CLS **ADVISOR IQ** SERIES

MAKING RETIREMENT INCOME LAST:
A ROADMAP FOR GUIDING INVESTORS THROUGH RETIREMENT INCOME ISSUES

ADVISOR IQ

CLS INVESTMENTS

Table of Contents

Executive Summary

- Each day since January 1, 2011, 10,000 Baby Boomers have reached the standard retirement age of 65, and this will continue through 2029. This means a huge number of investors are shifting their investment goals from wealth accumulation to income.

- Determining the amount of income to take from retirement investments is a tricky calculation for investors. What William Bengen found from his research is that retirees who choose to withdraw more than 4 percent annually greatly risk their ability to fund their entire retirement.

- When determining how much income is enough to fund an investor's retirement, retirees and their advisors must keep in mind the effects of three main drains on resources that no retiree can avoid: inflation, taxes, and healthcare expenses.

- Traditionally, investors have relied on pensions, bonds, and variable annuities as their primary sources of retirement income. However, due to extremely low interest rates, rapidly declining pension offerings, and retirees' growing demands for more flexibility with their savings, these individuals are increasingly looking for alternative sources for income after they retire.

- Rather than choosing just one option to help a client meet their retirement income needs, retirement and financial planning experts recommend using a combination in order to provide the market participation and protection needed to maintain steady income throughout retirement.

Introduction

Each day since January 1, 2011, 10,000 Baby Boomers (defined as those born between 1946 and 1964) have reached the standard retirement age of 65, and this will continue through 2029. This means a huge number of investors in the U.S. will likely shift their investment goals from wealth accumulation to income in an effort to support retirements that may last 30 years or more.

Determining how much savings is enough and the amount of income to take from retirement investments is a tricky calculation for investors. Those who do not take enough income throughout retirement could see their current lifestyles suffer. Those who take too much in early retirement may sacrifice their future lifestyles. Considering these possibilities leads to a whole set of investor queries regarding their investments:

- "How do I support my income needs in retirement?"
- "Will my risk tolerance allow me to use a total return approach?"
- "What place do bonds have in my portfolio?"
- "Should I buy a Variable Annuity?"
- And, most worrisome: "Will I outlive my money?"

An investor's risk tolerance during the accumulation (pre-retirement) phase is a huge factor in ensuring assets grow to the appropriate level and last throughout retirement. Under a total return approach (the actual rate of return of investments – including interest, capital gains, dividends, and distributions – over a given evaluation period), setting and sticking with the correct risk tolerance can be tricky. When the market is going up, investors tend to be more risk averse, and vice versa. However, this type of fluctuating risk tolerance, or lack of discipline, based on current market conditions can be disastrous to an investor's financial wellbeing.

So, how should an investor and his or her financial advisor best approach the subject of how much savings and income is enough and how to make it last?

This innovative guide has been developed to provide financial advisors with a roadmap for helping guide their clients through these important issues.

The Magic Number

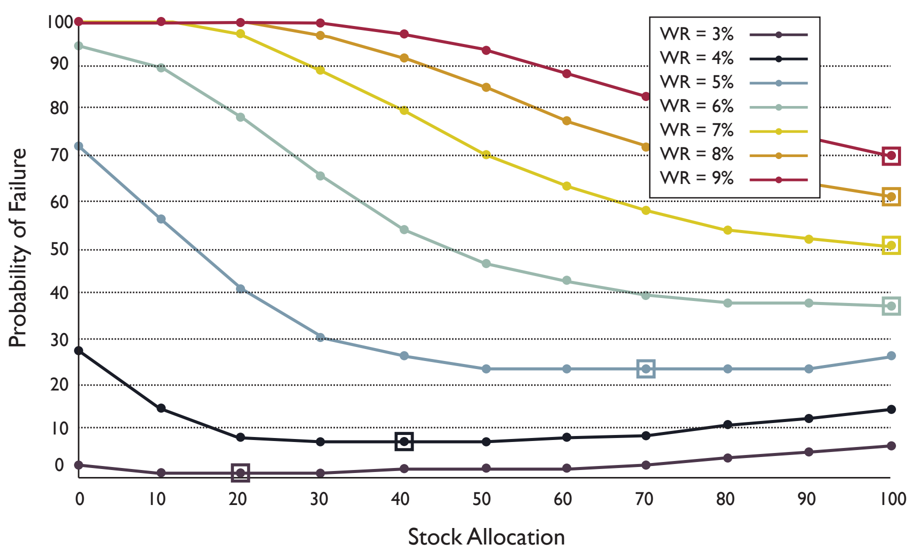
In 1994, William Bengen introduced the "Safemax" withdrawal rate approach (a.k.a. the "4 percent rule") for determining the success of various income withdrawal rates after retirement. Essentially, what Bengen found from his research is that retirees who choose to withdraw more than 4 percent annually greatly risk their ability to fund their entire retirement.

The graph below shows a take on Bengen's seminal work. It shows a number of withdrawal rates and their probabilities of failure over a 30-year horizon. For example, if between 0 and 30 percent of an investor's portfolio is invested in stocks and he or she plans to withdraw 9 percent annually, the investor has a 100 percent chance of NOT meeting his or her income needs over that time period. Even if 100 percent of the portfolio's assets are invested in stocks, the probability of NOT funding a 30-year retirement at a 9 percent withdrawal rate is about 70 percent.

This data illustrates how critically important it is for investors to stay disciplined when they are saving for retirement and adhere to a portfolio allocation appropriate for their individual income needs and retirement time horizon. Additionally, financial advisors must educate their clients about setting realistic withdrawal targets once they are retired, since even a one percent increase in withdrawal rate can make a significant difference in the probability of portfolio assets lasting as long as necessary. For example, a 70 percent stock allocation with a 4 percent annual withdrawal rate has a 90 percent probability of funding a 30-year retirement. Conversely, a 5 percent withdrawal rate drops that to a 77 percent probability of success.

Failure Probabilities for Inflation-Adjusted Withdrawal Strategies

Over a 30-Year Retirement Horizon



Source: Wade Pfau, advisorperspectives.com, April 17, 2012

Income Considerations

When determining how much income is enough to fund a retirement that could last 30 years or more, retirees and their advisors must keep in mind the effects of three main drains on resources that no retiree can avoid: inflation, taxes, and healthcare expenses.

Inflation

Inflation: a rise in the general level of prices of goods in an economy over a period of time.

"Inflation is when you pay fifteen dollars for a ten-dollar haircut you used to get for five dollars when you had hair." - Sam Ewing

"Inflation is the crabgrass in your savings." - Robert Orben

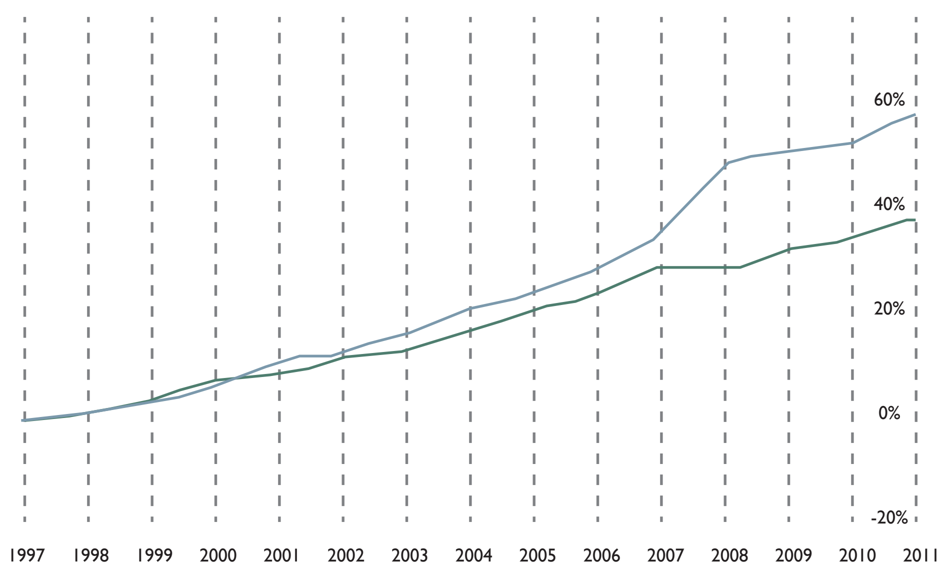
Failing to account for the effects of inflation during retirement can be a very damaging mistake, as – even at low rates – it can rob investors of significant buying power. Unfortunately, many investors underestimate the impact inflation will have. The general recommendation is to prepare for a 3 percent annual inflation rate, but it's important to be cognizant of the fact that rates can be drastically higher at times. In fact, in the 1970s and early 1980s, inflation was as high as 10 percent.

Put into actual numbers, a 2 percent inflation rate in 2000 would mean a 27 percent increase by 2012. At a 3 percent rate, that would be 43 percent. Without accounting for inflation, a 65-year-old who figures he or she needs $50,000 per year for 20 years in retirement would need a $1 million nest egg. However, factoring in a 3 percent annual inflation rate means that investor would actually need $1,383,824 to make it through those 20 years, since, by the end, it would take more than $90,306 to buy the same things he or she could buy for $50,000 20 years earlier.

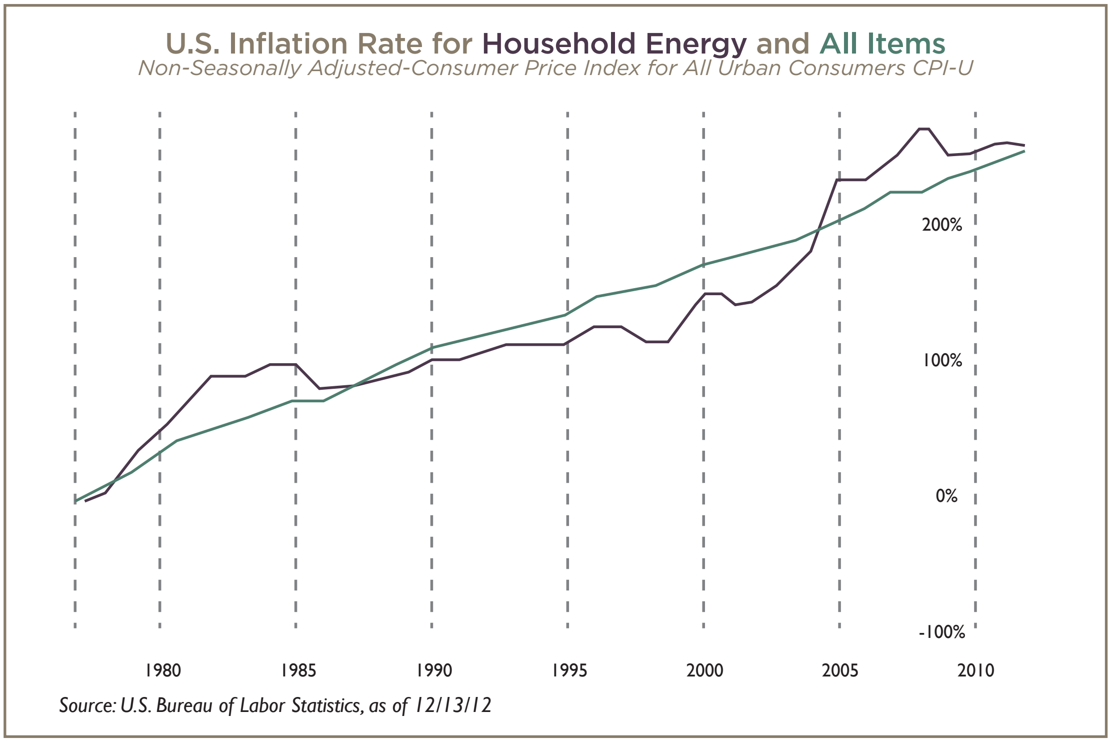
Unfortunately, very few expenses are immune to inflation. The chart below illustrates how inflation even impacts pet care. Currently, the cost of keeping "Fido" is outpacing inflation in general. Also, shown on the next page is the inflation rate for home energy costs. Though these are typically fairly consistent with inflation, they do tend to be somewhat unpredictable.

U.S. Inflation Rate for Pets, Pet Products, and Services and All Items

Non-Seasonally Adjusted-Consumer Price Index for All Urban Consumers CPI-U



Source: U.S. Bureau of Labor Statistics, as of 12/13/12



Taxes

Taxes – which always seem be going up – are also a huge consideration in retirement. Where a retiree lives is an important part of the tax picture, as some states have no income tax and others exempt some retirement income, such as military and government pensions. In all, income tax rates among the 50 U.S. states range from 0 percent to around 13 percent. Some retirees choose to move abroad after retiring in order to enjoy a different culture or scenery, or to maintain their pre-retirement standard of living at a lower cost. However, since retirees living abroad are still required to file a state tax return, they may have to pay state income taxes if the state in which they are filing requires it. A thorough understanding of how the state will get its share of retirement income is important when evaluating the overall retirement income needs picture. Some states, for example, may have low property taxes but high sales taxes.

Federal taxation is another consideration for retirees. Those who carry debt, such as a mortgage, typically have to withdraw more money from tax-protected retirement accounts. Therefore, it is always advisable to pay down as much debt as possible prior to retiring. The amount withdrawn from these accounts can have a huge impact on tax liability since Social Security benefits are not subject to federal taxation if taxable income is under a certain amount. In fact, many retirees living on Social Security alone probably will not have to pay any taxes on it. And even those taking income from a retirement account may still not have to pay taxes on Social Security if they are knowledgeable about tax rules regarding combined income:

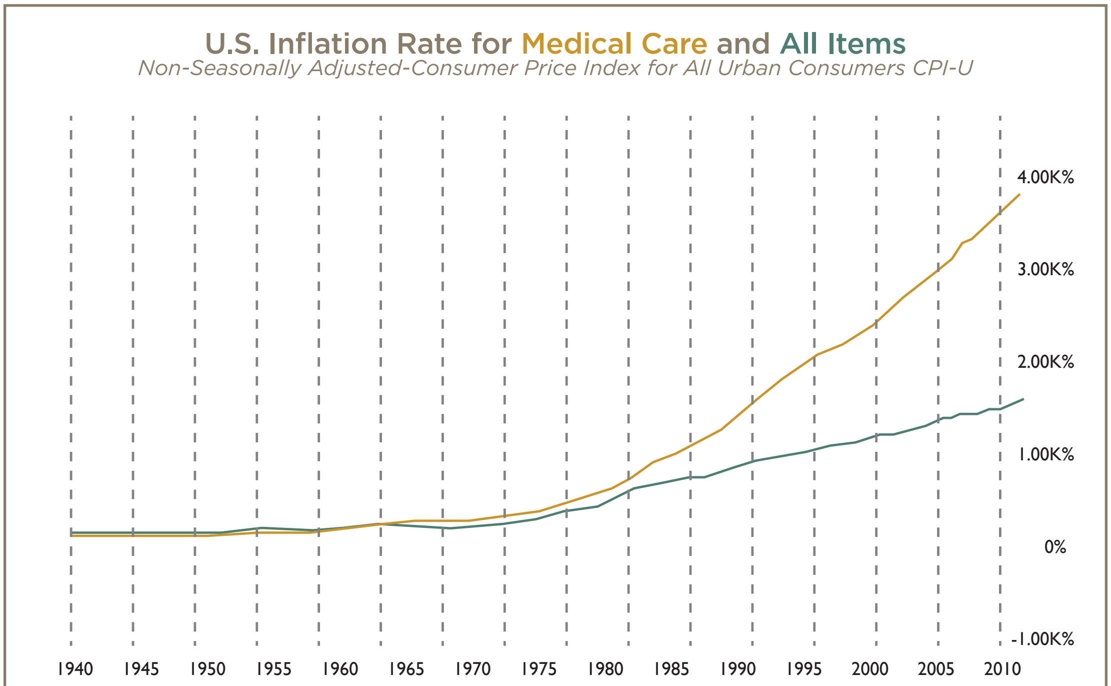
- If combined income is $24,999 or lower for a single person, or $31,999 or lower for couples filing jointly, benefits aren't taxable.
- If combined income is between $25,000 and $33,999 for a single person, or $32,000 to $43,999 for couples filing jointly, the retiree(s) will have to pay income tax on up to 50 percent of their Social Security benefit.
- If combined income is $34,000 or more for a single person, or $44,000 or more for couples, the retiree(s) will have to pay income tax on up to 85 percent of their benefit.

Health Care

For most, retiring from full-time employment means leaving behind employer-provided health care coverage. According to the Henry J. Kaiser Family Foundation's 2012 Employee Health Benefits Survey, only 25 percent of firms with 200 or more employees offer retirement health care coverage. In contrast, 66 percent of these firms offered retirees coverage in 1988. Even those who do get insurance from their former employer may find the plan differs dramatically from its pre-retirement version. Additionally, among large firms offering retiree health benefits, 88 percent offer them to early retirees under the age of 65 and only 74 percent offer them to Medicare-age retirees.

According to Fidelity Investments, a couple, both 65, retiring in 2013, is expected to need $220,000 to cover health care cost in retirement if the husband lives to 82 and the wife to 85. Additionally, a study by the AARP Public Policy Institute and Georgetown University found that national health care spending averaged $8,402 per person in 2010. That's 72 percent higher than 10 years earlier and nearly three times the 1990 level of $2,854.

As shown in the graph below, between 2000 and 2010, health care spending per person grew at an average rate of nearly 6 percent per year, much higher than the 2.4 percent inflation rate. Since 1940, health care spending has grown at about 2.5 times the rate of inflation in general.



Source: U.S. Bureau of Labor Statistics, as of 12/13/12

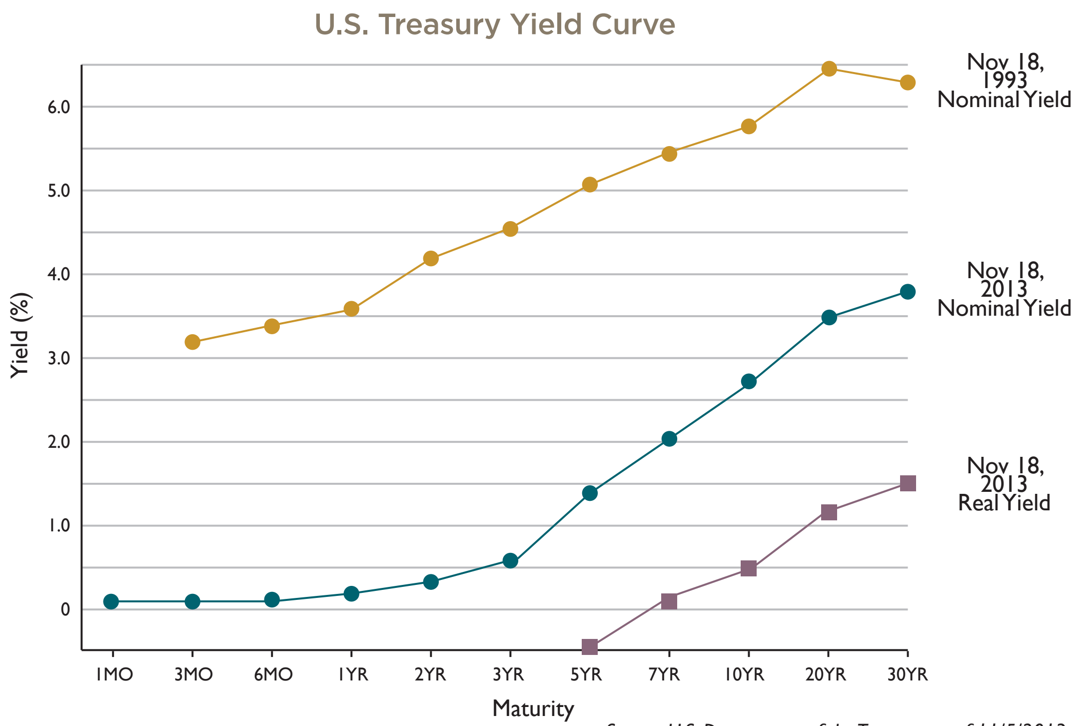
Health care costs and long-term care costs are two reasons why many retirees are nearly destitute by the time they pass away. Purchasing long-term care insurance can help cover many of these costs, although policies are becoming harder to come by and those that are still available are becoming increasingly expensive. Investors should keep in mind that it is cheapest to buy these policies in their 40s or 50s, as the costs significantly increase after the policy holder reaches the age of 60.

Funding Retirement: What are the Options?

Traditionally, investors have relied on pensions, bonds, and variable annuities as their primary sources of retirement income. However, due to extremely low interest rates, rapidly declining pension offerings, and retirees' growing demands for more flexibility with their savings, these individuals are increasingly looking for alternative sources for income after they retire.

Traditional Income Source: Bonds

Typically looked to as a reliable way to generate income, bonds' ability to do so has been greatly reduced as a result of the Federal Reserve's extraordinary monetary policies of the past few years. Below, we see the U.S. Treasury yield curve compared to 20 years ago. In 1993, the 3-month T-bill was yielding what a 30-year Treasury bond yields today.



Source: U.S. Department of the Treasury, as of 11/5/2013

Obviously, today's environment makes it very difficult for bonds to contribute to income. These low yields contribute to the biggest risk in bond investing – interest rate risk, or the risk that rates will rise, thereby decreasing the value of the bond portfolio. The table below illustrates how quickly 10-year Treasury bond prices can fall with rising rates. As indicated, if rates rise 1 percent to about 3 percent, the price of a 10-year Treasury note is expected to fall over 8.5 percent. If rates rise going forward, there will be significant hurdles to simply relying on bonds.

Basis Points Change	New Yield	Current Price	New Price	Loss
+0.5%	2.55%	$99.54	$95.20	-4.36%
+1.0%	3.05%	$99.54	$91.05	-8.53%
+1.5%	3.55%	$99.54	$87.15	-12.45%
+2.0%	4.05%	$99.54	$83.40	-16.21%
+2.5%	4.55%	$99.54	$79.80	-19.83%
+3.0%	5.05%	$99.54	$76.40	-23.25%

Traditional Income Source: Variable Annuities

"...since assets are locked up with an insurance company, accessing the proceeds for an unexpected emergency can be very expensive. If it is within seven years of the purchase date, the investor will likely face a surrender charge, which typically starts at 7 percent..."

Many individuals transitioning from accumulation to distribution – as the Baby Boomer generation is currently doing at a rapid pace – need to devise an income plan that will insure their money will last through retirement, even in today's low-yield environment. In order to meet this requirement, many advisors use variable annuities (VAs) for a portion of their clients' retirement accounts due to the guarantees they provide.

VAs do not have annual contribution limits. This allows investors to save more money which is also tax-deferred. This is great for investors who are close to retirement and need to "catch up" as this allows them to save more than they would be able to through their qualified retirement plan account, such as an IRA or 401(k).

There are disadvantages to using these types of investments as an investor's sole income-generating tool. First, since assets are locked up with an insurance company, accessing the proceeds for an unexpected emergency can be very expensive. If it is within seven years of the purchase date, the investor will likely face a surrender charge, which typically starts at 7 percent, but usually declines one percentage point per year until it reaches zero. Second, VAs tend to have high cost structures around 3.50 percent, compared to regular mutual funds that charge an average of 1.5 percent a year or index funds, many of which charge less than 0.50 percent a year. Third, depending on the type of annuity, an annuitant dying at a young age can be expensive since payments sometimes stop when the policyholder passes. Finally, as rates have come down and equity markets have increased, the payout rates on VAs have come down to around the 4.5 percent range, putting them more on par with other retirement investment options.

Non-Traditional Income Source: A Multi-Bucket Income Approach

"By directing the portfolio toward investments with different income-generating objectives, portfolio segments can work in tandem to provide investors funds for immediate and future use, regardless of market conditions. "

Many experts now agree that the better approach to funding retirement is to combine a variety of options, including a "multi-bucket" approach, in which the retiree's portfolio is allocated toward investments with different income-generating objectives. Ideal portfolios contain an allocation to:

- interest- and income-generating investments
- low-risk fixed income assets for approaching income needs
- a money market account for immediate cash needs

Some strategies also allow the investor to set systematic withdrawal and reserve bucket amounts based on individual income needs. This is unique in that investors are not locked into a specific withdrawal amount, like with a VA, thus giving them the freedom to access funds as needed, should they need to make a large or unexpected purchase.

By directing the portfolio toward investments with different income-generating objectives, portfolio segments can work in tandem to provide investors funds for immediate and future use, regardless of market conditions. Because different market conditions offer growth opportunities for different types of income assets, using a variety of income-producing investments provides the ability to easily tilt the portfolio toward different asset classes depending on economic factors. Income-generating investments may include preferred stocks, investment grade bonds, high yield bonds, high dividend-paying stocks, covered calls, managed future, Real Estate Investment Trusts (REITs), and more.

A Comprehensive Solution

Rather than choosing just one option to help a client meet their retirement income needs, retirement and financial planning experts recommend using a combination. For example, combining a variable annuity with a multi-bucket income approach, enables the investor to reap the benefits of an annuity – such as tax-deferred growth and gains that can be used to raise the withdrawal rate in the future – as well as those of a more flexible option that does not lock up funds or instate early withdrawal penalties.

Combining the strengths of a variety of income-generating products provides investors guaranteed and flexible income sources that will give them the market participation and protection they need to maintain steady income throughout retirement.

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High yield bonds are subject to numerous risks including higher interest rates, economic recession, and possible deterioration of the junk bond market, possible downgrades and defaults of interest and/or principal. High yield bond prices tend to fluctuate more than higher rated bonds; their values will generally fall as interest rates rise and are affected by short-term credit developments to a greater degree than higher rated bonds.

There are risks associated with bonds. These risks include, but are not limited to, the same interest rate, inflation, and credit risks associated with the underlying bonds owned by the portfolio and your return of principal is not guaranteed. High Yield bonds may be subject to greater fluctuations in value and risk of loss of income and principal.

An investment in a money market is neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the money market.

A REIT is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages.

A variable annuity is an investment vehicle issued by an insurance company. Investing in variable annuities involves risk. Variable annuities are not guaranteed by any bank or government agency. Variable annuities are not guaranteed to return an investor's money and the investor may leave with less money than originally put in. An investor should consider the objectives, risks, charges and expenses of the variable annuity before investing. In addition, investors should carefully consider all investment options before investing.

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