

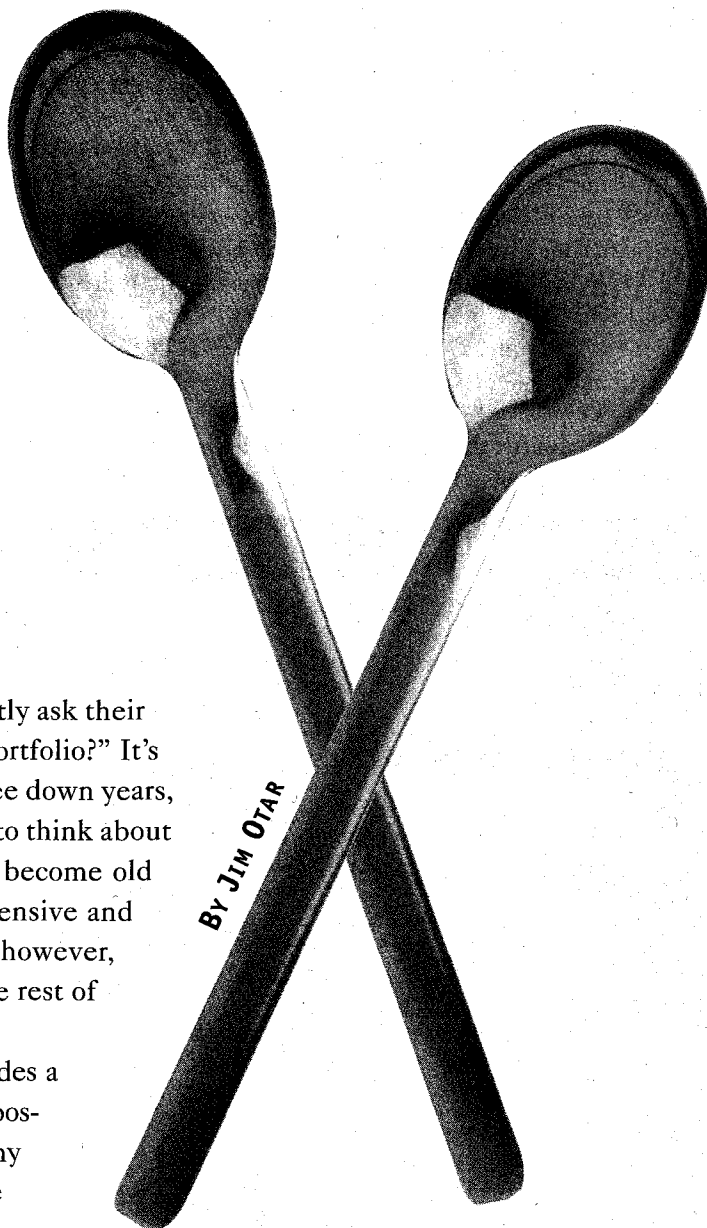
The Perfect mi

Take a life annuity ladder, add an investment portfolio, and stir. The result is a lifelong income stream, access to your capital, and a greater estate value.

One of the questions clients most frequently ask their planners is, "Am I going to outlive my portfolio?" It's always a relevant question, and after three down years, it's more pertinent than ever. Planners may want to think about answering this question with a product that has become old but not venerable: the annuity. Maligned as expensive and unsophisticated, annuities can be just the ticket, however, when laddered and properly coordinated with the rest of the financial plan.

An annuity has one obvious advantage—it provides a steady stream of income until death, removing the possibility of outliving one's money. However, in many cases there is no estate value upon death. On the other hand, a typical investment portfolio provides a retirement income, and upon death it passes on to the estate. Of course, it may run out of money prematurely, leaving little or nothing to heirs.

Ideally, if your clients want to keep control of their money and maximize their estate value, you have to help them buy just enough of an annuity to protect them from running out of income prematurely. You want a perfect mix. >>>



Part of reaching that goal is laddering, which is more effective than buying the annuity all at once. Benefits of laddering include the following:

- The older you are, the higher the payout. As you add new rungs to your annuity ladder, you receive higher payouts for the same amount of premium.
- Laddering reduces interest rate risk; the interest rate will be blended over time.
- Portfolio value may go up, providing more funds to buy more annuity over time.
- You have control of your money for a longer time period.

The first step is to calculate your client's own withdrawal rate (OWR). OWR is the total annual income requirement from the portfolio expressed as a percentage of the portfolio value. For example, if your client has saved \$500,000 for retirement and wants \$24,000 in annual income, then her OWR is 4.8%.

Next, establish the sustainable initial withdrawal rate (IWR) from an investment portfolio (see top chart in the box

below). For example, the sustainable IWR for a 65-year old client is 4%. Therefore, with retirement savings of \$500,000, her annual withdrawals should not exceed \$20,000 at age 65 (4% of \$500,000), adjusted each year for inflation.

The IWR percentages are based on 100 years of market history and assume that the asset mix is 60% fixed income and 40% equities, the projected age of death is 95, and equities in the portfolio outperform the Dow Jones Industrial Average by 2% annually. Two percent may seem unrealistic now, but it signifies the average dividend yield going forward. Different assumptions will change the IWR values, of course.

Next, get quotes for a life annuity for your client. Calculate the annuity payout rate (AR), which is the annual annuity payment divided by the single premium paid to buy the annuity. If your client is a married couple, get quotes for a joint annuity. If for a single premium of \$500,000 the quote provides \$40,000 of annual income, your client's AR is 8%.

Building an annuity ladder involves weighing the benefits of buying an annuity now against buying it in the future. If you could know for sure that your client would have less money in her portfolio to buy the same annuity income stream in the future, then you would have her buy the annuity now. Conversely, if you knew for sure that she would have more money in her portfolio in the future, you would delay the purchase. Following this logic, the client must buy each rung of the annuity ladder based on the probability of having less money in the investment portfolio in a future year.

It's possible to calculate the probability of having less money to buy the same income stream (adjusted for inflation and annuitant's age) for different levels of OWR. The bottom chart in the box at left shows this probability (P%), based on 100 years of market history for a 60% fixed income/40% equity asset mix.

Now you have all the data you need to design the perfect mix and an optimum annuity ladder for your client. Based on how much retirement savings your client has accumulated, he or she will fit in one of the following categories:

1. Insufficient savings, if OWR is greater than AR;
2. Sufficient savings, if OWR is between IWR and AR; or
3. Abundant savings, if OWR is smaller than IWR.

▪ **Insufficient Savings:** If your client is in this category, then his expectations are too high. He will need to adjust his lifestyle or reconsider his retirement age. Otherwise, his portfolio will likely expire before he does.

Some advisers will recommend taking higher risk. While this may work in a mega-bull market, it will fail in flat or bear markets. It is too much of a gamble trying to generate this income from an investment portfolio. The prudent solution is to purchase an annuity with all of his retirement savings.

Since the certainty of running out of money is high, you need to build the annuity ladder in one-year intervals. Each

The Right Ingredients

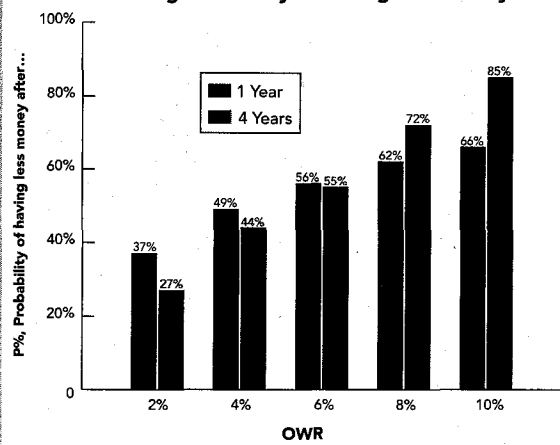
In order to determine the perfect percentage of annuities in a portfolio, you must calculate the sustainable initial withdrawal rate (IWR) and the probability of having less money to buy the same income stream, among other factors.

Calculating IWR

Retirement Age	IWR
55	3.5%
60	3.8%
65	4.0%
70	4.3%
75	5.1%

Based on 100 years of market history, assume that equities in the portfolio outperform the Dow Jones Industrial Average by 2% annually; asset mix is 60% fixed income and 40% equities, and the projected age of death is 95.

Calculating Probability of Having Less Money



Based on 100 years of market history for a 60% fixed income/40% equity asset mix.

