

# A FRAMEWORK FOR MANAGING RETIREMENT INCOME



GWM INVESTMENT MANAGEMENT & GUIDANCE

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You've probably spent most of your life focusing on the accumulation of assets. In retirement, however, you need a strategy to manage your distributions.

The Merrill Lynch Retirement Income Framework's holistic approach aims to provide you with retirement advice and guidance more suited to meet your individual retirement goals. It recognizes the diverse challenges you face in retirement and simplifies the planning process through a robust and comprehensive framework.

The oldest members of the 78 million U.S. baby boomer generation turn 63 this year. Unable to rely solely on government or corporate pensions, many are expected to fund a large portion of their retirement from private savings. In addition, early retirement and increased life expectancy mean that many of them must support longer retirements as well. As a result, the need for sound financial guidance to meet these complex financial challenges is stronger than ever.

Traditional retirement guidance has focused on annuitizing current income — or drawing down your retirement portfolio based on an initial percentage, typically 4%, depending on your age and other factors. But this guidance has shortcomings. Systematic withdrawals can expose you to investment risk and the potential that you may outlive your assets. In addition, these traditional approaches do not account for other potential retirement needs, such as bequest motives and unanticipated expenses.

To help clients plan for retirement, Global Wealth Management (GWM) Investment Management & Guidance has launched the Merrill Lynch Retirement Income Framework. This paper explains how the Framework approaches retirement income planning holistically, taking into account risk tolerance, retirement consumption needs, and appropriate asset allocation. It presents a three-step process that can help you and your Financial Advisor approach and implement the Framework. Finally, the paper uses case studies to illustrate how the Framework may be applied to real-life situations.

## Step One: Assess Your Retirement Situation

You've probably spent most of your life focusing on the accumulation of assets. In retirement, however, you need a different strategy to manage your distributions and, at the same time, protect and grow your assets to meet your longer-term needs.

Both short- and long-term retirement needs are mostly consumption-related. Consumption needs may not remain constant and can increase or decrease over time.

These needs include:

- **Anticipated expenses.** These include estimates of anticipated basic life-style expenses, planned out-of-pocket health care costs, and cost of living adjustments.
- **Unanticipated expenses.** These may be a result of a change in the tax code or an unanticipated health condition, long-term care, or educational expenses.
- **Discretionary expenses.** These include expenses beyond basic lifestyle expenses. Though these expenses are not considered "must-haves," they should be taken into consideration in retirement-income planning.

In addition to consumption, you may have **intergenerational goals** and hope to pass on your wealth to heirs or to an institution or cause. These goals are aspirational and can play an important role in shaping your wealth and consumption profile.

Together with your Financial Advisor, you should review your retirement consumption needs and goals and set realistic expectations based on a balance between those needs and your retirement income sources.

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As you prioritize your needs and goals, you should also consider your capacity to take on risk. Investing during retirement presents a set of risks that are generally absent when saving for retirement. These risks include: longevity risk, inflation risk, health care risk, asset allocation risk, and planning risk (see Exhibit 1 and definitions at the bottom of the page).

In addition, while market risk is present when you save for retirement, its impact can be even greater as you transition and live in retirement. Poor returns during the beginning of retirement can significantly impair your portfolio's ability to generate income over the long term.

**Exhibit 1: Retirement Risks**

<p><b>Short Term</b></p> <ul style="list-style-type: none"> <li>■ Planning risk</li> <li>■ Market risk/sequence of returns</li> </ul>
<p><b>Long Term</b></p> <ul style="list-style-type: none"> <li>■ Inflation risk</li> <li>■ Longevity/life-expectancy risk</li> <li>■ Unexpected health care risk</li> <li>■ Asset allocation risk</li> </ul>
<p><b>Intergenerational</b></p> <ul style="list-style-type: none"> <li>■ Inflation risk</li> <li>■ Longevity/life expectancy risk (that these assets may be used for living expenses)</li> <li>■ Asset allocation risk</li> </ul>

**Longevity risk** refers to the risk that you may outlive your assets by staying alive longer than what you planned for.

**Inflation risk** refers to the risk that the cost of living may rise faster than the value of your investments.

**Health Care risk** refers to both an unanticipated deterioration in your health situation and the unexpected rise in health care expenses.

**Planning risk** refers to the risk that your current retirement income plan may turn out to be too aggressive (or too conservative) and, as a result, you may have to readjust your spending habits in the future.

**Asset allocation risk** refers to the risk that a portfolio is not appropriately diversified.

**Case Study**

Sally and John talked to their Financial Advisor before they retired about their income plan. Since market conditions and their personal situation have changed since then, they are coming back to recalibrate. They are 65 years old with \$2 million in total investment assets. They fully own their current home, worth \$500,000, and plan to leave it to their three children. They estimate that they require a minimum of \$100,000 on an annual inflation-adjusted basis to maintain their current standard of living. They are expecting annual Social Security income of \$42,000. Sally is in excellent health but John has health-related issues. They want to plan for John's medical needs while ensuring they can fund their lifestyle expenses for the remainder of their lives. They consider themselves to be moderately risk-averse.

**Short-Term Consumption Funding**

Considering Sally and John's estimate of their expenses, they require investments to generate at least \$58,000 on an annual basis to support their retirement lifestyle. Taking their risk tolerance and John's health issues into account, John, Sally, and their Financial Advisor decide to fund four years of their spending needs (\$232,000), plus an additional \$55,000 in the event that John requires nursing care, in their consumption portfolio. Therefore, their short-term portfolio will total \$287,000. To add to this portfolio, Sally and John may take advantage of income laddering solutions, income-oriented structures, and certain types of annuities to fund their spending plans.

**Intermediate-Term Longevity and Income Replacement**

Sally and John will keep \$1.6 million of their funds in the intermediate-term and income replacement portfolio. This will cover their living expenses beyond the next four years as well as longer-term unanticipated health care costs. Over time, as their personal situation and market conditions warrant, rebalancing should occur to transfer appropriate amounts to their consumption portfolio and possibly their long-term wealth portfolio. This amount will continue to be invested according to their risk tolerance in target risk portfolios.

**Long-Term Wealth Structuring**

This leaves \$113,000 for educational expenses for their grandchildren, plus their house for their wealth transfer goals. Their Financial Advisor can help them with gifting and wealth transfer strategies.

## Step Two: Build Your Retirement Portfolio

Once you have prioritized your needs and determined your capacity for risk, you can work with your Financial Advisor to build an investment plan.

The Merrill Lynch Retirement Income Framework divides your retirement assets into three distinct portfolios: short-term consumption funding, intermediate-term longevity and income replacement, and long-term wealth structuring. (To see an example of how the Merrill Lynch Retirement Income Framework was used to build a portfolio, consider the case study at right).

Each portfolio has a different goal.

### Short Term

The **short-term** portfolio is designed to supplement your ongoing retirement income sources, such as Social Security, to meet your day-to-day expenses. While the years of spending funded by this portfolio will depend on your specific needs and circumstances, its income stream should last long enough to protect you from the need to sell equities or other assets when the market is unfavorable.

The short-term portfolio is typically constructed with high quality fixed income assets that will generate regular cash flows. Annuities that provide guaranteed income may also be appropriate. As the short-term portfolio is consumed to pay for expenses, more assets are transferred from the intermediate portfolio, which is described below.

When determining how much to hold in a short-term portfolio, consider the following factors:

- The general level of market interest rates (higher rates make it cheaper to fund more years of consumption than when there are lower rates)
- The risk that drawing on the longevity portfolio to fund the short-term portfolio will occur during a market downturn
- Your confidence in your consumption expectations over the short term
- The proportion of expenses that are covered by regular income streams such as Social Security, as well as the mix of anticipated and discretionary expenses as a proportion of the total
- The amount of “emergency reserve funds” you would like to maintain for shorter term, unanticipated expenses

Typically, the short-term portfolio should hold enough assets to fund at least two years of expected consumption, though it could go as long as seven years or even longer for clients who have relatively certain consumption expectations.

### Case Study

Dave is a 65-year-old investor who plans to continue to work part-time for the foreseeable future. He fully owns his home, which is valued at \$180,000, and has investments worth \$500,000. His basic annual after-tax expenses are \$34,000. He is planning to fund his discretionary expenses, such as travel, from his employment income. He is expecting an annual Social Security income of \$14,000. Dave is in good health and wants to plan for the next 30 years of his life. He has two grown children and does not expect to leave them a bequest, but he also does not want to create a financial burden for them. He considers himself to be risk-averse.

#### Short-Term Consumption Funding

Considering his annual Social Security income of \$14,000, Dave requires that his investments provide at least \$20,000 on an annual basis to support his retirement lifestyle. Given his risk aversion, no-bequest goals, and the fact that most of his portfolio will be used to support his basic needs, Dave and his Financial Advisor have been transitioning his entire \$500,000 to the consumption portfolio for the past several years. When doing this, Dave considered income laddering solutions, income-oriented structures, and certain types of annuities to fund his spending plan.

#### Intermediate-Term Longevity and Income Replacement

When Dave is no longer able to work, he plans to cut down on discretionary expenses such as travel. In the event he has unexpected health care costs, he plans to use liquidity from his home equity line of credit as a short-term solution. He will then work with his Financial Advisor to recalibrate his spending plan and consumption portfolio to pay back the loan over time.

### Intermediate Term

The **intermediate-term** portfolio is designed to generate returns over a longer period of time, thus making it less likely that you outlive your assets while keeping pace with inflation. The longer horizon allows the portfolio to be diversified across most major asset classes, including equities as well as fixed income, increasing expected growth and protection from inflation. Over time, this portfolio will be used to replenish the short-term portfolio, which provides consumption flexibility so that long-term assets don't have to be sold to fund consumption needs during periods when asset prices are down.

## Long Term

The **long-term** portfolio is structured to fund bequests or transfers of wealth to heirs.

In addition, the Framework manages assets with a transparent and efficient process to define each need as a separate portfolio objective, increasing the likelihood of overall success (for an overview of the Framework, see Exhibit 2 below). The management of the portfolios also takes into account your capacity to take on risk. In the case study at right, the Framework was used to help a couple create a plan they can be comfortable with.

## Step Three: Review, Monitor, Rebalance

To ensure your Retirement Income Framework is appropriate for your situation, it is important to review your portfolio annually or as needed to determine whether your risk tolerance, situation, income needs, cash flow, or goals have changed.

As a result of the review process, you may need to rebalance your portfolio so as to achieve alignment and consistency with your stated retirement goals. Ongoing monitoring of your portfolio is required to ensure you continue to meet your long-term retirement objectives.

The case study at right illustrates how the Framework will work for a couple planning for their retirement.

### Exhibit 2: Merrill Lynch Retirement Income Framework

#### Short-Term Consumption Funding

- Cover the retirement income gap for a number of years
- Reduce the risk of market shocks as clients take withdrawals

#### Intermediate-Term Longevity and Income Replacement

- Reduce the risk of outliving assets
- Outpace inflation
- Provide principal and income guarantees

#### Long-Term Wealth Structuring

- Structure wealth for purposes of bequests or intergenerational wealth transfer

## Summary

In this paper, a holistic framework has been presented to help you manage your assets during retirement. The Framework helps you take into account a variety of unique retirement needs and associated risks, in addition to your individual circumstances. Exhibit 3 on the next page presents a summary of the steps you can take, with the help of your Financial Advisor, to find solutions that best fit your retirement needs.

## Case Study

Lucy and Robert are considering their options and want to know if they will be able to retire in two years, when Lucy will be 66 and Robert will be 67. They paid off their home, they are both healthy, and they want to plan for a long life. While it would be nice to leave some money for their children, this is a secondary concern for them.

After their Financial Advisor ran a scenario showing a long-term plan and investment strategy, they felt more comfortable planning for their retirement. They have a portfolio of \$2.3 million, including variable annuities with guaranteed income benefits, excluding the value of their home. They also have significant value in stock options. In their plan, the Financial Advisor assumed a 1% return on those options, but she also ran other scenarios, including a much higher rate of return and a zero value for the stock options.

### Short-Term Consumption Funding

Taking Social Security income and anticipated health care expenses into account, Lucy and Robert will need an additional \$71,500 a year from their portfolio for living expenses and travel. Since they are fairly risk-averse, their Financial Advisor customized their plan to cover about ten years of their lifestyle in their consumption portfolio with a cost of living adjustment for each year, totaling \$800,000.

With guidance from their Financial Advisor, using a discount rate of 3% to account for investment returns over time, Lucy and Robert will rebalance their portfolio so that \$700,000 will be in the consumption portfolio by the time they retire. \$110,000 will be in cash equivalents for easy access to funds, and \$330,000 will be in municipal bonds, since most of their savings are not in tax-sheltered vehicles. The remainder will be in fixed income. Their Financial Advisor advised against tapping the annuity income for several years, since it is structured to pay more income if they wait.

### Intermediate-Term Longevity and Income Replacement

The remainder of their funds, \$1.6 million including the market value of their annuities, will be set aside to cover unanticipated health care expenses and to replenish their consumption portfolio over the long term. This amount will be invested according to their risk tolerance in target risk portfolios. Any stock options they exercise over the years would be used to replenish the consumption portfolio, and if they decide to tap the annuity income in later years, this will reduce the amount they need to withdrawal from their consumption portfolio.

As a final consideration, when the real estate market is favorable, they may consider selling their home to move closer to their children and grandchildren. At that time, they will consider whether to purchase another house or move to a condominium or apartment that will have fewer maintenance obligations.

## Breaking Down the Merrill Lynch Retirement Income Framework

The appropriate solution varies with investor type and should meet multiple and often competing financial goals. A description of each portfolio is described below:

### Short-Term Portfolio: Consumption Funding

The level of consumption needs varies based on your risk appetite, wealth level, and retirement stage. The lower your net worth and the earlier you are in retirement, the more important the objective of meeting your consumption needs becomes. In this case, consumption funding should be a dominant focus of your retirement income portfolio. As a result, providing a prudent consumption plan is important. In contrast, for investors with high relative net worth, consumption needs are less important, as they represent a small portion of their retirement portfolios.

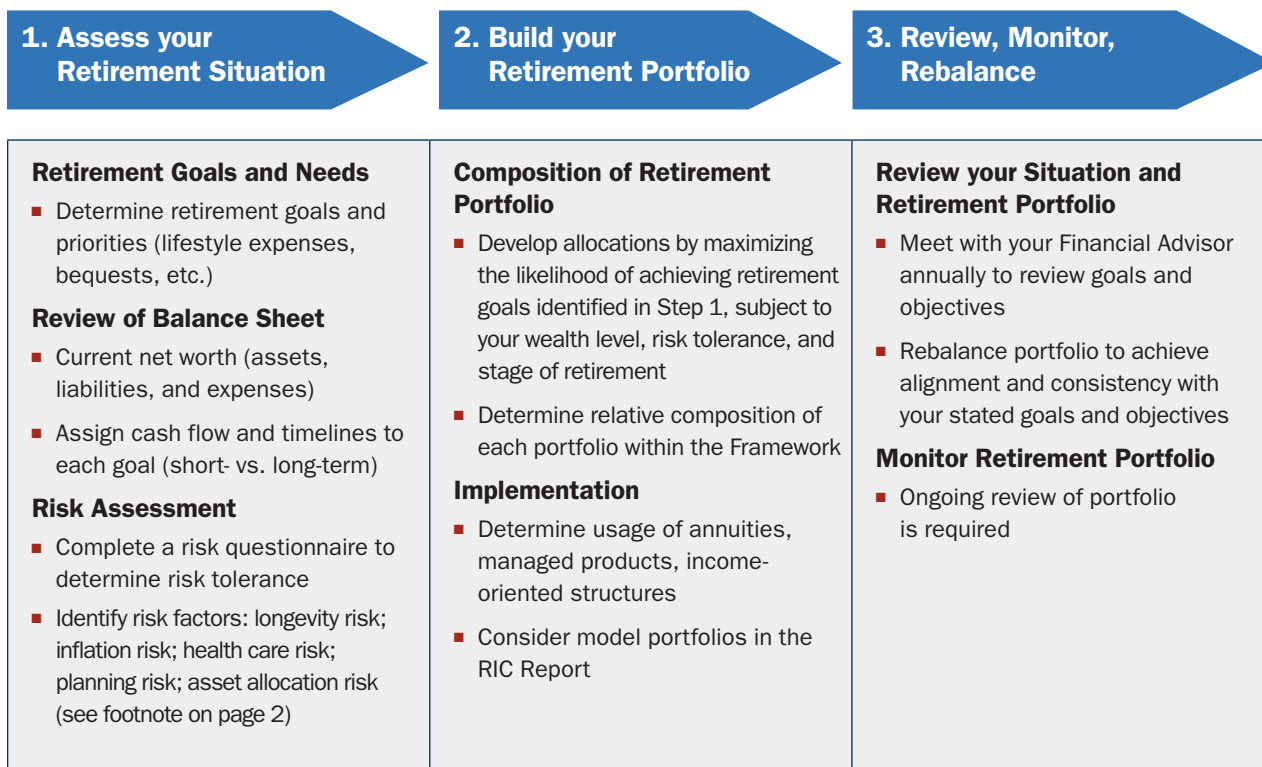
### Intermediate-Term Portfolio: Longevity and Income Replacement

The longevity and income replacement portion of your portfolio varies based on your risk appetite, wealth level, and retirement stage. For instance, the lower your risk appetite, the more conservatively the longevity and income replacement portion of your portfolio should be structured. In contrast, the higher your risk appetite, the more the longevity and income replacement portion of your portfolio should be structured towards more aggressive investments.

### Long-Term Portfolio: Wealth Structuring

The level of bequest typically varies based on the investors' wealth level. For many retired investors, meeting a bequest objective is less of a focus. In contrast, high net worth investors typically have greater bequest motives.

### Exhibit 3: Implementation of the Merrill Lynch Retirement Income Framework



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