

Investnet Retirement Income Series

Part I – Risks in Retirement

This is the first of a series of articles discussing the various aspects of investment planning necessary to serve the needs of investors who are in or near retirement. There are a number of changes necessary in investment thinking that make retirement planning much different than the accumulation strategies much of the investment world is currently comfortable with. This series will cover the different risks factors, investment products, and a way of assembling all of these into an integrated approach.

In this first article, we will take a look at the types of risk that investors face when they retire. The remaining articles will cover the following topics:

Part II – Retirement Products and Strategies Basics

Part III – Retirement Products and Strategies Compared

Part IV – Risk Measures in Retirement

Part V – Optimal Allocations for Retirement

Part VI – Location and Taxes

Retirement Basics

When evaluating decisions in retirement, there are several main risks to take into consideration. They are:

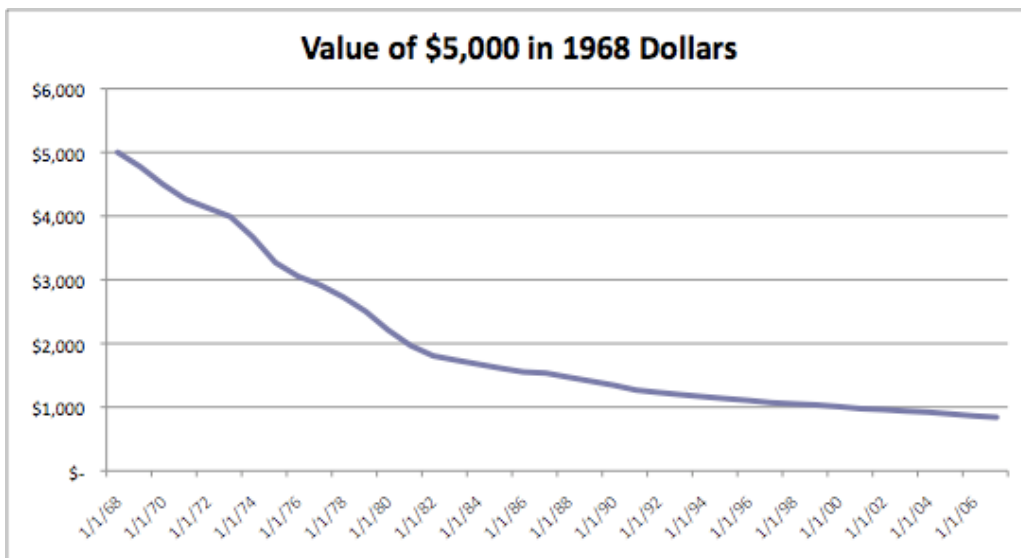
Inflation

A retiree's main goal is to make sure they can generate consistent, real purchasing power each year in retirement. That means it is essential that the level of cash generated by the retiree's portfolio is adjusted up at least every few years for inflation. The chart below shows the purchasing power of \$5,000 each year starting in 1968 after adjusting for inflation. Note that the original \$5,000 in 1968 buys only about \$1,000 worth of 2007 goods and services

So, as you can see, even with relatively low inflation, investment plans that do not correctly account for the erosion of purchasing power due to inflation will prove inadequate for the investor by potentially a very large amount.

Longevity

The median life expectancy for men is 85 years of age and for women is 87 years of age. Oftentimes, this statistic is misunderstood. Too many planning tools and models use this median date as the terminal date in planning for retirement which can cause some serious retirement planning issues.



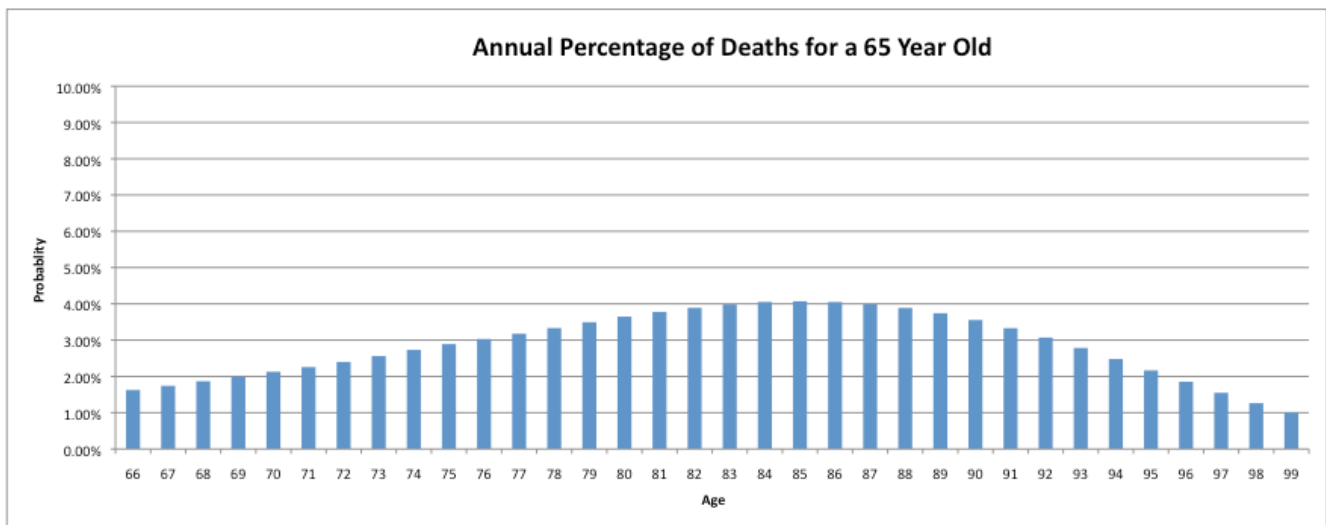
Source: US Consumer Price Index

It should be noted that inflation for the period 1968 to 1988 averaged over 6% per year. While inflation is currently far below the average over that period, even a constant 3% inflation rate reduces the purchasing power of \$5,000 to \$2,768 over the years shown in the graph.

The graph on the following page shows the likelihood of dying at each age given that an investor has reached 65. Notice how flat the distribution is. The most important point to remember about the mortality the investor is that it is a "probability distribution". A median life expectancy of 85 means that half the population dies earlier than this age and half later.

This problem is compounded when the planning is for a couple and the analysis needs to cover the last to die. A couple retiring today at 65 has a 25%

chance that at least one of them is alive past 92. Since few people are willing to live with a risk of running out of money given those odds, the planning horizon that many retiring couples should choose, given they understand these facts, is on the order of 30 plus years.



Source: American Society of Actuaries

Safe Withdrawal Rates

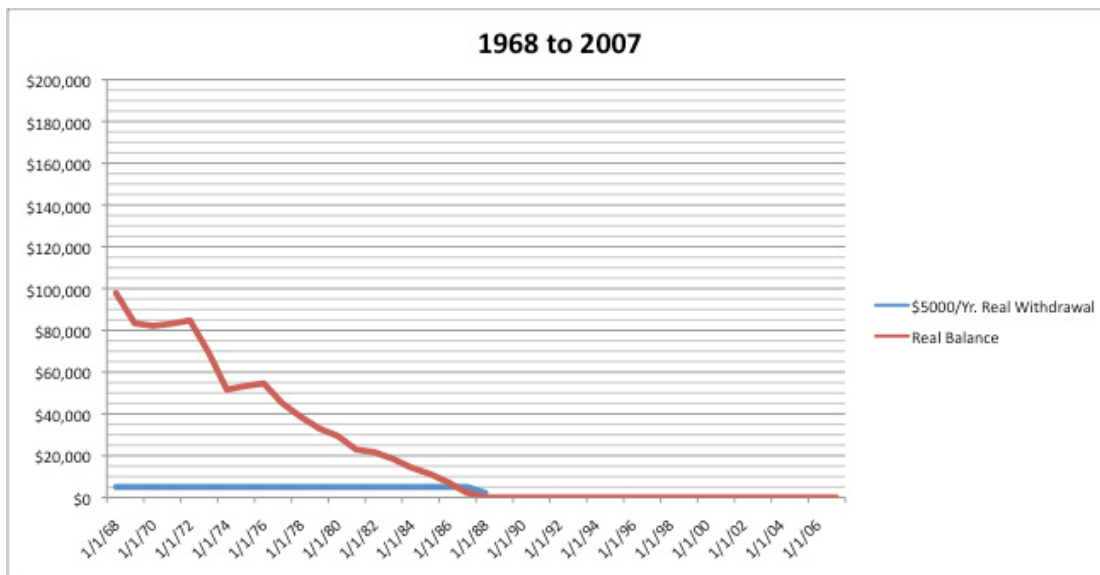
A great deal has been written on what is a safe percentage for a retiree to withdraw each year without running out of money. Much of what has been written is based on an analysis of historical data. The data used for these types of studies is typically from the last 30 years which incorporates a tremendous bull market in both equities and bonds. The average return on stocks as measured by the S&P 500 from 1980 to 2008 is 11% and the return for the US Government Bonds over the same period is 8.63%.

The most important factor in deciding a safe withdrawal rate is what will happen to returns in the future. Most expectations for capital market performance in the future are far more pessimistic than the average historical returns. Investnet's long-term capital market forecasts for a 15 year horizon call for an expected average stock return of 8.7% per year, a bond return of 6.0% per year and an inflation rate expectation of roughly 3.0%. After factoring in investment management fees, most investors should be expecting safe withdrawal rates much lower than indicated by most studies using historical data.

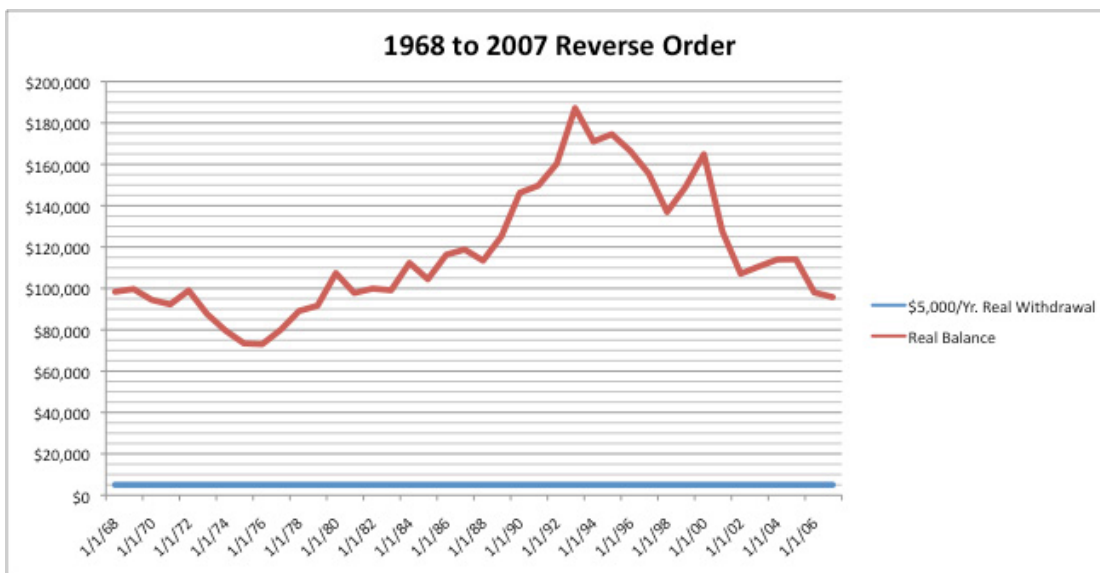
Volatility/Order of Withdrawal

Volatility of returns causes problems for anyone trying to create income in retirement. The worst case is when a string of bad years occurs early in retirement. Even if the markets generate average returns for the remainder of the horizon, these early period losses deplete the portfolio's ability to generate sufficiently for the remainder of the retirement horizon.

The easiest way to show this is by an example. The following two graphs show what happens when \$5,000 per year in income adjusted each year for inflation is taken from a \$100,000 initial portfolio invested in a mix of 50% stocks represented by the S&P 500 index and 50% bonds represented by the Ibbotson Associates intermediate government bond index. The first graph shows what happened using the actual returns from 1968 to 2007. The second graph uses the exact same returns but reverses the order so withdrawals start in 2007 and work backwards to 1968. The blue line represents the \$5,000 in real terms deducted from the portfolio's balance, which is shown by the red line, until the end of the illustration or the wealth is exhausted.



Source: S&P 500 and Ibbotson Associates Intermediate Term Bond Index



Source: S&P 500 and Ibbotson Associates Intermediate Term Bond Index

If an investor started their withdrawals in 1968 he would have run out of wealth by 1988. However, if the capital market returns were reversed and the withdrawals started in 2007 and worked backwards to 1968, the investor would have been able to pull his \$5,000 out each year adjusted for inflation and go for 30 years with essentially the same real wealth level he started.

Both return series obviously have the same mean and standard deviation. The only difference is that if you started in 1968 you suffered through some very poor returns early in retirement. In the reverse scenario that is not the case.

The lesson from this simple example is that protecting portfolio values early in retirement is important to making wealth last a lifetime.

Conclusion

Investment planning for retirement has a number of risks that must be addressed that are different than the risks present when planning for accumulation. As we have discussed above, inflation poses a much greater risk for the retiree than the saver. It is equally critical that retirement plans include a long enough investment horizon to correctly account for the life span of investors. Current capital market conditions call into question just what level of withdrawal rate is now considered safe. Finally, any investment decisions for retirees should ideally incorporate some type of protection of principal in the early years of retirement to avoid large losses.



Client Services: 888-612-9300 clientservices@investnet.com

All investments carry a certain risk and there is no assurance that an investment will provide positive performance over any period of time. The value of an investment and the return on invested capital will fluctuate over time and, when sold or redeemed, may be worth less than its original cost. This article is provided for informational purposes only and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should always be made based on the investor's specific financial needs and objectives, goals, time horizon, and risk tolerance. The statements contained herein are based upon the opinions of Envestnet and third party sources. Information obtained from third party sources are believed to be reliable but not guaranteed. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice. Neither Envestnet nor its representatives render tax, accounting or legal advice. Past performance is not a guarantee of future results.