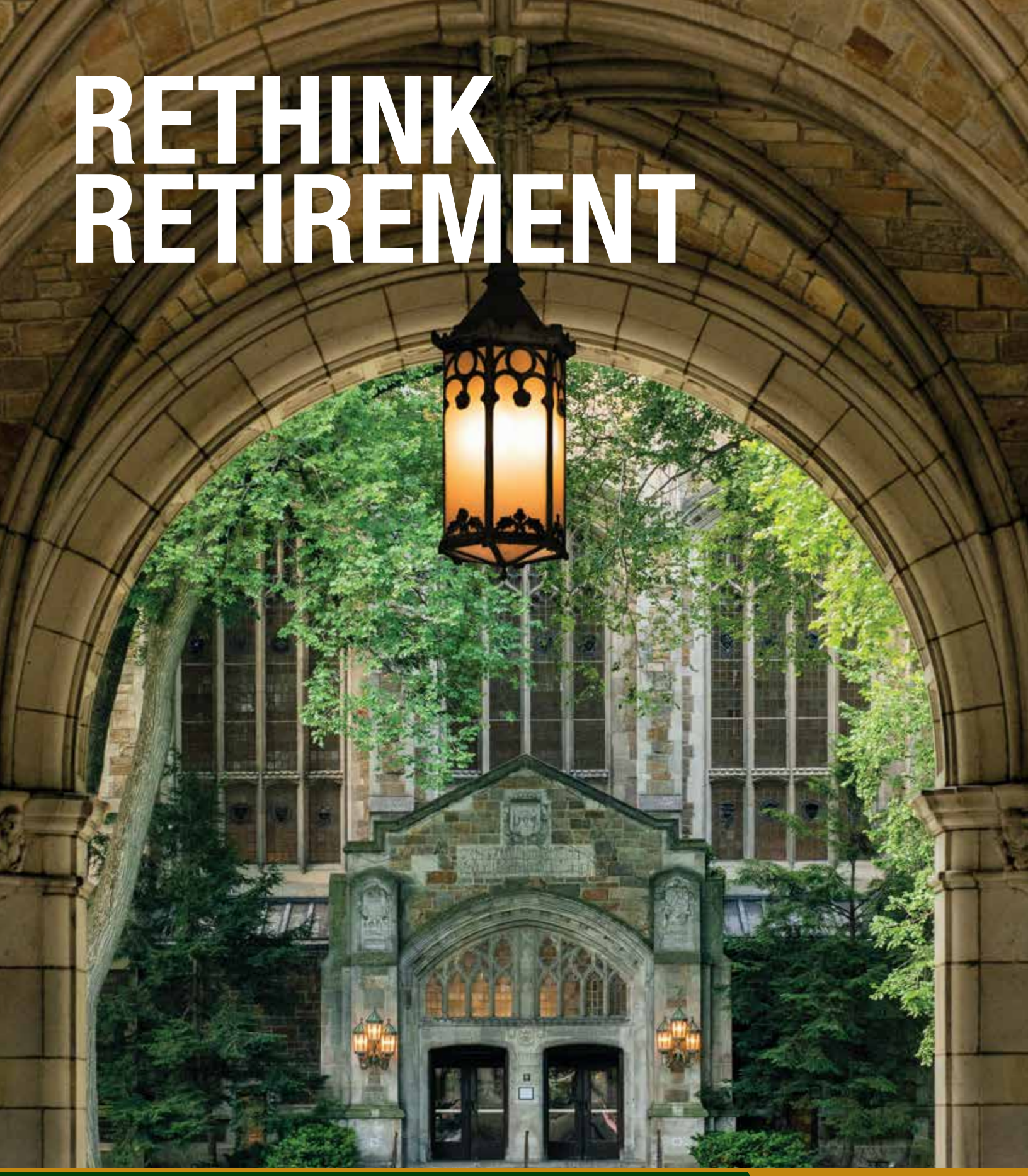
RETHINK RETIREMENT



VOLUME 1

FINANCIAL INSIGHTS FOR TODAY'S RETIREE

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RETHINK RETIREMENT

VOLUME 1

FINANCIAL
INSIGHTS
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VOLUME 1
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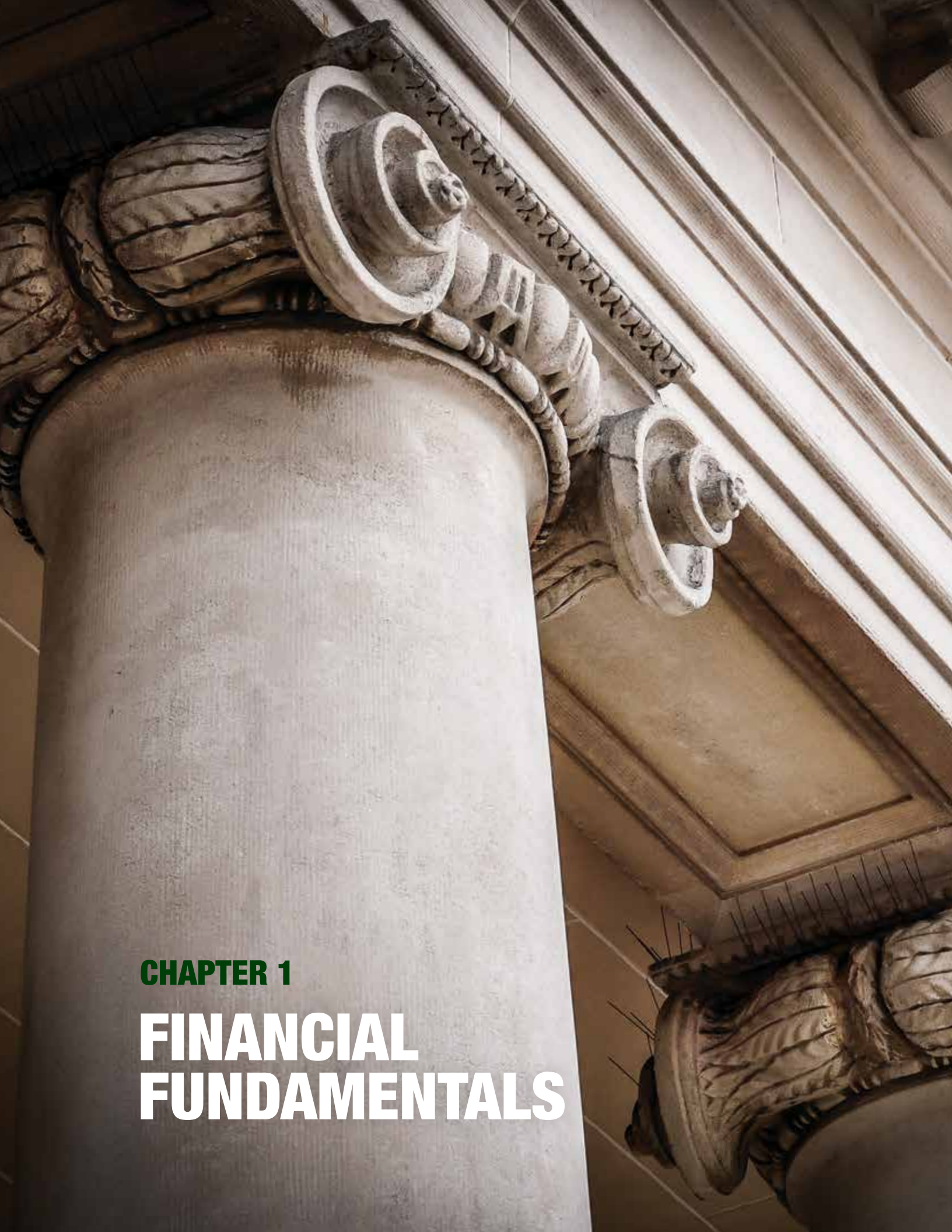


CHAPTER 1

FINANCIAL FUNDAMENTALS

THE NEW FACTS OF LIFE AFTER WORKING

For many retirees, living well after the paychecks stop can be more difficult than it used to be. Why is this the case? Let's look at some key reasons:

THE SHAKY STOOL

Consider a hypothetical Art Baker, born in the 1950s. Art's Dad Carl was born in the 1920s.

HOW THINGS USED TO BE

Carl's career spanned the 1940s to the 1980s. When he retired, Carl had a Social Security check and decades of personal savings to tap.

In addition, Carl had worked mainly for one corporation. When he retired, Carl received a pension.

Technically, Carl's employer offered a defined benefit (DB) plan. That is, the company promised a certain benefit to Carl and to his wife Diane, Art's Mom. They'd get a reliable payout each month, as long as either one lived.

This arrangement became known as the three-legged stool: Social Security, savings, pension. It was a solid base for a long and comfortable retirement.

HOW THINGS ARE NOW

When Art retired recently, something was missing. Art had little in the way of personal savings. Why was that?

Because Art had worked for several companies during his career. And most of Art's saving had been done through 401(k) plans at those employers. So Art's savings were tied up in 401(k)s and—after rollovers—IRAs.

As opposed to traditional pensions, 401(k)s and similar plans are defined contribution (DC) plans. Certain amounts can go into the plan. But the outcome is not guaranteed.

Art's 401(k)s may provide a satisfying retirement lifestyle—or, they may not. That will depend on how much Art has contributed including any company match, how well he selected plan investments, and how the financial markets have performed.

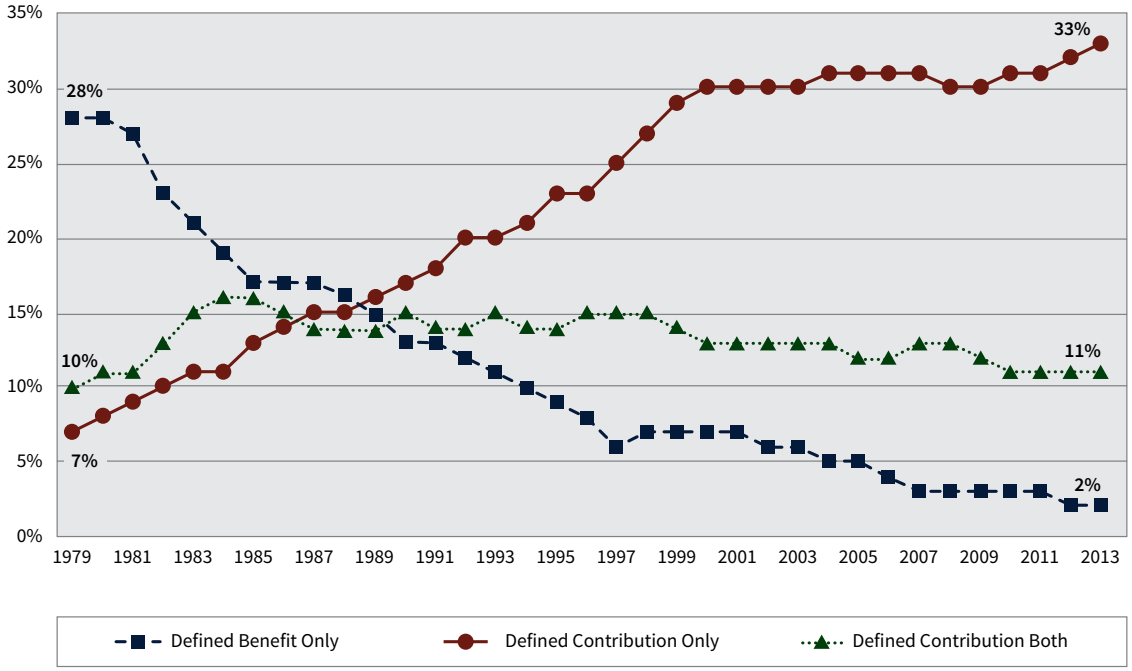
THE DB-TO-DC SHIFT COMPROMISES A LEG OF THE STOOL

Even in a best-case scenario, though, Art's retirement stool will have two strong legs, instead of three. Most private sector employers no longer provide retired employees with traditional lifelong pensions.

The Employee Benefit Research Institute has reported that 28% of all private-sector wage and salary employees participated in a defined benefit plan in 1979, while 7% were in a defined contribution plan. By 2013, 44% of such workers were in a DC plan and only 13% participated in a DB plan.

PRIVATE-SECTOR WORKERS PARTICIPATING IN EMPLOYMENT-BASED RETIREMENT PLANS, BY PLAN TYPE, 1979-2013[1]

(Among all workers)



Source: U.S. Department of Labor Form 5500 Summaries 1979 - 1998, Pension Benefit Guaranty Corporation.

Without lifetime pensions, seniors may run short of income over a long retirement.

LONGER LIVES, HIGHER COSTS

The shift from traditional pensions to 401(k)s is not the only change facing new retirees such as Art. People of Art's generation often live for many years with no earned income, after the paychecks stop.

According to the 2012 IAM Basic Mortality Table, one out of four 65-year-old men of average health will live to age 94, while one out of four 65-year-old women will live to age 96. For married couples, there is almost an even chance that one of them will live to celebrate a 94th birthday, a one in four chance that one or both will reach age 98, and a 5% chance that one will celebrate his or her 103rd birthday.[2]

The reality is retirees today have a realistic probability to living to at least, and possibly beyond, the average life expectancy. And with people living longer, the chances of outliving your financial resources increase.

EXPECT LESS FROM MEDICARE AND SOCIAL SECURITY

But living longer doesn't always mean living better. As people age, they face higher costs for health care and long-term (custodial) care. Such costs aren't fully covered by Medicare. In fact, Medicare's current fiscal crisis may lead to less coverage and more payouts by patients. *(Social Security's financial trouble is another story, and another cause for concern by current and future recipients.)*

THREE FOR THE MONEY

Those trends—moving from the traditional DB plans to DC plans along with the potential of longer lives after retirement, higher health care bills, and less government ability to provide support—are contributing to continued concerns. People who want to enjoy an extended retirement will need to plan for it.

One approach is to mentally divide an adult's life into three stages: An accumulation phase, a preservation phase, and a phase where preservation meets distribution. Here's how a retiree might view those basic life stages:

	ACCUMULATION	PRESERVATION	PRESERVATION AND DISTRIBUTION
	Working Years	*Nearing Retirement*	*Retirement*
OBJECTIVES	Accumulate enough to retire	Reduce portfolio risk, still accumulating	Reduce portfolio risk, still accumulate, begin taking income
TIME HORIZON	Known, based on certain assumptions	5-10 years before retirement, first 5-10 years after retirement	Unknown, until death

DETERMINING INCOME NEEDS

As the above table indicates, retirees probably will begin taking income from their savings accounts and their retirement assets once the paychecks stop. The question, though, is how much to take.

Take too much, and risk running short of money in the future; take too little, and risk forgoing an enjoyable retirement now.

To find the right amount of cash flow to draw down, a key step is to create a budget for a retirement lifestyle. A precise budget can indicate the amount needed.

A retiree can develop a budget by examining recent spending trends. Go over bank and credit card spending for the last 12 months, to eliminate seasonal variations. For a realistic retirement budget, ignore expenses that were work-related, as there might not be a need for business suits and commuting costs. Also ignore non-recurring outlays, such as major home additions that are not likely to be repeated.

A retirement budget will assume that every day is a Saturday or a Sunday, as there won't be a workweek to alternate with the weekend. Will that mean more days at the mall? Or more time at home, eating home cooking, instead of hanging out with colleagues from work?

After doing the research and crunching the numbers, a retirement budget could list needs and wants. *"Needs,"* for this purpose, include the products and services a retiree truly must have in order to maintain a familiar lifestyle. Without enough income to cover needs, a retiree might have to make a drastic change, such as move to a less expensive place. *"Wants"* go beyond needs to outlays for things a retiree would enjoy doing or having. When wants are covered, a fulfilling retirement is more likely.

HYPOTHETICAL EXAMPLE. Bob and Carol Graham go through their records and discover they would require $65,000 a year in retirement, to cover their anticipated needs. They calculate that $80,000 a year would enable them to meet their wants, and enjoy the retirement they desire.

In this example, an extra $15,000 a year—$1,250 a month—might make the difference between just getting by and living well, in retirement.

Once needs and wants are determined, the next step is to see how much income will be coming in, before tapping savings and investments. Possible sources include:

- ☐ **Social Security.** Retired workers and their spouses can start receiving retirement benefits at age 62. Those who have not yet started can estimate their Social Security retirement benefits online at www.ssa.gov/retire/estimator.html
- ☐ **Employment.** Especially in the early years after leaving a full-time job, part-time employment can help with the transition to full retirement. Working not only can provide extra cash flow, it can be good for a retiree's mental and physical health.
- ☐ **Pensions.** Public sector workers, including those who served in the military, are likely to receive a pension after decades of employment. Pensions are not common in the private sector, but some companies still provide lifelong payouts to retirees with many years at the firm.
- ☐ **Other Sources.** Retirees who own investment property might expect to receive monthly rents from tenants. Other possible sources of retirement cash flow include farm income, trust funds, royalties, payouts from lottery winnings or awards for damages, and drawing down home equity to name a few.

RETIREMENT EXPENSES WORKSHEET

EXPENSE CATEGORY	MONTHLY AMOUNT
Housing	
Mortgage	$
Property Taxes	$
Homeowners Insurance	$
Rent	$
Utilities	$
Maintenance/HOA Fees	$
Food	
Groceries	$
Dining Out	$
Transportation	
Vehicle Payment	$
Vehicle Maintenance	$
Fuel	$
Auto Insurance	$
Public Transportation	$
Health Care	
Medical Services	$
Medications And Supplies	$
Health Insurance	$
Personal Insurance	
Life Insurance	$
Long-Term Care Insurance	$
Other Insurance	$
Personal Care	
Clothing	$
Products And Services	$
Miscellaneous	
Entertainment	$
Travel/Vacation	$
Hobbies	$
Gifts	$
Charitable Contributions	$
Other	$
TOTAL MONTHLY EXPENSES	$

FILLING THE RETIREMENT CASH FLOW GAP

Beyond those and other sources of income, many retirees will make up an anticipated cash flow shortfall by drawing down their savings and investment assets: bank accounts, IRAs, brokerage accounts, mutual funds, and so on. Deciding how much to take from those assets can be a challenge.

HYPOTHETICAL EXAMPLE. As mentioned, Bob and Carol Graham would like to have $80,000 of annual income in retirement. Suppose the Grahams expect to receive $40,000 a year from their investment assets. The remaining $40,000 per year will have to come from the money they've saved. Assume that the Grahams have $1 million in savings and investment accounts. ***With these factors, Bob and Carol would seem to be ideal candidates to implement the "4% Rule"***

According to the financial professionals and academic researchers who support the so-called 4% Rule, retirees will be safe with a 4% first-year withdrawal rate. That is, they can plan to withdraw 4% of their portfolio in Year One of retirement. Subsequently, retirees can increase their withdrawal each year to keep pace with inflation. In this scenario, the traditional "4% Rule" indicates the odds are favorable that the portfolio will last through a 30-year retirement, if this schedule is followed.

In our example, Bob and Carol have $1 million of assets to tap. If they withdraw 4% in Year One, that would be $40,000: exactly enough to bring their total retirement income to $80,000, which they desire.

4% Rule: Retirees should plan to withdraw 4% of their portfolio in Year One of retirement.

How did this 4% initial withdrawal rate enter the mainstream? Principally, from a study of historic investment returns.

Researchers ran various simulations, assuming future returns will have patterns similar to what transpired in the past. They also assumed different allocations to stocks and bonds, within investors' portfolios. Then, they plugged in different withdrawal rates. A first-year withdrawal of, say, 6% or 7% ($60,000 or $70,000 from a $1 million portfolio), followed by increased withdrawals to match inflation, had a high probability of depleting the portfolio in a relatively short time. Dropping the initial withdrawal rate to 5% somewhat increased portfolio longevity. At a 4% initial withdrawal rate, the chance of a portfolio lasting for 30 years seems to be encouraging. However, that's a probability, not a guarantee.

Keep in mind that retirees can trim portfolio withdrawals if they reach, say, age 85 with a portfolio that's too small for comfort.

Few individuals or couples will accumulate exactly $1 million, retire at that point, withdraw $40,000 that year, and then withdraw, say, $40, 800 in Year Two if inflation is 2% then. Even if it's more a guideline than a recipe, the 4% Rule has positive features. For instance, the 4% Rule provides a reasonable idea of how much to save for a comfortable retirement. With $1 million of savings and investments, withdrawing $40,000 a year might be practical. Someone who wants to withdraw, say $80,000 a year should think in terms of accumulating $2 million.

KEY POINT. To have a desirable retirement, seniors will need a large retirement fund. More savings will make it more likely they'll be able to travel, play golf, dine at restaurants, treat the grandchildren, and so on after retiring. ***Also, understanding the 4% Rule may lead to a suitable asset allocation.***

Typically, the success of the 4% Rule depends on a retiree keeping 40% or 50% of an investment portfolio invested in stocks. Simulations with bond-heavy portfolios show rapid depletion, at virtually any withdrawal rate. ***Bond yields are so low now, and there is so little chance for appreciation, that retirees may need to hold a large allocation to stocks and similar assets, which might deliver higher returns than bonds, long-term.*** All that said, the 4% Rule is not really a rule. It's more of a benchmark, to use as a starting point for individualized plans.

HYPOTHETICAL EXAMPLE. Amy Morgan intends to work full-time until age 70 and expects some earned income even later in life. Amy has a debt-free second home that she probably won't use much after age 80, as well as a debt-free primary residence that she'll sell before moving into a smaller place. Considering that Amy may be retired for relatively few years, with future sources of cash from selling real estate, a 5% initial withdrawal from her portfolio might work. That's not true for everyone, however.

HYPOTHETICAL EXAMPLE. Gary Young wants to retire at age 60 and never work again. Almost all of Gary's money is in a tax-deferred traditional IRA and a traditional 401(k), so every withdrawal will be fully taxed as earned income in Gary's situation. With the prospect of taxable withdrawals for many years after retirement, he might be better served by a 4% drawdown strategy, or even one that's close to 3%. Other factors may come into play, when developing a plan for tapping a portfolio in retirement. These factors could include health, marital status, intentions to leave money to heirs, and favored pastimes. Starting with the 4% Rule is fine, but an experienced financial advisor may be able to fine-tune a withdrawal strategy and recommend an appropriate percentage play for a particular situation.

WINNING THE NUMBERS GAME

As mentioned, some research has indicated that 4% can be a "safe" withdrawal rate, for retirees tapping their investment portfolio. Computer simulations, based on historic results, indicate that an initial 4% withdrawal, followed by annual cost-of-living adjustments, provides a 90% probability that a portfolio will last 30-40 years in retirement.

Academic research is fine, but real life is something else.

A stock market crash early in retirement can deplete a portfolio in withdrawal mode. That's true even for those following the 4% Rule. ***Therefore, retirees may want to take an even safer belt-and-suspenders approach to retirement cash flow.***

The 4% Rule sounds good, and many advisors recommend it (or some variation) to their clients. However, articles such as, *"The 4 Percent Rule is Not Safe in a Low-Yield World,"* by researchers from Texas Tech University, the American College, and Morningstar Investment Management have raised doubts about this strategy. This article concludes that today's low-yield environment *"causes the projected failure rate for retirement account withdrawals to jump to 57%."* That is, low bond yields can decrease a portfolio's growth and lead to faster depletion. Instead of a 4% initial withdrawal, the *"safe"* initial withdrawal rate might be 3% or less.

Just as low bond yields can imperil a retirement based on the 4% Rule, the same can be said for stock market volatility. If there is a steep downturn in the early years of a retirement, the chances of running out of money increase dramatically.

An article titled, *"Say Goodbye To The 4% Rule,"* published in the Wall Street Journal, made this point by saying that *"the 4% rule has been thrown into doubt, thanks to an unexpected hazard: the risk of a prolonged market rout the first two, or even three years of your retirement."* In such an event, *"the danger of running out of money increases."* The Wall Street Journal article went on to provide the example of an investor who had retired on January 1, 2000, with an initial 4% withdrawal rate and a portfolio of 55% stocks and 45% bonds. That example assumed monthly portfolio rebalancing and withdrawal increases of 3% a year for inflation.

The conclusion: this investor's portfolio would have fallen by a third through 2010. According to investment firm T. Rowe Price Group, credited in the article as the source of this example, the investor *"would be left with only a 29% chance of making it through three decades."* Thus, retirees might consider 4% as a starting point, for planning portfolio withdrawals. However, more studies continue to bring that number down.

The Wall Street Journal suggested 2% as a safe initial withdrawal rate.

The Wall Street Journal suggested 2% as a safe initial withdrawal rate.

Consider what would happen with a lower initial withdrawal rate. In the example of Bob and Carol Graham, they want to start retirement with a $40,000 withdrawal from their portfolio. Using the 4% Rule, the Grahams would need a $1 million retirement fund. For that same $40,000 withdrawal, they would need $1.33 million, using a 3% withdrawal rate. And nearly $1.45 million, with a 2.8% withdrawal rate. For even greater safety, Bob and Carol would need $2 million, if they want a $40,000 withdrawal, using a 2% initial withdrawal rate. Or $2.67 million, if they want to be extremely cautious, with a 1.5% withdrawal rate.

Many people will struggle to build up retirement funds in the $1.33 million-$2.67 million range.

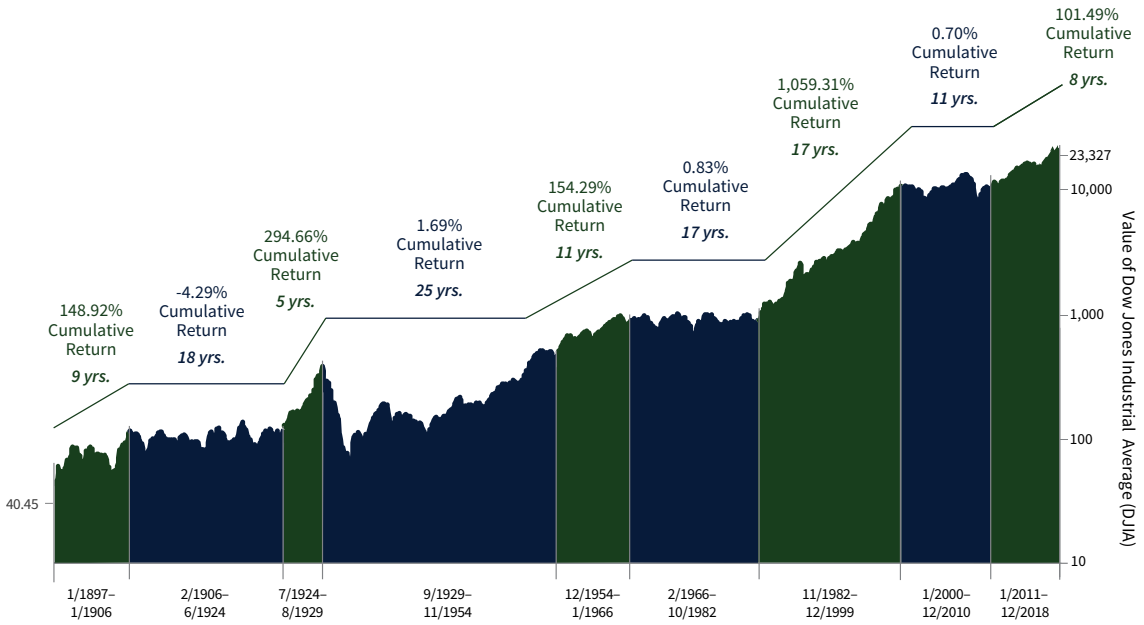
POOR TIMING

Just as low bond yields can imperil a retirement based on the 4% Rule, the same can be said for stock market volatility. If there is a steep downturn in the early years of retirement, the chances of running out of money increase dramatically.

In the above example, the Grahams withdraw $40,000 from their $1 million portfolio in Year 1 of retirement and $40,800 in Year 2, adjusting for a 2% inflation rate. With a following year of 3% inflation, this couple would be withdrawing about $42,000 in Year 3.

However, what will happen if a stock market crash drops the value of their portfolio from $1 million to, say, $700,000? Continuing with a $42,000 distribution would raise the withdrawal rate to 6%, which would hasten portfolio depletion. The issue here is sequence-of-returns risk, sometimes known simply as *"sequence risk."* A bear market just before or just after retirement can be much more perilous than a stock market slide at other times.

DOW JONES INDUSTRIAL AVERAGE HISTORICAL TRENDS



History shows that the market typically moves in cycles. In the past 119 years, there have been five bull markets and four bear markets. Investment strategies that work in bull markets may not be effective in flat or bear markets.

Graph created by Guggenheim Investments using data from dowjones.com. Cumulative returns are calculated by Guggenheim Investments. Logarithmic graph of the Dow Jones Industrial Average from 1/1897 through 12/2018. Bull and bear markets illustrated are long-term secular periods, and do not necessarily indicate all bull or bear market periods, which may differ based on methodology utilized. For this analysis, we considered the end of a bull market when the index drops below its peak and stays there for a significant period of time.

Performance displayed represents past performance, which is no guarantee of future results.

HYPOTHETICAL EXAMPLE. Bill Scott retires at age 65 with a $1 million portfolio of stock mutual funds, which typically track the broad stock market. In his first year of his retirement, Bill withdraws 4% of his $1 million: $40,000. Bill would withdraw $40,800 in Year Two, with 2% inflation. With 3% inflation, he'd withdraw $41,200 in Year Two. And so on, year after year. If inflation averages 3% a year, Bill would be withdrawing about $80,000 in Year 25.

Under the "Rule of 72," money doubles in 24 years, at a 3% rate: 72 divided by 3.

If Bill withdraws 4% ($40,000) in Year One and his portfolio returns 7% ($70,000) that year, he would have a net gain of 3% ($27,200). Then Bill would start the next year with $1,027,200, in this example.

If Bill's portfolio returns more than the amount withdrawn, it will keep growing. Even if the portfolio growth lags Bill's withdrawal slightly, the portfolio will shrink slowly. ***This sequence of events would allow Bill's $1 million portfolio to last for 30 years or longer, so he'll have an increasing stream of income throughout his retirement.***

CRASH COURSE

Unfortunately, investments—especially equities—go down as well as up. Some people pick a good time to retire, but even a few years' difference in the starting date can radically affect a retiree's risk of running short of money.

Suppose that Bill had retired in 1996, near the start of the historic dot-com bull market. Looking at the chart on the next page - from 1996 through 1999, the benchmark S&P 500 Index gained between 19.5% and 31.0% each year, for an annualized return of just over 19%.

Fast forward 19 years, through 2015, more than halfway through a hypothetical 30-year retirement. Adjusted for 3% annual inflation, Bill's withdrawals would have gone from $40,000 a year to about $70,000 a year. Thanks to the bull market at the start of his retirement, Bill would still have over $1.5 million in his portfolio. He could look forward to tapping his portfolio, with cost-of-living increases, for another 19 years or even longer.

Now suppose that Bill has a younger sister, Jill, who retired three years later, in 1999. Jill also retired with a $1 million portfolio of large-company stock funds and followed the same path, increasing her initial $40,000 distributions each year to adjust for inflation. In this scenario, though, according to the chart on the next page you see that Jill retired just before the steep bear market of 2000-2002. Tech stocks crashed and the S&P 500 lost 10%, 13%, and 23% in successive calendar years. Stocks rose to new heights after that, crashed again in 2008-2009, and has re-rebounded since then. ***Even with ups following the downs, the poor start damaged Jill's portfolio and her chance for a financially healthy retirement.***

In 2015, the same year that Bill (who started three years earlier) was withdrawing about $70,000, Jill was taking over $64,000 from her portfolio, following the 4% rule. However, due to the nasty bear market at the start of her retirement, Jill's $1 million stock portfolio had declined to around $250,000.

If Jill keeps taking out $64,000+ each year, her portfolio will run dry in less than five years. Bill, who retired in 1996, has a much better chance of financing a long retirement, despite the fact

that they both started with similar amounts, held in similar portfolios, and followed the same withdrawal plan.

POTENTIAL EFFECTS OF SEQUENCE OF RETURNS RISK, FIGURE 1

BIG BROTHER BILL					
Year	*Beginning Value*	*One-Year Index Return*	*Change in Value Income*	*Annual Withdrawal*	*Year End Value*
1996	$1,000,000	20.26%	$202,600	$40,000	$1,162,600
1997	$1,162,600	31.01%	$360,522	$41,200	$1,481,922
1998	$1,481,922	26.67%	$395,229	$42,436	$1,834,715
1999	$1,834,715	19.53%	$358,320	$43,709	$2,149,326
2000	$2,149,326	-10.14%	($217,942)	$45,020	$1,886,364
2001	$1,886,364	-13.04%	($245,982)	$46,371	$1,594,011
2002	$1,594,011	-23.37%	($372,520)	$47,762	$1,173,729
2003	$1,173,729	26.38%	$309,630	$49,195	$1,434,164
2004	$1,434,164	8.99%	$128,931	$50,671	$1,512,424
2005	$1,512,424	3.00%	$45,373	$52,191	$1,505,606
2006	$1,505,606	13.62%	$205,064	$53,757	$1,656,913
2007	$1,656,913	3.52%	$58,323	$55,370	$1,659,866
2008	$1,659,866	-38.49%	($638,882)	$57,031	$963,953
2009	$963,953	23.45%	$226,047	$58,742	$1,131,258
2010	$1,131,258	12.78%	$144,575	$60,504	$1,215,329
2011	$1,215,329	0.00%	$0	$62,319	$1,153,010
2012	$1,153,010	13.41%	$154,619	$64,189	$1,243,440
2013	$1,243,440	29.60%	$368,058	$66,115	$1,545,383
2014	$1,545,383	11.39%	$176,019	$68,098	$1,653,304
2015	$1,653,304	-0.73%	($12,069)	$70,141	$1,571,094
2016	$1,571,094	9.54%	$149,882	$72,245	$1,648,731
2017	$1,648,731	19.42%	$320,184	$74,412	$1,894,503
2018	$1,894,503	-6.24%	($118,217)	$76,644	$1,699,642
2019	$1,699,642	28.88%	$490,857	$78,943	$2,111,556

ASSUMPTIONS

- **Investment Amount:** $1,000,000
- **Index Illustrated:** SP500
- **Time Period:** 1996 - 2019
- **Annual Income Withdrawal:** 4.00%
- **COLA on Desired Income:** 3.00%

ENDING BALANCE

- **Average One Year Index Return:** 9.11%
- **Total Annual Withdrawal:** $1,337,065
- **Total Change in Account Value:** 111.16%

POTENTIAL EFFECTS OF SEQUENCE OF RETURNS RISK, FIGURE 2

LITTLE SISTER JILL					
Year	*Beginning Value*	*One-Year Index Return*	*Change in Value Income*	*Annual Withdrawal*	*Year End Value*
1999	$1,000,000	19.53 %	$195,300	$40,000	$1,155,300
2000	$1,155,300	-10.14%	($117,147)	$41,200	$996,953
2001	$996,953	-13.04%	($130,003)	$42,436	$824,514
2002	$824,514	-23.37%	($192,689)	$43,709	$588,116
2003	$588,116	26.38%	$155,145	$45,020	$698,241
2004	$698,241	8.99%	$62,772	$46,371	$714,642
2005	$714,642	3.00%	$21,439	$47,762	$688,319
2006	$688,319	13.62%	$93,749	$49,195	$732,873
2007	$732,873	3.52%	$25,797	$50,671	$707,999
2008	$707,999	-38.49%	($272,509)	$52,191	$383,299
2009	$383,299	23.45%	$89,884	$53,757	$419,426
2010	$419,426	12.78%	$53,603	$55,370	$417,659
2011	$417,659	0.00%	$0	$57,031	$360,628
2012	$360,628	13.41%	$48,360	$58,742	$350,246
2013	$350,246	29.60%	$103,673	$60,504	$393,415
2014	$393,415	11.39%	$44,810	$62,319	$375,906
2015	$195,300	-0.73 %	($2,744)	$64,189	$308,973
2016	$308,973	9.54%	$29,476	$66,115	$272,334
2017	$272,334	19.42%	$52,887	$68,098	$257,123
2018	$257,123	-6.24%	($16,044)	$70,141	$170,938
2019	$170,938	28.88%	$49,367	$72,245	$148,060

ASSUMPTIONS

- **Investment Amount:** $1,000,000
- **Index Illustrated:** SP500
- **Time Period:** 1999 - 2019
- **Annual Income Withdrawal:** 4.00%
- **COLA on Desired Income:** 3.00%

ENDING BALANCE

- **Average One Year Index Return:** 6.58%
- **Total Annual Withdrawal:** $1,147,066
- **Total Change in Account Value:** -85.19%

Bill didn't succeed because of skillful investing, in this example—his holdings had the same initial value as Jill's. Both Bill and Jill had the same withdrawal strategy. ***The huge difference in results is solely because of when they retired, and because of the stock market returns in their first three years away from their jobs.***

Figures 1 and 2 on the previous pages are hypothetical examples for illustrative purposes only. The hypothetical returns are not indicative of actual market performance. Actual market returns will vary. This is not intended to project the performance of any specific investment or index. It is not possible to invest directly in an index. If this were an actual product, the returns may be reduced by certain fees and expenses. Withdrawals are subject to ordinary income tax and, if taken prior to 59½, a 10% federal tax penalty.

BEGINNER'S LUCK

Therefore, the performance of the stock market in the first three to five years of retirement could potentially determine the probability of running short of money. That probability, in turn, may affect how comfortable or uncomfortable retirement is likely to be.

Sequence risk could be the greatest financial gamble someone ever takes, and most people don't know they're taking it!

Reducing sequence risk isn't simple. Possible solutions include working longer and saving more. Extending a career will reduce the time spent drawing down the portfolio; building up a larger retirement fund will provide more cash to draw down. There may be limits though to how long a senior can work based on potential health issues and how much can be put away for retirement in qualified accounts, but some astute tactics can tilt the odds in a retiree's favor. Those tactics include , but are not limited to:

- ☐ **Keep a cash cushion.** Plan to enter retirement with ample cash in assets such as bank accounts and money market funds. Figure how much will be needed to spend on basics (food, housing, medical care, transportation) and how much will flow in from Social Security and perhaps a pension.

  Ideally, retirees should have enough cash to cover any income shortfall for a year or two. This will prevent selling equities at the bottom, which is a severe mistake for investors.

- ☐ **Stay on the job.** Don't retire sooner than originally planned because a bull market has boosted portfolio values. As described in this section, extended periods of stock market strength often are followed by corrections.

  Someone who retires when the market has soared may increase the chance of a drop within a few years, generating additional sequence risk. Try to stick to a long-time retirement goal, good times or bad.

- ☐ **Stay the course.** Don't sell equities in a panic when the market skids. Generally, it's better to be a buyer than a seller when stocks are "on sale," after a broad correction. Instead of buying high and selling low, rebalance regularly. Sell the asset classes that have moved up and put the sales proceeds into investments that have lagged. ***Buying low increases the chances of eventually selling high.***

For retirees who are taking distributions, one way to hold onto money for the long term after a steep drop is to skip the cost-of-living adjustment (COLA).

Above, Bill Scott started retirement withdrawals with $40,000 in Year One and followed with a $41,200 withdrawal in Year Two, due to 3% inflation. What if inflation remains at 3% the following year but a stock market drop takes Bill's $1 million portfolio down to $900,000? Instead of increasing his Year Three withdrawal by 3%, to $42,440, Bill might do without a COLA and keep his withdrawal at $41,200. Bill might even go back to his original $40,000 withdrawal, with the intention of recovering lost ground once the market rebounds. Such trims in cash flow won't squeeze his lifestyle very much and the money retained inside his investment fund will help Bill's long-term cash flow prospects.

REDUCING THE RISK

Savvy investing also can dampen sequence risk. One approach is to include investments other than equities in a retirement fund. Bonds, for instance, have their down years but the drops are not as steep as they are in stocks.

Over the past 90 years, going back even earlier than Black Tuesday in 1929, the largest one-year loss for long-term corporate bonds has been 8%, in 1969.[3] Blue-chip stocks also lost heavily in 1969, and have had six other years with even larger losses since then, including a 37% drop in 2008.[4] Thus, holding bonds as well as equities may keep a portfolio from steep losses when the stock market falls. (Seniors shouldn't hold all bonds, either, because they lack the upside potential of equities.)

Another rule, the "Rule of Age 100," offers a plan to diversify between your equity holdings and your other asset classes. For example, at age 60 a retiree might hold 40% of a portfolio in stocks (100-60=40. By age 70, the Rule of Age 100 would dictate a more conservative investment stance, with only 30% (100-70=30) in equities.

The Rule of Age 100 is just a starting point, which can be adjusted for an individual's specific circumstances. For example, aggressive investors and those with long life expectancies might want to use a Rule of Age 110 or 120 instead. That might provide a 50% or a 60% allocation to stocks at age 60, instead of 40%, for more stock market exposure (and more risk in case of a bear market at the start of retirement). ***Especially for seniors who are heavily invested in equities, using stock funds and asset managers with good records in prior crises can provide a higher probability of success.***

Losing 10% isn't ideal, but any manager who was down 10% in 2008, when the broad U.S. stock market sank by 37%, did a good job. Any manager who showed a gain that year did even better. Past performance is not reflective of future results, however, evaluating performance in previous bear markets can be useful. A manager's excellent past record is no guarantee against losing in the future, but why choose a manager who took a beating in 2000-2002 and in 2007-2009?

The "Law of Large Losses" shows the value of avoiding them.

THE LAW OF LARGE LOSSES	
After a Loss of	*Gain Needed to Break Even*
10%	11%
20%	25%
30%	43%
40%	67%
50%	100%
60%	150%

In both the 2000-2002 and 2007-2009 bear markets, major stock indexes fell significantly. Does that mean that an investor would need an equal gain, just to get back to the previous account value? No!

When a $1 million stock portfolio falls by 50%, to $500,000, a 50% bounce brings the total to $750,000: still off by 25%. ***After a 50% drop, a 100% gain is needed to recover those losses.*** Indeed, the Law of Large Losses illustrates the value of avoiding major mishaps in a bear market. The deeper the hole, the harder it is to regain the lost value. ***Thus, choosing a manager who has held down losses in previous bear markets may help investors recover more rapidly, when the cycle turns bullish.***

Once retirees have their stock market allocation decided and their managers chosen, they can think about their overall portfolio. Some of the portfolio not invested in stocks and stock funds can go to less-volatile bonds and bond funds. For even greater safety, retirees can diversify further into cash equivalents, real estate, precious metals, and other alternative asset classes. A knowledgeable financial advisor can help put together a portfolio designed to reduce stock market risk while maintaining growth potential.

BEYOND INVESTMENTS

Non-stock financial products might include some conservative strategies. For people approaching retirement or already there, this conservative portion can include fixed index annuities (FIAs). ***FIAs are tax-deferred, so any growth won't be taxed until money is withdrawn, perhaps many years in the future.***

In an FIA, the contract value is pegged to a major market index such as the S&P 500. Typically, there will be a cap on the annual growth, while the annuity value won't drop (or will decline only a modest amount due to any additional-cost riders), even if the stock market crashes. Such a no- or low-loss guarantee can help overcome sequence risk.

With such a potentially defensive asset in their portfolio, retirees might be a bit more aggressive with their other money, increasing stock market exposure while moderating down sequence risk in their early retirement years. Such a portfolio could be partially growth-oriented yet also partially safe and secure from market volatility. Be aware that FIAs vary, from one issuer to another, so any retiree considering this choice as part of a diversified portfolio should work with a reputable financial professional.

HOW INFLATION FOLLOWS THE RULES

We've described certain "Rules" that retirees need to know for financial success. The Age-100 Rule, for example, can help determine how to allocate a portfolio between stocks and bonds while the 4% Rule may offer some guidance as to how to draw down that portfolio.

Perhaps the most widely-known rule, in the world of financial professionals, is the Rule of 72, as mentioned previously. Dividing an investment return into 72 shows you an estimation on how long it may take for your money to double. Thus, it would take 12 years for an investment to double, with 6% annualized returns. But an estimated 9 years for a double, with 8% returns. As a corollary, there's a Rule of 115: dividing an investment return into 115 shows you an estimation on how long it will take for money to triple. With a hypothetical 10% annualized return, an investment could triple in 11.5 years. ***Both rules illustrate the power of compound investment results, over time***. At the same time, retirees should consider the flip side of the rules of 72 and 115. They work for the cost of living, too.

Both the Rule of 72 and the Rule of 115 illustrate the power of compound investment results, over time.

Historically, official U.S. inflation (the annualized increase in the price of basic goods and services) has averaged approximately 3% a year. The Rule of 72 suggests a doubling in 24 years (72 divided by 3), so a retiree would need to double his or her income in 24 years, just to maintain the same living standard. Some observers believe that the real inflation rate is 4%, including food, energy and health care.[7] Those are key costs for retirees. If a 4% inflation rate really is the case, prices will double in 18 years (72 divided by 4). Thus, retirees would need to double their income in 18 years, to keep up.

Today, retired couples can expect one spouse to live to age 90 and beyond.[5] Someone who retires at age 62—the earliest age for collecting Social Security—may have a 28-year retirement, if he or she lives until 90. Under the Rule of 115, dividing 115 by 4% inflation shows a tripling of living costs in 28.75 years. Thus, someone who now needs $50,000 a year for a comfortable retirement lifestyle could potentially need $150,000 a year, 30 years from now, if inflation averages 4%.

Regardless of whether inflation is 3% or 4% or some other number in the future, the Rules of 72 and 115 have a sobering as well as an encouraging message. Compound returns can help people build a retirement fund during their working years, but compound price increases will require more cash flow over a long retirement. To live by the rules, it is imperative that seniors prepare for rising costs of health care, energy, and food. A helpful financial professional can increase the chance that a retiree's money—and lifestyle—will last for decades, after the paychecks stop.

COMPOUND VS. AVERAGE RETURNS

As explained, after a large loss, investors must have a larger gain, just to regain their account value. What's more, the amount of the loss is not the biggest problem, especially for retirees.

After a loss, markets will bounce back. That's been the case for the past 90 years, through the Depression and wars and other disasters, so there's every reason to believe that a bear market will be followed by a bull run. However, after a bear market, while investors who lost heavily

are rebuilding their net worth, they may be losing an entire period of positive compounding. In fact, the lost compounding period can be the most valuable one, the one with the greatest payoff because the growth rate starts from a higher base.

This can be the time when retirees' wealth might grow to its maximum, to pass on to loved ones or to charity, or to enhance a retirement lifestyle.

To understand the value of positive compounding, retirees should differentiate between average returns and compound returns. This distinction can be critical, especially for evaluating products that offer guaranteed benefits.

HYPOTHETICAL EXAMPLE. To explain why this terminology is so important, let's start with an example of two investors—Arlene and Ray—who both start with the same amount of money, and see which one actually has done better after three years. Arlene's investment results are -50%, +50%, and +33% over the three-year period, while Ray earns 0%, +10%, and +10% over those years.

Arlene's returns of -50% and +50% and +33% puts her total at +33% for the three-year period. That's an average return of 11% over three years. Ray earned 0% and +10% and +10%, which equals +20%. Divide Ray's total by three and you'll get an average return of 6.67%, far below Arlene's average of 11% a year. However, this is an example of how misleading average returns can be. ***In this example, Ray actually winds up with 21% more money, despite a much lower average return!***

How is this possible? Let's look at the math.

Assume each investor has a $100,000 investment at the start of this example. Arlene experiences a 50% loss, dropping her balance to $50,000, followed by a 50% gain, which takes her investment up to $75,000.

Many people assume that a 50% gain after a 50% loss gain will get you back to breakeven, but that's not the case. As mentioned, a 100% gain is needed after a 50% loss to fully recover. To continue, now Arlene has a $75,000 balance and realizes a gain of 33% ($25,000) in Year Three, which will get her back to her starting point of $100,000. How is it possible to average 11% over a three-year period, and not have made any money? Because it's an average return, not a compound return.

When analyzing investment performance, make sure to look at compounded annual returns instead of average annual returns.

Ray, meanwhile, starts with $100,000 and earns 0% the first year, so he is still at $100,000. In Year Two, Ray earns 10%, moving him to $110,000, and then another 10% gain in Year Three adds $11,000 to his total, ending the three years with $121,000. ***Ray's average return of 6.67% soundly beats Arlene's average return of 11%, in wealth accumulation!***

Therefore, when analyzing investment performance, make sure to look at compounded annual returns instead of average annual returns. The difference can be enormous.

As these examples illustrate, when retirees stop earning income and begin taking withdrawals from savings for cash flow in retirement, loss management becomes critical. The significance of the ten years surrounding the starting date of retirement is substantial. ***This period of time can be described as the "retirement red zone."***

What's more, the misuse of long-term average return numbers can make those 10 years extremely precarious. Many advisors and mutual fund companies point to long-term returns and urge investors to buy stocks and hold them, through bull and bear markets. These advisors and fund companies tell investors to stay the course in the midst of painful bear markets. *"It's only a paper loss,"* investors might hear. *"Hang in there, the market will come back, just as it has each time before."*

Now, it's true that most major market indexes have recovered from setbacks. However, large losses of principal while withdrawing from a portfolio can prove disastrous to a retiree's financial security.

ADDING LONGEVITY RISK TO SEQUENCE RISK

As mentioned earlier, Americans are living longer today. With extended life expectancy, many retirees today will live into their late 80s, 90s, and even reach triple digits. An extended retirement can increase the risk of running short of money. Therefore, sequence risk and longevity risk are two of the more significant risks to retirement income security. What's more, these two perils feed into each other.

HYPOTHETICAL EXAMPLE. Elly Richards retires at age 65 and begins drawing income from her portfolio. Unfortunately, a severe bear market begins just as Elly retires. If Elly dies in under 10 years, the longevity of her portfolio won't matter to her. On the other hand, Elly could live to age 80, 90, or even longer. ***After experiencing the bear market early into retirement, each dollar Elly withdraws from her savings for income will increase her risk of a premature depletion of her portfolio.***

There are ways for Elly to deal with longevity risk. However, they might not contribute to an enjoyable retirement. One possibility is for Elly to reduce her withdrawal rate. Or at least do without the annual cost-of-living increase.

HYPOTHETICAL EXAMPLE. Elly starts her retirement with a $1 million portfolio and a $40,000 (4%) withdrawal. However, a bear market reduces her portfolio to $800,000. If inflation is 3% that year, Elly normally would increase her withdrawal by 3%, from $40,000 to $41,200. However, because her portfolio has lost value, Elly fears such a withdrawal would increase her risk of running short of money.

One option, for Elly, is to keep her withdrawal at $40,000, with no increase for inflation. That would be a 5% distribution rate, from a portfolio that has dropped to $800,000. Alternatively, Elly could adjust her 4% withdrawal rate to her new circumstances.

On a portfolio now worth $800,000, that would be a $32,000 distribution: 3.2% of her original amount. Cutting back from $40,000 to $32,000 might crimp Elly's lifestyle. However, it also will increase the chance that her savings will last over a long retirement. ***Elly might suspend her retirement plan withdrawals altogether, if the money is not needed for basic living expenses.***

LIMITING DOWNSIDE LOSSES

In another approach to addressing longevity risk, retirees might take steps to meet their income needs from a predictable source, regardless of market performance. That reliable source should be able to keep the cash flowing as long as the individual, or couple, lives. For instance, a retiree might acquire an annuity from an established insurance company. By using a portion of their savings this way, retirees would limit their exposure to market losses, reducing both sequence risk and longevity risk. We've already touched on fixed index annuities, but we will discuss annuities in more detail during later sections of this course.

- **Single-premium immediate annuity (SPIA)**. With these annuities, a consumer pays a sizable amount to an insurer. The company starts to return cash flow, right away. An SPIA can be structured to last as long as the recipient (annuitant) is alive. Another possibility is to acquire an SPIA that will cover two lives — usually a married couple — as long as either is alive.

- **Deferred income annuity (DIA).** Just as savings yields are low now, so are the payout rates on SPIAs. One way to boost payouts is by buying a DIA. With a DIA, the consumer pays the single premium upfront, then waits for the payout to begin. The longer the wait, the higher the eventual payout will be, as a percentage of the single premium paid by the annuitant.

- **Qualified Longevity Annuity Contract (QLAC).** A QLAC is a type of a DIA. It's *"qualified"* because such annuities are bought within a tax-deferred retirement account such as an IRA. With a QLAC, the start date can be deferred until as late as age 85. Deferring the payout until then will produce a relatively high stream of cash flow afterwards, reducing longevity risk. In addition, buying a QLAC will reduce the amount of required distributions from the retirement account

- **Deferred annuity with a Guaranteed Lifetime Withdrawal Benefit (GLWB).** Again, the idea is to pay now and receive cash flow later. However, instead of locking in payouts from an annuity, consumers can choose to get cash flow via withdrawals. A GLWB might promise that consumers will be able to withdraw certain amounts of cash indefinitely, regardless of market performance. However, the tax treatment of annuity withdrawals is not as favorable as the tax treatment of periodic annuity payments.

TAXES AND INFLATION IMPACT RETURNS

Consumers may be pleased to learn that they made 6% or 8% or even 10% annualized growth. This *"gross"* number doesn't reveal the *"net"* value received by consumers. The net growth to consumers recognizes the amount consumers actually get to keep, after paying tax on various assets providing the income. A true net income from various financial products also adjusts for inflation, as the purchasing power of growth is reduced by any increase in the cost of goods and services that someone buys. More than 90 years of data illustrate the effects of taxes and inflation on earned growth.

Since the 1920s, the annualized return of the broad U.S. stock market has been around 10%.[6] During that time, U.S. government bonds had annualized returns around 5.5%. Using certain assumptions on investors' income and historic tax rates, the after-tax return on stocks drops to about 8%, annualized. For government bonds, that after-tax return is around 3.6%. Adjusting for the purchasing power of a dollar, which has fallen over the years, the annualized return on stocks drops even further, to about 5%, annualized. The real, after tax returns on bonds almost vanishes, to less than 1%.

There may not be much that retirees can do about inflation's impact on returns. Moving to a lower-cost area of the U.S. might help to maintain or even increase purchasing power, though. On the other hand, many tax-saving tactics can add value. For instance, waiting to take profits until an investment is held for more than a year will qualify for lower long-term capital gains tax rates, now no higher than 20%. Selling before that year is up, on the other hand, means that any gains will be taxed as ordinary income, with rates as high as 37% now. In the future, tax rates might move higher.

IRS TAX RATE TABLES FOR 2020[7]

TABLE 1: MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES	
If Taxable Income Is:	*The Tax Is:*
$0 - $19,750	10% of the taxable income
$19,751 - $80,250	$1,905 + 12% of the amount over $19,750
$80,251 - $171,050	$8,907 + 22% of the amount over $80,250
$171,051 - $326,600	$28,179 + 24% of the amount over $171,050
$326,601 - $414,700	$64,179 + 32% of the amount over $326,600
$414,701 - $622,050	$91,379 + 35% of the amount over $414,700
$622,051 +	$161,379 + 37% of the amount over $622,050

TABLE 2: HEADS OF HOUSEHOLD	
If Taxable Income Is:	*The Tax Is:*
$0 - $14,100	10% of the taxable income
$14,101 - $53,700	$1,360 + 12% of the amount over $14,100
$53,701 - $85,500	$5,944 + 22% of the amount over $53,700
$85,501 - $163,300	$12,698 + 24% of the amount over $85,500
$163,301 - $207,350	$30,698 + 32% of the amount over $163,300
$207,351 - $518,400	$44,298 + 35% of the amount over $207,350
$518,401 +	$149,298 + 37% of the amount over $518,400

TABLE 3: UNMARRIED INDIVIDUALS *(Other than surviving spouses and heads of households)*	
If Taxable Income Is:	*The Tax Is:*
$0 - $9,875	10% of the taxable income
$9,876 - $40,125	$952.50 + 12% of the amount over $9,875
$40,126 - $85,525	$4,453.50 + 22% of the amount over $40,125
$85,526 - $163,300	$14,089.50 + 24% of the amount over $85,525
$163,301 - $207,350	$32,089.50 + 32% of the amount over $163,300
$207,351 - $518,400	$45,689.50 + 35% of the amount over $207,350
$518,401 +	$150,689.50 + 37% of the amount over $518,400

TABLE 4: MARRIED INDIVIDUALS FILING SEPARATE RETURNS	
If Taxable Income Is:	*The Tax Is:*
$0 - $9,875	10% of the taxable income
$9,876 - $40,125	$952.50 + 12% of the amount over $9,875
$40,126 - $85,525	$4,453.50 + 22% of the amount over $40,125
$85,526 - $163,300	$14,089.50 + 24% of the amount over 85,525
$163,301 - $207,350	$32,089.50 + 32% of the amount over $163,300
$207,351 - $311,025	$45,689.50 + 35% of the amount over $207,350
$311,026 +	$80,689.50 + 37% of the amount over $311,025

IMPACT OF INCOME TAXES AND INFLATION ON RETURNS[8]

TAXED VS TAX DEFERRED		
Years	*Taxed*	*Tax Deferred*
0	$1.00	$1.00
1	$1.72	$2.00
2	$2.96	$4.00
3	$5.09	$8.00
4	$8.75	$16.00
5	$15.05	$32.00
6	$25.89	$64.00
7	$44.53	$128.00
8	$76.60	$256.00
9	$131.75	$512.00
10	$226.61	$1,024.00
11	$389.77	$2,048.00
12	$670.41	$4,096.00
13	$1,153.11	$8,192.00
14	$1,983.34	$16,384.00
15	$3,411.35	$32,768.00
16	$5,867.53	$65,536.00
17	$10,092.15	$131,072.00
18	$17,358.49	$262,144.00
19	$29,856.61	$524,288.00
20	$51,353.37	$1,048,576.00

A BUCKET LIST FOR A FINANCIALLY SUCCESSFUL RETIREMENT

As indicated, retirees have many financial concerns. Sequence risk, longevity risk, taxes, inflation, and so on. Success might not come easily. However, chances are greater with a reasonable plan in place. Here's one suggestion. Other advisors might have other thoughts.

HYPOTHETICAL EXAMPLE. Alice and Ben Jones are both age 66, entering retirement. They establish a financial plan that calls for them to create three different buckets of money.

- **Bucket #1. This bucket is structured to meet their income needs for the next 10 years.** For the first bucket, Alice and Ben placed some of their money with a private wealth management firm. They chose a wealth manager who has produced respectable returns over the past 20-25 years, with limited losses and very few negative years in their history. With a track record like that, why not use this wealth manager for 100% of the couple's assets? The answer: Just because this firm has rarely had a negative year, it doesn't mean that can't happen.

  Assume that Alice and Ben will need $40,000 a year from their portfolio. They might put $400,000 of their savings into this bucket. Their plan for this bucket is to keep these funds 100% liquid, so they could spend down that money, as needed. Yet Alice and Ben also could potentially increase the rate of return they had been getting from low-yield bank accounts and money market funds.

- **Bucket #2. The next bucket would begin paying income to Alice and Ben in 10 years.** For this bucket, the couple purchases a fixed index annuity (FIA) with an income rider. They will put about $600,000 of their portfolio assets into the purchase of the FIA; in return, the couple will get a guarantee of minimum yearly income from the issuing insurance company (based on the issuers financial strength and claims-paying ability) just under $50,000 per year, starting in Year 10, for as long as either is alive. This FIA also offers the possibility of some growth on top of its contractual guarantees.

- **Bucket #3. The third bucket contains investments with the potential for long-term growth.** Here, Alice and Ben can be a little more aggressive, taking some risk in return for potentially superior returns. Again, the couple will use some excellent private wealth managers who have strong track records, for the balance of their portfolio assets.

Summing up, the goal with this three-bucket plan is to help retirees meet their income needs throughout retirement, using the lowest possible amount of their savings. By eliminating the need to use every dollar saved, just to meet retirement living needs, such a plan may provide funds to do those things that retirees have thought about and dreamed about doing for a long time.

CHAPTER 1
CHECK FOR UNDERSTANDING QUIZ

1. *A defined benefit (DB) plan is a retirement plan such as a 401(k) where certain amounts go into the plan, but the outcome is not guaranteed.*

   a. True
   b. False

2. *If utilized, the 4% withdrawal rule will guarantee you will not run out of money in retirement.*

   a. True
   b. False

3. *What rate of return should you expect for your money to potentially double in 10 years?*

   a. 5.2%
   b. 6.2%
   c. 7.2%
   d. 8.2%

4. *The risk of receiving lower or negative returns early in a period when withdrawals are made from an individual's underlying investments is known as:*

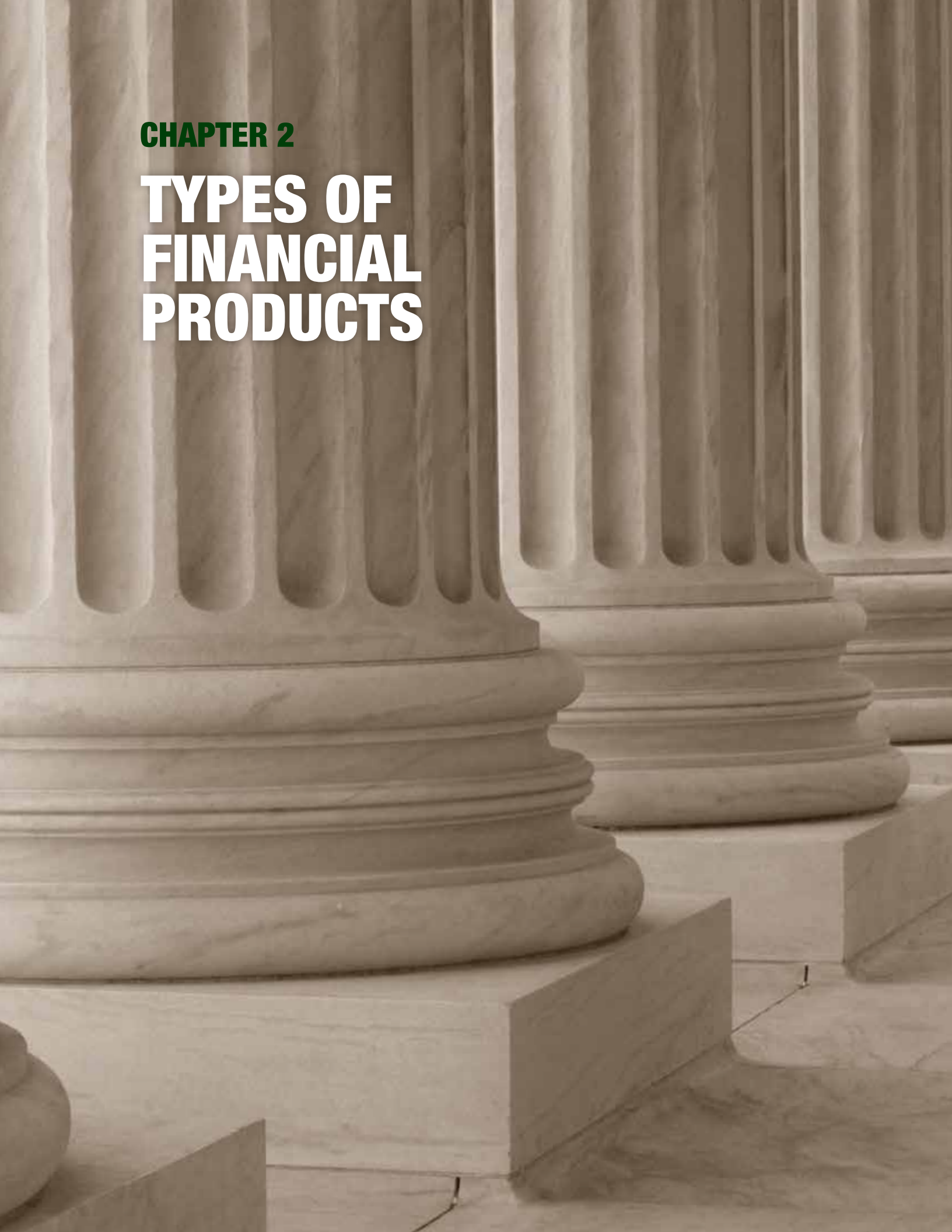
   a. Sequence Risk
   b. Withdrawal Risk
   c. Investment Risk
   d. Speculation Risk

5. *Longevity Risk is the risk of potentially outliving one's assets during retirement.*

   a. True
   b. False

ANSWERS. **1** - b. False **2** - b. False **3** - c. 7.2% **4** - a. Sequence Risk **5** - a. True

NOTES



CHAPTER 2

TYPES OF FINANCIAL PRODUCTS

INVESTING: NEW RESPONSIBILITIES FOR RETIREES

Retiring from work doesn't mean retiring from investment responsibilities. Just as workers need to save money during their careers, to finance their retirement, retirees must continue to manage their portfolio prudently, to help ensure their money lasts for what could be decades without earned income.

What's more, today's retirees face difficult choices in managing their investments. The days of simply using bank accounts, high-quality bonds, and perhaps a few blue-chip stocks should potentially be strongly reconsidered.

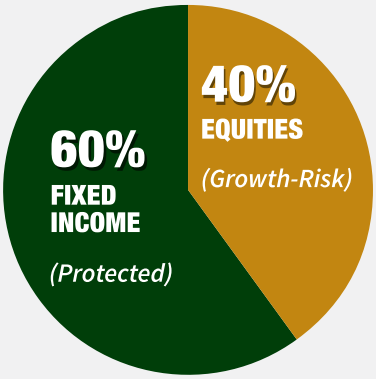
TOO BULLISH ON BONDS?

Historically, investors have been told to use the *"Rule of 100"* in putting together a portfolio. Under this *"rule,"* investors subtract their age from 100 to see how much of their investments should be in stocks and stock funds, known as equities. The balance would be in bonds or bond funds, known as fixed income. Thus, someone retiring at age 60 would have an asset allocation of 40% (100 minus 60) in equities and 60% in fixed income.

That traditional plan has flaws, which have been revealed in this century. For example, bonds may not be as risky as stocks, but they certainly have risks. Consider what happened in 2008, the year when the financial crisis hurt stocks heavily. Many bonds also lost value:[9]

- **High-yield (junk) bond** funds lost more than 26%.
- **Emerging markets bond** funds lost almost 18%.
- **Municipal bond** funds lost over 9%.
- **General bond** funds lost almost 5%.

RULE OF 100
Hypothetical Example



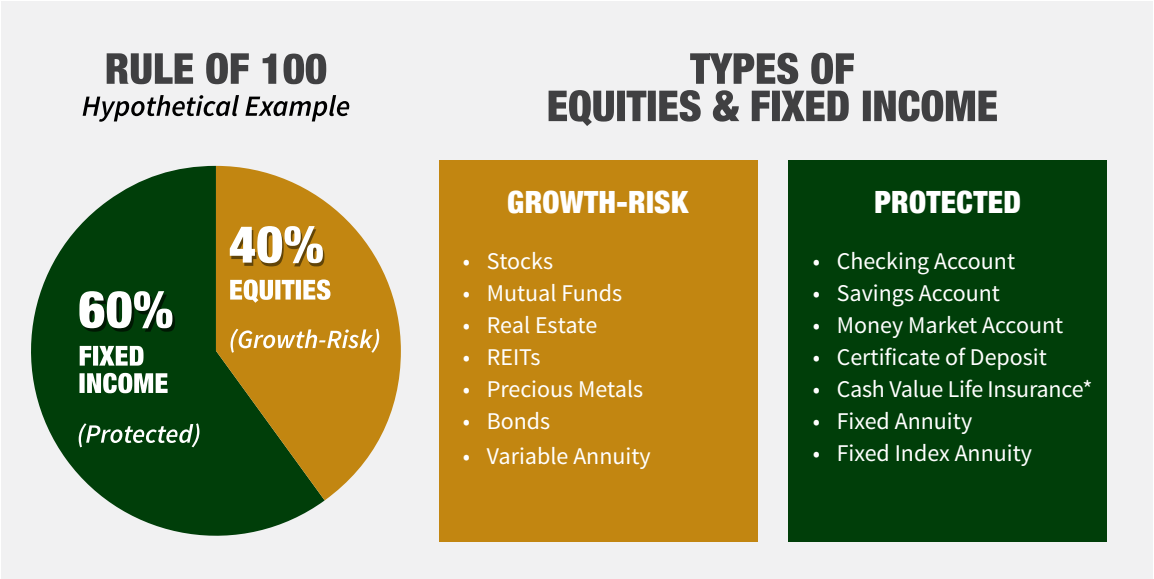
Rule of 100: Investors subtract their age from 100 to see how much of their investments should be in stocks and stock funds, known as equities.

Many retirees who held 60% of their portfolio in "safe" fixed income investments would have lost money in bonds as well as stocks that year.

In the coming years, interest rates are widely expected to rise, which would devalue current holdings of bonds. Besides interest rate risk, bonds have default risk, as some investors (such as those holding issues from Detroit and Puerto Rico) have learned recently.

The bottom line is that traditional asset allocation has failed recently, especially in the financial crisis of 2007-2009. Retirees in the 21st century shouldn't rely upon a failed theory to building a financial plan, which may have to last for many decades.

PROBABILITY OF SUCCESS



*Policy loans and withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force.

Nevertheless, the Rule of 100 still has some validity. A 60-year-old retiree may be well served by holding 40% of his or her portfolio in growth assets, which have short-term price risk but also the possibility of substantial long-term results.

Realistically, the *"Risk"* area of the Rule of 100 Circle should include fixed income as well as equities. Based on long-term results, covering nearly a century of booms and busts, Depression and wars, recessions and inflation, a portfolio of well-chosen stocks and bonds might return 5% or 6% a year, for those investors who hold on throughout the market's ups and downs.

If stocks and bonds are in the Risk area, along with real estate and precious metals, what can be considered protected? Federally insured bank accounts and short-term government bonds, most likely. Money market funds also have a solid history of preserving investors' capital. However, yields on such safe holdings are scant today. In many cases, you might receive 0.1% or less, per year (you can check bankrate.com for current rates). That's $1 of annual interest a year, for every $1,000 invested in these conservative instruments.

Suppose Bill King has 60% of his retirement portfolio earning 0.1% while the other 40%, in risk investments, earns 5%-6%, long-term. Overall, his portfolio will likely return from 2% to 2.5% a year, over an extended retirement. Will that be enough to enable Bill to keep up with inflation and maintain his lifestyle for decades? The probability might be low.

Raising expected returns by putting more money into risk assets can be dangerous. A severe bear market near the start of Bill's retirement could put his worth into a tailspin, if he overloads on volatile assets. Bill would be withdrawing money to live on while lacking earned income to replenish his portfolio. One possible solution is to find ways to position a portion of his assets in the Protected area, without settling for meager yields. One way to do so is to look for financial products that have guarantees, from sound companies.

FIRST THINGS FIRST

Before exploring some guaranteed products, it's necessary to create a firm financial foundation. That means having an adequate amount of Rainy Day money in a checking account or another account linked to a debit card, for instant access. When unexpected expenses arise—dental implants, perhaps, or replacement home appliances—having some easily accessible cash can prevent selling assets at the wrong time, or say, taking taxable dollars from an IRA.

It's necessary to create a firm financial foundation. That means having an adequate amount of Rainy Day money... for instant access.

The conventional wisdom might be too cautious. Some advisors advocate keeping six months' expenses in such emergency funds. That would be $60,000, for a retired couple seeking to spend $10,000 a month. Some seniors go even further, parking hundreds of thousands of dollars in bank checking accounts and short-term certificates of deposits (CDs). However, retirees probably shouldn't keep too much money in a rainy day fund. That's especially true with the paltry yields now available from bank accounts, Savings Bonds, etc.

Why is this a problem? Suppose Bill King has $100,000 in short-term CDs and savings accounts, yielding under 1%. In truth, Bill has never had a $100,000 emergency, and he probably never will. Thus, Bill is losing an opportunity to earn more from that money.

Bill's strategy also puts pressure on the rest of his investments to take more risks, in order to bring up his overall rate of return. If Bill's goal is to earn 5% on his savings and investments, the assets outside of his emergency fund must earn much more than 5% to reach his goal. Chasing those higher yields might mean too much exposure to growth stocks, too much in long-term bonds, and other holdings with substantial risk.

Instead, Bill might keep, say, $15,000 or $20,000 at his bank. That would be enough to provide instant funds in case of an emergency. As long as Bill's investments include some liquid assets that can quickly be converted to cash, he'll be able to meet any larger expense. Meanwhile, by holding more non-cash assets, Bill might increase his investment earnings, reduce overall portfolio risk, and improve his chances of having enough money for a comfortable retirement.

MONEY IN THE BANK

For truly safe money, consider putting some in a bank. Yields are low now, but the Federal Deposit Insurance Corporation (FDIC) insures deposits up to $250,000 per depositor per bank. People who want to insure even more money have several options to consider:

- ☐ **Spread accounts among multiple banks for more coverage.** Up to $500,000 can be held in two banks, for example.
- ☐ **Stay at the same bank but add joint accounts.** Say Ken and Marie Larson each have $250,000 in individual deposits at their local bank, covered by the FDIC. The Larsons can open an additional $500,000 joint account there and get full FDIC coverage.
- ☐ **Keep IRAs at the same bank.** Additional FDIC coverage, is available, up to $250,000 per IRA owner.
- ☐ **Use simple trust accounts.** In addition to all the accounts mentioned above, FDIC insurance also covers "trust accounts." These trust accounts aren't like the ones created by attorneys, for steep fees. Instead, depositors merely sign an agreement on the bank's signature card when opening the account.

For these trust accounts, which may be known as *"Totten trusts," "payable on death"* accounts, or *"in trust for"* accounts, the FDIC limit is $250,000 per beneficiary, excluding the account owner. Suppose Ken Larson deposits $600,000 in a CD at his local bank and signs a trust agreement, naming his wife Marie and their two children as the beneficiaries. If the bank fails and no other bank assumes the deposits, the FDIC will provide up to $750,000 worth of insurance—$250,000 times the three beneficiaries—so the entire $600,000 CD will be covered.

In this scenario, Ken owns the CD and maintains full control of the funds. Any FDIC insurance payment would go to Ken, not to the beneficiaries. With these arrangements, the money in the CD will go to the three beneficiaries, if Ken dies. Any other instructions in Ken's will would be disregarded.

DAILY ACCESS

Among the different types of bank accounts, depositors typically must put money into a CD, in order to get any yield worth mentioning. This limits access to the money, as premature withdrawals may trigger a penalty.

Banks also offer money market accounts, with daily access, but yields are scant. Often, yields are a bit higher with money market funds, offered by financial firms. Money market funds, as they're known, have no federal insurance. They do offer substantial convenience, with easy deposits at any time and withdrawals via check writing. ***Money market fund yields fluctuate daily, so investors will be able see yields increase right away, if the long-expected rise in interest rates occurs.*** Money market shares sold to individual investors usually are priced at $1, with interest income automatically invested in new shares. Historically, such funds have generally maintained the $1-per-share price, historically preventing losses to investors.

FOCUSING ON FIXED INCOME

Once retirees have adequate cash reserves, as an emergency, other portfolio assets can be invested for potentially higher returns.

THE TWO MAIN INVESTMENT CATEGORIES

BONDS / FIXED INCOME
(Growth-Risk)

STOCKS / EQUITIES
(Growth-Risk)

Why put bonds first? Because many retirees hold more fixed income than equities in their investment portfolios. ***Under the traditional "Rule of 100," a 65-year-old would have 65% of investment assets in bonds and 35% in stocks.*** Bonds offer two main appeals to retirees:

- **Investment income.** Bond issuers essentially borrow money from investors, promising to pay interest income. That cash flow tends to be predictable and relatively high, compared to other types of investment income.
- **Stability.** Bondholders generally rank at or near the top of the list, among the issuer's creditors. Redemption is promised, at or before the bond's maturity date.

With these assurances, bond prices don't fluctuate as much as stocks prices.

LARGEST CALENDAR YEAR LOSSES SINCE 1980[10]

LONG-TERM CORPORATE BONDS	
Year	*Return*
1980	-2.8%
1981	-1.2%
1994	- 5.8%
1999	-7.4%
2013	- 7.1%

LARGE-CAPITALIZATION STOCKS	
Year	*Return*
1981	- 4.9%
2000	- 9.1%
2001	- 11.9%
2002	- 22.1%
2008	- 37.0%

BASIC BOND CATEGORIES

Investors tend to categorize bonds by the way they're taxed.

- **Taxable bonds** are issued by corporations and other private lenders. The interest they pay typically is subject to federal income tax as well as any applicable state or local income tax. Mortgage-backed bonds, called mortgage-backed securities, also pay interest that's fully taxed. Interest payments may be relatively high but they're not as certain, as mortgage prepayments by homeowners will affect cash flow to investors.

- **Tax-exempt bonds** are issued by states and local government agencies. Collectively, they're called municipal bonds. Interest income typically is not subject to federal income tax. Residents of the issuer's home state may avoid state and local income tax as well.

- **U.S. Treasury bonds** ***can be considered a hybrid, as the interest is subject to federal income tax but not to state or local income tax.*** Retirees who want a higher level of safety compared to other bond types may prefer Treasury bonds for the fixed income portion of their portfolio. These bonds won't default and they can provide protection against a bear market in equities: long-term government bonds returned over 13% in 2008, while stocks crashed. Because of these advantages, however, Treasury bonds are poplar, tending to have relatively low yields.

TAXABLE VS. TAX-EXEMPT

Retirees in low tax brackets may choose taxable bonds, to get their higher yields. Conversely, high-bracket seniors may opt for municipal bonds, if they'll generate more aftertax income.

"Tax-equivalent yields" can be misleading. Financial firms often use *"tax equivalent yields"* to promote municipal bonds or funds. Here's the basic formula:

TAX EQUIVALENT YIELD = TAX-EXEMPT YIELD / (1-MARGINAL TAX RATE)

For example, let's say that Jan Parker is in the 25% federal tax bracket and is considering a municipal bond with a 3% yield. Her tax equivalent yield would be .03 / (1-0.25), or .03 / .75. The solution is .04, or 4%. Thus, getting a 3% yield on a municipal bond would be better than a taxable bond yielding less than 4%, for Jan.

In this exercise, though, there's no assurance that Jan could find a taxable bond with a 4% yield, equivalent in quality to the municipal bond she's considering. The *"4% taxable bond"* is hypothetical.

BETTER WAY. Find two bonds of equal quality and maturity, then get the aftertax yield on those two similar bonds. Say Jan is considering a 3.5% corporate issue as well as a 3% in-state muni, and her effective tax rate (state and federal) is 28%. Then, Jan would net only 2.52% from the corporate bond, after tax, in real money: 3.5% interest income minus 0.98% (28% of 3.5%) paid in tax. The 3% muni would be better.

IDEAL WAY. Recognize that the tax code is extremely complex. For instance, the interest income from a "tax-exempt" municipal bond counts as income, when determining the tax retirees will pay on their Social Security benefits. For a true reading, it's best to have a tax professional run the numbers on the net yields from a taxable and a taxable bond.

BOND MARKET RISKS

The bond market is broad and diverse, with varying yields on different issues. Typically, higher-yielding bonds are riskier bonds. Major concerns:

- **Possible default.** A company with questionable financial strength will pay higher bond interest than a company with a high credit rating. Bondholders collect more interest, but have some concern they won't be repaid.
- **Interest rate risk.** If interest rates rise, existing bonds lose value. Hypothetically speaking, suppose Pete Roberts invested a year ago in a bond paying 3% interest. Today, after rates have risen, a comparable company issues a bond paying 4%.

In a world where 4% interest rates now prevail, Pete's 3% bond won't appeal to investors. If he wants to sell, Pete will have to drop his asking price and take a loss. On the other hand, falling interest rates cause bond prices to rise, as existing bonds with higher yields gain appeal. As of this writing, interest rates are near historic lows so bond prices appear more likely to decline (from a rise in rates) than increase (from a fall in rates).

CALL RISK

In today's low-yield world, investors have to pay a premium for older bonds with higher yields. For example, Sue Taylor might pay $12,000 to buy bonds with a face value of $10,000.

Say Sue buys those premium bonds, which mature in seven years. Even though Sue will have a built-in $2,000 loss (buy for $12,000, get $10,000 at redemption), Sue figures that the high interest she'll receive over those seven years will more than make up for the shortfall. However, some bonds allow the issue to be called (redeemed) prematurely. If Sue's bonds are called in, say, five years, Sue will forgo two years' interest and wind up with a much less valuable investment.

Retirees should have some fixed income in their portfolios, but also should be aware of the risks they assume if they chase high yields.

CORPORATE DISTRIBUTIONS

There is one other reason why retirees may choose bonds over stocks. In a corporate bankruptcy, bondholders have priority in terms of repayment. After bondholders are paid, holders of preferred stock are next in line. (Preferred shares typically pay higher dividends than common shares, and they often trade like bonds.)

Owners of common stock—the shares traded by investors—are the last in line to be paid in bankruptcy. Common shares are considered to be the riskiest way to invest in a corporation, but common share owners have more appreciation potential, as a reward for taking that risk.

STOCKS HAVE BEEN RISKY

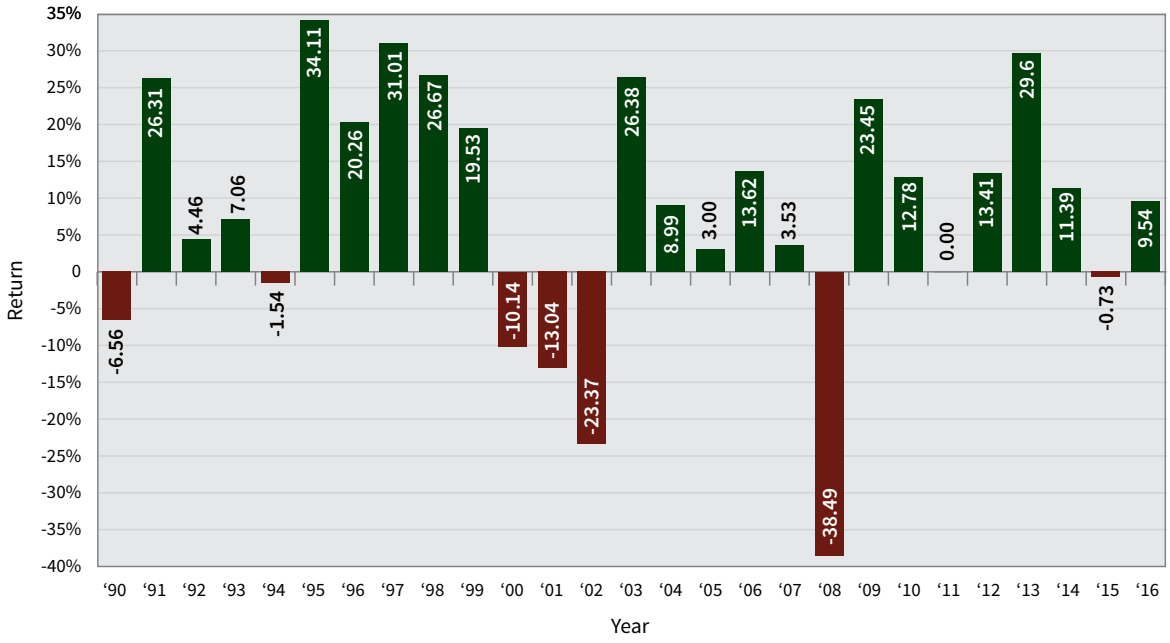
When it comes to investment risks, the perils of the stock market are all too familiar. In 2000-2002 and again in 2007-2009, the broad market lost about 50% of its value each time.

Consider a hypothetical John Smith, who retired in 2006 with a $1 million portfolio, broadly diversified in stocks. Three years into his retirement, John's portfolio would have been reduced by around $500,000, if he held on through the financial crisis! Now, John has to make up that $500,000, just to return to where he started. And he'll have to do that while tapping his portfolio and doing without earned income.

NOW FOR THE GOOD NEWS

Stock market crashes occur periodically, but they don't appear out of nowhere. Often, the busts come after a boom. There was a tech stock surge in the late 1990s, followed by the 2000-2002 crash. Then stocks boomed again, as housing values spurred the economy, followed by another crash in 2007-2009. As of this writing, the stock market has set new highs once more. In late 2016, the broad U.S. market was showing an annualized return around 9%, over the past 24 years. ***Investors willing to buy on market drops have prospered in the past and may do so in the future.***

S&P 500 INDEX: 1990-2016[11]



INTERPRETING STOCK TABLES

Some investors are willing to invest in a broad pool of stocks but others prefer to buy individual securities. To choose among all the available issues and subsequently track those holdings, investors can study stock market tables. To a large extent, newspaper stock market tables have been supplanted by online versions. Regardless of the medium, stock market tables generally have certain information about each listed company's shares:

- **Name and ticker symbol.** The ticker symbols may be an abbreviation of the company name, or some word associated with the company. The Anheuser-Busch ticker, for instance, is BUD.
- **Open, high, low, close.** These numbers show how a stock's price has ranged throughout the previous trading day.
- **Net change and % change.** Suppose that the trading price of BUD goes from a $130.21 open to a $130. 47 peak to a $128.86 low and finally closes at $128.91. The stock's net change for the day would be $1.30 a share, from the $130.47 open to the $128.91 close. That's a drop of just under 1% for the day. Online, daily drops might show up in red while daily increases might be in green.
- **Volume.** The number of shares traded the previous day. Some traders believe that a rising price and high volume indicate bullish short-term prospects for a stock.
- **52 week high and low.** The highest and lowest prices the stock has reached over the last 52 weeks. These numbers may indicate a stock's volatility.
- **Dividend.** The amount an investor will receive in dividends per year, per share of stock.
- **Yield.** The ratio of the annual dividend to the current stock price. For example, if BUD is paying $4.60 a share in dividends, a closing price of $128.91 a share would indicate a current yield of 3.57% for today's buyer, at that price.
- **YTD % change.** The stock's performance so far, in this calendar year. Again, online tables may show gains in green, losses in red.
- **P/E.** The price to earnings ratio compares the current trading price to earnings per share. A high p/e, compared with that of other companies, may indicate investors' belief that the company's earnings will grow rapidly, justifying the high per share.

BEYOND THE P/E RATIO

As indicated, a stock's price to earnings ratio might be listed on stock market tables. Thus, this is a key metric used to evaluate a stock as a possible investment. On stock tables, the p/e ratio is generally the last four quarters' reported earnings, compared to the closing trading price. For instance, if ABC Co. has earned $2 per share, in total, in the last four reported quarters and trades at $20 a share, its p/e ratio will be listed as 10; with a $40 trading price, its p/e would be 20.

Historically, major U.S. corporations trade at around 15 times trailing earnings. Some analysts prefer to use a p/e of expected future earnings, to judge whether a company could be a good buy, at the current price. Other market metrics have their supporters, who contend these numbers have value for analyzing stocks:

- **PEG ratio**. Here, the trailing p/e ratio is compared with the company's expected earnings growth rate over the next, say, five years. A PEG ratio under 1.00 is considered attractive, and the lower the better.

  For example, DEF Co. has a p/e ratio of 12 and is expected to increase earnings by 15% a year. The PEG ratio is 12/15, or 0.80. The catch is that future earnings growth is difficult to predict so precisely. Even so, a low PEG ratio may indicate that a reasonably priced stock is available from a company with solid future prospects.

- **Price to cash flow ratio.** In this ratio, accounting items such as depreciation and amortization are removed from earnings to show how a company is doing, in terms of producing cash. Again, a lower number may indicate investors are getting more bang for their buck.

  When using this ratio, though, investors should see exactly how cash flow is defined. Operating cash flow is good to have, but the stock might not be as attractive if the company is using its cash for debt service and other purposes. *"Free cash flow"* is a term often used to judge the success of a business.

- **Price to book value ratio.** To get this number, divide a company's market capitalization (total value of outstanding shares) by it net worth (difference between total assets and total liabilities). Some investors like the idea of paying a relatively low price for corporate assets.

None of these ratios is a magic formula for separating tomorrow's stock market winners from losers. Instead, they can provide useful shortcuts for experienced investors hoping to put some promising individual stocks into a well-diversified portfolio.

GOING PRO

Many people, including retirees with increased leisure time, like to make their own investment decisions. They're in control, and they're not paying anyone to manage their money. ***Today, the Internet offers ample information to do-it-yourself investors seeking successful strategies.*** That said, many retirees don't choose to take the time and effort necessary to make informed investment decisions. They'd rather interact with family and friends, pursue favorite pastimes, and so on. For those retirees, one approach is to hire someone else to professionally manage how their retirement funds should be invested:

- **A money manager** will focus on maximizing portfolio returns with acceptable levels of risk.
- **A financial advisor**, on the other hand, will go beyond investments to help with insurance, estate planning, tax planning, charitable giving, asset protection, and other aspects of wealth management.

For advice from such professionals, clients will pay fees. Those might be hourly charges, sales commissions, periodic payments based on assets under management, annual retainers, or some combination of these methods. ***When engaging professional management, it's vital to enter into a formal arrangement that spells out the compensation to be paid.*** Beyond compensation, clients should know how their money will be handled. Portfolio managers generally fall into one of several broad categories.

ACTIVE MANAGEMENT

As the name suggests, active portfolio managers seek out securities that will provide satisfactory results. Those results might be better-than-average returns, but they could be something else.

For retirees, active management could focus on putting together a portfolio that will provide a certain level of current income. An active manager could tailor a strategy to preserve wealth over an extended life expectancy, or to leave a substantial legacy for loved ones. In any case, active management means selecting specific investments to help meet stated goals. There are no guarantees, and some active managers do better than others.

Portfolio managers generally fall into one of several broad categories:

- Active Management
- Passive Management
- Tactical Investing
- Mechanical Investing

PASSIVE MANAGEMENT

Passive managers don't lie around their office, waiting for ideas to strike. Instead, the term *"passive management"* is used to show the opposite of active management.

Passive investment managers do not seek specific securities for clients. Often, passive investing means tracking a major market index, such as the S&P 500 Index of large company stocks. Investors can expect to get the index returns, minus the manager's fees. Generally, passive investing is less expensive than active management, due to reduced research and trading costs. Taxes may be lower, too. Over time, low costs and low taxes can make a significant difference in investors' returns. Passive managers may assert that few active managers beat the indexes consistently.

In recent years, hybrid approaches to active and passive investing have emerged. In one such hybrid approach, some investment professionals actively seek out factors that tend to boost returns, such as regular dividends increases from profitable companies. Then these pros create an index, weighted towards such stocks, and invest passively in this customized index. This approach might be called *"Smart Beta,"* indicating a rules-based approach to constructing indexes that will outperform traditional benchmarks.

TACTICAL INVESTING

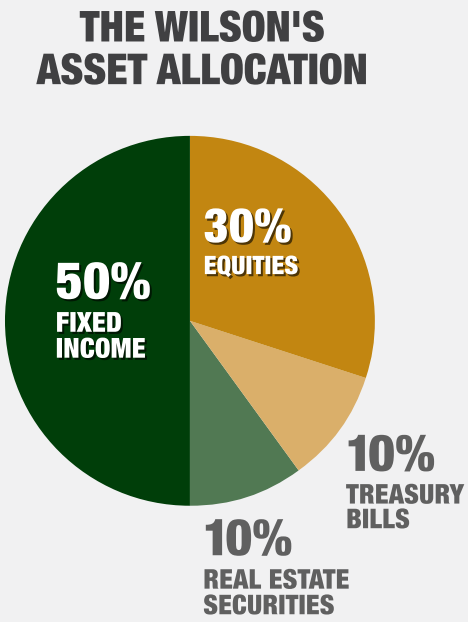
This style of management is actually an offshoot of strategic investing, which might be considered basic portfolio management. Strategic investing starts with asset allocation.

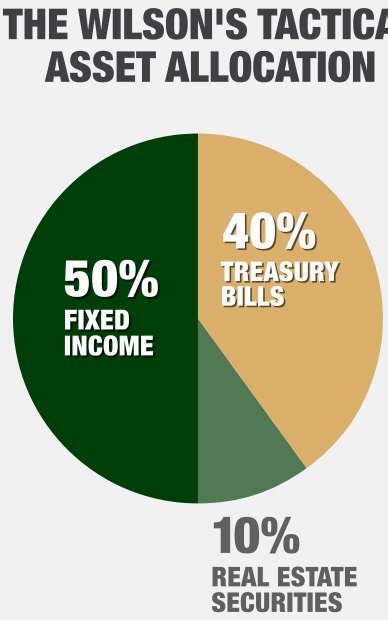
HYPOTHETICAL EXAMPLE. Ted and Claire Wilson are retired. They hire a financial advisor for wealth management, including portfolio decisions. This advisor creates an asset allocation plan for the Wilsons. Basically, they will hold 50% of their assets in fixed income, 30% in equities, 10% in real estate securities, and 10% in other assets, such as precious metals and Treasury bills.

In a strategic plan, the Wilsons would maintain this allocation throughout retirement, unless circumstances indicate a reason to change. Market moves might increase one asset class and decrease another asset class, as a percentage of their portfolio, so the Wilsons' advisor periodically will rebalance, selling some over-weighted assets and buying under-weighted assets, to return to the baseline allocation. Such strategic asset allocation strategy is widely accepted among wealth managers, as a plan that can create portfolio growth. ***Tactical investing goes in and out of asset classes.***

In our example, though, the Wilsons' advisor is a believer in tactical, rather than strategic, asset allocation. That is, the advisor believes that some asset classes can become too pricey, and thus too risky. If equities seem too high, for instance, that 30% position might be sold and the proceeds invested in Treasury bills, which are safe cash holdings.

Timing the market—determining the ideal times to buy and sell—has proven to be extremely difficult. However, a tactical asset allocation model that sticks to a process for evaluating asset classes may help investors avoid frothy market extremes and thus boost long-term returns.





MECHANICAL INVESTING

Some money managers take what's known as an automatic or *"quant"* (for quantitative) approach to picking selected securities or asset classes. With mechanical investing, selections are made on the basis of certain pre-set criteria. Perhaps the original form of mechanical investing, the *"Dogs of the Dow,"* was designed for individual investors. This plan starts with the 30 stocks in the Dow Jones Industrial Average, most of which pay dividends to shareholders.

Each year, perhaps in December, investors would buy the 10 highest-yielding DJIA stocks. Those issues were affectionately labeled dogs because they probably had lagged during the year, and the depressed stock price had driven up the dividend yield. ***A stock paying a $2 annual dividend will have 4% yield when trading at $50 but a 5% yield if the price drops to $40.***

History indicates that one year's laggards often become the next year's leaders. By repeating the process each year, selling some stocks and buying others in order to have the highest-paying DJIA stocks, investors have done well over the long term. As might be expected, mechanical investing has become much more sophisticated since the Dogs were born. Some professional managers have developed screens for selecting investments and programmed computers to do the buying or selling when certain events occur. The premise is that making investment decisions more logical and less emotional can lead to greater success.

DOW JONES TOP 30 HOLDINGS[12]

Ticker	*Company*
MMM	3M
AXP	American Express
AAPL	Apple
BA	Boeing
CAT	Caterpillar
CVX	Chevron
CSCO	Cisco
KO	Coca-Cola
DIS	Disney
DD	E I du Pont de Nemours and Co
XOM	Exxon Mobil
GE	General Electric
GS	Goldman Sachs
HD	Home Depot
IBM	IBM
INTC	Intel
JNJ	Johnson & Johnson
JPM	JPMorgan Chase
MCD	McDonald's
MRK	Merck
MSFT	Microsoft
NKE	Nike
PFE	Pfizer
PG	Procter & Gamble
TRV	Travelers Companies Inc
UTX	United Technologies
UNH	UnitedHealth
VZ	Verizon
V	Visa
WMT	Wal-Mart

INVESTING IN MUTUAL FUNDS

As explained, one way to invest is by purchasing individual issues of stocks or bonds. Alternatively, investors can put their money into pools of investments, managed by financial firms. Key advantages include:

- **Professional management.** The companies that offer mutual funds have teams of researchers who evaluate potential investments, as well as portfolio managers who make the decisions about securities to buy and sell for the pool. Individuals who invest through these pools have time for other activities in their lives.

- **Diversification.** These pools typically hold dozens or even hundreds of different securities. When some fall in value, others can rise. Over a long term, this reduced volatility may be less stressful for individual investors, compared to the price fluctuations of a few holdings.

FOCUSING ON MUTUAL FUNDS

Investors have many types of pools from which to choose. Examples of pools that are accessible to most investors, with relatively modest required minimum outlays, include exchange-traded funds and closed-end funds, both of which will be covered later. However, the most popular and most far-ranging type of investment pool is the mutual fund. Total assets in mutual funds in 2015 topped $15 trillion.[13]

What differentiates mutual funds from the investment pools mentioned above?

Mutual funds do not trade like stocks. Technically, mutual funds are *"open-end"* funds. Investors buy and sell mutual fund shares from the sponsoring company, rather than from other investors on an exchange. Generally, mutual fund companies will issue any number of shares to interested investors. These companies—often known as mutual fund families, if they sponsor multiple mutual funds—also will purchase shares from shareholders who wish to sell (redeem shares), usually with minimal waiting time. Purchase and redemption prices are set according to the current values of the securities held by the fund.

PAYING THE PRICE

Mutual funds can be subdivided into many type of categories. For example, funds can be differentiated by how they're obtained and relinquished by investors.

- **No-load funds.** Some mutual funds are sold and redeemed directly from sponsoring financial firms.

  HYPOTHETICAL EXAMPLE. Walt Young wishes to invest $10,000 in a mutual fund offered by ABC Fund Co., so he sends a $10,000 check to ABC and receives a certain number of shares. A few years later, when Walt needs $5,000 to meet a current expense, he requests a $5,000 redemption from ABC and receives a check for that amount, reflecting the sale of a certain number of shares. Walt pays no transaction fees when buying or selling shares, so this fund from ABC is known as a no-load.

- **Load funds.** While some mutual funds are no-load, others are known as load funds. Investors buy and sell these funds through a financial advisor, who receives some type of commission.

  HYPOTHETICAL EXAMPLE. Thelma Vance reads an article about a mutual fund from DEF Fund Co., and decides to buy. However, DEF does not sell shares of its funds directly to investors. As a result, Thelma works with her financial advisor to buy shares of this DEF fund; when Thelma wants to redeem some or all of those shares, the redemption also will be done through her advisor.

  In return for helping Thelma with her investments, her advisor will receive some form of compensation, known as a sales load. Many load funds have more than one share class, and that share class will determine the amount and nature of the advisor's compensation.

KEY POINT. Regarding A, B and C Shares, specific details for fund share classes vary. Investors should read the terms carefully before making any commitments.

ASSESSING THE A-B-Cs

If investors work with advisors and invest through mutual funds with a sales load, how can they choose among the share classes? A few general rules can help.

- **A shares.** ***"A" shares have an upfront load that's deducted from the initial investment.*** These may make sense for long-term investors. The upfront sales charge might be offset by the lower annual 12b-1 fees. Also, investors who want maximum flexibility may like the freedom to sell at any time, without redemption fees.

  Suppose that Thelma invests $10,000 in A shares, which have a 5% sales commission. Thelma will pay that amount immediately. Therefore, the initial charge is $500 (5% of $10,000), and Thelma will receive $9,500 worth of shares in her account.

- **B shares.** ***"B" shares have redemption fees, which might be paid later.*** These can be appealing if investors are uncertain about their plans to sell. They'll avoid a front load and, if they decide to hold for the long term, may wind up with lower-cost A shares.

  Instead of A shares, Thelma may be able to buy B shares of that fund. B shares usually have a *"contingent deferred sales charge (CDSC)."* There's no upfront load but investors will owe a fee if they sell within a specified time period.

  For example, Thelma chooses B shares so she receives $10,000 worth of shares when she invests, not $9,500 worth. However, the fund will impose a 5% fee if Thelma sells within one year, 4% if she sells within two years, etc. Eventually, there will be no redemption fee, as well as no upfront load, IF Thelma holds onto those shares. However, annual administrative charges probably will be higher with B shares than with A shares.

- **C shares.** ***"C" shares may have the highest ongoing fees.*** These might be good choices for investors who think they'll sell shares after a few years. Investors in C shares pay no upfront load and may expect to avoid redemption fees.

  Yet another opportunity, for Thelma, might be buying C shares of this fund. Generally, C shares have no upfront load and a modest redemption fee that expires after a short time period. The disadvantage: investors in C shares usually pay the maximum annual amount for a different type of charge, known as a 12b-1 fee: ***With load funds, investors often pay 12b-1 fees every year.***

Many mutual funds, especially load funds, impose an annual charge known as a 12b-1 fee. This fee, named for a section of the Investment Company Act of 1940, a federal law, helps mutual fund companies pay marketing and distribution costs, including advisors' compensation with load funds. Typically, annual 12b-1 fees range from 0.25% to 1% of the fund's assets. Shareholders pay their portion, per share owned.

Investors who buy A shares might pay 0.25% in 12b-1 fees while investors who buy C shares may pay the maximum 1% each year. B shares can be a hybrid, charging a 1% 12b-1 fee initially but changing to A shares once the redemption charges expire, with a 0.25% 12b-1 fee.

All mutual funds have expense fees. Annual 12b-1 fees are included in a fund's "expense ratio:" the percentage of assets that shareholders pay each year to the company operating the investment pool. Note that no-load and load funds all have expense ratios, which can vary dramatically, from fund to fund, and impact returns to investors.

HOLDING PATTERNS

Besides loads and no-loads, there are many other ways to differentiate mutual funds from each other. One way is to classify funds according to the securities they hold.

STOCKS, BONDS, AND MORE

Some mutual funds largely hold shares of corporate stocks, also known as equities. Other funds hold bonds and various debt obligations, all of which come under the heading of fixed income. Yet other funds hold significant amounts of equities and fixed income, so they're called balanced funds.

Those investment categories may be traditional, but today's full menu of mutual funds is much broader. There are funds that own real estate securities, for example, and those that execute alternative investment strategies. Some investors (and some advisors) are satisfied with a meat-and-potatoes approach of emphasizing stocks and bonds while others believe there are advantages to holding a more diverse mix of investments.

INVESTING IN STYLE

One way to illustrate the possibilities of mutual fund classification is to start with stock funds. They generally have the largest potential for long-term gains but also the greatest risk of sharp price plunges along the way. ***Stocks have had several years of gains over 30%, but also years when losses topped 30%.***

Within stock funds, further distinctions exist. Some mutual funds focus on foreign stocks, for instance, while others invest mainly in companies based in the U.S. Foreign stock funds can go in different directions. Some focus on companies from industrialized countries (such as Japan, Germany, France, the U.K.); other funds offer participation in emerging markets (Brazil, Russia, India, China, for example.)

GROWTH VS. VALUE

Either domestically or internationally, stock funds may focus on one type of company, as defined by their past and current trading prices.

- **Growth stocks.** Some companies have enjoyed rapid earnings growth in recent years, or have the potential for such growth. These companies tend to trade at a relatively high price, compared to their profitability.

  For example, GHI Corp., which is growing rapidly, might have a trading price per share equal to 20 times its earnings per share. Investors are paying this steep price in return for expected higher earnings in the future.

- **Value stocks.** On the other hand, other companies have what seem to be relatively low trading prices. JKL Corp., for example, has a trading price per share equal to only 10 times its earnings per share. This may be because JKL has posted slow earnings growth over the years.

  Investors might find this trading price to be a bargain, if they're upbeat on prospects for the company, or they might find that the low trading price generates an appealing dividend yield. Some stock funds lean heavily towards growth or value stocks, but other mutual funds, which might be called blend or core funds, hold a mix of growth and value stocks.

SIZE MATTERS

Yet another way to look at equity funds is by the size of the companies whose stocks they own. A fund that typically holds the largest companies is called a *"large-cap"* fund while a fund with the stocks of relatively small companies is a *"small-cap"* fund. In between are companies that are neither the largest nor the smallest publicly-traded firms, known as *"mid-caps,"* so a stock fund that mainly holds the stocks of such companies is a mid-cap fund.

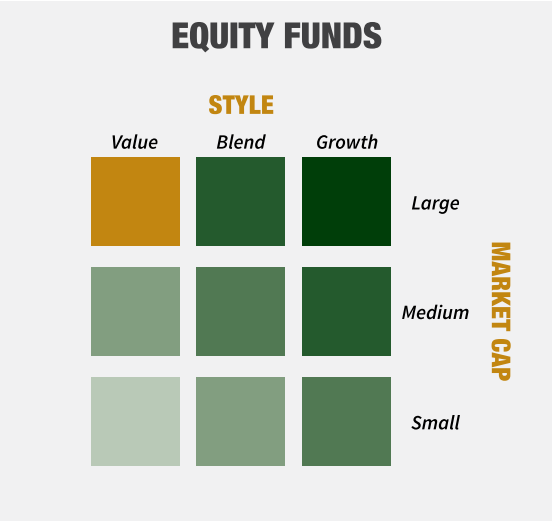
The word *"cap,"* in this context, is short for capitalization. A large-cap fund generally holds the stocks of companies with a huge market capitalization: the current value of all the shares it has issued. Small- and mid-cap funds hold smaller companies, but not mom-and-pop grocery stores. Even a small-cap company probably has outstanding shares worth hundreds of millions of dollars.

TIC TAC DOUGH

Therefore, equity funds may be sliced by whether they mainly invest in growth stocks, value stocks, or a blend of both types. Then they may be diced by whether they mainly invest in large-caps, mid-caps, or small-caps.

The result is a diagram that resembles the familiar tic-tac-toe grid, with three boxes on each side of the square.

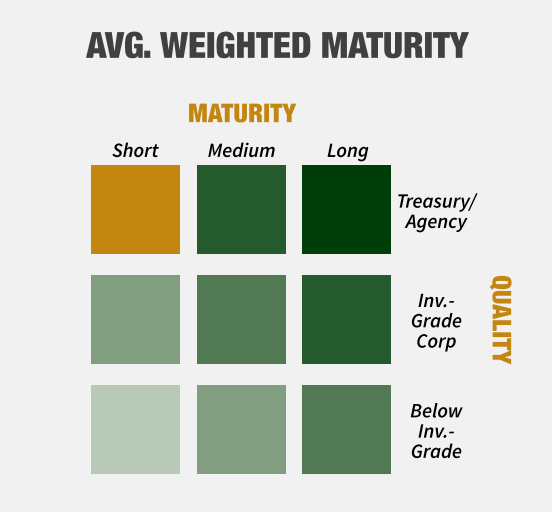
At the upper left of this box, with large-cap value funds, investors tend to get the most



conservative equity mutual funds: such funds hold giant companies with relatively low trading costs. Moving to the right and down, the funds hold more volatile issues—the stocks of smaller companies priced to reflect expectations of increased profitability. Foreign stock funds have a similar style box.

For bond funds, the shape is the same but the style box has different labels. Instead of value vs. growth, fixed income funds are classed by the credit quality (risk of default) of the bonds they hold.

- **High-quality bonds** are government issues or other securities considered nearly default-proof.
- **Medium-quality bonds** are issued by corporations with solid credit ratings, or the equivalent.
- **Lower-quality bonds**, in some cases known as junk bonds, have relatively high risk of default.



In addition, fixed income funds are classed by the maturity of the bonds they hold: how long until the bonds are redeemed and investors get their money back. The longer the time frame, the greater the risk of price fluctuation while the bonds are outstanding.

Again, moving from the upper left to the lower right of the style box, from short-term, high-quality bond funds to funds that hold long-term bonds from lower-rated issuers, means going from conservative to aggressive investments. Conservative bond funds likely will deliver asset preservation while aggressive funds may provide more interest income as well as steeper price drops in bad years.

Online, investors can find many websites, including Morningstar.com, where they can learn where equity or fixed income funds fall into the relevant style box.

TAKING ADVANTAGE OF TECHNOLOGY

Indeed, today's technology makes it much easier for investors to evaluate mutual funds. Astute computer searches can result in extensive information.

For example, on Yahoo! Finance (finance.yahoo.com), investors can look up specific funds by name or by ticker symbol. The fund's historic performance and its expense ratio, including any 12b-1 fee, will be displayed. On that site, investors can learn a fund's turnover ratio, which indicates how often management buys and sells securities. This information can be very useful for tax planning, as funds that trade their holdings actively tend to generate higher annual tax bills for shareholders, versus funds that are more likely to hold securities for the long term.

OTHER KEY POINTS

In addition, Yahoo! Finance and other websites provide more details about each mutual fund:

- **Category.** A fund might be a small-cap value fund, say, or a mid-cap blend. That tells investors where on the risk/reward spectrum a fund likely will fall.
- **Performance.** Investors can see past returns and how they ranked in the category. If a fund has a 15th-percentile rank for the past five years, for example, it has posted higher returns than 85% of the funds it its category, in that time period.
- **Yield.** At a time when bank accounts and money market funds have scant yields, investors may turn to stock funds or bond funds for dividend or interest income. (Technically, bond funds collect interest from their holdings but pay out dividends to investors.) A mutual fund's current yield is reported online, on many websites.

Some sites will report a trailing 12-month (TTM) yield and a 30-day SEC yield (reflecting required reports to the federal Securities and Exchange Commission). The SEC yield is more current: an SEC yield that is lower than the TTM yield may indicate that the fund's yield will decline in the near future while an SEC yield higher than the TTM yield might suggest a rising payout.

FUND STATURE AT A GLANCE

Investors don't have to drill down to all the fund's detail, if they choose not to do so. Yahoo! Finance also shows a fund's Morningstar rating, issued by the well-respected investment research firm. A fund with a five-star rating, for example, has posted excellent returns, compared to the risks (price drops) investors have faced. A four-star rating indicates a fund just below the top level. And so on, to three-star funds, etc. More stars may reassure investors that a fund has been well-managed. (Of course, future results aren't guaranteed, even for top-rated funds.)

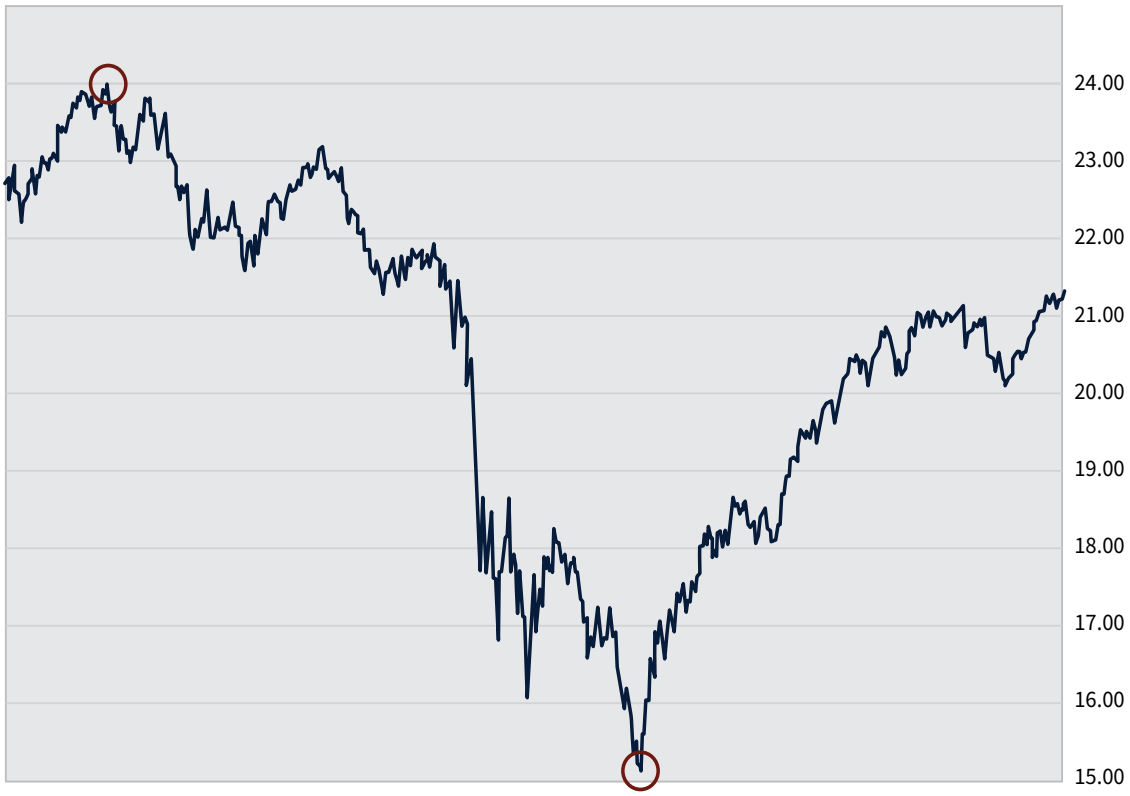
PICTURE PERFECT

Yahoo! Finance has yet another valuable feature: interactive charts. When investors are looking at a particular fund there, they can see how a fund's share price rose or fell in any specific time period. This can be particularly useful in getting a realistic idea of how a fund has performed in bear markets.

To give an example, suppose Paul Rand searches for Vanguard Target Retirement 2010 (Ticker: VTENX). This fund holds a mix of equity and fixed income funds. Thus, it might be considered relatively conservative, in terms of its exposure to a bear market in stocks. Say Paul wanted to see how this fund fared in the financial crisis caused by the collapse of the real estate bubble. He might look at this fund's results in 2008, when the crisis became major news. ***That year, VTENX investors suffered a loss of more than 20%.*** However, Paul might go one step further and request the interactive chart to show the results of the past 10 years. Then, he'll see that VTENX peaked in October 2007, at $23.99 a share, and fell to a low of $15.77 a share in February 2009. Instead of a calendar-year drop, this bear market was a 16-month slide, spanning three calendar years. ***Altogether, the fund lost more than 34%, from market peak to market trough.***

VTENX PRICE DROP: OCTOBER 2007 - FEBRUARY 2009

The one year calendar year loss in this example would have been -20.67. However, if you look at the peak to trough, the loss was actually -37.02% (23.99 at it's peak, 15.11 at it's low).



Source: finance.yahoo.com

Peak-to-trough performance gives a better idea of a fund's volatility. An investor who might have borne a 20% fall may be leery of a fund that lost more than 34% in the last bear market. Knowing the recent high and low values for a fund may help investors decide whether it's a good choice, considering their risk tolerance.

ETFS VS. MUTUAL FUNDS

As mentioned, mutual funds are open-end funds, which don't trade like stocks. On the other hand, some funds are exchange-traded, just like shares of Apple or General Electric. Exchange-traded funds come in two varieties, commonly known as closed-end funds or ETFs.

Closed-end funds may offer securities at a discount. For many decades, investors have been able to buy closed-end funds. These funds typically are managed in an attempt to beat industry benchmarks. Just as is the case with mutual funds, closed-end funds can hold stocks, bonds, or some combination. A closed-end fund might hold a portfolio of low-rated but high-yielding bonds; another closed-end fund might hold shares of selected companies based in India, for instance, or in Brazil. Two factors may differentiate closed-end funds from other traded securities:

- **Leverage.** Many closed-ends funds, especially those in the fixed income sector, borrow to buy additional shares. MNO Closed-End Bond Fund, for example, might raise $100 million from a sale of shares to investors and borrow $50 million, then purchase $150 million worth of bonds. In a fund that can borrow, say, 2% but buy bonds yielding 5%, the dividend yield to investors can increase. On the other hand, using leverage can increase losses in a down market.

- **Premiums and discounts.** Intuitively, closed-end fund MNO, holding $150 million worth of securities and having 15 million shares outstanding, for example, should trade at $10 a share, the net asset value (NAV) per share. However, many if not most closed-end funds trade at a premium or discount to NAV. MNO might trade at, say, $9.50 a share, for a 5% discount, or at $10.20 a share, for a 2% premium.

Such disparities reflect supply and demand for shares of a particular closed-end fund; premiums and discounts will vary over time. Some investors look for closed-end funds trading at a substantial discount to NAV, hoping to earn higher yields, because of the reduced purchase price, and to profit from a sale if the discount narrows or turns into a premium.

ETFs promise low costs and low taxes. Although closed-end funds are traded on exchanges, the term ETF has come to stand for a newer, different type of exchange-traded fund. In this century, exchange-traded products (ETFs and their cousins, exchange-traded notes) have gone from little-known newcomers to buzz words, with over $3 trillion in total assets.[14]

In this century, exchange-traded products have gone from little-known newcomers to buzz words, with over $3 trillion in total assets.[14]

Closed-end funds, as noted, typically attempt to deliver superior returns to shareholders. ETFs, for the most part, track indexes. They might hold stocks in the S&P 500, for instance, in order to replicate the result of that broad stock market index.

As mentioned earlier, index funds (those used in a passive rather than an active strategy) have two advantages over funds that seek better-than-market results:

- **Low expense ratios**. A fund that mimics the index has no need for highly-paid analysts and portfolio managers, who use state-of-the-art technology in an effort to choose securities that will excel for fund shareholders. Instead, this type of fund holds the stocks or bonds in the index.

- **Low trading.** Indexes usually change their composition infrequently, reducing the need for ETFs to do a great deal of buying and selling of securities. Fewer transactions can lead to lower transaction costs as well as lower trading profits, which can mean lower taxes to pass through to shareholders.

Moreover ETFs are structured to avoid recognizing taxable gains, which must be distributed. Similarly, the structure of ETFs usually helps to minimize the discounts and premiums to NAV common among closed-end funds.

KEY POINT. REITs may deliver substantial income, a play on real estate growth, and portfolio diversification. However, investors should look under the roof carefully, to see exactly what's inside the deal.

GOING BEYOND INDEXES

The most heavily traded ETFs tend to track major market indexes. That said, the ETF universe also includes many niche products. A fund company, for example, might put together a basket of Chinese stocks related to the Internet, label that basket a Chinese Internet Index, and offer an ETF to track this index. Some ETFs depart from indexing altogether. Billions of dollars are now invested in gold bullion ETFs, which provide investors with a virtual portion of warehoused physical gold. Practically every month, new ETFs are introduced, some designed to give investors access to a unique market or strategy. As is the case with mutual funds, it's vital for investors to know what they're getting for their money. There's no magic to the ETF structure, but its growing popularity indicates acceptance by investors and financial firms.

MUTUAL FUNDS OR ETFS?

Index-tracking investments are not limited to ETFs. Many mutual funds track market indexes, and they also offer low costs and low taxes. Indeed, competition between index mutual funds and index ETFs has led to competition on expenses and tax efficiency, often to the benefit of investors. The major difference is that ETFs, like closed-end funds, trade like stocks. An ETF's buying and selling prices may vary during the day, with transactions handled by a financial firm or an advisor.

Investing in ETFs may require lower minimum investments: someone might buy 100 shares of an ETF trading at $10 for $1,000, while mutual funds may require $2,500 or more as an initial investment. At the same time, ETFs are generally bought and sold through third parties, who will receive a commission. ETFs might lend themselves more easily to various strategies, such as using limit orders or selling short or buying on margin or trading options on the ETF. Those are tactics for sophisticated, active traders, who may prefer ETFs.

For most investors, in for the long term, index mutual funds and ETFs are fairly similar. Those who buy no-load mutual funds directly might prefer index mutual funds, if offered by the fund family they trust. Investors who are used to dealing with an advisor might ask for suggestions about ETFs that would fit into their portfolio.

All mutual funds and ETFs are sold by an offering document or prospectus. All information regarding the fund, including risks and fees, are found in the prospectus and should always be reviewed prior to making an investment decision.

BUY AND HOLD

Besides mutual funds and exchange-traded funds, yet another type of investment pool is a unit investment trust *"UIT."* Generally, a UIT will hold either a mix of bonds or a mix of stocks.

At inception, a UIT will sell shares, known as units, to investors and buy securities from a relatively small number of issuers. Typically, a UIT won't hold more than 20 different stocks or bonds. And that's it. The UIT won't buy or sell any other securities. If some are sold along the way, the proceeds will be distributed to the unit holders.

Many UIT sponsors will maintain a secondary market, allowing unit holders to sell units back to the sponsor, which may in turn sell those redeemed units. The trading prices will be at market value. UITs will have a termination date, which might be many years in the future. At that time any remaining securities held by the UIT will be sold, and the proceeds distributed to the current investors.

The advantages of a UIT include transparency: investors can see what they'll be owning, via the UIT. Often, UITs pay monthly income from stock dividends or fixed-income distributions. The predictable cash flow, from an unchanging portfolio of stocks and bonds, may be welcomed by retirees. Nevertheless, investors are depending on the skill and judgment of the people who selected the securities that go into the UIT—and stay there.

REAL OPPORTUNITIES

Another type of pooled investment involves real estate, which can be an excellent asset class for investors. However, retirees may be reluctant to buy investment property, considering the time involved in property management, the amount of cash needed to buy in, and the lack of liquidity. Real estate investment trusts (REITs) can be an attractive alternative, but are not risk free. Unfavorable financial and economic factors can cause REITs to lose money. Many REITs trade like shares of common stocks, offering investors broad real estate diversification for a modest price per share. REITs fall into two categories.

- **Equity REITs own one or more properties**. REIT ABC might own only industrial buildings, for example, while REIT XYZ might own hotels.
- **Mortgage REITs are fixed income investments.** They might buy home mortgages, collect payments from borrowers, and pass cash through to investors.

CASH COWS

REITs are required to pay investors at least 90% of their taxable income each year. Thus, REITs generally have relatively high yields.

In late 2016, for example, equity REITs paid around 3.7% to investors, on average, which was much higher than the yield on the S&P 500 Index of large company stocks. Mortgage REITs paid over 10%. Besides receiving these yields, REIT investors often receive favorable tax treat-

ment. A portion of dividends from a REIT might qualify for low long-term capital gains tax rates while another portion might be currently untaxed, as a return of capital

Note: Some REITs do not trade publicly. They might promise higher yields but also restrict investors' ability to sell for many years.

ANNUITIES: CASH FLOW FOR A LIFETIME

Financial dictionaries define annuities as contracts sold by life insurance companies, which guarantee payment to a recipient (an *"annuitant"*). In practice, the term *"annuity"* is applied to many products sold to consumers; all of them may offer some form of ongoing cash flow in the future, including lifelong payouts.

An annuity that doesn't pay cash right away is known as a deferred annuity.

IMMEDIATE VS. DEFERRED

One way to categorize annuities is to consider when the cash flow will begin. If the payments start right away, the contracts may be called *"immediate annuities."* Some insurers call these products *"payout annuities"* or *"income annuities,"* but the concept is the same: the purchase of a contract that is soon followed by a series of payments to the purchaser. A life-only annuity might be the baseline immediate annuity.

HYPOTHETICAL EXAMPLE. George Carter, age 70, pays $100,000 to an insurance company for a straight life annuity. Right away, George will get $600 a month, in this hypothetical example. The payments will last as long as George lives.

HYPOTHETICAL EXAMPLE. Paula Walker, age 50, pays $100,000 to an insurance company for a deferred annuity. Such annuities involve a double deferral:

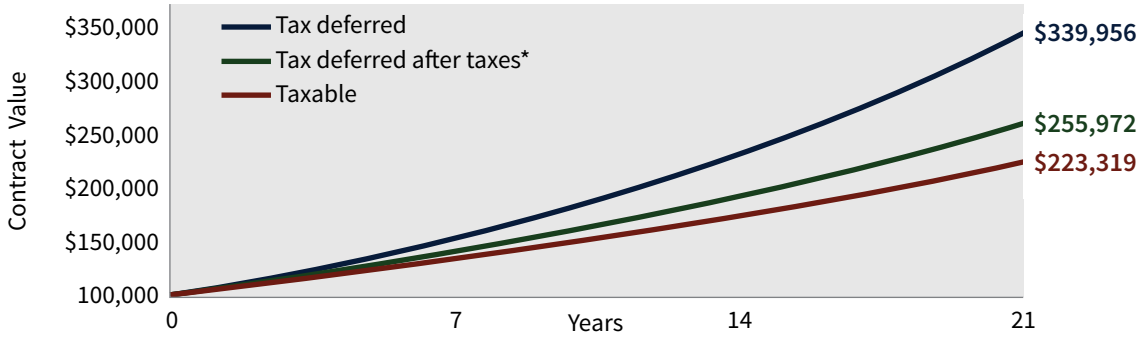
- ☐ With no immediate payout, the premium paid by Paula stays in the contract, to be invested in some manner. Cash distributions to purchaser may not start for many years.
- ☐ If the premium paid into the contract remains, no income tax will be due until any distributions are taken. Thus, deferred annuities may be known as tax-deferred annuities.

Suppose that Paula's deferred annuity is positioned in a manner that earns 6% a year. At that rate, money is expected to double in about 12 years. (The so-called Rule of 72 is explained elsewhere in this course.) Thus, Paula's deferred annuity contract would be worth $200,000 at age 62 and $400,000 at age 74, assuming no distributions. A higher or lower earnings rate would result in a greater or lower buildup, inside the annuity contract.

THE POWER OF TAX DEFERRAL

Postponing taxes on earnings allows more money to compound over time. The increased compound can potentially result in greater long-term returns.

TAX DEFERRAL FOR POTENTIAL GROWTH



* Assumes $100,000 initial purchase with a 6% annual growth rate and 35% tax rate over a 20-year period.

Withdrawals of earnings are taxable as ordinary income and, if taken prior to age 59, may be subject to an additional 10% federal tax.

This example is hypothetical and for illustrative purposes only. The hypothetical rates of return shown in this example are not guaranteed and should not be viewed as indicative of the past or future performance of any particular investment. Changes in tax rates and tax treatment of earnings may impact the hypothetical example.

A tax-deferred annuity will generate taxes when money is withdrawn. However, paying taxes later than sooner is generally a good idea, because a dollar in tax paid in the future usually is less valuable, in terms of spending power, than a dollar in tax paid currently. Tax-deferred annuities give purchasers considerable control over when money will be withdrawn, and tax paid. Retirees may benefit from withdrawals in a lower tax bracket, if they have little or no earned income.

FIXED OR VARIABLE

Another way to look at annuities is by regarding the nature of the growth potential inside the contract, or the nature of the payout to the contract owner. A buyer's cash flow might be fixed, by contract, or variable, according to the specific terms of the contract.

In practice, immediate annuities usually are fixed annuities. Payout is set at the time the contract is purchased and payments begin. Immediate variable annuities, with payments that rise and fall according to investment performance, are relatively rare. Both deferred fixed annuities and deferred variable annuities are common.

BASIC ANNUITY OPTIONS

- **A traditional deferred fixed annuity** might resemble a bank CD in that the purchaser is guaranteed a certain growth rate over a stated period of time. At the end of that period, the stated interest rate will re-set for another time period. Deferred fixed annuities are insurance products.

- **A deferred variable annuity** usually presents investors with a series of options that resemble mutual funds. Effectively, investors' money can go into stocks and bonds. Contract growth will depend on how well the selected investments perform as these products are tied directly to market performance. As such, these products are subject to market volatility risk based on performance of the sub-accounts.

TWO OUTLIERS

In recent years, two types of annuities that don't fit neatly into the two-by-two grid have gained popularity.

- **Deferred Income Annuities.** Insurers usually call these products by names such as deferred income annuities or longevity annuities, to avoid confusing buyers. With these annuities, the buyer pays now but don't start to receive promised payouts until years in the future.

HYPOTHETICAL EXAMPLE. George Carter pays $100,000 to an insurer at age 70, as in a previous example, but defers the payment stream until age 75. Instead of getting, say, $600 a month ($7,200 a year), starting at age 70, as mentioned, he might be able to get, say, $950 a month ($11,400 a year), starting at age 75.

Longevity annuities may make sense for people who have other retirement income resources for immediate income needs.

- **Fixed Index Annuities (FIAs).** FIAs may be considered a hybrid between fixed and variable deferred annuities. They resemble fixed annuities as there is no risk to principal due to market volatility for contract owners, even when financial markets skid. However, the actual growth potential is not a stated rate, thus can vary based on the specific terms of the contract.

As the name suggests, FIAs have growth potential that results from the performance of one or more chosen market indexes, such as the S&P 500. However, FIA returns are capped based on caps, spreads and participation rates determined by the issuer.

Result: FIAs offer the possibility of generating higher returns than standard deferred fixed annuities, with similar downside protection. However, they lack the upside potential of deferred variable annuities, which can carry more investment risk.

DRILLING DOWN: IMMEDIATE ANNUITIES

Immediate annuities are designed to deal with longevity risk: the possibility that assets will dwindle over a retirement that lasts for multiple decades. In our hypothetical example, George Carter will get his monthly payout no matter how long he lives, as a supplement to Social Security, even if he outlives all of his other assets. An immediate annuity can help address the once prevalent lifelong pensions of the past that employers generally provided to long-tenured employees.

Straight life annuities, such as the one purchased by George Carter, expire at the annuitant's death. It might pay out for 25 years, but also for only 25 months, or even 5 months, if that is when George dies.

Most people don't relish the idea of paying $100,000 to an insurance company but possibly collecting only $5,000 or $10,000. Thus, insurance companies typically offer several options to make immediate annuities more palatable. Most common:

- **Joint Annuities.** Often chosen by married couples, they pay out as long as either annuitant is alive. There might be a payment reduction after the first death.
- **Period Certain/Refund Annuity.** Term-certain or cash refund annuities promise to pay out at least a certain amount, even if the annuitant dies prematurely. Some payments would be made to a designated beneficiary.
- **Inflation-Protected Annuities.** Payments will increase to match cost-of-living increases.

All of these options decrease the payments received by annuitants. If the insurance company issuing the annuity is taking on more risk, it will lower the amount of cash flow contract owners will receive. Nevertheless, immediate annuities are among the few financial contracts that guarantee cash flow for as long as the purchaser might live.

TAX TREATMENT

The location of an immediate annuity will determine how payouts are taxed.

- **If the source of the immediate annuity money is an IRA and other qualified retirement account.** Immediate annuity distributions generally are fully subject to income tax.
- **In a regular nonqualified account.** Immediate annuity distributions are partially taxable and partially a tax-free distribution on the annuitant's premium paid.

The calculation will be made by the insurance company. Consumers can ask the company for a quote before buying.

CALCULATING THE "EXCLUSION RATIO"

Let's say that a hypothetical client, Heidi Jones, purchases a $200,000 straight life immediate annuity when her life expectancy is 20 years. She will receive $1,000 a month ($12,000 a year) for the rest of her life. Over 20 years (240 months), Heidi is expected to receive $240,000. Thus, her original purchase premium of $200,000 is 5/6 of the $240,000 that Heidi is expected to receive. ***Then the exclusion ratio is 5/6, in this example.***

Consequently, only 1/6 of each payout is income taxable: $2,000 a year. Assuming a 25% tax rate, Heidi will owe $500 in tax (25% of $2,000) and net $11,500 a year, from her immediate annuity, on her $200,000 contract.

This exclusion ratio is effective only until all of the contract owner's outlay has been returned, free of income tax. Subsequently, all distributions for an immediate annuity are usually subject to income tax. The tax treatment of immediate annuities, described above, also applies to pay-outs received from deferred immediate annuities, sometimes referred to longevity annuities.

DRILLING DOWN: DEFERRED ANNUITIES

There are three main types of deferred annuities: fixed annuities, variable annuities, and fixed index annuities. They all have some common features:

- **Credited Interest.** All deferred annuities offer the opportunity to earn credited interest. With variable annuities, premium payments are allocated to sub-accounts, similar to mutual funds, where values can fluctuate up and down based on the sub-account performance. With fixed annuities, a declared interest rate is credited on premium payments. With fixed-index annuities, credited interest is linked to market index performance, with no downside risk to premium due to market volatility.
- **Annuitizing.** After a specified period of time, the contract can be annuitized. Annuitization converts the contract into a series of periodic income payments either for a certain period of time or for the life of the annuitant.
- **Guaranteed withdrawal benefit.** Instead of annuitizing, contract owners can take money

from a deferred annuity via withdrawals. Some types of annuities have this feature built into the product, while some offer an rider at an additional cost. With the purchase of any additional-cost riders, the contract's values will be reduced by the cost of the rider. This approach provides more flexibility and possibly more potential upside, but the tax treatment is not as favorable (see following *"Tax Treatment"* section).

- [ ] **See your financial professional.** Product features and limitations should be clearly understood. A financial professional's assistance may be necessary to explain the fine points, and to go over the multiple ways in which such features and limitations can differ, from contract to contract.

TAX TREATMENT

Once a deferred annuity is annuitized, most of the same tax rules apply as they would to immediate annuities. For example, if a non-qualified annuity is annuitized, the basis is recovered tax-free over the life expectancy of the account owner. If a qualified annuity is annuitized, all distributions are generally taxable.

On the other hand, for a nonqualified annuity, withdrawals taken from the contract will be taxed gain-first. If the annuity is qualified, withdrawals generally will be fully taxable.

TEN PERCENT ADDITIONAL TAX

Before age 59½, a 10% penalty usually will be added to the taxable portion of any distribution from a qualified or non-qualified annuity.

TAX-DEFERRED ANNUITIES IN TAX-DEFERRED ACCOUNTS

Some critics contend that tax-deferred annuities do not belong in tax-deferred retirement accounts. Nevertheless, many tax-deferred annuities are held in such accounts. It's true that putting a deferred annuity into an IRA is redundant, in terms of taxation. Also, annuity contracts can have many rules and restrictions; why add complexity by putting them into a retirement account where even more regulations may be imposed?

That said, there can be situations where a deferred annuity in pension account is worth consideration. People who have virtually all of their savings in tax-deferred retirement plans may find that is the only practical place to hold a deferred annuity, if one is desired and if the plan allows.

What's more, deferred annuities can have guaranteed lifetime and at-death benefits. Consumers might want such guarantees in their retirement accounts. Thus, care should be taken in deciding whether to buy a deferred annuity, which contract to choose, and where to hold the annuity after the purchase.

HOW DEFERRED ANNUITIES COMPARE

	FIXED ANNUITIES	FIXED INDEX ANNUITIES	VARIABLE ANNUITIES
Initial Premium Requirements	Single or flexible payment(s)		
Payments to Annuitant(s)	Election to annuitize. Alternatively, withdrawals from contract, subject to penalty provisions as to time and amount		
Market Volatility Risk	Principal & any credited interest fully protected—not directly tied to the stock market	Principal & any credited interest fully protected—not directly tied to the stock market	Considerable, if chosen investments perform poorly
Growth Potential	Modest, at today's yields	Chance for moderate growth, based on performance of chosen indexes	Chance for high returns, if chosen investments perform well
Guaranteed Minimum Return	Yes, limited to issuer's claims-paying ability	Yes, limited to issuer's claims-paying ability	No
Income Tax Considerations	Deferred until money is paid out		
Liquidity	Limits apply		
Special Provisions	Specified living and death benefits may be offered		

This is not a comprehensive overview of all the relevant features and benefits of each type of product shown. Be sure to review all of the material details about these products before making any financial decisions. Guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company. Variable annuity guarantees do not apply to the performance of the variable subaccounts, which will fluctuate with market conditions.

CASH VALUE ACCUMULATION THROUGH LIFE INSURANCE

The purpose of life insurance might seem straightforward. Someone pays premiums to an insurer and receives a policy that will pay beneficiaries if the insured individual dies. However, life insurance can serve other purposes, including living benefits and potential cash value accumulation. To see how, it's necessary to put policies into two categories.

- **Term life.** These policies, in effect for a specified time period, pay death benefits, as described in the policy, on a death while the policy is in effect.
- **Permanent life.** These policies may stay in effect indefinitely, as long as the premiums are paid. The premiums tend to be much higher than the premiums for term life, given equivalent initial death benefits.

Permanent life premiums are higher because only a portion goes to cover current life insurance obligations. The balance of the premiums paid has the potential to accumulate and provide cash value. Any cash value accumulation grows tax-deferred. As the insured individual grows older and the actuarial cost of life insurance increases, the cash value can be used to pay the higher charges.

WHERE THE CASH FLOWS

Permanent life insurance policies generally fall into three categories—Whole Life, Universal Life, and Variable Life Insurance policies.

- **With whole life and universal life policies**, increases in cash value usually match yields on fixed income investments. Whole life policies typically have more guarantees while universal life has more flexibility.
- **Variable life policies** (including variable universal life) often provide an investment menu from which policyholders might choose. Those options usually include choices that resemble equity mutual funds, providing upside potential and downside risk inside the policy's cash value.

With all permanent life policies, the cash value can grow until it is needed to pay steep premiums late in life.

HYPOTHETICAL EXAMPLE. Len Vaughn bought a permanent life policy at age 40 and has kept it in force for 25 years, paying premiums regularly. He is now 65, retired, with hundreds of thousands of dollars in the policy's cash value: that includes many thousands of dollars of untaxed cash accumulation income. Len may be able to take some money from the cash value, via withdrawals and loans. If he proceeds cautiously, leaving enough in the cash value to keep the policy viable, Len may be able to avoid income tax on this incoming cash flow.

Keep in mind, any cash value accumulation used as living benefits through policy loans and/or withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Tax laws are subject to change. You should consult a tax professional.

The insurance company will be able to tell policyholders how much they can take from a permanent life policy without triggering unwelcome consequences. If the need for a death benefit can be firmly established, permanent life insurance may turn out to be a good protection resource through the death benefit it offers, as well as a supplemental source of cash in retirement.

DOLLAR COST AVERAGING

For all types of financial products—stocks, bonds, funds, even life insurance—one strategy has proven to be a winner. It's known as averaging. The idea is to pay a fixed amount regularly: annually or quarterly or monthly or bimonthly. As share prices fluctuate, the fixed outlays buy more shares when prices are low and fewer shares when prices are high.

Dollar cost averaging can result in a lower cost per share, leading to greater gains over the long term.

HYPOTHETICAL EXAMPLE. Joan Pierce has $100,000 to invest in GHI Corp. She could invest all at once, but instead she invests $25,000 per quarter, for four quarters. Here's what might happen if GHI shares fall during the following 12 months.

In this example, even though the share price of GHI has dropped by 10%, from $100 to $90, in that year, Joan still has a profit of more than 4.5%, because dollar-cost averaging has lowered her cost per share.

	AMOUNT	PRICE	SHARES
Q1	$25,000	$100	250
Q2	$25,000	$90	277.7
Q3	$25,000	$70	357.14
Q4	$25,000	$90	277.7

Total Shares Purchased: 1,162
End Price: $90
Market Value: $104,580

It's true that investing everything upfront would be better, if the investment is made at the stock's low price. However, stocks tend to fluctuate and dollar-cost averaging can reduce the risk of buying when the stock is at its high price.

Many investors essentially use dollar-cost averaging if they participate in a 401(k) plan. Participating employees may have 401(k) contributions deducted from each paycheck. A worker putting, say, $1,000 per month into a 401(k) would get 20 shares when they sell for $50 and 25 shares, if the price falls to $40. So they're buying more shares on price dips and fewer shares when the price rises, resulting in a lower price-per share. Outside of a 401(k), a similarly disciplined dollar-cost averaging plan enables investors to keep buying when stocks fall, a buy-low strategy likely to pay off in better long-term results.

CHAPTER 2
CHECK FOR UNDERSTANDING QUIZ

1. *Which of these is* **not** *a type of risk associated with bonds?*

   a. Default Risk
   b. Interest Rate Risk
   c. Call Risk
   d. Tax Risk

2. *Active investment management means selecting specific investments to meet a stated goal, not just investments that mirror a selected index.*

   a. True
   b. False

3. *A 12b-1 fee is an annual marketing or distribution fee on a mutual fund. The 12b-1 fee is considered to be an operational expense and, as such, is included in a fund's expense ratio. It is generally between 0.25 and 1% (the maximum allowed) of a fund's net assets.*

   a. True
   b. False

4. *All listed below are types of annuities except:*

   a. Variable Annuity
   b. Flexible-Premium Immediate Annuity
   c. Fixed-Index Annuity
   d. Fixed Annuity

5. *Real Estate Investment Trusts (REITs) allow the investor to cash out at any time without penalties.*

   a. True
   b. False

ANSWERS. **1** - d. Tax Risk **2** - a. True **3** - a. True **4** - b. Flexible-Premium Immediate Annuity **5** - b. False

GLOSSARY

TERM	DEFINITION
12B-1 FEES	A 12b-1 fee is an annual marketing or distribution fee on a mutual fund. The 12b-1 fee is considered to be an operational expense and, as such, is included in a fund's expense ratio. It is generally between 0.25 and 1% (the maximum allowed) of a fund's net assets. The fee gets its name from a section of the Investment Company Act of 1940.
401(K)	A 401(k) plan is a qualified employer-established plan to which eligible employees may make salary deferral (salary reduction) contributions on a post-tax and/or pretax basis. Employers offering a 401(k) plan may make matching or non-elective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings in a 401(k) plan accrue on a tax-deferred basis.
403(B)	A 403(b) plan is a retirement plan for specific employees of public schools, tax-exempt organizations and certain ministers. These plans can invest in either annuities or mutual funds. A 403(b) plan is another name for a tax-sheltered annuity (TSA) plan. The features of a 403(b) plan are comparable to those found in a 401(k) plan.
457 PLAN	A 457 plan is a non-qualified, deferred compensation plan established by state and local governments and tax-exempt governments and tax-exempt employers. Eligible employees are allowed to make salary deferral contributions to the 457 plan. Earnings grow on a tax-deferred basis and contributions are not taxed until the assets are distributed from the plan.
ADDITIONAL 10% FEDERAL TAX	Early distributions, prior to age 59 1/2, from qualified accounts, such as traditional IRAs or 401(k)s, generally incur an additional federal tax equal to 10% of the taxable amount. There are some exceptions to this rule. Consult your tax professional for more details.
ANNUITIZATION	Annuitization is the process of converting an annuity contract into a series of periodic income payments. Annuities may be annuitized for a specific period of time or for the life of the annuitant. Annuity payments may only be made to the annuitant or to the annuitant and a surviving spouse in a joint life arrangement. Annuitants can arrange for beneficiaries to receive a portion of the annuity balance upon their death.
ANNUITY	An annuity is a contractual financial product sold by insurance companies that is designed to accept and grow funds from an individual and then, upon annuitization, or through an income rider (either offered for an additional cost, or built into the product) pay out a stream of payments to the individual either immediately or at a later point in time. The period of time when an annuity is being funded and before payouts begin is referred to as the accumulation phase.

TERM	DEFINITION
BEAR MARKET	A bear market is a condition in which securities prices fall and widespread pessimism causes the stock market's downward spiral to be self-sustaining. Investors anticipate losses as pessimism and selling increases. Although figures vary, a downturn of 20% or more from a peak in multiple broad market indexes, such as the Dow Jones Industrial Average (DJIA) or Standard & Poor's 500 Index (S&P 500), over a two-month period is considered an entry into a bear market.
BENEFICIARY	In the financial world, a beneficiary typically refers to someone who is designated to receive distributions from a trust, will, annuity, life insurance policy or other financial vehicle. Beneficiaries are either named specifically in these documents or have met the stipulations that make them eligible for whatever distribution is specified.
BONDS	A bond is a debt investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds are used by companies, municipalities, states and sovereign governments to raise money and finance a variety of projects and activities. Owners of bonds are debtholders, or creditors, of the issuer.
BULL MARKET	A bull market is a financial market of a group of securities in which prices are rising or are expected to rise. The term *"bull market"* is most often used to refer to the stock market but can be applied to anything that is traded, such as bonds, currencies and commodities.
CAPITAL GAINS	Capital gain is an increase in the value of a capital asset (investment or real estate) that gives it a higher worth than the purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.
CAPITAL LOSSES	A capital loss is the loss incurred when a capital asset, such as an investment or real estate, decreases in value; this loss is not realized until the asset is sold for a price that is lower than the original purchase price. A capital loss is essentially the difference between the purchase price and the price at which the asset is sold, where the sale price is lower than the purchase price. For example, if an investor bought a house for $250,000 and sold the house five years later for $200,000, the investor realizes a capital loss of $50,000.
CERTIFICATE OF DEPOSIT	A certificate of deposit (CD) is a savings certificate with a fixed maturity date, specified fixed interest rate and can be issued in any denomination aside from minimum investment requirements. A CD restricts access to the funds until the maturity date of the investment. CDs are generally issued by commercial banks and are insured by the FDIC up to $250,000 per individual.

TERM	DEFINITION
CHARITABLE REMAINDER TRUST (CRT)	A tax-exempt irrevocable trust which generates a charitable tax deduction for the donor. A CRT first pays income to the beneficiaries of the trust for a specified period of time and then distributes the remainder of the trust to the designated charity.
COST-OF-LIVING ADJUSTMENT COLA	An adjustment made to Social Security income benefits and other Supplemental Income sources to counteract the effects of inflation. Cost-of-living adjustments (COLAs) are generally equal to the percentage increase in the consumer price index for urban wage earners and clerical workers (CPI-W) for a specific period.
DEFERRED ANNUITY	A deferred annuity is a type of annuity contract that delays payments of income, installments or lump sums until the investor elects to receive them. This type of annuity has two main phases: the savings phase in which money is deposited into the contract with growth potential, and the income phase during which distributions are received. A deferred annuity can be variable, indexed or fixed.
DEFINED-BENEFIT PLAN	A defined-benefit plan is a retirement plan that an employer sponsors, where employee benefits are computed using a formula that considers factors, such as length of employment and salary history. The company administers portfolio management and investment risk for the plan. There are also restrictions on when and by what method an employee can withdraw funds without penalties.
DEFINED-CONTRIBUTION PLAN	A defined-contribution plan is a retirement plan in which a certain amount or percentage of money is set aside each year by a company for the benefit of each of its employees. The defined-contribution plan places restrictions that control when and how each employee can withdraw these funds without penalties.
DIVIDEND	A dividend is a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. Dividends can be issued as cash payments, as shares of stock, or other property.
DOLLAR-COST AVERAGING	Dollar-cost averaging (DCA) is an investment technique of buying a fixed dollar amount of a particular investment on a regular schedule, regardless of the share price. The investor purchases more shares when prices are low and fewer shares when prices are high. The premise is that DCA lowers the average share cost over time, increasing the opportunity to profit. The DCA technique does not guarantee that an investor won't lose money on investments. Rather, it is meant to allow investment over time instead of investment as a lump sum.

TERM	DEFINITION
ESTATE TAX	A federal estate tax is levied on a decedant's estate (or the property they own) at death if the value of the estate exceeds an exemption limit set by law ($11.18 million in 2018). The estate tax is mostly imposed on assets left to non-spousal heirs, but it does not apply to the transfer of assets to a surviving spouse. The right of spouses to leave any amount to one another is known as the unlimited marital deduction, but when the surviving spouse who inherited an estate dies, the beneficiaries may then owe estate taxes if the estate exceeds the exemption limit. In addition to the federal government, a state may impose its own estate tax.
EXCHANGE-TRADED FUNDS ETFS	An ETF, or exchange traded fund, is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold. ETFs typically have higher daily liquidity and lower fees than mutual fund shares, making them an attractive alternative for individual investors.
EXCLUSION RATIO	The portion of the return on investments that is income tax exempt. It represents a payback of initial investments rather than capital gains.
FEDERAL DEPOSIT INSURANCE CORPORATION FDIC	The Federal Deposit Insurance Corporation (FDIC) is the U.S. corporation insuring deposits in the United States against bank failure. The FDIC was created in 1933 to maintain public confidence and encourage stability in the financial system through the promotion of sound banking practices. The FDIC insures deposits of up to $250,000 per institution, as of 2016, as long as the bank is a member firm.
FIXED ANNUITY	A fixed annuity is a type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. In exchange for a lump sum of capital, a life insurance company credits the annuity account with a guaranteed fixed rate of interest while guaranteeing the principal purchase payment. A fixed annuity can be annuitized to provide the annuitant with a guaranteed income payout for a specified term or for life. Any guarantees are backed by the financial strength and claims-paying ability of the issuer.
FIXED INDEX ANNUITY	A fixed index annuity is another type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. However, it is a special class of annuities that can receive credited interest when the chosen external index has a positive change. These annuities are purchased from an insurance company, and similar to other types of annuities, the terms and conditions associated with payouts depend on what is stated in the original annuity contract. Any guarantees are backed by the financial strength and claims-paying ability of the issuer.
FIXED-INDEX UNIVERSAL LIFE INSURANCE	A permanent life insurance policy that allows policyholders to tie cash value accumulation values to positive performance of a stock market index. Fixed-index universal life insurance policies typically contain a minimum guaranteed fixed interest rate component along with the potential of additional credited interest. Indexed policies give policyholders the security of fixed universal life insurance with the growth potential of a policy linked to positive index performance.

TERM	DEFINITION
FULL RETIREMENT AGE	Full retirement age generally refers to the age you must reach to be eligible to receive full benefits from Social Security. Depending on when you were born, this age can vary. The Social Security Administration has been slowly increasing this age as life expectancies lengthen. Early retirees receive a reduced benefit. For individuals born prior to 1938, full retirement age is 65, while those born between 1938 and 1960 are on a graduated scale up to age 67.
IMMEDIATE ANNUITY	An immediate annuity is an annuity contract that is purchased with a single lump-sum payment and in exchange, pays a guaranteed income for a specified period of time or lifetime based on life expectancy, in which the payment starts almost immediately.
INTESTATE	The act of dying without a legal will. Determining the distribution of the deceased's assets then becomes the responsibility of a probate court, using the guidelines established by state law.
IRREVOCABLE LIFE INSURANCE TRUST (ILIT)	An ILIT is an irrevocable trust created for the purpose of owning a life insurance policy. Most ILITs are designed to keep the life insurance death benefit from inflating the value of the insured's estate for estate tax purposes. The insurance trust is a contract between a grantor and a trustee to administer an insurance contract for the benefit of the named beneficiaries. The ILIT cannot generally be rescinded, amended or modified in any way after it is created. Once the grantor contributes property to the trust, the grantor cannot later reclaim ownership of the property.
IRREVOCABLE TRUST	An irrevocable trust can't generally be modified or terminated without the permission of the beneficiaries and trustees. The grantor, having transferred assets into the trust, effectively removes all of his rights of ownership to the assets and the trust. This is the opposite of a revocable trust, which allows the grantor to modify and potentially control the trust and its assets.
LIFE INSURANCE	Life insurance is a protection against financial loss that would result from the premature death of an insured. The named beneficiary receives the proceeds and is thereby financially protected up to the death benefit amount from the financial impact of the death of the insured. The death benefit is paid by a life insurer in consideration for premium payments made by the insured.
LIVING BENEFITS	Living benefit riders, usually available for an additional cost, allow for benefits to paid when applicable during the life of an annuity owner or life insurance policyholder. Typically, life insurance policies only pay a death benefit and annuities only pay living benefits, however riders attached to either can allow for living benefits in life insurance policies and can add death benefits to annuities.

TERM	DEFINITION
LONG-TERM CARE INSURANCE	Coverage that provides nursing-home care, home-health care, personal or adult day care or other limited benefits for individuals with a chronic or disabling condition. LTC insurance offers more flexibility and options than many public assistance programs.
LONGEVITY RISK	Longevity Risk is any potential risk attached to the increasing average life expectancy, specifically the risk of potentially outliving one's assets during retirement.
MEDICAID	Medicaid is a health care program that assists low-income families or individuals in paying for long-term medical and custodial care costs. Medicaid is a joint program, funded primarily by the federal government and run at the state level, where coverage may vary. Medicaid is available only to individuals and families that meet specified criteria. Recipients must be legal permanent residents or citizens of the United States and may include adults with low income, their dependents and people with specified disabilities.
MEDICARE	Medicare is a U.S. federal health program that subsidizes people who meet one of the following criteria: 1. An individual age 65 or older who has been a U.S. citizen or permanent legal resident for five years. 2. An individual who is disabled and has collected Social Security for a minimum of two years. 3. An individual who is undergoing dialysis for kidney failure or who is in need of a kidney transplant. 4. An individual who has Amyotrophic Lateral Sclerosis (Lou Gehrig's disease). Medicare helps out people at a time in their lives when they may have serious health problems but lack the funding for treatment.
MORTALITY CREDITS	With a participating lifetime annuity, premiums paid by those who die earlier than expected that contribute to gains of the overall pool and provide a higher yield or credit to survivors than could be achieved through individual contributions outside of the pool. The mortality credit increases significantly with age and hedges longevity risk, often creating a return that would be impossible to match in the broader financial markets.
MUTUAL FUND CLASS A SHARES	Class-A shares charge a front-end load that is taken off your initial investment.

TERM	DEFINITION
MUTUAL FUND CLASS B SHARES	These shares are classified by their back-end or contingent deferred sales charge. These shares are typically good for investors with little investment cash and a long investment horizon.
MUTUAL FUND CLASS C SHARES	Class C shares are a type of level-load fund. This class works well for individuals who will be redeeming shares in the short term.
MUTUAL FUNDS	A mutual fund is an investment vehicle made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.
PENSION PLAN	A pension plan is a retirement plan that requires an employer to make contributions into a pool of funds set aside for a worker's future benefit. The pool of funds is invested on the employee's behalf, and the earnings on the investments generate income to the worker upon retirement.
PERMANENT LIFE INSURANCE	A universal term for life insurance policies that do not expire (unlike term life insurance) and combine the primary focus of life insurance, the death benefit with a potential for cash value accumulation. This savings portion can build a cash value—against which the policy owner can borrow funds, or in some instances, the owner can withdraw the cash value to help meet future goals, such as paying for a child's college education. The two main types of permanent life insurance are whole and universal life insurance policies.
POWER OF ATTORNEY (POA)	A power of attorney is a legal document giving one person (called an "agent" or "attorney- in-fact") the power to act for another person (the “principal” or “grantor”). The agent can have broad legal authority or limited authority to make legal decisions about the principal's, health care, property and finance. The power of attorney is frequently used in the event of a principal's illness or disability, or when the principal can't be present to sign necessary legal documents for financial transactions. A POA can be durable, meaning it persists through an individual’s incapacity, or springing, meaning a condition must be met before the POA can be exercised by the agent.

TERM	DEFINITION
PRICE TO EARNINGS RATIOS P/E	The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price-earnings ratio can be calculated as: (Market Value per Share / Earnings per Share). For example, suppose that a company is currently trading at $43 a share and its earnings over the last 12 months were $1.95 per share. The P/E ratio for the stock could then be calculated as 43/1.95, or 22.05.
PROBATE	Probate is the legal process through which a court supervises the transfer of a decedent's assets. Probate can occur when the decedent dies intestate (see page 82), or when the decedent passes away with a will. If the decedent had a will, the probate process determine whether it is valid and authentic. The court appoints either an executor named in the will (or an administrator if there is no will) to administer the process of collecting the assets of the deceased person, paying any liabilities remaining on the person's estate and finally distributing the assets of the estate to beneficiaries named in the will or determined as such by the executor.
QUALIFIED DISCLAIMER	A refusal to accept property that meets with provisions set forth in Section 2518 of the Internal Revenue Code, allowing for the property or interest in property to be refused by the heir, beneficiary or successor owner. These types of refusals can be used to avoid federal estate tax and gift tax, and to create legal inter-generational transfers which avoid taxation, provided they meet the following set of requirements: 1. The disclaimer must be made in writing and signed by the disclaiming party. 2. The disclaimer must identify the property, or interest in property that is being disclaimed. 3. The disclaimer must be delivered, in writing, to the person or entity charged with the obligation of transferring assets from the giver to the receiver(s). 4. The disclaimer must be written less than nine months after the date the property was transferred. In the case of a disclaimant aged under 21, the disclaimer must be written less than nine months after the disclaimant reaches 21.
QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST	A qualified terminable interest property (QTIP) trust is a type of trust that enables the grantor to provide for a surviving spouse, and also to maintain control of how the trust's assets are distributed once the surviving spouse dies. Income, and sometimes principal, generated from the trust is given to the surviving spouse to ensure that the spouse is taken care of for the rest of her life. Properly drafted, a QTIP trust qualifies for the unlimited marital deduction against federal estate taxes.
REAL ESTATE INVESTMENT TRUST REITS	A REIT is a type of security that invests in real estate through property or mortgages and often trades on major exchanges like a stock. REITs provide investors with an extremely liquid stake in real estate. They receive special tax considerations and typically offer high dividend yields.

TERM	DEFINITION
REQUIRED MINIMUM DISTRIBUTION (RMD)	A required minimum distribution (RMD) is the amount that traditional, SEP or SIMPLE IRA owners must begin distributing from their retirement accounts by April 1 following the year they reach age 72. Qualified employer plan participants may be able to defer RMDs until April 1 of the calendar year following the year in which they retire. RMD amounts must then be distributed by December 31 of year following the year in which they reach age 72 based on the current RMD distribution calculation amounts.
REVERSE MORTGAGE	A type of mortgage in which a homeowner can borrow money against the value of his or her home. No repayment of the mortgage (principal or interest) is required until the borrower dies or the home is sold. After accounting for the initial mortgage amount, the rate at which interest accrues, the length of the loan and rate of home price appreciation, the transaction is structured so that the loan amount will not exceed the value of the home over the life of the loan.
REVOCABLE TRUST	A revocable trust is a trust whereby provisions can be altered or canceled dependent on the grantor. During the life of the trust, the principal and income earned is usually available to the grantor, and only after death does property transfer to the beneficiaries. This type of agreement provides flexibility and income to the living grantor; He is able to adjust the provisions of the trust and earn income, all the while knowing that the estate will be transferred upon death. The revocable trust is used primarily as a tool to avoid probate.
ROTH IRA	Named for Delaware Senator William Roth and established by the Taxpayer Relief Act of 1997, a Roth IRA is an individual retirement plan (a type of qualified retirement plan) that bears many similarities to the traditional IRA. The biggest distinction between the two is how they're taxed. Since traditional IRAs contributions are made with pretax dollars, you pay income tax when you withdraw the money from the account during retirement. Conversely, Roth IRAs are funded with after-tax dollars; the contributions are not tax deductible. Qualified distributions—those taken after the taxpayer is older than 59.5 and five years after the first Roth contribution—are tax free.
RULE OF 100/110/120	According to a traditional rule of thumb, the percentage of stock allocation should be equal to 100 minus your age with the remaining percentage allocated to a bond portfolio. So if your age is 25, then 75% of the portfolio should be allocated toward stocks and 25% allocated to a bond portfolio. With increased longevity, you can use 110 or even 120 minus your age to determine your asset mix.
SEP IRA	A SEP IRA is a type of traditional IRA for self-employed individuals or small business owners. (SEP stands for Simplified Employee Pension.) Any business owner with one or more employees, or anyone who has business income (as opposed to employment income), can establish a SEP.

TERM	DEFINITION
SEQUENCE RISK	Sequence risk, also called sequence-of-returns risk, is the risk of receiving lower or negative returns early in a period when withdrawals are made from an individual's underlying investments. The order or the sequence of investment returns is a primary concern for retirees who are living off the income and capital of their investments.
SIMPLE IRA	A SIMPLE IRA is a retirement plan that may be established by employers, including self-employed individuals (sole proprietorships and partnerships). The SIMPLE IRA allows eligible employees to contribute part of their pretax compensation to the plan. This means the tax on the money is deferred until it is distributed.
SOCIAL SECURITY	Established by the United States federal government in 1935, Social Security is the commonly used term to describe the Old-Age, Survivors, and Disability Insurance (OASDI) program. OASDI is a social insurance and federal welfare program that provides benefits to retired workers, disabled workers and survivors of deceased workers as well as eligible spouses and dependents.
STOCK CLASS A SHARES	Class A shares refers to a classification of common stock that is accompanied by more voting rights than Class B shares, usually given to a company's management team. For example, one Class A share may be accompanied by five voting rights, while one Class B share may be accompanied by only one right to vote. A detailed description of a company's different classes of stock is included in the company's bylaws and charter.
STOCK CLASS B SHARES	Class B shares are a classification of common stock that may be accompanied by more or fewer voting rights than Class A shares. Although Class A shares are often thought to carry more voting rights than Class B shares, this is not always the case: Companies will often try to disguise the disadvantages associated with owning shares with fewer voting rights by naming those shares "*Class A*" and those with more voting rights *"Class B."* A detailed description of a company's different classes of stock is included in the company's bylaws and charter.
STOCKS	A stock is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. There are two main types of stock: common and preferred. Common stock usually entitles the owner to vote at shareholders' meetings and to receive dividends. Preferred stock generally does not have voting rights, but has a higher claim on assets and earnings than the common shares. For example, owners of preferred stock receive dividends before common shareholders and have priority in the event that a company goes bankrupt and is liquidated. Also known as *"shares"* or *"equity."*

TERM	DEFINITION
STRETCH IRA	A tax planning concept that is applied to defer the distribution—and accompanying income tax—of a qualified employer account or an Individual Retirement Account (IRA) to a beneficiary or beneficiaries. A stretch IRA strategy allows the original owner of an IRA to distribute assets to a designated beneficiary. By using this strategy, the IRA can be passed on while beneficiaries enjoy tax-deferred growth as long as possible. Non spousal IRA beneficiaries generally take taxable distributions of all funds within 10 years of death of the account owner whom they inherited it from. The term "stretch" does not represent a specific type of IRA; rather it is a financial strategy that allows people to stretch out the life—and therefore the tax advantages—of an IRA
TERM LIFE INSURANCE	Term life insurance is a policy with a set duration limit on the coverage period. Once the policy is expired, it is up to the policy owner to decide whether to renew the term life insurance policy or to let the coverage end. This type of insurance policy contrasts with permanent life insurance, in which duration extends until the policy owner reaches 100 years of age (i.e. death) or lapses due to insufficient funds.
THRIFT SAVINGS PLAN	A retirement savings plan created by the Federal Employee's Retirement System Act of 1986 for current or retired employees of the federal civil service. The thrift savings plan is a defined-contribution plan designed to give federal employees the same retirement savings related benefits that workers in the private sector enjoy with 401(k) plans. Contributions to the plan are automatically deducted from each paycheck.
TRADITIONAL IRA	A traditional individual retirement account (IRA) allows individuals to direct pretax income towards investments that can grow tax-deferred; no capital gains or dividend income is taxed until it is withdrawn. Individual taxpayers are allowed to contribute 100% of any earned compensation up to a specified maximum dollar amount. Contributions to a traditional IRA may be tax-deductible depending on the taxpayer's income, tax-filing status and other factors.
TRUST	A trust is a fiduciary relationship in which one party, known as a trustor, gives another party, the trustee, the right to hold title to property or assets for the benefit of a third party, the beneficiary.
UNIT INVESTMENT TRUST (UIT)	A unit investment trust (UIT) is an investment company that offers a fixed portfolio, generally of stocks and bonds, as redeemable units to investors for a specific period of time. It is designed to provide capital appreciation and/or dividend income. Unit investment trusts, along with mutual funds and closed-end funds, are defined as investment companies.

TERM	DEFINITION
UNIVERSAL LIFE INSURANCE	Universal life insurance is type of flexible permanent life insurance offering the low-cost protection of term life insurance as well as a savings element (like whole life insurance), which is positioned to provide potential cash value accumulation. The death benefit, savings component and premiums can be reviewed and altered as a policyholder's circumstances change. Unlike whole life insurance, universal life insurance allows the policyholder to use the interest from his accumulated savings to help pay premiums over time.
VARIABLE ANNUITY	A variable annuity is a type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. As opposed to a fixed annuity that offers a guaranteed interest rate and a minimum payment at annuitization, variable annuities offer investors the opportunity to generate higher rates of returns by investing in equity and bond subaccounts. If a variable annuity is annuitized for income, the income payments can vary based on the performance of the subaccounts.
VARIABLE LIFE INSURANCE	A variable life insurance policy is a form of permanent life insurance. Variable life insurance provides permanent protection to the beneficiary upon the death of the policyholder. This type of insurance is generally more expensive than term insurance because it allows the insured to allocate a portion of the premium dollars to a separate account comprised of various instruments and investment funds within the insurance company's portfolio, such as stocks, bonds, equity funds, money market funds and bond funds.
WHOLE LIFE INSURANCE	Whole life insurance is a policy with premiums that includes insurance and investment components. The insurance component pays a predetermined amount when the insured individual dies. The growth component has the potential to build an accumulated cash value the insured individual can borrow against or withdraw. Policy loans with withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. This is the most basic type of cash-value life insurance.
WILL	A will, also known as a Last Will and Testament, is a legally enforceable declaration of how a person wants his property or assets to be distributed after death.
YIELD	The yield is the income return on an investment, such as the interest or dividends received from holding a particular security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value or face value. Yields may be considered known or anticipated depending on the security in question as certain securities may experience fluctuations in value.

APPENDIX

[1] Employee Benefit Research Institute: FAQs About Benefits - Retirement Issues, What are the trends in U.S. retirement plans?, January 2017

[2] IAM Mortality Table, 2012

[3] 2016 SBBI Yearbook - Stocks, Bonds, Bills and Inflation - U.S. Capital Markets Performance by Asset Class 1926-2015, Duff & Phelps, Appendix C-3 (21)

[4] 2016 SBBI Yearbook - Stocks, Bonds, Bills and Inflation - U.S. Capital Markets Performance by Asset Class 1926-2015, Duff & Phelps, Appendix C-1 (5-8)

[5] LIMRA Fact Book, 2015, pg 89

[6] 2016 SBBI Yearbook - Stocks, Bonds, Bills and Inflation - U.S. Capital Markets Performance by Asset Class 1926-2015, Duff & Phelps, Appendix C-1 (1-2)

[7] Internal Revenue Procedure 2019-44, November 2019

[8] financialmentor.com/calculator/taxable-vs-tax-deferred-calculator
www.allianzlife.com/retirement-and-planning-tools/tax-deferral-calculator

[9] Fidelity Investments - Mutual Fund Research, as of January 26, 2017

[10] 2016 SBBI Yearbook - Stocks, Bonds, Bills and Inflation - U.S. Capital Markets Performance by Asset Class 1926-2015, Duff & Phelps, Appendix C-3 (22-24) & C-1 (6-8)

[11] MacroTrends, S&P Historical Annual Trends, June 2017

[12] CNNMoney - Dow 30 Companies - Dow Jones Global Indexes, INDU, May 2017

[13] Investment Company Institute - 2016 Investment Company Fact Book: 56th Edition, pg 2

[14] InvestorPlace - Understanding ETFs (And Why You Want Them in Your Portfolio), Sept 21, 2016

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