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NAFA Annuity Outlook

The Fixed Annuity Resource

TOP 10 FINANCIAL CHALLENGES TO FUNDING RETIREMENT

Leading Economist **Dr. David F. Babbel** Reveals His Strategies

SPECIAL INSERT

8-Page Social Security Toolbox Loaded with Information for Your Clients

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MY PERSONAL STORY:

DR. DAVID F. BABBEL REVEALS HIS APPROACH TO FUNDING RETIREMENT SUCCESSFULLY

We live in an era that is unprecedented since 1950 in terms of the extraordinary economic challenges that face a person preparing for retirement. For the vast majority of us, there will be no pensions similar to those that have provided income throughout the remaining lifetime of past retirees. Instead, we have defined contribution plans whose returns can be positive or negative, depending on our investment prowess or (mostly) sheer luck (or lack thereof).

The safety net we have backing us is shredded. We have an overburdened Social Security System that thrived in past decades on the backs of an ever-increasing working population. My generation (the "boomers") spent much of its resources on funding the previous generation, who were provided huge Social Security benefits relative to their payments into the system. We also had to fund our own benefits, yet our payments have been diverted for general federal expenditures and left us with little more than an unfunded promise. The next generation is unlikely to be willing or able to fund us, as they are much smaller relative to the number of people who will be entering retirement. (There used to be 8 workers for each retiree, but shortly we will have only 2.5 workers per retiree.) The rates of return on our Social Security investments are low or negative, except for the lower earning among us. And those low or negative rates of return *assume* that somehow, the owed benefits will be undiminished in real terms and paid as promised.

In this note, I will explain my own approach to dealing with the approaching challenges. I recognize that it reflects my own risk tolerance (which is low) and my own circumstances. It is not a perfect plan, nor is it a foolproof plan, yet it is the best that I could come up with for my wife and me and it might have some applicability for others who face similar circumstances. My own background might provide a useful backdrop to understand my choices.

I received a B.A. in economics, an MBA in international finance and a PhD in finance. I have taught investments courses, fixed income, portfolio management and insurance courses since 1978, when I began my academic career at the University of California at Berkeley. After serving on that faculty for six years,

I completed a postdoctoral fellowship in risk and insurance at The Wharton School of the University of Pennsylvania and became a professor there, where I taught courses both in finance and insurance. I have published over 100 books and articles on investment and insurance topics, most of which were peer reviewed. I consulted with some of the largest financial institutions in the world, and have also consulted various government organizations, including the Treasury, Federal Reserve, Office of the Comptroller of the Currency, Commodity Futures Trading Commission, Department of Labor, Pension Benefit Guaranty Corporation, and others. I took a leave of absence from Wharton beginning in 1987 and worked on Wall Street at Goldman Sachs. My time there was divided across several departments, including the Financial Strategies Group, the Fixed Income Division, the Pension and Insurance Department, and Goldman Sachs Asset Management. Later, in the 90's, I took a second leave of absence and worked as a senior financial economist at the World Bank, where I helped developing countries strengthen their capital and retirement markets. I returned to Wharton and continued there until I became a professor emeritus a few years ago (although I still teach there occasionally) and entered the consulting world, where I continue to conduct research and advise financial firms. My specialty is helping financial firms invest in such a way that their economic risk is minimized in the face of volatile market conditions. This is accomplished through the creation of asset-liability matching and dynamic hedging strategies such that their assets and liabilities move in value in the same direction and by the same amounts under various economic scenarios. My point in rehearsing this background is that I should be reasonably equipped to manage my own investments during retirement, yet I choose not to, for reasons stated below.

The situation I faced a couple of years ago was that I was rapidly approaching retirement age, and the investment world was undergoing a transformation that made it most difficult to plan for retirement. I had only a small pension from Berkeley ($900/month, complete with the full faith and credit of California standing behind it!) as well as the university equivalent of a 401(k) from Wharton. And, of course, I have Social Security, which is a system that has been skewed to subsidize the poor. Although I had built up a reasonably gracious lifestyle, I recognized that to maintain it in retirement, I would have to supplement those resources. As I turned to my academic colleagues from Berkeley, Wharton and elsewhere, and my Wall Street colleagues, it quickly became apparent that there was no consensus among those who specialize in investments about what should be done. Indeed, I found that many were just as bewildered as I was. I consulted with other investment professionals as well, but found their suggestions often did not address the main problems that I faced in a manner consistent with my low tolerance for risk. Many had no ideas at all regarding how to deal with the mess that we face. Among those who did have suggestions, they amounted to risky bets on continued low interest rates, spiking interest rates, deflation, hyperinflation, precious metals, real estate, junk bonds, hedge funds, private equity, stock market bubbles, bursting bubbles, foreign exchange rates, and so forth. I felt that I had accumulated sufficient savings that I shouldn't need to take risky bets and relegate their outcome to luck.

Some had very complex strategies that would require me to be savvy well into my 90's and able to operate dynamic hedges with synthetic derivatives. As an alternative, I could pay healthy annual fees and let these folks handle the dynamic hedges, never mind that these same people are likely to be headed to a different investment firm or other career long before I am headed to the grave!

IN THE FOLLOWING ESSAY, I WILL BRIEFLY DISCUSS TEN OF THE MOST IMPORTANT FINANCIAL CHALLENGES TO FUNDING RETIREMENT:

1. **Longevity – not knowing how long you will live, and hence, how many years you must fund**
2. **Inflation – deflation – protecting the value of your future income**
3. **Personal cost of living – this does not closely track the general rate of inflation, but ultimately is what matters**
4. **Legacy**
5. **Liquidity sufficient to cover extraordinary events (e.g., new auto, roof, uncovered disease, etc.)**
6. **Tax – confiscation of wealth**
7. **Litigation risk**
8. **Insolvency of firm standing behind securities/insurance**
9. **Diminished investment capacity**
10. **Protection from the kids!**

None of the traditional retirement strategies covers all of these bases and some simply amount to dubious bets on the direction of interest rates, inflation, benevolence of kids, no litigation, etc.

My personal approach to addressing and balancing these risks includes deferred and immediate annuities in an innovative and responsive, albeit simple way. I will not be able to cover it fully in this limited space. I will not discuss long-term care insurance, uncovered medical expenses, trusts and life insurance. However, I will describe the essence of my strategy in a manner that should help you see whether or not it offers elements that might be useful for your own situation. My

approach is prone to leaving some money on the table, but it allows me to sleep at night. I have no interest in keeping up with the Joneses, who might well surpass me if their stock or precious metals bets turn out right; rather, I have an interest in maintaining my lifestyle as long as practically possible. Nothing more, nothing less.

I should disclose here that I have no products to sell and never have. I don't endorse any particular investment or insurance companies, brokers, agents, or specific products. I do not engage in any personal consulting on these issues.

> "There was no consensus among my colleagues... Investment professionals didn't address the main problems I faced in a manner consistent with my low tolerance for risk."

1) Uncertain lifetime

Certainly the most daunting risk facing most retirees is their uncertainty regarding the length of life they will need to fund. It could be one year or forty years, or anywhere in between. It is difficult to salt away enough during a 30-40 year working life to provide for another 20-40 years. The lower the interest rate is, the more difficult this task becomes. At zero interest, you would need to save almost half of your income to be virtually sure that you will have enough to last as long as you do. As the real rate of interest increases (and it has been zero or negative since mid-2011 on 5-year, 7-year, and 10-year TIPS and during part of 2012 even negative on 20-year TIPS), you can reduce your savings somewhat. Alternatively, you can play the equities, commodities, or real estate market and hope you don't get burned. You may be able to get by with saving a lot less, if you're lucky, but you may wind up having to save a lot more. Consider Japan, which 24 years ago was the world's second largest economy by many measures. The stock market then (the Nikkei 225) reached 39,000. Twenty-four years later, it is hovering around 13,000 – some 66% lower. So much for "stocks for the long run"! Many of us won't live long enough to benefit from the long run. As John Maynard Keynes aptly put it, "In the long run, we are all dead." Even with dividends, which get taxed each year, investors in the Japanese stock market would be far behind. In the USA, we are still behind where we were twelve years ago in real terms, even after the huge 4-year run-up in stocks artificially pumped up by unprecedented monetary expansion and deficit spending. (There is precedent in other countries for such monetary stimulus and deficit spending, but it didn't work out very well...)

Fortunately, with ordinary fixed annuities, you can provide income for your maximum lifespan for about 40% less than it would take to provide the same level of lifetime income security using noninsurance vehicles. However, that leads us to our second challenge.

2) Inflation

The average length of retirement for a healthy person retiring at age 65 is about 20-23 years, depending on gender. About half of those people will die before they reach that average, while the other half will live longer, and many will live much longer. In fact, actuaries estimate that about 25% of couples who are healthy at 65 will have at least one member live longer than 97 years.

If you consider every 20-year period since the U.S. eliminated dollar convertibility into gold on August 15, 1971 (e.g., January 1972 – January 2002, February 1972 – February 2002, and so forth until July 1992 – July 2012), you will find that the dollar lost from 36 to 70 percent of its purchasing power by the end 20 years, depending on the period. In other words, if you were receiving $10,000 per month at the outset of retirement, that same $10,000 received 20 years later would have a purchasing power of only $3,000 to $6,400, depending on when you happened to retire. Now, you have to ask yourself, "Do I expect that the rate of deterioration in the purchasing power of the dollar will remain within that same range over my first 20 years of my retirement?" Really? Neither do I. When considering the profligate deficit spending combined with unprecedented monetary expansion that we have seen over the past several years, I along with many other economists expect that this will all come home to roost, but who really knows?

Therefore, if you are trying to maintain some semblance of purchasing power over your remaining lifespan, you might want to consider keeping a goodly portion of your wealth in reserve rather than annuitize most of it at the outset. Alternatively, you could annuitize the bulk of it but save much of your monthly income for the first 10 or so years so that the savings can supplement an eroded annuity payment later. Of course, this would expose you to the uncertain lifetime predicament, and your supplemental savings might run out before you do. Another alternative is to purchase an escalating annuity that provides higher payments over time.

There are two kinds of such inflation-protected annuities available. The first kind is one where you choose an annual escalation factor, such as 1%, 2%, ... or up to 6%. This is meant to cover escalating costs over time. But what if there is very low inflation or even deflation? You would be forgoing a lot of current consumption to cover an inflationary scenario that might not emerge to the degree predicted. Economists have a rough time predicting inflation more than a year or two away, much less 20 years. Yet you would essentially be using your expertise to predict long into the future. The likelihood that your guess would be right is close to zero.

The other kind of inflation-protected annuity is actually indexed to the CPI, although it is common to have a maximum annual adjustment capped at 4% or 6% or some other number that could prove to be very inadequate if we have another bout of inflation like the early 1980's, or worse.

Moreover, our CPI index keeps getting "refined" (read that, "reduced"). Traditionally, the consumer price index measured changes in the prices of a basket of common goods and services. I studied inflation and its effect on financial assets

(including life insurance products) in depth when I wrote my doctoral dissertation. I even went to Brazil for a year to see its effects up close. I saw how third-world countries rigged their inflation accounting in order to meet public targets. They would do this by, effectively, throwing out or reducing the weights of certain items from the consumer "basket of goods and services" that had gone up in price too fast. By doing this, the governments could meet their targets and reduce their expenses that were tied to inflation. Economists from the USA who worked with me there were appalled by such manipulations but grateful that we lived in a country that eschewed such a practice. However, since returning from Brazil in 1976, we have witnessed our own country undertake measures that have a similar effect. They altered the method of calculating inflation in the mid 1980s, again in the early-to-mid 1990s, and then again in 2013. I won't go into the mathematics of these changes here, but can attest that each of these methodological changes has had the effect of reducing reported inflation. One website that tracks the effects of these changes indicates that actual annual price inflation rates, if measured the same way we did for most of the 20th century up through 1980, would be about 7% higher than what we are currently reporting. If we continued to use the calculation methodology in place in 1990, we would be reporting 3% more annual inflation than we currently report. Those economists who helped the government trim its expenses by devising such methodologies were worth every penny they were paid! (See http://www.shadowstats.com/article/archived-438-inflation-measurement and http://www.shadowstats.com/alternate_data/inflation-charts .)

You can see the implications. Even if you could accurately forecast inflation over the length of your retirement, or alternatively, acquired an inflation-indexed annuity fully linked to the CPI, without any imposed caps, you may not be covering the value erosion that actually ensues. (Note also that a fully inflation-indexed annuity begins with annual payments that are about 25% to 30% lower than a level-payment annuity. However, if inflation ensues thereafter, the annual annuity income increases and may surpass that of the level annuity after a sufficient number of years.) But suppose that these alternatives get you pretty close. That leads to the third challenge.

3) Your cost of living versus the CPI

The CPI measures the change in a basket of consumer goods. Currently, that basket contains about 200 categories of goods and services. The problem is that the basket used does not track the basket of a retiree, and more importantly, does not track your particular cost of living. The components and, more particularly, the weights applied to those components of the retiree's basket of goods and services differ significantly from the general basket used to measure inflation. Moreover, a retiree's relevant basket changes drastically over time, and your particular basket may not correlate well with that of the average retiree. Travel may be a big part of the basket during early retirement, but may not be relevant later on; conversely, the cost of assisted living may dominate during the last years. And there are many steps along the way. The strategy that I will propose later will address this challenge. Which leads me to the next one.

4) Legacy

Many but not all retirees would like to leave something of monetary value to their heirs. Most who do simply leave what remains, if anything, after expending what is needed to keep them alive. This sets up a potential conflict of interest. Those heirs who may be sacrificing and providing significant assistance to you in your most senior years will likely receive less and less the longer you live, and perhaps may even feel forced to pay your living and burial expenses when you run out of money. This is particularly likely if you follow a retirement strategy that avoids the lifetime income guaranties of annuities, because you and they will be much more exposed to the risks of your outliving your income.

On the other hand, if you annuitize the bulk of your wealth, there probably won't remain anything for them at all unless you get a lifetime annuity with a "period certain" payout of, say, five, ten or twenty years. In that case, your heirs may receive something, but probably not if you survive the stipulated period. Moreover, you will receive significantly lower monthly payments during the rest of your life for having opted such a period certain payout provision, especially if you select a period certain longer than ten years. The strategy that I describe later addresses this issue in a different way. Which leads me to the next one.

5) Liquidity sufficient to cover extraordinary events (e.g., new auto, roof, uncovered disease, etc.)

Suffice it to say that to the extent that your monthly income is generated from pensions, annuities, and Social Security, it will be essentially level, for all practical purposes. However, living expenses are not level at times, which means that you will need to set aside some additional funds to handle such expenses. Those funds must be available when needed, and not subject to significant losses occasioned by the caprices of the marketplace. I'll share my own approach to this need.

Even if you could accurately forecast inflation over the length of your retirement, or alternatively, acquired an inflation-indexed annuity fully linked to the CPI, without any imposed caps, you may not be covering the value erosion that actually ensues.

6) Tax – confiscation of wealth

Our income tax has morphed into a wealth tax in some ways. The easiest way to see this is by considering the taxation of government-issued inflation-indexed bonds, or TIPS. Such bonds pay a fixed real rate of interest, such as 2% applied to a principal that floats upward with inflation. For example, if a bond is purchased for $1000, and if inflation during the first year is 10%, the bond's principal is increased to $1,100. If you apply a 2% rate to that, the interest payment will be $22. However, the tax authorities will assess a tax based not only on the $22 interest income, but also on the adjustment to principal of $100, so you will be taxed on $122, not $22. (The

actual calculation of this is a bit more complex due to accounting accrual formulas, but this is approximately right.) However, $100 of that return was not an increase in your real wealth; rather, it was an adjustment made simply to preserve the wealth that you gave to the government for its inflation-indexed bond. Suppose that you are taxed at a rate of 40%. Then your tax will be $48.80 even though you received interest of only $22. In effect, you were taxed on your principal, reducing its real value by the $26.80. This is a wealth tax, not an income tax, from the perspective of economists and other thinking people!

But the exact same argument can be made for nominal (non-indexed) bonds and stocks if you think about it carefully. I will not belabor the point here with a mathematical proof. Inflation is simply a back-door way of taxing wealth, but the effects are just as real as an income tax, albeit more pernicious because they often escape the public eye. Enough on that! I'll discuss the tax implications of my strategy later. Now for the next challenge of retirement planning.

7) Litigation risk

If you have accumulated a reasonable sum of money to fund your retirement, you are also a target for someone else – a person or an institution – to try and transfer it to themselves. This often occurs through litigation. Even if you prevail in a lawsuit, the costs of litigation can take a sizable chunk out of your retirement savings. My own approach to retirement reduces this risk greatly.

8) Insolvency risk of the person or institution standing behind your retirement

In the past, many corporations provided lifetime income to their retirees through traditional pensions. When the pensions were underfunded, the corporations were on the hook to contribute more until they were properly funded. If the corporations failed, the PBGC (Pension Benefits Guaranty Corporation) stepped in to make up the difference, up to certain maximum limits per individual (currently $57,477 per year for a 65-year-old). Most of us in the baby boom generation will have none of that protection.

If we leave our money invested in the market, whether stocks or long-term bonds, we are subject to losses of 10% to 60% in any given year. If we give our money to a bank or insurer, they too may suffer losses and become insolvent. My retirement strategy takes this into account in several ways, as discussed later.

9) Diminishing investment acumen with age

Several studies have documented the decreasing investment acumen that we suffer as we age. A recent study showed that people over the age of 60 average about 3% to 5% lower annual returns on their investment portfolio each year than those younger, even after adjusting their portfolios to the same risk levels and taking into account experience. (See George Korniotis and Alok Kumar, "Do Older Investors Make Better Investment Decisions? The Review of Economics and Statistics, February 2011, Harvard College and MIT.) Performance deteriorates quickly after age 70. This implies that over a period of, say, 20 years, you could be far behind what you would be if you had been investing like a younger person. Although I am trained in investing, I recognize that as I age I too am likely to succumb to diminished investment prowess. Besides, I do not wish to spend my retirement years pouring over company financial statements and reports of dubious value. Not all of us are as resilient to age as Warren Buffet. Therefore, my strategy takes into account the aging mind.

10) What about the kids?

One of the most difficult situations in which older people find themselves occurs when there are many people trying to get their hands on your hard-earned money. Let's face it. Some of us get rather feeble as we age, and our judgment sometimes lapses. We become vulnerable to impassioned pleas from others to "ante up" our savings to them. This vulnerability is particularly strong in connection with our caregivers who often are members of our own family. How many aged people have lost everything in such situations, sometimes even to well-intentioned recipients? Whatever portion of your wealth is annuitized becomes less prone to these kinds of transfers. Moreover, having full access to all of your wealth at once greatly increases your risk of overspending.

A Description of our Retirement Funding Strategy

Our personal strategy is to get on base, not swing for the fences. (Too many of my colleagues have done the latter and are back in the dugout, or worse.) It addresses each of the aforementioned retirement risks in various ways. None of our approaches is without at least some risk, but in most cases, we are avoiding substantial risks that face most people in my age cohort.

Our strategy is quite simple, and one that I should be able to easily manage as I age. Our qualified assets (tax deductible savings) are mostly in two asset classes: TIPS and Stable Value Funds. The TIPS grow each year by their stated coupon rate as well as inflation. We are not taxed on either until we begin to withdraw for consumption purposes. We also have saved a goodly amount in Stable Value Funds (SVF) through my current 401(k). Stable Value Funds account for about $1 trillion in the retirement space, and are typically the first or second most popular investment choice in those plans that feature them. These assets have yields that move much more slowly than intermediate-term government bond yields. Also, they provide us with no capital losses, unlike bonds and notes. SVF have yielded about 2%-3% over money market funds ever since their inception some 30 years ago, except for a couple of very brief periods where money market fund yields spiked higher. We can withdraw funds from SVF at book value at any time. Elsewhere, I have written extensively on the investment performance of these funds.

These two asset categories allow us to handle

foreseeable, albeit extraordinary expenses, such as a new car, new roof, as well as unforeseeable expenses. We also have some much more modest positions in stock and high-yield bonds, but mostly to keep me abreast of markets for purposes of genteel conversations at social gatherings. If we lose it all, we won't be hurting.

The bulk of our savings is in unqualified (purchased with after-tax money) assets. Most of it is in deferred fixed annuities – 13 in all. Two are in equity-indexed annuities, that provide an annual floor return of 0%, but also give a limited upside based on how the S&P behaves. The upside is subject to an annual cap. None of these investments is unusual. What is less common, however, is how we have structured them.

We handle the insolvency risk in three ways. First, the annuities that we have purchased are all from upper tier companies with excellent credit ratings. Second, they are diversified across many companies so that our exposure to any one company is limited. Third, most of them are in amounts below the Pennsylvania Life and Health Insurance Guaranty Association limits. Each state has such a program, and when an insurer faces insolvency, if another healthier insurer does not assume its policy liabilities (the usual case), remaining insurers are assessed a charge to make good on the insolvent insurer's policies. Depending on the state in which you live, this guaranty is limited to somewhere between $100,000 and $500,000 per policyholder. If you purchase an annuity worth $600,000 at the time of insolvency, for example, and your state's limit is only $300,000, your coverage in the event that the company becomes insolvent and no other company steps up to take over the policies would be only 50%. However, if you and your spouse purchase separate annuities of $300,000 each, you would have full coverage for both annuities. My wife and I purchase most of our annuities separately, although some are held jointly. She will inherit all annuities that are not in payout status if I go first, as well as have sufficient life insurance to augment her assets, if necessary. That will compensate for the fact that some of the annuities in payout status expire when I do, but in the interim, we get about 15% more income than if they were in joint payout status.

Half of them will be annuitized within two years, providing us with lifetime income sufficient for our needs with enough extra to maintain our lifestyle. The other six will continue to be held in deferral, exchanged upon maturity into other deferred annuities. However, at any time they can be either liquidated (in the unlikely event that our extraordinary expenses exceed the TIPS and Stable Value Funds mentioned earlier) or annuitized only when necessary, due to the erosion of the purchasing power of the level payment stream generated by the 7 annuities in payout status.

Inflation risk is handled in five ways. First, only one of our annuities has a maturity beyond 6 years. Thus, our surrender fees are quite low and for any rise in interest over 1%, we can pay the surrender fee and redeploy those assets into another deferred annuity offering the higher yields. Yes, we will lose a bit of money on that transaction that we wouldn't lose if the money had been in money markets, but it will quickly be made up with the new annuity. Also, the yields that we have received in the interim on the deferred annuities greatly exceed what is being offered on money market funds. Second, the annuities in deferral continue to grow, tax deferred. Most of them grow at 3% to 6.5% per year. Third, our primary inflation hedge is that for each year that they remain in deferral, we get not only a higher amount to ultimately annuitize, if needed, but because of our increasing ages we also receive higher "mortality credits" – the repayment of principal baked into the payout rates that are designed to return all of your principal over your expected remaining lifetime. If I or my spouse lives beyond our expected lifetime, the mortality credits come from someone else who logged off early. If I exit early and leave some mortality credits on the table from those annuities already in payout status under my name, I will not have any remorse. I will be dead! My wife will be able to quickly make up for any income insufficiencies with the annuities remaining in deferral, as well as through the whole life insurance I maintain. These mortality credits are substantial, and grow quickly with age. Together with the interest that is credited annually to annuities in deferral, they are able to serve as an excellent income hedge against all but the worst kind of inflation. The lifetime annual payouts available can grow to 10%, 15%, and 20%. When added to the increased annuity value that accrues during the deferral period, a relatively small annuity can dwarf the size of payments of those that were already annuitized. Only insurance products are able to offer mortality credits; other investments leave you prone to running out of money prematurely.

Fourth, recall that all of my university funds are in TIPS, which keep pace with officially reported inflation. The SVF are not subject to capital losses when inflation rises, because we can withdraw them at book value at any time. And finally, we do not plan to access Social Security until I reach age 70, allowing us to have the highest basis subject to annual inflation adjustments throughout out lives. Yes, I know I'm hyper about inflation, but it is the second most important risk for most retirees who live beyond a few years.

I call our approach "staggered annuitization" rather than "laddered annuitization," which is an approach already well understood. The reason not to ladder annuities is that we cannot predict our personal cost of living very well. Remember that hedging against general inflation is not really the goal here. We need to hedge against our personal cost of living. Because mortality credits grow at an increasing rate as we age, there is an incentive to forestall annuitization until we simply cannot maintain the lifestyle we wish to have anymore without turning on another annuity. We will have 6 chances to do this throughout retirement, which should suffice. If we reach an age where it no longer suffices, we will have to reduce our expenditures. We began purchasing deferred annuities in our early fifties, so we have some policies that feature relatively high embedded rates of interest. They also have minimum annuitization rates locked in by a stipulated mortality table. Because lifespans have lengthened significantly, as reflected by updated mortality tables, we are able to get higher mortality credits than if we purchased a new annuity. However, all is not that good, because the older deferred annuities will soon

mature. But those are precisely the ones that we will deploy to begin our annuitization.

The annuities address the legacy challenge in three ways. First, by foregoing the annuitization of half of our annuities, the remaining 6 are all inheritable, as well as our TIPS and SVF. Second, by having a plan that will see me and my wife through our lifetimes, we are able to bequeath funds to our children prior to our demise. This we have done and it is gratifying to see how they carefully use what is transferred to them to pay down graduate school debt and live lives of less quiet desperation than otherwise would be the case. Third, they are unlikely to ever have to sacrifice their own needs to cover for our poor planning. As for the tax issue, we handle that in several ways. Our annuity money grows in tax deferral, as do our qualified Stable Value assets and TIPS. When the annuities are converted into payout status, 40% to 85% of the income is excluded from tax, depending on the basis involved in the purchased annuities. This will help keep us below the maximum tax rate thresholds. Yes, if we had been able to place our money for the children in something with even better tax treatment, such as common stock, we could leave more, but then again, that assumes appreciation in the stock, and also it would require us to wait longer until the legacy is given due to our own financial situation lingering in greater uncertainty. Besides, we have been passing along what we can in amounts that are not subject to the gift tax.

One characteristic that annuities have which is particularly attractive to people who are approaching or already within retirement is that in most states, they are not subject to attachment or confiscation in litigation. Some states have high limits for this protection, while others have unlimited protection.

We are also sensitive to our likely diminishing investment acumen over time, but have set things up in such a way that the performance of the various asset classes we have chosen will not depend much upon any further choices that we make. The only real susceptibility we will be exposed to is in the selection of replacement annuities when the annuities in deferral mature. But we have some help there too. The annuities I have chosen are plain vanilla fixed deferred annuities, except for the two equity-indexed annuities that we purchased. The plain vanilla variety is in the market's sweet spot, because virtually all annuity providers feature that kind of annuity in their menu, and they are priced very competitively, with relatively low margins. The main other choice that my wife and I will have to make going forward is how long we can continue to maintain our lifestyle before annuitizing another one of our remaining annuities. Again, the evidence will be pretty plain to see as our monthly budget numbers will reveal. Also, there is no reason for us to necessarily convert the remaining annuities into a life annuity. For example, if we learn that we are subject to a terminal illness, we might choose instead to annuitize over a period certain, the residual of which our heirs could inherit. This would provide accelerated income over our remaining lifetimes.

As for protection from the kids, we don't have that kind of kids! They are the most loving and supportive children and sons-in-law that one could ever want. They understand and enthusiastically support our strategy, and especially appreciate getting some of their legacy at their time of greatest need. But even if they weren't that kind of children, the difficulty of accessing and liquidating the deferred annuities gives some additional measure of protection, and they simply cannot access the annuities in payout status.

Now some naysayers will undoubtedly berate our retirement strategy. These naysayers will come in several flavors. Some will be true experts and be able to enhance our strategy with some excellent ideas. We welcome any suggestions, as long as they are not too complex, costly or difficult to implement, because we want to be able to fully understand and oversee our assets as long as possible.

There are some kinds of true retirement experts who will have certain products available that combine features of what I have described into a single product. If that single product is from a superior company, it will be worth considering. Also, if the amount you are considering allocating to such an annuity is below the guaranty program threshold, it might be worth listening. The product developments in the annuity field have been remarkable over the past fifteen years and I'm certain that clever professionals could have devised a more efficient strategy for many people than what we have adopted. Nonetheless, we have purchased our annuities in the sweet spot, have diversified the risk, and can manage them into our old age, so based on our risk intolerance, we have not pursued these other legitimate and efficient products. Other people in our situation may find these other products more to their liking. But don't get swayed by guaranteed payout ratios on variable products without first checking out the payout ratios of fixed products. While a 5% to 7% payout ratio on a guaranteed growth rate variable annuity may sound attractive in today's market, it should be compared with the payout ratios on fixed products at the same effective payout age. None of my payout ratios are that low, and we don't have to wait for 10 years to access them. You will typically find the payout ratio to be higher on the fixed products, but when considering the superior guaranteed growth rate on the account value during the deferral period of the variable product, it might end up a horse race. The hedging costs and annual fees are higher on such hybrid products, but can be worth it, depending on how the market behaves.

Other naysayers will criticize our strategy because we are leaving too much potential money on the table by not undertaking greater equity exposure. Let them criticize, and let us sleep.

Others might be irate because our strategy commits "annuicide." That is a term that people in the accumulation business, such as stockbrokers, bond sales people and mutual fund marketers use to describe those of us who annuitize our wealth. Such people lament our kind because they would rather have us keep our assets in a place where they can earn annual asset management fees and trading commissions. Be careful when you listen to such folk, as their motives might not align themselves with yours.

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