WHAT IS IT YOU WANT YOUR PORTFOLIO TO DO?

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INTRODUCTION

USING YOUR SAVINGS IN RETIREMENT

As you move into retirement, you are faced with a lot of decisions. Retirement income planning – making a plan to coordinate these decisions to ensure that you have enough income to pay the bills and prepare for uncertainty – is critically important.

One retirement planning challenge many people have experienced in the last 15 years is volatility. Taking withdrawals from an investment portfolio with volatile returns means that you have to be conservative in how much you take out each year.

In the past, when yields from bonds, dividend-paying stocks and other fixed-income investments such as CDs were higher, you could invest primarily for income and hold onto your principal. With today's low fixed-income returns, however, many of us are forced to invest for total return and must generally spend interest, dividends and gains from assets to meet our retirement income needs.

While your "market" retirement assets might average an 8% return over the course of your retirement, that doesn't mean you can safely withdraw 8% of the value of the portfolio each year and not run out of money. The ups and downs of the market require that withdrawals are conservative to make sure that the account is not depleted in case returns are negative at some point in your retirement.

Traditionally, the safe withdrawal rate was found to be only 4% of the initial retirement portfolio, assuming a 30-year retirement. But other research using today's investment returns has found that even 4% may be too high to be safe.

Reliable and predictable income (a paycheck!) should be your goal when you finally retire. And making sure you understand not only how much you can take from your savings, but also how to do it in a safe, and reliable, and predictable manner is the key to having that paycheck last for as long as you live!

In the poll reported on by AARP, 61% of people aged 44 to 75 said they feared depleting their savings *more* than they feared dying. It's an amazing statistic when you consider that this phenomenon is relatively new; people haven't always been this afraid of living.

So, what changed?

You can probably point to three things that have people unnerved:

1) We're living a lot longer.
2) There are fewer guarantees… and
3) The future just doesn't feel quite as bright.

> Death may be frightening, but to a majority of older Americans, the possibility of outliving their savings is even worse.
>
> *-- Carol Fleck AARP Bulletin July 1, 2010*

If you are in your mid 60's (the age most people look to retire) your average life expectancy is 85 with a good chance that if you are married, one or the other of you will live past age 90. That means your retirement savings may have to last 25 years or more.

And that's at a time when pensions have largely gone away. There just aren't the same kinds of guarantees and safety nets there used to be for people who retire. Even Social Security (one of the few guarantees left for most people) is under constant scrutiny and attack.

The markets and the economy certainly haven't helped either. Long-term problems like the deficit, high gas prices, and skyrocketing healthcare costs tend to weigh down the markets. So, older Americans are right to be concerned about their financial futures.

How do you retire and make your money last given all the obstacles?

WHAT WORKED THEN DOESN'T WORK NOW

It comes down to income; while you were working you had a paycheck. But how do you replace that paycheck in retirement?

One idea from the past was to take income from a bond portfolio. Bonds were generally considered safe as long as you held them to maturity. And they paid a fixed rate of interest that you could use as reliable and predictable income.

Most advisors don't recommend this strategy anymore, and it's easy to see why:

Imagine you needed $40,000 per year to live comfortably and bonds were paying 4%. How much would you have to put in bonds to generate an annual income of $40,000?

That's an easy question for a financial planner. You'd have to put $1,000,000 into that kind of a bond portfolio ($40,000 divided by 4%).

But that's a lot to allocate to bonds (even if you have the money). And more importantly, the income doesn't go up with inflation.

With people living longer and healthcare costs rising exponentially it doesn't take long for inflation to overwhelm the "paycheck" you get from bonds. It's a strategy that doesn't work when people retire early and live a long time.

But it's a strategy that worked when people retired at 65 and only had a life expectancy to age 72. If you were only going to be retired for 6 or 7 years, then you didn't have to worry about inflation.

Relying on bonds for retirement income is an example of something that used to work but doesn't work any longer because the retirement landscape has changed so dramatically in the last few years. People live a lot longer and have to rely a lot more on their personal savings.

Living longer means inflation has become a very real problem; and it's a problem that bonds can't solve.

WHAT WORKS NOW MAY NOT WORK FOR LONG

Growth is the only way to combat inflation, and historically there is no better place to grow your money than in the stock market.

A typical investor's portfolio is stock-heavy to maximize growth (with a few bonds sprinkled in to smooth out any temporary losses). These "balanced" portfolios adjust as the years go by to include more bonds as a person ages. But even after rebalancing, these portfolios continue to hold half or more of their assets in stocks for growth.

The idea is that you can safely withdraw 4% from that kind of portfolio (growing with inflation) in retirement and never run out of money.

That strategy worked through the decade of the 90's and is still used today to draw income in retirement. In theory, you are pulling money from a combination of interest, dividends, and capital gains. And as long as the markets cooperate you'll be fine.

As long as the markets cooperate.

There lies the problem. The markets don't always cooperate. There are years when both stocks and bonds are down…it's something we know to be true from our experience with the markets in the last 10 years.

And if you don't have interest, dividends, or capital gains to pull from…and you still need the "paycheck" …you have to withdraw it from your principal.

And that's when you run the very real risk of running out of money.

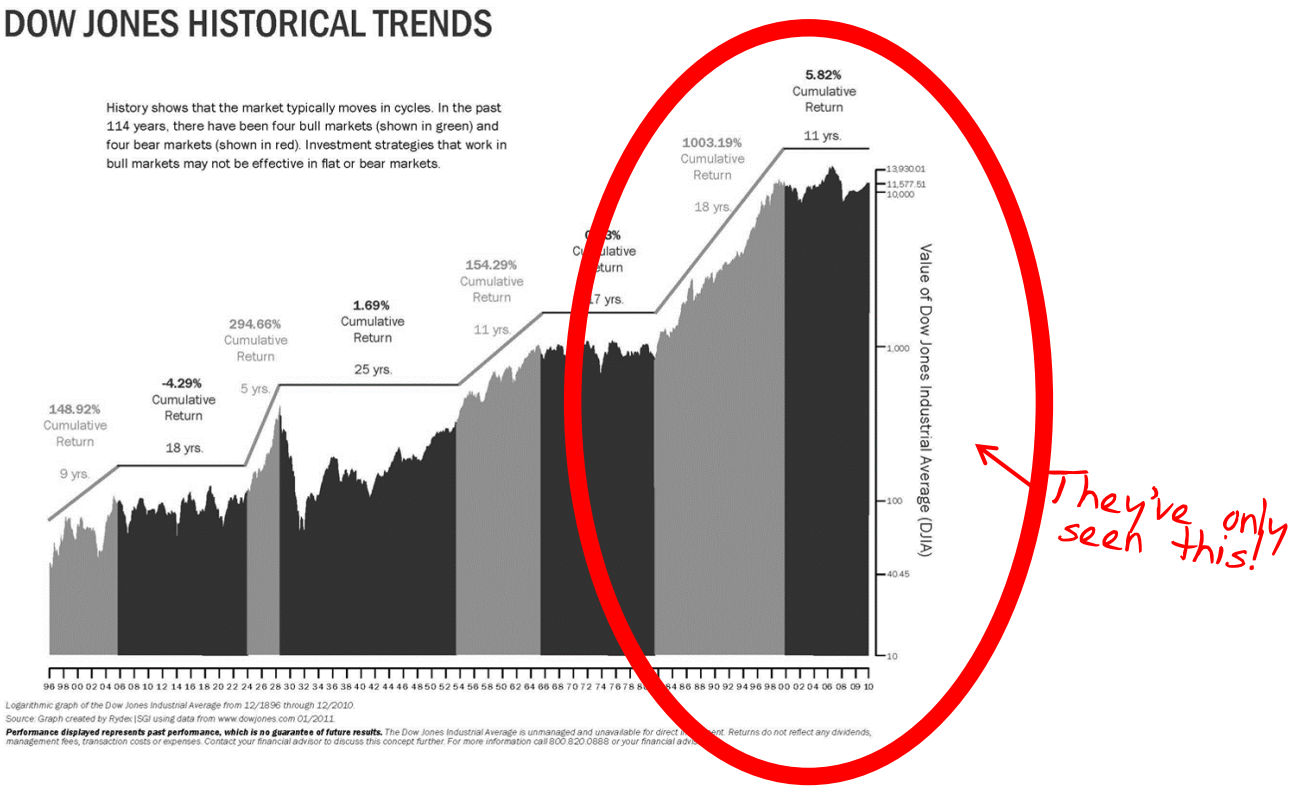
WHAT KIND OF MARKET ARE WE IN?

It's a risk that is a lot more real than most advisors care to admit. Why? <u>They just don't have any experience with today's problems.</u>

Consider this:
Most advisors are in their late 40's or early 50's. If we just take age 50 as a reasonable average, the typical advisor was born around 1966. Assuming they graduated college, they entered the workforce around 1988 (age 22).

What were the markets like for the next 12 years?

Look at the graph:



From 1988 to 2000 the market was straight up…and people were making a lot of money in nearly every stock or mutual fund they invested in. Sure, there were occasional dips in performance, but if you simply sat tight and did nothing you recovered and continued to grow your money.

What was the best financial advice at that time? *Buy stocks and hold them through the downturns; you can't go wrong!*

And for most advisors, that's the bulk of their experience. They still generally stick to that advice.

But look at the market immediately preceding 1982…the 17-year period between 1965 and 1981. The cumulative return during that entire 17-year period was only 0.83 percent!

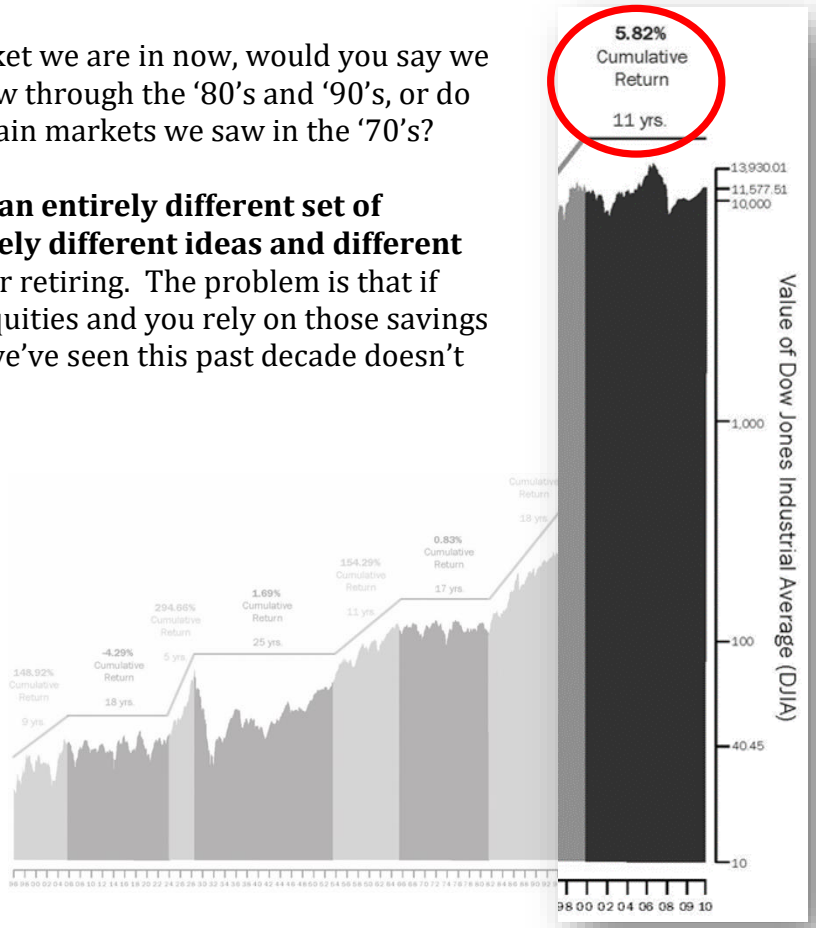
That is TOTAL… Cumulative… NOT Average!

The graph shows that those kinds of markets are not anomalies. They happen, and they last a long time.

If you had to guess what kind of market we are in now, would you say we are in another bull market like we saw through the '80's and '90's, or do you think we are closer to the uncertain markets we saw in the '70's?

It's an entirely different time with an entirely different set of problems. And it requires completely different ideas and different advice, especially if you are retired or retiring. The problem is that if your savings are predominantly in equities and you rely on those savings to draw a "paycheck," a market like we've seen this past decade doesn't allow you to withdraw 4% per year.

Let's say you withdrew 4% a year. From the beginning of 2000 through the end of 2009 that means you withdrew a total of 40%. The inset shows that the cumulative return during that entire decade was only 5.82 percent! The market went up 5.82… you withdrew 40%... you are down 34.18% by 2010. Again, that's cumulative…for the entire decade…not the annual average rate of return.



And while it's been considerably better in the 5 years since 2010, we've still experienced some uncertainty!

It isn't that there aren't any years in which you could withdraw 4%, *it's just that there are too many years where you can't*; you end up drawing from principal instead. And by doing that you absolutely run a risk of running out of money the longer you live.

For many people who retired in the early 2000's, the reality of that happening is beginning to sink in. It's why 61% of them responded that they fear outliving their assets more than they fear dying.

WHAT'S THE SOLUTION?

You could say "Don't take money in down years" … or at least take less. But that's really not an option for the vast majority of people. They need a paycheck to live. And they can't afford to take a 50% pay cut after the market falls… and then wait several years while their accounts recover…or worse, go without income at all for that period of time.

Bonds don't work because inflation eventually overwhelms an income that doesn't grow. And a stock-heavy portfolio sprinkled with a few bonds doesn't work because you need income each and every year…even years when the market is down. So, what can you do?

An idea that emerged from many of the country's leading business schools was a modified form of asset laddering. The idea of asset laddering was something that had been around a long time. Many of us are familiar with (or have at least heard of) laddering CD's or bonds.

I'm not going to go into the ins and outs of laddering, but essentially laddering was an attempt to increase the yields on fixed-rate investments to overcome the obvious inflation problem as people began living longer. Laddering also sought to ease the interest rate sensitivity of bonds by having shorter term bonds in the front part of the ladder. By laddering, people could buy bonds or CD's with longer maturities that paid higher yields while still minimizing the risk of loss due to interest rate sensitivity.

It helped, but it didn't really solve the two biggest problems inherent in bonds:

First, things like health care and food (because of oil prices and transportation costs) tend to rise a lot faster than the government's official inflation rate. So, the higher yields still didn't make a dent in the kind of inflation most retirees experience.

Second, there was still the problem of the amount of money you needed to allocate to bonds to start with. Remember our rather modest income of $40,000? It required us to allocate $1,000,000 to bonds in a 4% interest rate environment (more if interest rates were lower). That's an awful lot to allocate to fixed assets.

THE EVOLUTION OF AN IDEA

But in 1997 a group of graduate students working on their MBA at the University of San Francisco began looking at ways to modify laddering. That research resulted in a lengthy white paper entitled "Asset Dedication".

The concept that emerged was something they called "bridging". It introduced two novel ideas:

1) Add equities into the laddering equation. Before this, it was assumed that equities couldn't be laddered because the returns were uncertain and unreliable; there would be gains, but there would also be losses.

2) Mix of fixed investments (some bonds…some other guaranteed investments) could be laddered and *spent down to zero* as an income "bridge" to the growth and equities side of the portfolio.

Spent down to zero – This means a portion of the assets is set aside to be spent during a five-year period. This allows all the other assets to grow untouched.

It's not my intention to go into the math or academic theory behind the idea of "bond bridging". I only bring it up to make the point that the idea was a real improvement on the laddering concept.

By introducing equities in the ladder and using a mix of fixed investments that included bonds and other guaranteed investments seemed to <u>solve the problem of inflation and volatility</u>.

And spending the fixed portion of the portfolio to zero (not just spending fixed interest) substantially <u>reduced the initial investment</u> someone would have to make in fixed assets to get the income they were looking for.

A Big Plus!

It's too bad the paper came out in the late '90's. The stock market was booming and not many people outside of academia took notice.

BUT COULD IT WORK?

A debate inside the halls of this country's leading business schools broke out over the merits of "bridging". And when the dust settled the consensus was that "bridging" would work, but that it might not be necessary.

Let me explain:

"Bridging" advocates argued that you could withdraw more money as a result of structuring your portfolio this way.

They also argued that the "bond bridge" would provide virtually guaranteed income for the first 5 years of withdrawals which would get someone to the equities side of the portfolio where they could reallocate some of the growth of that money to create another "bridge" of income for the next 5 years.

It's important to note that no one came out and said, "You shouldn't do this." All they said was, "it might not be necessary". Their argument went something like this:

> *It's true that the first 5 years of income would be virtually guaranteed. And that would "bridge" someone to the growth side of the portfolio (which would presumably have grown during those 5 years). Having the equities on the back side of the bridge is a good idea since even if there were down years the account would have time to recover. But, 5 years may not be enough time to recover… most times it will be. But there are scenarios where it won't. People may be lulled into a false sense of security that it will always work when, in actuality, it might only work "most of the time".*

NOTE: The sum of the parts can't be more than the whole. If, for example, you ladder 50% of the assets in the income bridge and ladder the remaining 50% of the assets to growth; the performance of that portfolio will be the same as a conventional 50/50 balanced portfolio. The income you would generate couldn't be more than the income that the 50/50 portfolio could generate. It's ultimately unnecessary to do this.

Remember, this was the late '90's when the stock market was booming, and a lot of financial professionals weren't looking for a solution to a problem that didn't exist. At the time, no one ever imagined there would be a year (much less "years") when you couldn't take 4% from any kind of stock portfolio.

The naysayers were right and they were wrong. I'll explain in a minute, but for now it's only important to note that while no reasons emerged not to do this, it was clear that the idea could be improved.

THE CADILLAC OF RETIREMENT PLANS

Advocates of "bridging" went to work right away to improve it. The result is something I call the Smart Asset Income Ladder…or SAIL for short.

How does it work?

It improves on the improvements that "bridging" made to the laddering concept. It's a ladder that like "bridging:"

- Includes stocks and other growth assets as part of the bridge
- Is structured to spend the income assets to zero as a bridge to the growth assets

But it's improved to:

- Extend the bridge to a 10-year time horizon
- Efficiently leverage the "non-bond" concept original to "bridging" so that it's not even necessary to change any of your investments. *You can simply take what you already have and restructure it in a mathematical ladder.*

Let's look at an example:

Suppose you had a $300,000 portfolio and you needed to supplement your Social Security in retirement. Most advisors would tell you that as long as the markets cooperate you can safely take out $12,000 (4%) each year.

But what if the markets don't cooperate? What if you're caught in a choppy and volatile market?

If you find yourself in that kind of market, there will be years when your advisor will recommend that you take less than $12,000…or even suggest you take no income at all until your accounts recover.

*However, by using the SAIL concept, not only can you safely pull out your needed income…**you can pull out more than $12,000 safely.***

SAIL Plan

Stated Income - 10 year

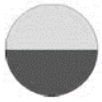
Prepared for Hypothetical

Prepared by Hypothetical

Principal of $300,000

Monthly income of $1,250

With a weighting of



50% Principal Preservation

50% Market Sensitive

Growth Rate:		2.00%	4.00%	6.00%	7.00%	
Age	Year	Asset 1	Asset 2	Asset 3	Asset 4	Account Balance
65	0	$71,315	$55,787	$22,897	$150,000	$300,000
70	5		$67,874	$30,642	$210,383	$308,898
75	10			$41,005	$295,073	$336,078

The projections are hypothetical and do not represent actual trading. The return projections do not reflect the impact that material economic and market factors might have on a portfolio over a period of time. Projections are based on assumptions that are tied to historical performance information which is not necessarily indicative of future results. The performance figures exclude any effects of fees or commissions. The figures assumed that dividends and other income were reinvested. This is to be used for educational purposes only. All investments have some kind of risk. This is an educational tool to help you make informed financial decisions in planning for your retirement. It does not advise or recommend specific investments or investment strategies.

This isn't complicated or costly to do. Remember, one of the improvements of SAIL was that you don't have to change any of your investments; you just have to organize them the way the SAIL calculator suggests.

It's the same $300,000 invested the same way. But notice you are getting $1,250 per month. That's $15,000 per year…a significant improvement over the $12,000 most advisors would recommend.

THAT'S A 25% INCREASE…
WITHOUT CHANGING YOUR INVESTMENTS!

In addition, that $15,000 is guaranteed for 10 years. Regardless of how choppy or volatile the markets get you never have to take a pay cut or go without income.

IS SAIL REALLY NECESSARY?

"Bridging" didn't have any real critics. But, remember, many financial professionals liked to point out that it might not be necessary.

If you don't have to change any of your investments, why can't you take the same $15,000 from the 50/50 portfolio that every other advisor would recommend?

Remember, I noted that the naysayers were right and they were wrong. They were right in the sense that the sum of the parts isn't necessarily more than the whole. In *hindsight,* they *might* have been able to withdraw $15,000 per year from the 50/50 portfolio.

But only in hindsight (in other words, they would never have recommended you start the first couple of years that way), and you still might have had to take a pay cut in a non-SAIL portfolio somewhere along the way. Here's why:

The front part of the SAIL plan guarantees your income for the first 10 years. In this case, you are assured of 10 years of $15,000 per year income…*but only because you are spending the front part of the plan to zero.* You are comfortable doing that because it's a ***bridge*** to the back part of the plan where your assets are growing to replace (and even exceed) your original investment.

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<u>In a conventional 50/50 portfolio you wouldn't be able to withdraw your $15,000 in a year when the market was down.</u>

The reason is that your advisor isn't planning on spending ***any*** assets in the portfolio down to zero. Instead, he's relying on your income coming from the interest and capital gains inside the portfolio.

So, what does he recommend you do in a year where there is a loss or insufficient growth?

He recommends that you take less income or he recommends that you don't take any income until your portfolio recovers; you end up taking a pay cut for a period of time (sometimes years).

Your advisor knows that if you start spending principal to make up the income gap in down years you could end up in a death spiral:

- You lock in losses and reduce your principal
- Which reduces the amount of interest in future years (because of the reduced principal) …
- Making it necessary to dip into principal again the following year…
- Which reduces your principal
- Which reduces the amount of interest in future years…?

You get the point. Advisors counsel their clients not to do that. But they turn a blind-eye when the client (out of necessity) is forced to do it anyway. Advisors know that the effect of these withdrawals in down years will ripple as the client ages until the client realizes too late that they won't have enough money if they live too long. Remember the AARP poll?

THE DANGER OF USING A BALANCED PORTFOLIO

If you retired at the beginning of the year 2000 with $300,000 in retirement savings and withdrew $15,000 from a conventional 50/50 portfolio you would end up with an ending balance of $178,527 at the end of 2009.

At that point you would need to grow that portfolio by 8.4% each and every year just to maintain the $178,000 balance and still pull your $15,000 per year paycheck. Next time you sit down with your advisor, ask him what he thinks would happen if you withdrew 8 ½ percent from your portfolio each and every year. He will tell you that you will probably run out of money.

WHY DOESN'T THAT HAPPEN IN A SAIL PLAN?

Because of the math embedded in the SAIL calculator. The SAIL is essentially an income roadmap that tells you how to organize and systematically liquidate your slowest growing assets in sequence as a bridge to the growth assets.

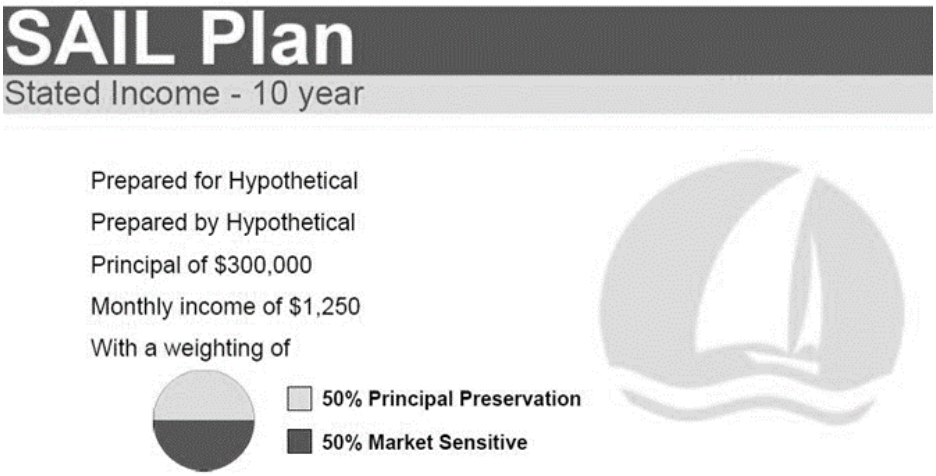
Growth assets will sometimes lose money. But given enough time, they recover and grow…provided they are untouched during the recovery period. The SAIL ensures that you can take your income and still not tap into the growth assets during the recovery period.

In the typical 50/50 portfolio, your advisor can't liquidate any of your assets in down years because he doesn't know when the market will fall, how much it will fall, or how long it will take to recover. And, as we've seen, once you begin to liquidate assets you can't ever go back to just withdrawing interest because of the "death spiral" we looked at.

That's why a $300,000 account fell to $178,527 from 2000 through 2009…even though there were more years that the market did better than 4% than years where it fell short. The best thing to do, then, is to ***plan from the very beginning*** to systematically spend down the income assets ***in case*** there are any down years. That way you are covered no matter what happens. That's what makes the "SAIL" concept so revolutionary.

The naysayers were right; you don't need this kind of plan when things are going great…it doesn't hurt, but it isn't necessary.

But you *do* need this kind of plan if things ever get unpredictable or choppy. The SAIL calculator makes it easy to mathematically construct an income plan that works in any kind of market!



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IS TEN YEARS ENOUGH?

SAIL solves the problems people face when trying to replace their "paycheck" in retirement. And because there are no criticisms of SAIL everyone should at least look into it.

Only one question remains: Is ten years enough? Will a ten-year time-frame be enough for down markets to recover? SAIL assumes that it will, because of downturns we've seen in the past we can't be positive.

Fortunately, the last three years have seen the development of special investments specifically designed to keep pace with inflation and provide a lifetime stream of income. The only catch? You need to be invested 10 years before turning on the income.

These special investments almost seem tailor-made for SAIL plans. If you are at (or approaching) retirement, I encourage you to seek out an advisor familiar with the SAIL

concept and the accompanying “income investments” that have only recently appeared on the scene.

THINK PAYCHECK!

Your retirement income needs to meet your expenses. But it also has to be reliable and predictable...like a paycheck! Contact us if you want to learn more about the SAIL strategy or if you just want ideas of what others are doing to turn their savings into income!