CH 1

Insured Retirement

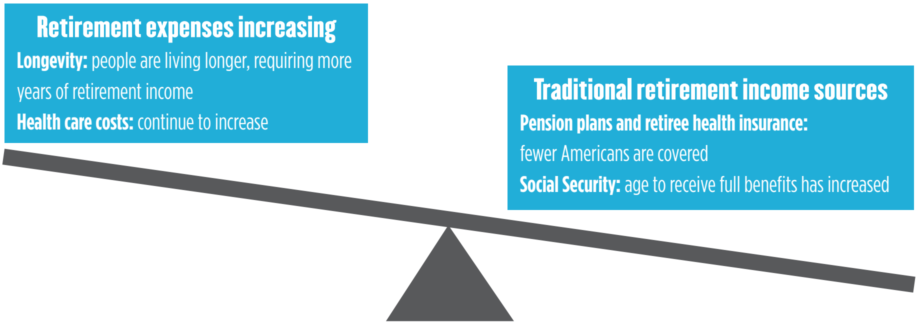
The Changing Face of Retirement

Retirement has changed over the generations – long gone are the days Americans worked at the same company for 40 years and then retired with a gold watch and the confidence that their pension plan and Social Security would provide adequate income for their remaining years.

The pre-retirement years have also changed as the responsibility for saving for retirement has shifted away from employers (traditional pension plans) to individuals (defined contribution plans such as 401(k) plans).

There are about 76 million Baby Boomers in the United States, more than 40 million of whom are already age 65 or older. The United States is facing a potential retirement crisis as the number of retirees increases significantly over the coming decades: 10,000 Americans will reach retirement age every day through at least 2030, when almost 73 million individuals, or 20 percent of the U.S. population, will be age 65 or older. At the same time, traditional retirement income sources have diminished, and retirement is becoming more expensive. And the United States is hardly alone; other developed countries are facing the same issues.

Figure 1-1 Retirement Expenses Increasing While Traditional Income Sources Diminish



All of this is creating opportunities for financial services companies and the individuals who sell their products to address the needs of a changing retirement. Insured retirement products help Americans prepare for retirement and offer protection and guaranteed income during retirement.

What Is Insured Retirement?

One enters retirement facing many unknowns: How long will one live? How long will one's spouse live? Will he or she require long-term care? How will changes in equity markets and interest rates affect one's financial well-being?

Americans simply underestimate their life expectancy. The average life expectancy for a U.S. male is 77, and for a U.S. female it is 82 (World Health Organization, 2015), but that is life expectancy from birth. For those who avoid accidents, illnesses, etc. and live to age 65 in good health, a male has a 61 percent chance of living to age 85, a 42 percent chance of making it to age 90, and more than one in five can expect to live to age 95. A female has a 71 percent chance of surviving to age 85, a 53 percent chance of reaching 90 and almost one in three will attain age 95. For a male/female couple age 65, there is an 89 percent chance one will make it to age 85, a 73 percent chance one will reach age 90, and in almost one-half of couples one person will survive to at least age 95. (Source - Society of Actuaries Longevity Illustrator). In most cases the surviving spouse will be female; in fact, after the age of 80 the ratio of widows to widowers will be 5 to 1. The probability that one member of a 65 year-old couple will outlive the other by more than 5 years is 74 percent and by 10 years is 48 percent. The unfortunately reality is that women are especially vulnerable during retirement as they will likely live longer, and may live as widows for years or even decades. Compounding the problem, due to a variety of factors such as lower earned income and time out of the workforce caring for children or other family members, they may also have saved less for retirement.

Almost one-third of working Americans plan to retire at age 68 or older, but over two-thirds of retired Americans fully left the work force prior to age 65 (Gallup, 2016) and 46 percent of Americans retired earlier than they expected (Employee Benefits Research Institute Retirement Confidence Survey, 2016). So Americans should expect, and plan for, their retirement to to be as long as their working years. The reality is that most do not plan for this possibility and do not have a plan which ensures their retirement savings can generate sustainable lifetime income. Americans simply must have a plan that contemplates a longer retirement than they might have envisioned, because the longer a person lives, the more other risks in retirement are magnified, such as unfavorable sequence of returns, above average inflation, health care, and long-term care.

There are a number of products that can provide retirement income. However, most of these products are not insured, leading to the potential of running out of money during one's lifetime. The financial events in 2008 and 2009 and the ongoing low interest rate environment illustrate the perils of relying on non-insured income during retirement.

For example, assume a 65-year-old retired in 2008 with a $1 million nest egg. The retiree was planning to withdraw $50,000 a year (5% of the nest egg) to supplement his or her Social Security and pension plan. However, assume the nest egg dropped in value to $600,000 because of withdrawals and weak equity markets in 2008 and 2009. If the retiree withdrew another $50,000, he or she would now be withdrawing 8.3 percent of the account value, a level that may not be sustainable. The retiree now has two choices: 1) continue to take out $50,000 and face a greater probability of depleting the account value, or 2) scale back the amount of the annual withdrawals (and still face the risk of running out of money during his or her lifetime). True, returns on equities have been robust over the past five years, but did retires who lost a significant portion of their nest eggs during the financial crisis participate in those gains? There is strong evidence to suggest they did not, and that retirement savers don't truly understand diversification: a 2015

Blackrock survey found that 57 percent of respondents believe their portfolios are diversified, despite holding 65 percent of their wealth in cash.

The Outdated "4 Percent" Rule?

Over the years, many have suggested using 4% as the amount that retirees can withdrawal from their assets, annually, with a reasonable expectation that their assets will last for the rest of their life. However, research conducted by Merrill Lynch shows that the 4% rule may not be adequate going forward. Because of increased longevity and interest rates levels, which are still lower than their historic average, many scenarios exist showing a lower rate than 4%. This research reveals changing attitudes toward asset drawdown strategies during retirement. The table shows the initial percentage of assets a client can withdrawal every year and the probability of this strategy lasting a person's lifetime. In general, the younger retiree needs to draw an initial percentage lower than 4% to have a high probability that the assets will last a lifetime. An older retiree can take a higher initial percentage and have the same probability of it lasting a lifetime. For example, a 60–year-old female retiree can only draw 3.2 percent annually to have a 95 percent probability of her assets lasting a lifetime.

Figure 1-2 Initial Percentage of Assets Client Can Withdraw Annually and Probability This Strategy Lasts a Lifetime

Probability: Age	High (95%) Initial %	Moderate (90%) Initial %	Low (80%) Initial %
MALE			
60	3.3%	3.7%	4.3%
65	3.7%	4.2%	4.9%
70	4.2%	4.7%	5.6%
75	4.8%	5.5%	6.5%
FEMALE			
60	3.2%	3.5%	3.7%
65	3.5%	3.9%	4.1%
70	4.0%	4.5%	4.5%
75	4.6%	5.2%	5.2%
JOINT			
60	3.0%	3.4%	3.8%
65	3.4%	3.7%	4.2%
70	3.8%	4.2%	4.8%
75	4.4%	4.9%	5.7%

Note: The information in this table is the maximum initial amount of assets that clients can spend and achieve a 95%, 90%, and 80% probability of not exhausting their assets. Spending is assumed to rise every year based on inflation. The mix of their asset allocation is the optimal mix (as calculated by Merrill Lynch) that minimizes expected lifetime shortfall. Source: Merrill Lynch Wealth Management, IMG Investment Analytics.

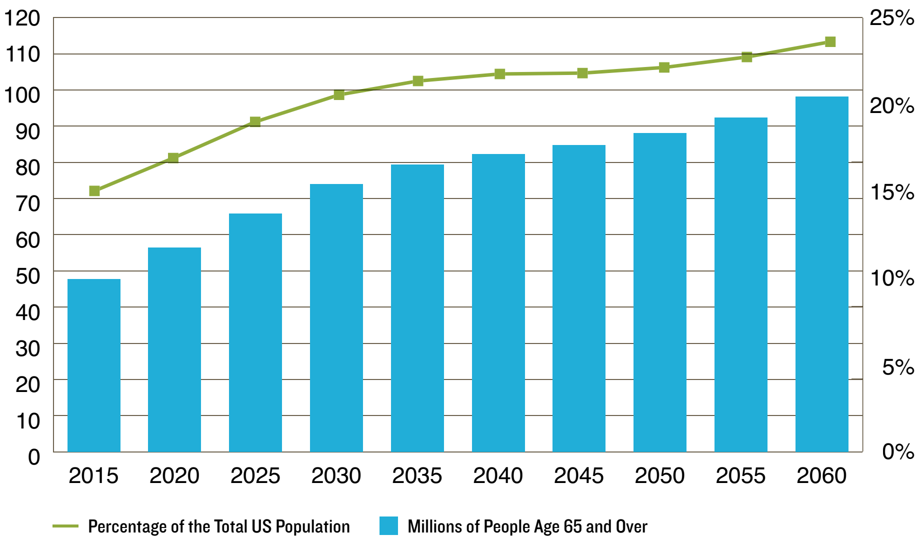
Systematic withdrawal strategies, whether a simple "x%" rule or based on a more sophisticated stochastic analysis of the probability that assets will not be depleted at various withdrawal rates, have two significant drawbacks: first, they are based on historic asset class returns, which are unlikely to repeat in the same sequence in the future, and secondly, they assume that the investor acts rationally, maintaining the asset allocation assumed in the models even during periods of significant negative returns, when in practice many consumers may weight more heavily toward cash and cash equivalents after a period of negative returns, and miss out on subsequent positive returns. ***Insured retirement*** refers to products and solutions that guarantee income and protection during one's retirement, regardless of market conditions. For example, annuities and pension plans guarantee lifetime income, while long-term care insurance provides financial protection against long-term care costs.

An Aging Problem

In 2015 there were 47.8 million individuals age 65 or older in the United States, representing 14.9 percent of the total population (U.S. Census Bureau, Annual Estimates of the Resident Population for Selected Age Groups by Sex for the United States, States, Counties, and Puerto Rico Commonwealth and Municipios: April 1, 2010 to July 1, 2015 – 2015 Population Estimates). These numbers are projected to increase steadily over the coming decades, with over 56 million individuals age 65 or older in 2020, or 17 percent of the population, and over 74 million in 2030, or 21 percent of the population. (U.S. Census Bureau 2014, *Projections of the Population by Sex and Age for the United States: 2015 to 2060*).

The increase in the number of retirees over the coming decades is expected to strain governmental retirement programs such as Social Security and Medicare, as there will be fewer workers supporting more retirees.

Figure 1-3 Number of People Age 65 and Older in the United States



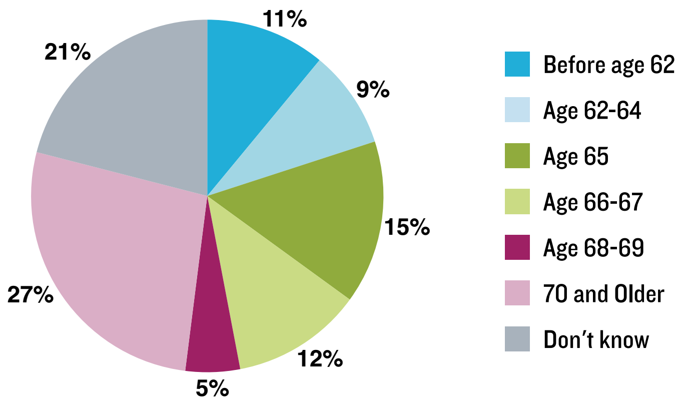
Source: U.S. Bureau of the Census

Two Financial Sides of Retirement

For all age groups, there are two sides to an individual's finances: expenses and income. However, there are significant differences between retirees and non-retirees. One major difference is that it is difficult for many retirees to increase their annual income amount if needed as they may lack adequate savings to do so, or be unable to re-enter the workforce due to their own health issues, or due to the health of a spouse or other family member.

While some people have a retirement date in mind, many Americans, particularly those in the Boomer generation, do not know when they will retire and among those that do many are planning to retire later. An annual series of IRI studies on Baby Boomers shows that in 2011 only 17 percent of Boomers planned to retire at age 70 or older; this has risen to 27 percent in 2017. The 2017 survey showed approximately 43 percent of the Boomer generation planned on retiring after age 65. (*IRI Boomer Expectations for Retirement 2017: Seventh Annual Report on the Retirement Preparedness of the Boomer Generation*).

Figure 1-4 Boomers' Anticipated Age of Retirement



Source: IRI

People retiring today face two core problems: Retirement has become more expensive (for example due to increasing longevity and health care costs), traditional retirement income sources have diminished as the age to receive maximum Social Security benefits has increased, and fewer Americans are covered by traditional pension plans and retiree health insurance.

Is Retirement Getting More Expensive?

Life Expectancy

Life expectancy has increased dramatically over the past century, with a person born in 2014 expected to live to age 79 (76 years for males, 81 years for females), thirty-two years longer than the age 47 life expectancy of a person born in 1900. (CDC/NCHS, National Vital Statistics System, Mortality Data, Key Mortality Statistics).

However, for the purpose of retirement planning, the more relevant statistic is not one's life expectancy at birth, which a century ago was heavily impacted by much higher rates of infant mortality, but one's life expectancy during retirement.

We have seen a significant increase in the life expectancy of a 65-year-old over the past generation. In 1980, the average life expectancy for a 65-year-old male was 79.1 years. By 2012, this number had increased by just under four years, to age 83. (CDC/NCHS)