QUARTER NOTES

Second Quarter 2016

Will you outlive your retirement money?

The answer to the question "How much money do you need to retire?" is another question: "How long are you going to live?" For most people, the answer to that second question is: "Longer than you think."

According to the Social Security Administration, a man reaching age 65 today can expect to live, on average, until age 84.3 and a woman until age 86.6, an extra 2.3 years.

But those are just averages. About one out of every four 65-year-olds today will live past age 90, and one out of 10 will live past age 95. Retirements today can last almost as long as careers.

Who lives the longest? According to a study by the Congressional Budget Office, those with the highest income have a longevity advantage as well, outliving the lowest income groups by 4.5 years.

Reaction from some plan sponsors

Increasing life expectancies create longevity risk for sponsors of pension plans. That's the chance a pensioner will outlive the assets that have been set aside to fund his or her pension. *The Wall Street Journal* reported last year that more and more employers are offering "pension buyouts" to their employees, in part to reduce their exposure to this risk. The employee accepts a lump sum distribution instead of the guaranteed pension. Normally, the distribution would be put into an IRA rollover to preserve tax benefits.

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Two IRS announcements last year are relevant to this issue. First, pension buyouts may no longer be offered to retirees once they are in pay status, that is, once pension payments have begun. The lump sum alternative is only permissible at or before retirement begins. Second, new mortality tables have been developed at the IRS, but they won't be put into effect until 2017. Under the new tables, which adjust life expectancies upward, the lump sum distributions will have to be larger. Hence, 2016 could be a big year for these offers.

In actuarial terms, the value of the lump sum will be the same as the present value of a stream of payments for the pensioner's life expectancy. Acquiring the money all at once can be very tempting, because it gives the retiree more flexibility to spend more in the early years of retirement, before health issues emerge that could make travel and other retirement activities difficult.

In addition to accepting longevity risk when they take a lump sum distribution, retirees also must accept investment management responsibility for the funds.

Investment concerns

The second prong regarding whether one will outlive one's retirement money is investment return. Imagine one has $1 million to work with. An 8% annual return on that money would provide $80,000 per year in pre-tax income, and that might be plenty for most retirees to live on.

But consistently getting an 8% return in today's financial markets is no easy task, and it will involve an element of investment risk. The safest investments are yielding only about 1%, so that million-dollar portfolio would provide a scant $10,000 each year. To increase those returns, one must move away from the ultra-safe investments. Some amateur investors have succeeded at this task, and some have not.

The annuity alternative

Retirees who are not comfortable with investment management and who are concerned about outliving their retirement resources may consider the benefits of an annuity. Annuities are contracts issued by life insurance companies that can meet a wide variety of saving and income needs.

With an immediate annuity, an individual is trading a lump sum of money for an income stream, payments to be made monthly, quarterly or annually. Payments may last for the individual's lifetime, for the joint lives of an individual and a spouse, for a specific number of years, or for life, but not less than a specific number of years. The amount of the payments may be fixed or variable, determined by financial market performance. The age of the annuitant or annuitants also will be a factor in determining the size of the payments.

Another choice to consider is a deferred annuity. Payouts don't begin until a future date, allowing for tax-deferred buildup of the principal. Each approach has advantages and disadvantages.

For some retirees an annuity offers more confidence by shifting the burden of investment management to professionals. On the other hand, one is sacrificing access to a significant sum of money, which may remain unavailable in case of emergency. If you decide to explore purchase of an annuity, you'll need to understand all your choices and keep an eye on expenses. Annuities are not right for everyone, but they have been a boon to many.

Seek informed advice

There are no simple answers when it comes to managing a retirement income for a long and comfortable life. A mix of investments, such as stocks, bonds, annuities and cash for emergencies, may deliver the necessary income for many families, but careful planning still will be the key to success.

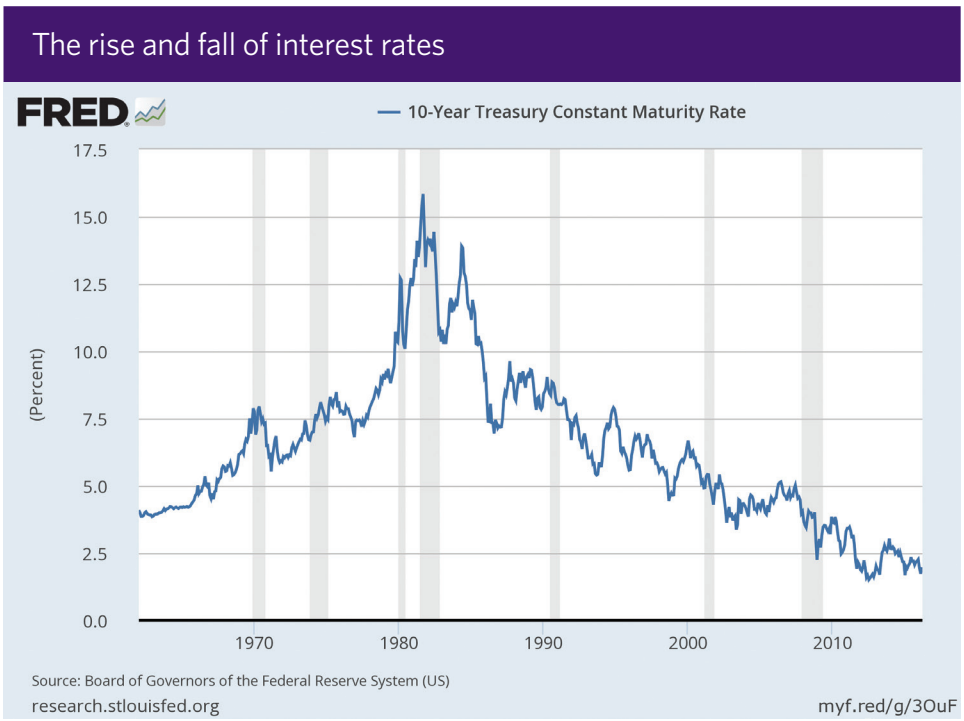
We can help you reach that goal. If you have questions about developing your capital base or managing your investments so that they last as long as you do, please give us a call. We'll be happy to share our ideas with you.

There is a surrender charge imposed generally during the first 5 to 7 years that you own the annuity contract. Withdrawals prior to age 59½ may result in a 10% IRS tax penalty, in addition to any ordinary income tax. The guarantee of an annuity is backed by the financial strength of the underlying insurance company. Investment sub-account value of variable annuities will fluctuate with changes market conditions. ***Investors should consider the investment objectives of the variable annuity carefully before investing. An investment in a variable annuity involves investment risk, including possible loss of principal. Variable annuities are designed for long-term investing. The contract, when redeemed, may be worth more or less than the total amount invested. Variable annuities are subject to insurance related charges including mortality and expense charges, administrative fees, and the expenses associated with the underlying funds.*** *The prospectus contains this and other information about the variable annuity. Contact the issuing company or your regist ered representative to obtain a prospectus, which should be read carefully before investing or sending money.*

Negative interest rates

Interest rates were on a fairly persistent upward path through the 1960s and 1970s, as shown in the graph at right from the St. Louis Federal Reserve Bank of the rates for 10-year Treasury bonds. The rate peaked at over 15% early in the Reagan presidency, when the Federal Reserve Board took strong anti-inflation measures. Since then, interest rates have declined, and they remain at historically low levels.

Rates tend to fall during recessions, as the Fed lowers short-term interest rates to stimulate the economy. In the graph, recessions are indicated by the grey shading. Since the 1980s, rates have not bounced back as the economy has expanded.



After the most recent recession, interest rates were held deliberately low for years to create and support an economic recovery. The Federal Reserve Board finally moved to lift short-term interest rates late last year. Unexpectedly, as short-term rates increased, the long-term interest rates fell. The culprit appears to be negative interest rates.

Going negative

Some interest rates fell below zero during the 2008 financial crisis, as worried investors sought maximum safety. With a negative interest rate, a lender is effectively paying the borrower to borrow money. The longer the money is held, the less the lender eventually will receive.

The 2008 experience with negative rates was a temporary anomaly. More recently, some central banks have been pushing interest rates into negative territory in the hopes of economic stimulus. *The New York Times* reported in March that some $4.5 trillion of Japanese government debt and $1.1 trillion of German bonds had negative interest, and that more than $7 trillion in the overall bond market had negative yields. The negative interest rates abroad appear to be pulling down the yields on longer maturities of U.S. bonds. Negative rates also would be expected to devalue the currency.

However, the negative rates have not yet had the hoped-for result. By mid-March, the Japanese yen was up 8% against the U.S. dollar. The Euro has strengthened as well.

Portfolio impact

The Fed has indicated that negative interest rates are in its toolkit, but are not expected to be needed to stimulate growth in the U.S. economy. Still, the Fed does seem to be pulling back from the pace of rate hikes that had been favored last December. Whether there will be another rate hike this year is an open question.

That's not great news for bond investors, a group that includes a great many retirees living on their portfolio income. Those who have employed "bond ladders" to increase returns while controlling risks are finding slim pickings for reinvestment as their bonds mature.

Might the stock market be a better alternative? Hard to say—one school of thought holds that these persistent low interest rates are a sign that global economic growth is slowing, and that central banks won't be able to do much about it. Stock markets got off to a very bad start this year, from which they have mostly recovered. As a wise man once said, predictions are hard, especially about the future.

If you have questions about how persistent low interest rates may affect your portfolio management, we are here to help explore some possible answers. Call on us at any time.

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Just Ask Us

I've heard that the Roth IRA can be a good alternative for saving for college costs. Is that true?

Roth IRAs are intended for retirement, of course. However, some people look to Roth IRAs to do double duty, as a supplemental source for education funding. Contributions to the Roth IRA may be withdrawn without taxes or penalties. Earnings withdrawn before age 59½ to pay education expenses would be subject to income tax, but no penalty tax would be due, as long as the account has been open at least five years.

The potential tax problem with Coverdell ESAs and 529 plans is that the tax exemption on earnings is dependent upon using the money for qualified education expenses, which is not an issue for Roth retirement distributions.

Roth IRAs have a higher contribution limit than the Coverdell ESA, and it applies on a per donor basis. If the money is needed for education, it is there; if not, it can remain in place for retirement.