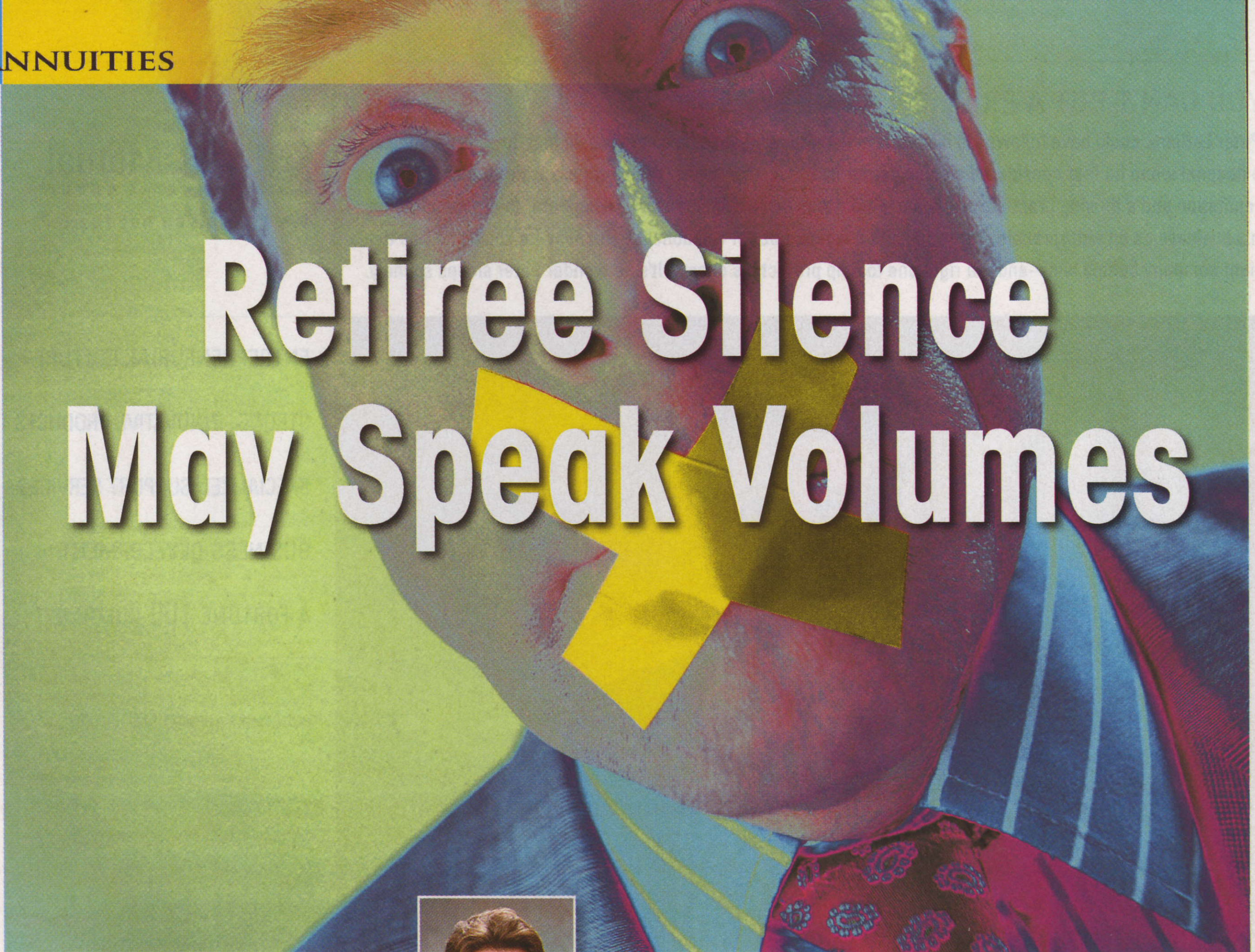
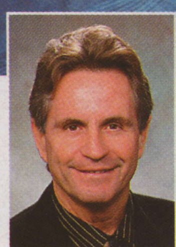


Retiree Silence May Speak Volumes



By Tom Scott, CFP, CFS

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Many of my long-term clients are retirees. I helped them plan for their transition in retirement from earned income to portfolio income. Typically, we used Monte Carlo simulations and historical audits to estimate their retirement needs and odds of success.

Recent events have made me aware of how difficult it is for retirees to grasp the psychological significance of retirement finances.

Perhaps you recall a TV series called *Crossing Over*, starring John Edwards, the psychic who claimed he could communicate with the spirits of audience members' deceased relatives. I don't subscribe to his claims, but it struck me that the term "crossing over" might be applied to the transition retirees experience, going from earned income to portfolio income. Consider what a truly stressful event it is for our clients.

During our working years, we rely on "sweat of the brow" income. Typically, if we suffer financial anxiety during our working years, it's over the possibility of a career setback or losing our job. Although justified, considering the potential disruption a job loss could cause, the reality is that intelligent, skilled professionals usually find replacement employment with little difficulty. The financial disruption is rarely disabling or permanent.

"If you lose your portfolio, it's gone forever. This possibility rarely hits people until they retire or are in the last stages of preparing for retirement."

In making the transition to retirement, job loss anxiety is replaced by an even more stressful apprehension: the loss of one's retirement portfolio and its attendant income. This anxiety is much more rational and serious. Losing one's portfolio income can't be solved by looking in the classified ads or going to an employment agency. If you lose your portfolio, it's gone forever. This possibility rarely hits people until they retire or are in the last stages of preparing for retirement.

I have several clients who, despite being exceptionally well prepared and adequately funded for retirement, hesitate to start taking distributions. Even those with the most optimistic outlooks and financial savvy change demeanor after they

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retire. Despite our retirement analysis, understanding the portfolio demands, and knowing we were well within the envelope of safety, they balked when it came time to actually start spending their retirement money.

Fears Dictate Distributions

Take the case of a married couple who were long-time clients. They had roughly $1.5 million set aside in their retirement portfolio. They wanted the portfolio to generate an additional $40,000 to $50,000 annual income to supplement what they received from the husband's company pension and their Social Security. When they retired last year, I expected them to call and tell me to "turn on the spigot." But they didn't. When I called them a few months later to ask when they wanted me to start sending their money, they said, "Just keep managing it; we'll let you know when we want to start distributions."

My initial thought was that things must be going well for them. I also had some other clients who were not taking their retirement money or were taking only a fraction of their planned distributions. I reasoned that we had done such a good job of planning for retirement, they didn't feel the need to take the additional income.

During this same period, I had some extremely conservative clients who insisted on avoiding equities for their retirement portfolios, fearing stock market losses. I knew they needed inflation protection, however, and that entailed exposure to equities, however limited. But they were adamant, despite my inflationary admonitions.

I was determined to find a way to help these "fixed-income addicts" get better balance into their portfolio allocations without causing them concerns over losses. In my investigations, I came across some new versions of an old product — variable annuities (VAs). In the past, I had always avoided VAs. Like many advisers, I considered them a poor choice for retirement planning. When I was introduced to VAs with the new generation of guaranteed minimum income and withdrawal benefits (GMIBs/GMWBs), however, I realized I was looking at a vastly different product.

I read an article by a Canadian economics professor who had been conducting research on VAs for a decade. Formerly one of the strongest critics of VAs, he now reversed his opinion on VAs as a retirement vehicle, based on the new guaranteed benefit riders. He had become a believer.

I began introducing VAs with guaranteed benefits to my conservative retirees as a way to introduce equities into their retirement portfolios to offset inflationary effects. In fact, not only could they dip their feet into the stock market, they could opt for an asset allocation that offered optimal chances for success since their income stream was now guaranteed for life.

Not only did my fixed-income addicts embrace VAs, they immediately began taking their full distributions. In fact, they were calling after a few months to see if they had locked in higher values so they could take even more! This was a revelation to me. These retirees had no fear of running out of money and so, psychologically, they had no uncertainty about taking their money and spending it.

I concluded that the reason so many of my well-funded retirees hesitated to take distributions from their portfolios was not because they were living so comfortably on their other retirement assets, but because they were afraid that if they took distributions from their retirement portfolio they might run out of money. They hadn't verbalized this, but there was no question in my mind that it was the reason. It was simply fear.

The couple I mentioned previously was living modestly on a combination of pension and Social Security income. I had continued to manage their retirement portfolio, which had now grown to about $2 million; meanwhile, they clipped grocery coupons and fretted over their money not lasting, despite their substantial assets. And this couple was not an isolated case. I know of many people with significant assets who are living an unnecessarily frugal retirement for fear of outliving their money. The psychological impact of being retired, realizing one no longer produces personal income, can be shattering, regardless of how many assets one has amassed for retirement.

In the ensuing months, as I conducted periodic reviews with my other retiree clients — those who were not taking their full distributions — I presented the opportunities available using the VAs with living benefits in situations where they were appropriate.

After the retirees understood what having a guaranteed income for life could mean to them, almost all elected to move their retirement portfolios into a VA wrapper. Overnight, these retirees who had previously hesitated to take distributions began maxing out their withdrawal rates (within the constraints of the guarantees). After they realized they could not outlive their income, no matter how their accounts performed, they said "let me at it." In essence, their retirement accounts have become something tangible in that they now are unafraid to take income. Before the guarantees, the retirement accounts were simply a statement, a balance amount that clients could look at every month, or every day, online.

Obviously, these retirees are more confident about their future. They are using the guaranteed withdrawal benefits to the maximum, and isn't that what a retirement fund is for?

Cautions

Obviously, caveats about VAs still exist. There are complexities, and clients must be aware of the potential pitfalls. For example, VAs can be costly and may not be the best option for every retiree. It's not unusual for VA fees to run a percentage or two higher than typical no-load mutual funds. Over a retirement of 20 or 30 years, the cost difference can be significant.

One way to evaluate whether the cost justifies the price is to compare a retirement portfolio of mutual funds in and out of a VA wrapper. Let's assume that outside the VA, the funds generate a hypothetical annual return of 11%. Over the long haul, the portfolio will experience volatility and likely some losing years. As subaccounts inside a VA with the new benefits, the funds might produce only a 9% or 9.5% average annual return — all things being equal — because of the VA's insurance cost. The retiree, however, receives a guaranteed income stream for life. Whether the benefit overcomes the lower portfolio performance is a consideration advisers must make on a case-by-case basis.

Depending on how various sponsors treat them, excess distributions can defeat the purpose of VAs by eroding the guaranteed income base and subsequently the guaranteed income. Clients could wind up continuing to pay a premium for a guarantee benefit that is no longer in force.

As with other sponsored products, diligence in choosing a carrier is important because guarantees are based on the claims-paying ability of the issuing insurance company. Also, withdrawals before age 59½ may be subject to a 10% IRS penalty, surrender charges may apply, and withdrawals will be taxed at their current ordinary income rate. A long-term focus is vital in any retirement strategy using VAs.

Naysayers

To the critics of VAs who say they are too costly or that advisers only recommend them to earn commissions, I suggest they consider that advisers who sell VAs typically reduce their overall compensation.

For advisers who sell VAs with

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GMIBs or GMWBs and opt for trailing fees versus up-front commissions, as clients withdraw income there is less money under management and so they receive less compensation. Second, assuming equal performance, the cost of the VA's insurance reduces the amount of assets under management. Client retirement assets, whether in mutual funds, subaccounts, or other portfolio strategies, perform the same inside or outside a VA wrapper. The VA insurance reduces adviser compensation because there are fewer assets to manage.

I like to compare the cost of guaranteed income for life with the cost of insuring one's home against fire. The odds of losing one's home to a fire are perhaps one in 10,000, but we rightly advise clients not to take that risk. As advisers, can we then expect clients to accept Monte Carlo simulations that provide a 75% or even 90% chance for success?

If the home burns down, it's a tragedy but a recoverable one. An exhausted retirement portfolio offers no opportunity for recovery.

Future Folly

Today, millions of boomers anticipate a fulfilling retirement, based on uncertain financial assumptions. Some of these people will run out of money before they die. What if that percentage is 70 or 80? Think what the economic effects will be, on both a personal and national basis.

The sanguine attitude of many in the financial services community is cause for concern. In a chilling way, it reminds me of the assurances the people in New Orleans received about the integrity of the levees just before they collapsed. Just as Katrina was a storm that couldn't happen, there are potential financial storms on the horizon that defy imagination.

The world is entering unprecedented economic waters, the result of globalization, emerging technology, medical advancements, and other factors. Inherent in this evolution is an inconceivable spectrum of possibilities, both good and bad. Thriving markets in former third world countries now make a middle class lifestyle possible in places it never was feasible before. But the same dynamic that opens the door to wonderful advances in the human condition also promotes terrorism, genocide, and other horrors on a global scale. A single, random act of terrorism has the potential to paralyze markets across the globe. We can only guess what these simultaneously exciting and fearsome prospects may bring. For advisers, it's no time to rely on antiquated market data or financial projections from the past century or even past decades.

Our uncertain future is likely to be both good and bad at different times. One thing is certain, and that's uncertainty. If there is anything that will roil the markets, it's uncertainty. It's our responsibility as advisers to strive for as much certainty as possible in crafting retirement income projections.

The psychological aspects of this future world are likely to be as important as the actual events that unfold. Some retirees will run out of money in their 80s and 90s. Even if it is only 10% of your retired clients, what will you say to them? What can you say?

The prospect of having just one client face that contingency keeps me awake at night. I've been fortunate that it hasn't happened to any of my clients yet, but it's a haunting possibility.

That's one important reason I think the case is so strong in retirement planning for considering VAs with guaranteed income benefits. They help us provide guaranteed income for life and provide clients with the confidence to spend their retirement funds as they please, without fear of running out of money. Equally important, they allow clients to choose an asset allocation with the peak potential for positive investment results.

Tom Scott, CFP, CFS, is founder and president of Scott Wealth Management. Mr. Scott is a registered principal with and offers securities through Linsco/Private Ledger.

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