

THINKING ABOUT RETIREMENT

Looking carefully at your priorities—and making the right choices to achieve them—is crucial in laying the groundwork for a successful future.

For many investors, retirement is an exciting opportunity to pursue new challenges and lifelong passions. With the demands of full-time employment becoming a thing of the past, retirees may enjoy an endless array of potential pursuits, whether engaging in volunteer work, starting a new business, or simply reconnecting with family. Some may choose to increase their travel, others to pursue a second degree or become involved in philanthropy.

Regardless of your interests, the transition to retirement is a major undertaking in terms of wealth planning. First, you may be moving from a period of accumulating earnings to one of spending savings—a shift that requires both psychological and practical adjustments. Second, as you look to the future, you must accurately gauge your priorities and the often competing potential uses for your assets. Third, you must effectively translate such considerations into a workable plan of action. Making good choices now will give you a better chance of achieving whatever goals you may have in mind.

Here, you'll find a few ideas to help you and your advisors develop a structure for retirement planning that will serve your needs over time.

CREATING SPENDING TARGETS

Self-assessment can be a hugely difficult task—whether in business or personal interactions—but it can also be important to achieve meaningful success. The same is true as you consider retirement. Practically speaking, you are being asked to think about how you want to live, not just tomorrow, but potentially 30 years from now. Will your needs be simple, or do you want to enjoy the same or a higher level of comfort? Will you want to keep a vacation home? How much traveling do you plan to do?

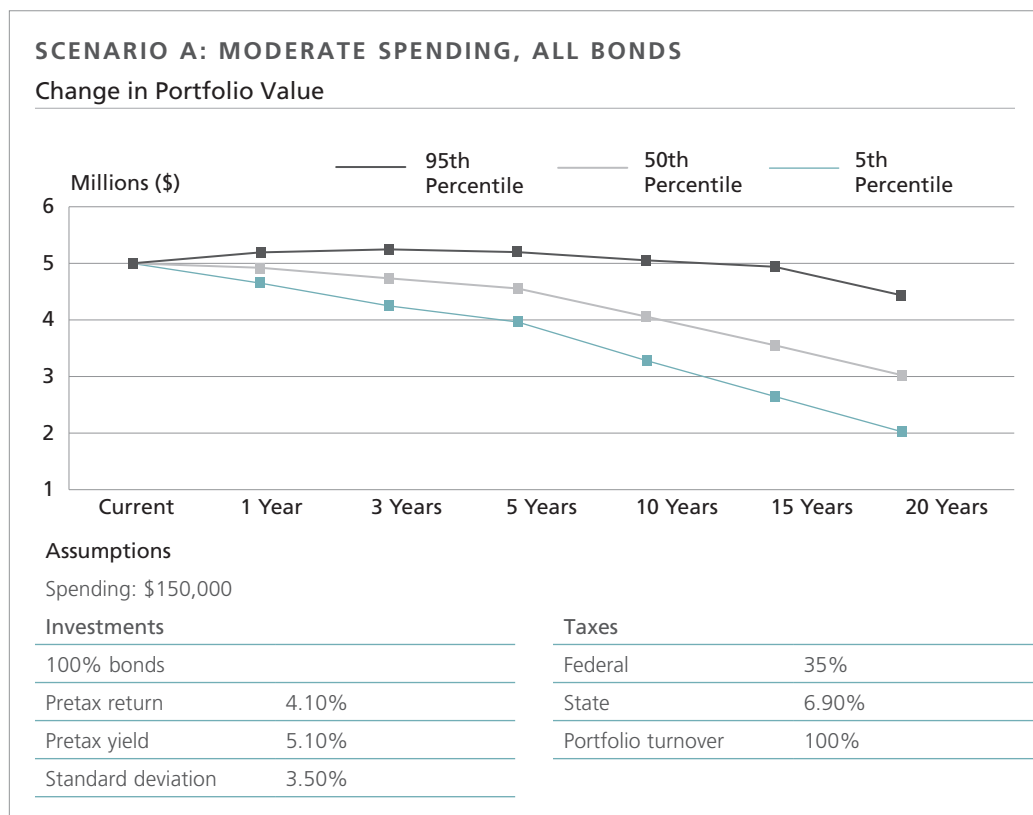
These are not idle questions; indeed, they affect the amount you have to set aside for personal consumption and, if you have additional goals, the amount that may be available for estate planning and gifting programs, as well as charitable donations. With work-related costs behind them, new retirees often underestimate their potential expenses, forgetting that with free time often come new opportunities to spend. As such, it's important not to rush into anything. "Taking a couple years before making decisions about legacy programs may make sense—so that you can experience retirement and assess what you'll need," notes Matthew Rubin, the Director of Investment Strategy at Neuberger Berman.

Getting spending right is very important, because it has a fundamental impact on the success of your retirement. To illustrate, we created hypothetical examples using

a \$5 million portfolio invested over a 20-year period. To make the scenarios more meaningful, we used a modeling tool known as Monte Carlo simulation, which illustrates how the portfolio might perform over time in average, poor and strong market environments.

The Monte Carlo system runs hundreds of scenarios assuming a variety of returns for annual periods and then, extrapolating for each such outcome, a whole range of new returns for subsequent periods. This technique is designed to capture a full range of ups and downs that may occur in an investment portfolio. As a practical matter, it also widens the disparity of potential results over time—just as might happen in real life. (See important disclosures on page 7.)

In Scenario A, we assume that the retiree invests entirely in a portfolio of taxable bonds that provide a median annual return of 4.1%, withdrawing \$150,000 a year—or a modest 3% of the initial value of the portfolio. Note that, in our hypothetical, spending increases along with inflation over time, and that the bonds are actively managed, with a turnover of 100% every year, which triggers a 35% ordinary income tax rate.¹ (The use of municipal bonds would typically provide yields exempt from federal and, in some cases, local taxes, although sales would be subject to capital gains tax, at the 35% rate for short-term gains and, currently, 15% for long-term gains of a year or more.)



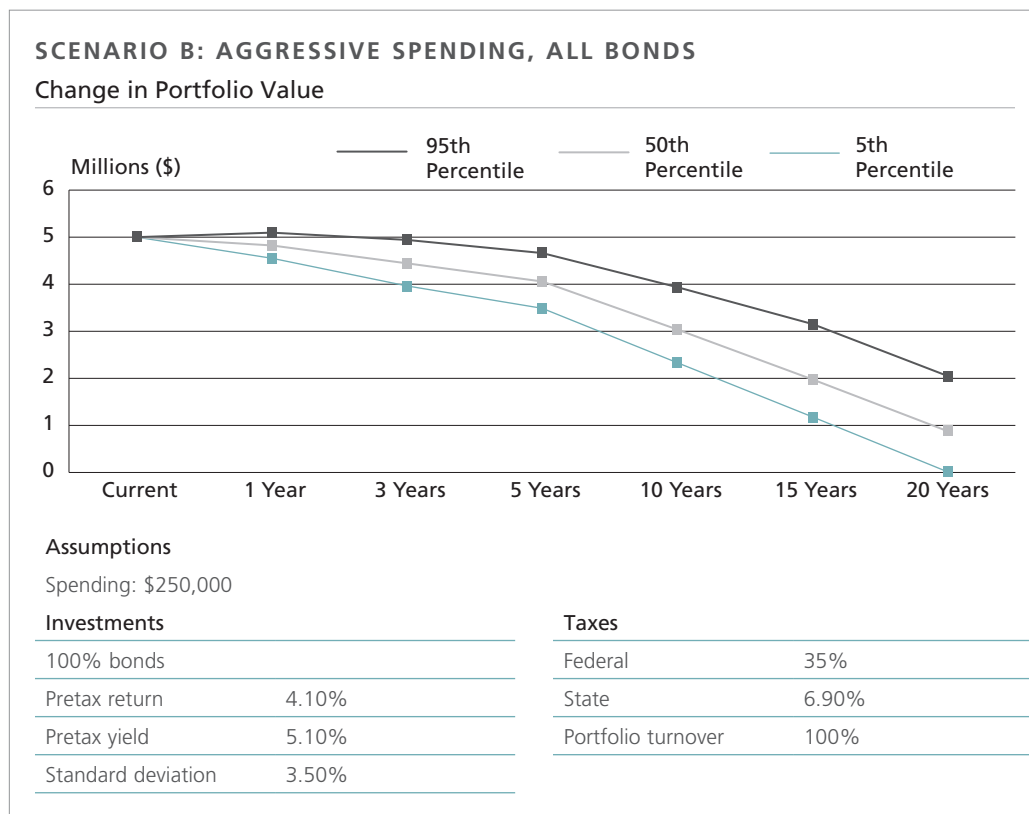
Source: Neuberger Berman.
Future dollars, adjusted for 2.5% inflation. Spending increases annually at same rate. For illustrative purposes only.

What we find is that, despite the regular withdrawals and the toll of inflation, the portfolio holds up reasonably well over time. In especially strong markets (representing the 95th percentile of all outcomes), the portfolio manages to retain the lion’s share

¹ This is to be distinguished from a portfolio of bonds held to maturity, which would not incur any capital gains tax. Also, such a “buy and hold” portfolio would typically generate only one return stream (as opposed to a range of returns) since, except in the event of default, the yield would be preset.

of its value at \$4.4 million on an inflation-adjusted basis. The median return (at the 50th percentile, right in the middle of all outcomes) leaves the investor with a little over \$3 million, while the 95th percentile (or relatively poor) outcome leaves the investor with \$2 million. Keep in mind that the model displays the most likely range of results, but that it is certainly possible that the investor could do better or worse in extreme circumstances.

But what if \$150,000 a year isn't enough for this investor? In Scenario B, we increase the spending level to \$250,000 a year or a 5% initial withdrawal rate. Here, even with the same return scenarios, the asset pool is drained rapidly. Although \$2 million remains in a strong market environment after 20 years, about \$876,000 is left in the median case and a paltry \$13,000 in poor markets. Remember, this is from a starting point of \$5 million.



Source: Neuberger Berman.
Future dollars, adjusted for 2.5% inflation. Spending increases annually at same rate. For illustrative purposes only.

If the investor doesn't have more than a 20-year investment horizon and doesn't mind spending down his assets, this withdrawal rate may not seem so bad—something that relatively elderly retirees could conceivably accept, assuming a somewhat shorter time horizon that might leave more of a cushion in bad markets. However, for someone just starting retirement, the outcome in Scenario B could be potentially disastrous. After all, life expectancy has grown substantially over the years. According to the Society of Actuaries, for example, a 65-year-old male today has a 50% chance of living to age 85 or more and a woman of the same age has a 50% chance of living to age 86 or more—leaving a substantial possibility that the retiree would outlive the assets.² Clearly, withdrawals have to be better calibrated with returns and time horizon to arrive at a more favorable result.

² Source: Society of Actuaries RP-2000 Report.

LOOKING FOR HIGHER RETURNS

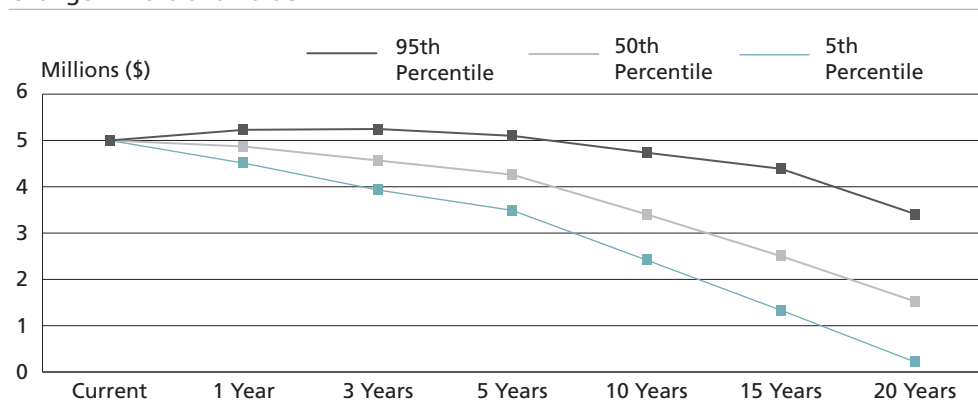
Obviously, one way to avoid the problem in Scenario B is simply to spend less as a proportion of assets. On the other hand, it may be more appropriate to adjust the mix of investments in the portfolio so they offer greater potential returns and thus can better withstand the corrosive impact of spending and inflation.

As retirement approaches, investors often shift more of their assets into income producing assets, whether traditional fixed income securities or income-producing stocks, and away from more aggressive investments. In general, this is a sound practice because of the need to reduce the potential for portfolio losses when an individual relies on investment income and has less time to recover capital. At the same time, it may be constructive to introduce additional risk if it can produce returns that extend the life of the portfolio over the sometimes exceptionally long time horizon posed by retirement.

Scenario C shows the impact of higher—but more volatile—returns on the growth of the portfolio. Instead of investing entirely in fixed income, here the investor adds a relatively modest 30% weighting in equities. The bonds provide a 4.1% hypothetical median return and a 3.5% standard deviation (a common measure of risk) and the stocks carry an 8% hypothetical median return and a 14.5% standard deviation. In contrast to the bonds, only 25% of the stock portfolio is sold each year and incurs a 15% capital gains tax. As in Scenario B, the investor withdraws \$250,000 annually.

SCENARIO C: AGGRESSIVE SPENDING, STOCK/BOND MIX

Change in Portfolio Value



Assumptions

Spending: \$250,000

Investments

	70% Bonds	30% Stocks	Overall Portfolio
Pretax return	4.10%	8%	5.30%
Pretax yield	5.10%	2.10%	4.20%
Standard deviation	3.50%	14.50%	4.60%

Taxes

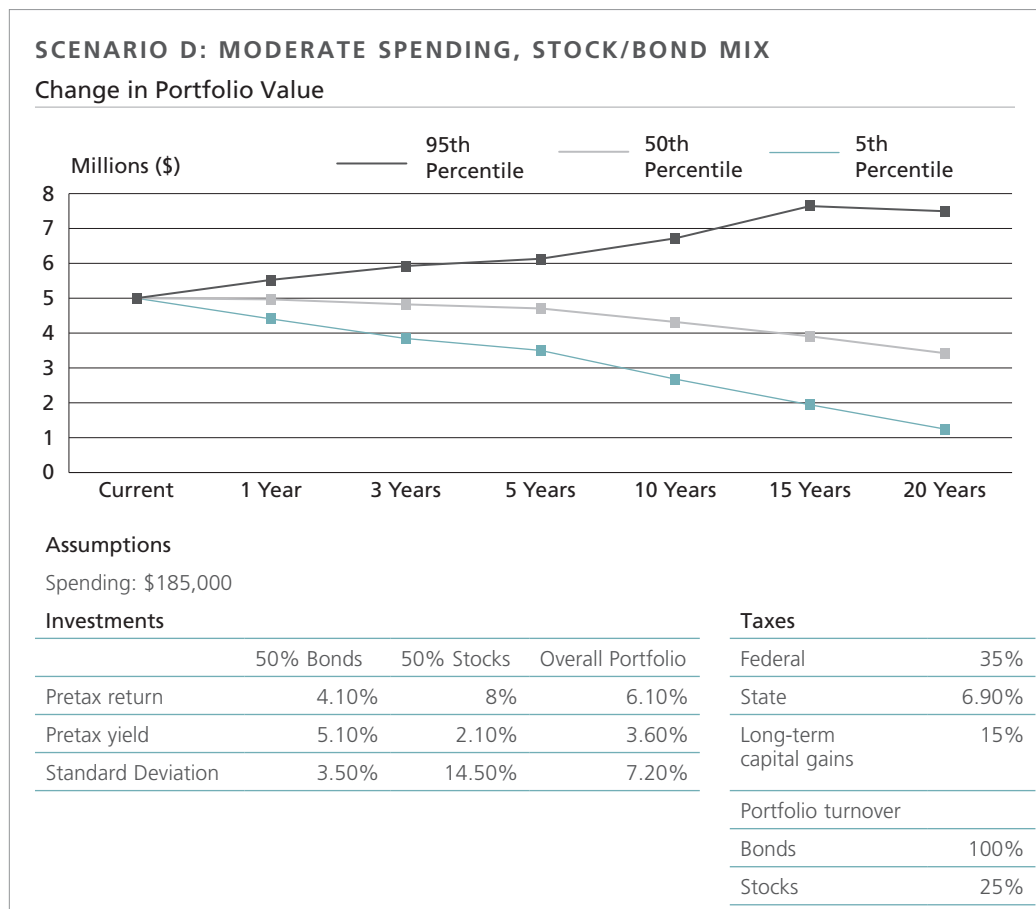
Federal	35%
State	6.90%
Long-term capital gains	15%
Portfolio turnover	
Bonds	100%
Stocks	25%

Source: Neuberger Berman.

Future dollars, adjusted for 2.5% inflation. Spending increases annually at same rate. For illustrative purposes only.

The results in this case are far more successful over the 20-year period. In particularly strong markets, the assets decline but manage to hold much of their value. At the median, the investor winds up with nearly twice the figure generated by the median all-bonds portfolio. As you would expect with relatively volatile assets, the range of potential returns is quite wide, but even at the 5th percentile of returns (worse than 95% of possible outcomes), the portfolio comes out better than in Scenario B.

How does the additional risk/return of Scenario C compare to the limited spending of Scenario A? In this particular case, there's no contest. The investor's decision for frugality trumps the combination of much higher spending and better long-term nominal returns afforded by the increase in stock exposure. However, there are many different combinations between these two choices. For example, a decision to invest 50% in stocks and spend \$185,000 per year (Scenario D) would have provided a substantially higher upside than Scenario A in good markets, growing assets to \$7.5 million over 20 years on an inflation-adjusted basis. In average markets, it would have marginally outperformed with a \$3.4 million outcome, while in poor markets it would have left the investor with a weaker but potentially manageable asset value of \$1.2 million.



Source: Neuberger Berman.

Future dollars, adjusted for 2.5% inflation. Spending increases annually at same rate. For illustrative purposes only.

“There’s always going to be tension between sleeping well and living well,” says Rubin. “The point is to find a suitable compromise that works for you.”

MULTIPLE GOALS, MULTIPLE STRATEGIES

For investors with relatively finite resources, our scenarios serve to point out the tradeoffs they may face in seeking to maintain portfolio value over time. For those with more ample assets and a variety of potential uses for their money, the lesson is also to have sufficient resources allotted to their personal needs before they look to other means to distribute their assets—that way they can avoid the need to get by on less or, alternatively, the temptation to become *too* aggressive with their investment strategies to make up the shortfall.

Once retirees have come to what appears a reasonable allocation for themselves, they can look to those additional goals and allot resources to make them happen. For example, let’s assume that a retiring couple determines that they would like to reserve the bulk of their assets for personal use, but also set aside funds for their children, charitable giving, and a new business venture. For all these elements, there may be distinct investment goals and wealth planning strategies.

- The couple’s plan may require that business-related assets remain in liquid assets, or instruments timed specifically to specific expenditures.
- For the children, the couple may want to establish an annual gifting program, collectively giving up to \$24,000 each year in non-taxable gifts to each recipient—a strategy that requires sufficient liquidity to make such payments.
- The parents may also want to transfer wealth to the next generation through “estate freeze” techniques like a Grantor Retained Annuity Trust (or GRAT). Such a trust provides an income stream to the donors over the life of the trust with any remaining principal going to the beneficiaries at the termination of the trust, free of transfer taxes. To be successful, the trust investments must generate returns that outpace the payments back to the donors and, as such, are typically funded with high volatility/potential return assets like a single stock.
- Finally, the couple may be interested in making deductible gifts to a charity. If available, appreciated stock can be useful for this purpose but should be planned for separately from their other assets. Cash gifts, meanwhile, obviously require liquidity at the appropriate times.

Of course, there are many other estate and charitable strategies that may be considered, but the point is that they all require individual attention while fitting into an overall framework for retirement planning. Be sure to consult your advisors before making any decisions.

TAXES AND OTHER CONSIDERATIONS

Thus far, we have touched on only some of the considerations that go into creating an effective retirement plan. Taxes, as always, are also an important part of the discussion. For example, municipal bonds with tax-free interest payments can help you minimize levies on portfolio income. If you have enough liquidity, the use of low turnover assets, such as buy-and-hold equity strategies or private equity may be appropriate.

Also crucial for many investors is the appropriate use of an IRA or other “qualified” retirement accounts. A tax-deferred IRA, for example, could be a good home for high turnover strategies that would otherwise be subject to high short-term capital gains

taxes; for taxable bonds; or even for stocks with a suitably long timeframe.³ Depending on the circumstances, you may want to limit withdrawals to take advantage of tax-deferred compounding, or use your retirement accounts as a source of income, especially after mandatory withdrawals begin at age 70½.⁴

Beyond these technical considerations, however, you'll want to remain flexible as time goes by. Often, priorities and interests change. You may decide that you miss the excitement of work and look for lucrative consulting assignments. Or you may become increasingly interested in a charity and want to give it more of your time and assets. As retirement progresses, you may realize that some adult children may be more in need of financial assistance than others, and feel the need to add to your legacy allocation. The only sure thing is that your circumstances will evolve, requiring that you periodically work with your financial advisors to review your planning framework, keeping it closely tied to your ongoing needs.

³ A longer investment time horizon could allow the tax-deferred compounding within the account to overcome the disadvantage of paying high income tax rates on withdrawal instead of lower rates associated with qualified corporate dividends and long-term capital gains.

⁴ Keep in mind that, at death, your estate will be liable for estate taxes on the entire value of the retirement accounts as well as ordinary income taxes on any unrealized gains therein. However, the account beneficiaries may be eligible for an offsetting tax deduction on the estate taxes.

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The Monte Carlo simulation engine that generated these examples is provided by Neuberger Berman. The simulation process generates 500 possible returns for each asset class for each time horizon of the simulation. Returns are randomly selected from a lognormal distribution based on asset class inputs. The simulation considers given cash flows and tax rates and generates wealth levels at each given time horizon and probability percentile. Because of the random element of return generation, results may not be exactly equal when rerunning the simulation with the same inputs. Results of the simulation may vary with each use or over time.

This forecasting tool does not attempt to predict future changes in asset class returns, risk levels, interest rate changes or any other variable. The model is sensitive to small changes in inputs which can produce large changes in outputs. All analyzed portfolios are hypothetical as it is not possible to invest directly in market indices. There is no guarantee that future performance results of the Monte Carlo Results or any asset class or any particular security will be comparable to past performance.

The model assumes the investor is well diversified within each asset class and can underestimate actual standard deviation of portfolios that are not well diversified within each asset class. The model assumes that asset class hypothetical return, standard deviation and yield behavior are stable over time. The model assumes that the investor can realistically implement proposed asset class mixes in the real world, it does not account for minimum required investment levels, hedge fund qualification requirements or other restrictions to the investor's universe of investment options. It is assumed that tax rates will be stable over the investment horizon and that withdrawal levels will happen as forecast.

The projections or other information generated by this analysis regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.

A bond's value may fluctuate based on interest rates, market conditions, credit quality and other factors. Income from tax-free municipal bond funds may be subject to state and local taxation and the Alternative Minimum Tax.

Standard deviation is a measure of risk that considers the dispersion of returns. Hypothetical expected standard deviation of the portfolio is determined by the weights of the portfolio mix, the standard deviations of the individual asset classes, and correlations of the assets calculated by historic correlations of the benchmark indices noted.

Portfolio turnover represents the proportion of the portfolio that is assumed to be sold each year for purposes of estimating capital gains tax.

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