Retirement Portfolio Design for a Changing Economy

Going beyond conventional wisdom to create a better retirement outcome

EXECUTIVE SUMMARY

Planning for retirement can be confusing and a bit scary. How do you manage your money now so you can be well-prepared financially for retirement? And how do you ensure that your retirement income will last throughout your life? With increased life expectancies, it's critical that you weigh all your options and plan carefully. This paper will discuss traditional retirement strategies, as well as introduce you to a less conventional, but potentially more effective and efficient approach to help you reach your retirement goals.

Your Retirement Advisor™ Hybrid Income Portfolio Strategy

Our Hybrid Income Portfolio (HIP) strategy is a retirement portfolio solution that offers growth potential and volatility reduction for those nearing or recently retired. Following the research (as highlighted in this paper), our HIP strategy integrates FIAs, Structured Investment Products (SIPs) and globally diversified stocks in combination to offer the lowest potential risk, highest potential return and highest probability of retirement success.

THE OPTIMIZED RETIREMENT PORTFOLIO

A recent research study commissioned by Nationwide Financial and completed by Morningstar Investment Management LLC, compared a traditional 60/40 stock and bond portfolio to a portfolio consisting of stocks, bonds and FIAs. The study concluded that by repositioning a traditional retirement portfolio consisting of 60% equities and 40% bonds to a portfolio consisting of 36% equities, 24% bonds and 40% FIAs offers virtually the same return, but with a 40% reduction in potential portfolio risk and volatility, both of which are the number one objectives for your portfolio as you head into retirement. The study used Nationwide's New Heights fixed indexed annuity in combination with stock and bond indexes to compile the results.[1]

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[1] Shift Away from Potential Risk and Toward Potential Return, Nationwide (Morningstar), June 2016.

Two Key Retirement Concepts

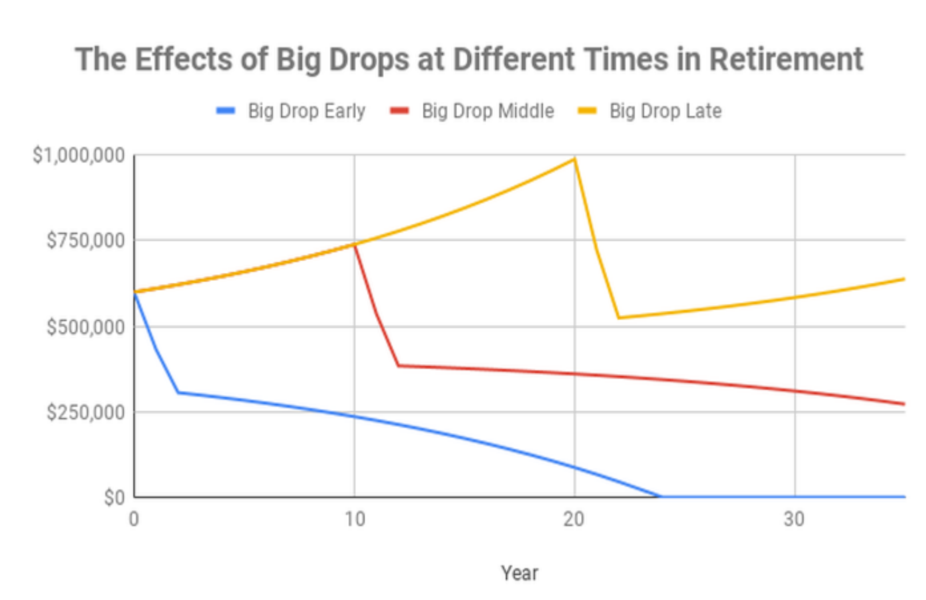
The following retirement concepts are extremely important to understand when creating a proper retirement plan.

Safe Withdrawal Rate (SWR) is one of the most important factors when creating an efficient retirement income strategy. The SWR is the amount of annual income that can be distributed "safely" from a retirement portfolio under all market conditions (negative markets, average markets or positive markets) with a high probability that the income will last a lifetime. Historically, a traditional stock and bond retirement portfolio could generate a 4% SWR from a portfolio, but recent studies have lowered the SWR to around 2.5%. This reduction in SWR equates to a lower income level realized from a traditional stock/bond portfolio. It is essential to employ strategies that potentially can increase the SWR and create the more efficient retirement income.

Investment Volatility can harm a retiree when withdrawals are taken from a portfolio systematically. Mathematics prove that the portfolio with the lower volatility or risk level will last longer when taking withdrawals, all other factors being equal.

Here's an even better example of what I'm talking about. In this scenario, three different portfolios each earn 6% after inflation but suffer a 25% decline for two consecutive years at varying stages of retirement. The colored lines represent the retirement savings balances over a 35-year retirement. Assumes 6% returns during 33 of 35 years and 25% declines during the remaining two years.

In all three scenarios, these retirees experience 33 years of 6% returns and just two consecutive years in which their portfolios drop 25% (for reference, the market lost a little over 50% in the financial crisis of 2008 and 2009). But as you can see, the timing of those drops makes an enormous difference whether you run out of money or not!



Real-life returns are never this regular, but the point is clearly illustrated; One of the greatest risks to your portfolio is a huge drop in your nest egg's returns during the first five years of retirement. If that fall comes later, the danger is mitigated because your portfolio has had plenty of time to grow. The dent isn't nearly as harmful.

From this, there are two clear takeaways:

1. We cannot control market losses and market behavior.
2. A market loss early in retirement will create a higher probability of portfolio depletion

The HIP STRATEGY

We have identified 2 key concepts you must understand to create a successful retirement strategy. Mitigating market losses while maintaining reasonable returns will offer a higher safe withdrawal rate (SWR) and higher income level over a retiree's lifetime. The HIP Strategy is designed with that end in mind; reduce portfolio risk and enhance portfolio returns above a traditional stock and bond portfolio.

Benefits of the HIP:

1. Reduce risk of loss by utilizing proper asset allocation
2. Integrate proper product allocation (Stocks, Bonds, SIPs & FIAs) to control risk of loss
3. Proper money manager selection to increase our returns long-term (Manager Alpha)

How The HIP Works

The HIP Strategy incorporates both traditional investments such as stocks and bonds to maximize growth potential but adds into the portfolio an allocation of Structured Investment Products (SIPs). SIPs are sponsored by Investment Banks or Insurance Companies and are designed to meet specific investment objectives utilizing derivatives and options contracts. These products can be utilized to enhance returns on a specific investment index or on the converse, can be utilized to quell or minimize risk on the specific investment index. When utilizing SIPs to maximize return potential on a given investment index, the downside or loss potential typically will be increased. When utilizing SIPs in a retirement portfolio, these products are structured as an alternative to bonds in the retirement portfolio, offering similar "low-risk" characteristics as bonds while being linked to investment indices to derive higher potential returns. The integration of traditional stocks and bonds with lower risk SIPs offers a similar return potential as a traditional retirement portfolio with less risk or volatility.

The HIP Strategy has been designed to reduce portfolio volatility while maintaining reasonable growth potential. This combination of growth with less volatility than a traditional stock and bond portfolio, can add value by increasing a retirees Safe Withdrawal Rate by up to 1-2% per year and add as much as 5-10 years to a retirement portfolio when taking income.

Mathematical evidence proves; the portfolio with the lower risk level (volatility), will last longer when taking withdrawals for income, all other factors being equal.

A CASE STUDY

The case study below simply shows the effect lower volatility has on a retirement portfolio when taking withdrawals for income. As can be witnessed by the case study, the HIP strategy outperforms the traditional stock and bond only portfolio due to the fact that it dramatically reduces risk while maintains the same return or growth potential.

Case Study Variables:

- Retirement Projection Age Range: 65 - 90
- IRA Investible Assets: $1,000,000
- Income derived: 4% or $40,000 per year (adjusted for inflation at 2% annually)
- Hypothetical Portfolio Growth Rate: 6% (net of fees)

Retirement Scenario Overview

Below you will find a summary of each retirement scenario developed for consideration. The Income Stability Ratio is the amount of retirement income that will not be affected by the stock market volatility.

Scenario A: TRAA 6040

- Retirement Income Generated: $40,000 annual (net)
- Retirement Income inflated @ 2% annually
- **Traditional Plan with 60% Global Diversified Stocks & 40% Diversified Bond funds**

Scenario B: HIP 303040

- Retirement Income Generated: $40,000 annual (net)
- Retirement Income inflated @ 2% annually
- **HIP with 30% Global Diversified Stocks, 30% Structured Investments & 40% FIAs**

Portfolio Balances age 90

After completing your Retirement Income Projection Analysis (RIPA) with all your personal income goals, variables and assumptions the following outcome is realized based upon several retirement scenarios. Each scenario offers a different retirement outcome which should be reviewed carefully to determine the best course of action to create the best potential retirement outcome (not running out of income)

Retirement Income Summary

Income Goal (net): $40,000 per year with 2% inflation increases

	Negative Sequence of Return Projection	*Average Sequence of Return Projection*	*Positive Sequence of Return Projection*
Scenario A **TRAA 6040**	Account balances $0 at age 85	Account balances $1,538,440	Account balances $2,944,161
Scenario B **HIP 303040**	Account balances $627,982 at age 85 Account balances $493,195	Account balances $1,901,723	Account balances $2,986,913

OTHER CONSIDERATIONS TO RAISE SAFE WITHDRAWAL RATE

In addition to changing variables and product allocation there are additional strategies that should be incorporated to dramatically increase a retiree's Safe Withdrawal Rate. We have identified four additional strategies that can be a major factor in raising a retiree's Safe Withdrawal Rate. These additional items should be addressed and potentially included in your retirement plan to lead to a more efficient retirement outcome:

- **Social Security Timing:** Using the proper strategy to maximize this guaranteed income source
- **Tax Efficiency:** Reducing taxes in retirement to increase the net after-tax income annually
- **Prudent Use of Home Equity:** Incorporating home equity as a tax-free income source or portfolio safety net
- **Alpha Portfolio Management:** Using active and passive portfolio management to potentially increase portfolio returns

CONCLUSION

Understanding your personal Safe Withdrawal Rate is paramount to creating an efficient retirement strategy that will last a lifetime. Using a retirement stress test technology can help identify how much you can withdraw safely and identify how different strategies can affect your overall outcome in various market environments (negative, average or positive).

Efficiency in retirement and increasing your Safe Withdrawal Rate is accomplished through proper product allocation (not just stocks and bonds), tax planning, prudent use of home equity and creating a portfolio with alpha generating managers. This combination can have a dramatic impact on your portfolio survivability creating the maximum income with what you have.

How to Implement the Hybrid Income Portfolio Strategy

How can you implement this progressive, unconventional, research-based portfolio design? You can try to do it yourself (which is quite complex and requires a deep understanding of the many financial disciplines) or you can work with a qualified retirement advisor who understands how each discipline integrates together. It's important to make sure that he or she is experienced not only with this type of portfolio strategy, but also in retirement planning and in the use of sophisticated retirement and investment planning technology. Few advisors have the knowledge in both insurance and investment disciplines to offer this truly objective retirement solution.

Your Retirement Advisor can assist you with the implementation of the HIP strategy as part of our overall Multi-Discipline Retirement Srategies (MDRS). MDRS incoporates tax minimization and optimal Social Security filing strategies to get the best potential retirement outcome.

Your Retirement Advisor offers complimentary income and portfolio assessments.

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