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CHAPTER 5.3

# FREEDOM: CREATING YOUR LIFETIME INCOME PLAN

Lifetime Income Stream Key to Retirement Happiness

–*TIME*, July 30, 2012

I have enough money to retire comfortably for the rest of my life. Problem is, I have to die next week.

-ANONYMOUS

In 1952 Edmund Hillary led the first expedition to successfully climb Mount Everest, a feat once thought to be impossible. The Queen of England promptly knighted him, making him "Sir" Edmund Hillary for his amazing trek.

Despite his accomplishment, many people believe Sir Edmund Hillary may not have been the first person to reach the peak of Everest. In fact, it is widely believed that George Mallory may have been the first person to reach the peak, nearly 30 years prior!

So, if George Mallory reached the peak of Mount Everest in 1924, why did Edmund Hillary receive all the fame—including being knighted by the Queen?

Because Edmund Hillary didn't just make it to the peak, he also successfully made it *back down* the mountain. George Mallory was not so lucky. Like the vast majority of those who have died on Everest, it was coming down that proved fatal.

## INVESTING FOR WHAT, EXACTLY?

I often ask people, "What are you investing for?"

The responses are wide and diverse:

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"Returns."

"Growth."

"Assets."

"Freedom."

"Fun."

Rarely do I hear the answer that matters most: ***Income!!!!!***

We all need an income that we can count on. Consistent cash flow that shows up in our account every single month, like clockwork. **Can you imagine never worrying again about how you will pay your bills or whether your money will run out?** Or having the joy and freedom of traveling without a care in the world? Not having to worry about opening your monthly statements and praying the market holds up? Having the peace of mind to give generously to your church or favorite charity and not wonder if there will be more where that came from? We all know intuitively: *income is freedom!*

Shout it from the hilltops like Mel Gibson in the movie *Braveheart*: "Income is freedom!!!"

**And *lack* of income is stress. Lack of income is struggle. Lack of income is not an acceptable outcome for you and your family. Make this your declaration.**

Dr. Jeffrey Brown, retirement expert and advisor to the White House, said it best in a recent *Forbes* article: "[I]ncome is the outcome that matters most for retirement security."

The wealthy know that their assets (stocks, bonds, gold, and so on) will always fluctuate in value. But you can't "spend" assets. You can only spend cash. The year 2008 was a time when there were lots of people with assets (real estate, in particular) that were plummeting in price, and they couldn't sell. They were asset "rich" and cash "poor." This equation often leads to bankruptcy. **Always remember that income is the outcome.**

By the end of this section, you will have the certainty and the tools you need to lock down exactly the income you desire. This is what I

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call "income insurance." A guaranteed way to know for certain that you will have a paycheck for life without having to work for it in the future—to be absolutely certain that you will *never* run out of money. And guess what? You get to decide when you want your income checks to begin.

There are many ways to skin the proverbial cat, so we will review a couple of different methods for getting the income insurance that makes sense for you.

One of the more exciting structures for locking down income has other powerful benefits as well. It is the *only* financial vehicle on the planet that can give you the following:

- 100% guarantee on your deposits.> (You can't lose your money, and you keep total control.)
- Upside without the downside: your account value growth will be tied to the market, so if the market goes up, you get to participate in the gains. But if the market goes down, you *don't lose* a dime.
- Tax deferral on your growth. (Remember the dollar-doubling example? Tax efficiency was the difference between having $28,466 or more than $1 million!)
- A guaranteed lifetime income stream where *you* have control and get to decide when to turn it on.
- Get this: the income payments can be made *tax-free* if structured correctly.
- No annual management fees.

You get all of these benefits by using a modern version of a 2000-year-old financial tool! How is this possible? I am sure it sounds too good to be true, but stick with me. It's not! I use this approach, and I am excited to share the details with you.

As we have highlighted throughout the book, the financial future that you envision is very much like climbing Mount Everest. You will

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work for decades to accumulate your critical mass (climbing to the top), but that's only half the story. **Achieving critical mass without having a plan and strategy for how to turn it into income that will last the rest of your lifetime will leave you like George Mallory: dead on the back side of a mountain.**

## ANEW AGE

We are, without a doubt, in uncharted waters. In the past 30 years, the concept of retirement has transformed radically. Heck, even as recently as the late 'Sos, over 62% of workers had a pension plan. Remember those? On your last day of work, you got a gold watch and the first of your guaranteed lifetime income checks. Today, unless you work for the government, a pension is a relic; a financial dinosaur. Now, for better or worse, you are captain of your own ship. You are ultimately responsible for whether or not your money will last. That's quite a burden to bear. Throw in market volatility, excessive fees, inflation, and medical "surprises," and you quickly start to understand why so many are facing a massive retirement crisis. Many people, including your neighbors and colleagues, are going to face the real likelihood of outliving their money. Especially with the prospect of living longer than ever before.

## IS 80 THE NEW 50?

A long, fruitful retirement is a concept that's only a few generations old. If you recall from our discussion earlier, when President Franklin Roosevelt created Social Security in 1935, the average life expectancy was just 62. And the payments wouldn't kick in until age 65, so only a small percentage would actually receive Social Security benefits to begin with.

At the time, the Social Security system made financial sense because there were 40 workers (contributors) for every retiree collecting benefits. That means there were 40 people pulling the

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wagon, with only 1 sitting in the back. By 2010, the ratio had dropped to only 2.9 wagon pullers for every retiree. The math doesn't pencil out, but since when has that stopped Washington?

**Today the average life expectancy for a male is 79, while the average female will live to 81. For a married couple, at least one spouse has a 25% chance of reaching age 97.**

BUT WAIT, THERE'S MORE!

You could be living *way* longer than even these estimates. Think how far we have come in the past 30 years with technology. From the floppy disk to nanotechnology. Today scientists are using 3-D printing to generate new organs out of thin air. Researchers can use human cells, scraped gently from your skin, to "print" an entirely new ear, bladder, or windpipel-? Science fiction has become reality. Later we'll hear directly from my friend Ray Kurzweil, the Thomas Edison of our age and currently the head of engineering at Google. When asked how advances in life sciences will affect life expectancies, he said:

"During the 2020s, humans will have the means of changing their genes; not just 'designer babies' will be feasible, but designer baby boomers through the rejuvenation of all of one's body's tissues and organs by transforming one's skin cells into youthful versions of every other cell type. People will be able to 'reprogram' their own biochemistry away from disease and aging, radically extending life expectancy."

Those are exciting words for us boomers!!! Wrinkles be damned! We may all soon be drinking from the proverbial fountain of youth.

**But the implications for our retirement are clear. Our money has to last even longer that we may think.** Can you imagine if Ray is right, and us boomers live until we are 110 or 120? Imagine the type of technology that will alter the lifespan of millennials. What if 110 or 115 is in your future? Nothing will be more important than guaranteed lifetime income. A paycheck that you can't

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outlive will be the best asset you own.

When I was young, I thought that money was the most important thing in life; now that I am old, I know that it is.

—OSCAR WILDE

## THE 4% RULE IS DEAD

In the early 1990s, a California financial planner came up with what he called **the "4% rule."** The gist is that if you wanted your money to last your entire life, you could take out 4% per year if you had a "balanced portfolio" invested in 60% stocks and 40% bonds. And you could increase the amount each year to account for inflation.

"Well, it was beautiful while it lasted," recounts a 2013 *Wall Street Journal* article entitled "Say Goodbye to the 4% Rule." Why the sudden death? Because when the rule came into existence, government bonds were paying over 4%, and stocks were riding the bull! If you retired in January 2000, and you followed the traditional 4% rule, you would have lost 33% of your money by 2010, and, according to T. Rowe Price Group, you would now have only a 29% chance that your money would last your lifetime. Or spoken in a more direct way, you'd have a 71% chance of living beyond your income. Broke and old are not two things that most of us would like to experience together.

Today we are living in a world of globally suppressed interest rates, which is, in effect, a war on savers. And most certainly a war on seniors. How can one retire safely when interest rates are near 0%? They must venture out into unsafe territory to try to find returns for their money. Like the story of the thirst-stricken wildebeest that must venture down to the crocodile-infested waters to seek out a drink. Danger lurks, and those who need positive returns to live, to pay their bills, become increasingly vulnerable.

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## CRITICAL MASS DESTRUCTION

No matter what anyone tells you, or sells you, there isn't a single portfolio manager, broker, or financial advisor who can control the primary factor that will determine if our money will last. It's the financial world's dirty little secret that very few professionals know. And of those who do, very few will ever dare bring it up. In my usual direct fashion, I put it smack dab in the middle of the table when I sat down with legend Jack Bogle.

Remember Jack Bogle? He is the founder of the world's largest mutual fund, Vanguard, and about as straightforward as a man could be. When we spoke for four hours in his Pennsylvania office, I brought up the dirty little secret, and he certainly didn't sugarcoat his opinion or thoughts. "Some things don't make me happy to say, but there is a lottery aspect to all of this: when you were born, when you retire, and when your children go to college. And you have no control over that."

What lottery is he talking about?

It's the big luck of the draw: What will the market be doing when *you* retire? If someone retired in the mid-rcqos, he was a "happy camper." If he retired in the mid-zooos, he was a "homeless camper." Bogle himself said in an early 2013 CNBC interview that, over the next decade, we should prepare for *two* declines of up to 50%. Holy sh*t! But maybe we shouldn't be surprised by his prediction. In the 2000s, we have already experienced two drawdowns of nearly 50%. And let's not forget that if you lose 50%, you have to make 100% just to get back to even.

The risk we all face, the dirty little secret, is the devastating concept of sequence *of returns*. Sounds complicated, but it's not. In essence, the earliest years of your retirement will define your later years. If you suffer investment losses in your early years of retirement, which is entirely a matter of luck, your odds of making it the distance have fallen off the cliff.

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You can do everything right: find a fiduciary advisor, reduce your fees, invest tax efficiently, and build up a Freedom Fund.

But when it's time to ski down the backside of the mountain, when it's time for you to take income from your portfolio, if you have one bad year early on, your plan could easily go into a tailspin. A few bad years, and you will find yourself back at work and selling that vacation home. Sound overly dramatic? Let's look at a hypothetical example of how the sequence of returns risk plays out over time.

## JOHN BIT THE DOG

John bit the dog. The dog bit John. Same four words, but when arranged in a different sequence, they have an entirely different meaning. Especially for John!

John is now 65 and has accumulated $500,000 (far more than the average American) and is ready to retire. Like most Americans nearing retirement, John is in a "balanced" portfolio (60% stocks, 40% bonds), which, as we learned from Ray Dalio, isn't balanced at all! Since interest rates are so low, the 4% rule won't cut it. John decides that he will need to take out 5%, or $25,000, of his nest egg/Freedom Fund each year to meet his income needs for his most basic standard of living. When added to his Social Security payments, he "should" be just fine. And he must also increase his withdrawal each year (by 3%) to adjust for inflation because each year the same amount of money will buy fewer goods and services.

As John's luck would have it, he experiences some market losses early on. In fact, three bad years kick off the beginning of his so-called golden years. Not such a shiny start.

# JOHN

| Age | Hypcthettcal stock market gains *or* losses | Withdrawal at start of year | Nest egg at start of year |
|---|---|---|---|
| 64 | | | $500,000 |
| 65 | | $25,000 | $500,000 |
| 66 | | $25,750 | $426,839 |
| 67 | [redacted] | $26,523 | $348,766 |
| 68 | 14.62% | $27,318 | $246,956 |
| 69 | 2.03% | $28,318 | $251,750 |
| 70 | 12.40% | $28,982 | $228,146 |
| 71 | 27.25% | $29,851 | $223.862 |
| 72 | [redacted] | 530,747 | $246,879 |
| 73 | 26.31% | $31,669 | $201,956 |
| 74 | 4.46% | $32,619 | $215,084 |
| 75 | 7.06% | $33,598 | $190,084 |
| 76 | [redacted] | $34,606 | $168,090 |
| 77 | 34.11% | $35,644 | $131,429 |
| 78 | 20.26% | $36,713 | $128,458 |
| 79 | 31.01% | $37,815 | $110,335 |
| 80 | 26.67% | $38,949 | $95,008 |
| 81 | 19.53% | $40,118 | $71,009 |
| 82 | 26.38% | $36,923 | $36,923 |
| 83 | [redacted] | $0 | $0 |
| 84 | 3.00% | | |
| 85 | 13.62% | | |
| 86 | 3.53% | | |
| 87 | 26.38% | | |
| 88 | 23.45% | | |
| 89 | 12.78% | | |

Average return **8.03%** Totlll withdrawal **$580,963**

**Average return** **8.03%**
**Total withdrawal** **$580,963**

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is just too steep. By his late 70s, he sees the writing on the wall and knows that he will run out. By age 83, his account value has collapsed. In the end, he can withdraw just $580,963 from his original $500,000 retirement account. In other words, after 18 years of continued investing during retirement, he has just an additional $80,000 to show for it.

*But here is the crazy thing:* during John's tumble down the mountain, the market averaged over 8% annual growth. That's a pretty great return, by anyone's standards!

Here's the problem: the market doesn't give you *average* annual returns each year. It gives you *actual* returns that work out to an average. (Remember our discussions about the difference between real and average returns in chapter 2.3, "Myth 3: 'Our Returns? What You See Is What You Get' "?) And "hoping" you don't suffer losses in years in which you can't afford them is *not* an effective strategy for securing your financial future.

## FLIP-FLOP

Susan is also age 65, and she too has $500,000. And like John, she will withdraw 5%, or $25,000 per year, for her income, and she too will increase her withdrawal slightly each year to adjust for inflation. And to truly illustrate the concept, we used the exact same investment returns, but we simply flipped the sequence of those returns. We reversed the order so that the first year becomes the last year and vice versa.

By merely reversing the order of the returns, Susan has an entirely different retirement experience. In fact, by the time she is 89, she has withdrawn over $900,000 in income payments and still has an additional $1,677,975 left in her account! She never had a care in the world.

Two folks, same amount for retirement, same withdrawal strategy: one is destitute, while the other is absolutely free financially.

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## SUSAN

| Age | Hypothetical stock market gains or losses | Withdrawal at start of year | Nest egg at start of year |
|---|---|---|---|
| 64 | | | $500,000 |
| 65 | 12.78% | $25,000 | $500,000 |
| 66 | 23.45% | $25,750 | $535,716 |
| 67 | 26.38% | $26,523 | $629,575 |
| 68 | 3.53% | $27,318 | $762,140 |
| 69 | 13.62% | $28,318 | $760,755 |
| 71 | [redacted] | $29,851 | $827,524 |
| 70 | 3.00% | $28,982 | $832,396 |
| 72 | 26.38% | $30,747 | $490,684 |
| 73 | 19.53% | $31,669 | $581,270 |
| 74 | 26.67% | $32,619 | $656,916 |
| 75 | 31.01% | $33,598 | $790,788 |
| 76 | 20.26% | $34,606 | $991,981 |
| 78 | | | |
| 77 | 34.11% | $35,644 | $1,151,375 |
| | [redacted] | $36,713 | $1,496,314 |
| 79 | 7.06% | $37,815 | $1,437,133 |
| 80 | 4.46% | $38,949 | $1,498,042 |
| 81 | 26.31% | $40,118 | $1,524,231 |
| 82 | [redacted] | $41,321 | $1,874,535 |
| 83 | 27.25% | $42,561 | $1,712,970 |
| 84 | 12.40% | $48,383 | $2,125,604 |
| 85 | 2.03% | $45,153 | $2,339,923 |
| 86 | 14.62% | $46,507 | $2,341,297 |
| 87 | | $47,903 | $2,630,297 |
| 88 | [redacted] | $49,340 | $1,978,993 |
| 89 | [redacted] | $50,820 | $1,677,975 |

**Average return** **8.03%**

**Total withdrawal** **$911,482**

Average return 8.03%
Total withdrawal $911,482

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And what's even more mind boggling: **they both had the same average return (8.03% annually) over the 25-year period!**

How is this possible? Because the "average" is the total returns divided by the number of years.

Nobody can predict what will happen around the next corner. Nobody knows when the market will be up and when it will be down.

Now, imagine if John and Susan both had income insurance. John would have avoided an ulcer, knowing that as his account dwindled, he had a guaranteed income check at the end of the rainbow. Susan would have simply had more money to do with as she pleases. Maybe take an extra vacation, give more to her grandkids, or contribute to her favorite charity. The value of income insurance cannot be overstated! And when coupled with the All Seasons portfolio, you have quite a powerful combination.

## 6 DEGREES OF SEPARATION

You might recall from earlier in the book when I introduced Wharton professor Dr. David Babbel. He is not only one of the most well•educated men I have ever met but also a gentle and caring soul with a grounding faith. And he prefers David over "Doctor" or "Professor."

Here is a quick refresher on David's accomplished background. He has six degrees! A degree in economics, an MBA in international finance, a PhD in finance, a PhD minor in food and resource economics, a PhD certificate on tropical agriculture, and a PhD certificate in Latin American studies. He has taught investment at Berkeley and the Wharton School for over 30 years. He was the director of research in the pension and insurance division for Goldman Sachs. He has worked for the World Bank and consulted for the US Treasury, the Federal Reserve, and the Department of Labor. To say he knows his stuff is to say Michael Jordan knows how to play basketball.

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David is also the author of a polarizing report in which he lays out his own personal retirement plan. When it came time for David to retire, he wanted a strategy that would give him peace of mind and a guaranteed income for life. He remembered that *income is the outcome*. And he also wisely took into consideration other factors such as not wanting to make complex investment decisions in his older years. He considered all his options and drew upon his vast knowledge of risk and markets. He even consulted with his friends and former colleagues on Wall Street to compare strategies. In the end, David decided that the best place for his hard-earned retirement money was *annuities*!

*Whoa!* Wait a second.

How could Babbel commit what his Wall Street buddies call "annuicide"? *Annuicide* being the term that brokers first coined for a client who withdraws money from the stock market and uses age-old insurance companies to guarantee a lifetime income. Brokers see it as an irreversible decision that no longer allows them to generate revenues from your investment. The death of *their* profits.

Come to think of it, **when was the last time your broker talked to you about creating a lifetime income plan?** Probably never. Wall Street typically has no interest in promoting concepts related to withdrawal. To them, *withdrawal* is a four-letter word. Here is the irony: you represent a lifetime of income for the broker so long as you never leave.

Americans should convert at least half of their retirement savings into an annuity.

—US TREASURY DEPARTMENT

Dr. Jeffrey Brown knows a thing or two when it comes to creating a lifetime income plan. He is an advisor to the US Treasury and the World Bank, and is one of the people called on by China to help evaluate its future Social Security strategy. He was also one of only

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seven individuals appointed by the president of the United States to the Social Security Advisory Board.

Jeff has spent most of his professional career studying how to provide people an income for life. What did he resolve? That annuities are one of the most important investment vehicles we have.

Jeff and I had a fascinating three-hour interview around income planning and how baffling it is to him that income is omitted from most financial planning conversations. How is it possible that income insurance is barely discussed in the offices of most financial planners, nor is it included as an option inside 401(k) plans, the primary retirement vehicle for Americans?

I asked him, "How do people find a way to protect themselves so they really have an income for life when they are living longer than ever before? They're retiring at sixty-five, and today they've got twenty or thirty years of retirement income needs ahead of them, but their financial plan won't last that long. What's the solution?"

"The good news, Tony, is we actually do know how to address this problem," he said. "We've just got to get people to change the way they are thinking about funding their retirement. There are products out there in 'economist land' that we call annuities, which basically allow you to go to an insurance company and say, 'You know what? I am going to take my money and put it with you, you're going to manage it, grow it, and you're going to pay me back income every month for as long as I live.' The easiest way to understand this is, it's exactly what Social Security does. With Social Security, you know, you're paying in over your lifetime while you're working, and then when you retire, you get paid back income every month for as long as you live. You don't have to be limited by Social Security; you can expand your lifetime income by doing this on your own as well."

Jeff and his team performed a study where they compared how

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annuities were described, or "framed," and how the shaping of that conversation completely changed people's perceptions of their need or desire for an annuity.

First, they portrayed them the way stockbrokers do: as a "savings" account or investment with relatively low levels of return. Not surprisingly, only 20% of people found them attractive. Sound familiar? You can hear the broker saying, "Annuities are a bad investment!"

But when they changed just a handful of words and described the *actual* and *real* benefits of an annuity, the tide changed. By describing the annuity as a tool that gives you a guaranteed income for the rest of your life, more than 70% found them attractive! Who doesn't want income insurance that kicks in if you have burned through your savings? Maybe your cost of living was greater than you expected. Maybe you had an unexpected medical emergency. Or maybe the market didn't cooperate with its timing of returns. What a gift to know that your future income checks are just a phone call away.

And today a revolutionized financial industry has created a whole new set of annuity opportunities. Many of these pay you returns that mimic the performance of the stock market but carry none of its downside losses. Annuities aren't just for your grandpa anymore. Turn the page, and let me show you the five types of annuities that could change your life.

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16. Insurance guaranty associations provide protection to insurance policy holders and beneficiaries of policies issued by an insurance company that has become insolvent and is no longer able to meet its obligations. All states, the District of Columbia, and Puerto Rico have insurance guaranty associations. Insurance companies are required by law to be members of the guaranty association in states in which they are licensed to do business. Each state has its own maximum amount that you are covered up to, and in most states, that varies per person up to $300,000 to $500,000.

17. Dr. Anthony Atala, director of the Wake Forest Institute for Regenerative Medicine,

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has been creating and implanting organs like this for more than a decade.