for the spike in expenses that typically accompanies the last few years of life.

Figure 4: Low Bond Yields = Low Income

The following chart shows the income generated by yields on 10-Year U.S. Treasury Bonds from January 1, 1982 to December 31, 2011.

Figure 5 illustrates how augmenting a portfolio of fixed income investments with a component of stocks may work to sustain withdrawal rates over an extended period.

Figure 5: A Place for Equities in Retirement

Setting Realistic Expectations

Based on historical data, this table illustrates the probability of sustaining annual withdrawals over a 30-year period, assuming a 3% annual increase to adjust for inflation.

<table>
<thead>
<tr>
<th>Initial withdrawal rate with a 3% annual increase</th>
<th>100% US Bonds</th>
<th>100% US Stocks</th>
<th>80% US Bonds 20% US Stocks</th>
<th>40% US Bonds 60% US Stocks</th>
<th>40% US Bonds 40% US Stocks 20% Global Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>4%</td>
<td>91%</td>
<td>&gt;95%</td>
<td>&gt;95%</td>
<td>&gt;95%</td>
<td>&gt;95%</td>
</tr>
<tr>
<td>5%</td>
<td>66%</td>
<td>87%</td>
<td>81%</td>
<td>88%</td>
<td>90%</td>
</tr>
<tr>
<td>6%</td>
<td>35%</td>
<td>73%</td>
<td>50%</td>
<td>70%</td>
<td>72%</td>
</tr>
</tbody>
</table>

Disclosure Information: The Monte Carlo simulation uses historical data for asset classes, including arithmetic mean (return), standard deviation (risk) and correlation, to estimate a range of possible outcomes. Each Monte Carlo simulation generates randomized scenarios consistent with the historical characteristics of the asset classes. Each Monte Carlo simulation we employ at Franklin Templeton generates 10,000 possible scenarios for each time period.

IMPORTANT: The Monte Carlo projections or other information generated by Zephyr Associates, Inc. regarding the results. This simulation does not take into account taxes on withdrawals, nor early withdrawal penalties. The projections or other information generated by the Monte Carlo simulation regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.
With advancing age, investors show a marked preference for investments perceived as safe. Only 17% of those currently retired would advise those not yet retired to consider more growth-oriented investments. What they may not realize, however, is that in addition to legitimate concerns about their ability to recover from losses and the need to preserve capital, loss aversion may also be impairing their judgment. Loss aversion is another behavioral finance term that describes the intense emotions triggered by financial loss. Studies have determined that the pain associated with a loss is far deeper and longer-lasting than the pleasure associated with financial gain. Individuals need to realize that this emotional response can lead to potentially detrimental financial decisions such as panic selling or remaining exclusively in low-yield investments that generate a negative return.

**What's Next: The Value of Product Allocation**

Increasingly, retirement planning experts are encouraging clients to expand their perspective from asset allocation in the years leading up to retirement to product allocation during retirement. The goal of the product allocation strategy is to group a range of mutual funds, banking, insurance and other financial products into a sustainable source of income, allowing investors to turn a portion of their retirement portfolio into what is essentially a private pension. Options are broad and varied, but can include:

- Equity and fixed mutual funds
- Managed payout funds
- Target-date funds
- Zero-coupon bonds
- Bond ladders
- Laddered certificates of deposit (CDs)
- Treasury inflation-protected securities (TIPS)
- Traditional fixed-income lifetime annuities
- Variable annuities

Products linked to the capital markets, including mutual funds (stock, bond and money market funds), annuities, standalone stocks, bonds or Treasuries, can fluctuate in value and are not insured against losses by any government agency. Some products, such as deferred fixed annuities, may offer a guaranteed rate of return for a specified period of time regardless of market conditions; however, only checking accounts (including money market deposit accounts), savings accounts and certificates of deposit (CDs) are covered by the Federal Deposit Insurance Corporation (FDIC) to a limit of $250,000. Consequently, many investors maintain a “cushion” of other assets (such as cash) so they will not be placed in the position of having to draw money from their investments in down markets.

Investments designed to provide lifetime income and protection from volatility tend to have higher up-front costs than those without the guarantees, but if the RISE survey is any indication, many investors would happily absorb the cost to ensure protection of their retirement nest egg.

Overall, some 49% of survey participants were willing to pay for protection against outliving their retirement savings or retirement asset volatility. That number increased even further with rising income levels. Of those with an annual household income of $100,000 or more, 59% indicated they would be willing to pay either to protect themselves from outliving their retirement savings or to protect their retirement assets from volatility.

**Planning for the Unexpected**

The survey indicated a higher level of stress and anxiety 11–15 years before retirement (76%) compared to total respondents (68%). This could stem from a number of causes:

- Response to market volatility
- Overspending while saving for retirement
- Onset of health concerns
- Caring for an aging parent
- Paying for children’s post-secondary education while saving for retirement

Every retirement plan should include a contingency plan for unexpected events. For some people, the most unexpected development is that they are still alive far beyond the ages at which their parents died. One of the most pressing issues in medical care today is quality of life for the millions of people with chronic illness who in the past would have died at an early age, but who can now expect to live a normal lifespan.

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with their illnesses, including the expensive treatments they will need. Health and medical issues were the number one concern for survey participants.

The financial implications of inadequate planning for retirement can be life-altering during a time of great vulnerability. Numerous vehicles are available that can be used to help preserve the nest egg and generate a lifetime of reliable income, but success is likely to be largely dependent on decisions made in the preceding decades. With advance planning, a solid understanding of the issues, help from financial experts and a little bit of luck, happiness in retirement is an eminently achievable goal.

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