Chapter Three

The Rise of the "DIY Pension Plan"

People often buy too much risk when investing in the equity markets because of the belief that past performance indicates future possibilities. However, if we take a close look at the realities of the past, more often than not you will see that the markets didn't cooperate with every retiree's needs. In order for your retirement to be truly secured, the market must cooperate 100% of the time. But it never has and never will. In fact, the markets have turned downward so dramatically that people have lost over 40% of their portfolio values in recent years. And so, if the world is getting increasingly unstable, why would we base our retirement planning on the rosy expectation that things will only change for the better?

Yet, many people still choose to invest their entire retirement savings in the equity markets. Most of these people are the do-it-yourself types or people that simply trust their brokers' advice. Over the years, I've seen prospective clients come into my office only after they took a devastating loss in the markets. When the dot-com bubble imploded, people were obviously concerned because we had not seen a market correction like that or a pullback as dramatic as that. The market had basically gone up for nearly eighteen years, from 1982 onwards, and so people initially said, "Well, it'll bounce right back." But it didn't. From 2001 to 2003, the market went down every year, and ended up down about 50% after a three-year time period. And some things, particularly in the dot-com sector, lost all of their value.

Then it happened again.

A couple years back, we had the banking fiasco immediately follow the subprime mortgage mess. The markets went down 50% in about six months. We saw the collapse of large financial institutions like Lehman Brothers and Bear Stearns. And again, people were shocked and said, "We thought this was a safe stock." But when it comes to an equity position, even in the blue-chip stocks, stockholders are always the last to get paid. Bondholders will get paid first, preferred stockholders after that, and then if there's any money left, the common stock holder. So if you're last on the food chain in a declining market, should you really be surprised if your value goes to zero?

Of course, some people were hit very hard. This was the second major market correction just within the last decade. So it became apparent our equity investments could go down very far, very fast. That's not an encouraging sign if you're an equity holder who is at or near retirement age. For anyone to take a 50% hit on his or her net worth is absolutely devastating. And if that's right at the time where you need to retire, you have a major problem because you might need to draw on that money. But you can't draw money out of an account that's already underwater because you'll spend that principal down to zero. From a planning perspective, it was truly frustrating to see people come in with $300,000, when a year or two earlier, they were at a million. And they came in saying, "Well, I need $50,000 a year." At that rate, they'll be out of money in six years.

Even more terrifying, the clients who put their money in money markets were not safe either. The money they thought to be safe and liquid turned out to be not safe and not liquid due to concerns of a complete liquidity crisis in the United States. In 2008, the Fed had emergency meetings because the money markets had broken the dollar. So for every dollar you had saved in a money market account, the actual value of the dollar would be less than a dollar. And that's if you could even get your money out. Let's say you had $100,000 saved in a money market account and you wanted to get your money, but every dollar ended up being worth 95 cents. In reality, you would only have $95,000 if you were lucky enough to be able to withdraw it. A few money market funds were completely frozen when people tried to make a withdrawal. You couldn't withdraw any money for a period of time, and when they did finally release it, you only could partial amounts over time. For all practical purposes, it wasn't worth anything because you couldn't get it if you needed it to survive in retirement.

When the money markets broke the dollar, astute financial managers looked at their class portfolios and anybody who had exposure over $100,000 (the maximum amount insured by the government at the time) had that money removed that day. Checks were immediately cut to clients. A total of $87 billion left the financial institutions that day. In cash. $87 billion. In just one day.

The Fed saw that and realized that the amount would be north of a trillion dollars the next day. So they immediately increased the reserves and guaranteed to insure up to $250,000. They pumped all kinds of money into the system. Had the federal government not intervened successfully in 2008, it would have been a run on the banks. It would have been a banking crisis worse than the thirties. And the world would have come to a screeching halt.

So while the dot-com bust simply gave everybody a big haircut, the banking crisis of 2008 threatened to take down the entire economy.

Today, the world is considerably more unstable than it was even three years ago. The American economy has not come back, unemployment is still high, and housing has not come back. Even worse, we've got all this instability in the Middle East and North Africa. Gas prices are skyrocketing. The natural disasters in Japan are forcing American car factories to shut down because they cannot get Japanese parts, and Tokyo could be in rolling blackouts for years. The case against risk is even stronger today than it was in 2008 or 2001.

Many people have decided to just go safe.

After seeing the people in financial peril from too much risk exposure, and the people that were just sitting on a pile of cash, many have developed more perspective. We shifted our focus toward protecting value, especially if clients were at retirement or near retirement. 'Near retirement' being a couple of years from retirement. Because once you *have* enough money, you can say, "I'm okay from here on out, provided I don't lose my savings." So we began to look for strategies that would set up a stream of income in retirement — something that will provide a guaranteed stream of income for life, something like a personal pension plan. In essence, we're going to create our own personal pension plan through fixed indexed annuities. And it (the income) can exist for the rest of your life and your spouse's life. Even more, it can even be a potential inheritance for your beneficiaries.

We have been placing fixed indexed annuities for years now because we figured out a while back that as good as the equity market can be, it will never provide the consistency you need in a retirement plan. As we see the equity markets begin to trend toward these products, more and more people will begin to use them to accomplish their financial goals. We have already seen some 401(k) plans incorporate them into their savings plan. We suspect that very soon, even brokerage firms like Merrill Lynch and Fidelity will be offering fixed index annuities as well because they really are that safe and good.

Even though fixed indexed annuities are one of the best products to build a retirement plan, you still find a lot of resistance and objections to the idea of annuities. Now I'll be the first to admit that fixed indexed annuities are not the sexiest type of investment you can make. You'll never hear guys bragging about how much money they made in a fixed indexed annuity at a cocktail party. People tend to gravitate toward excitement and the thrills of highs and lows. We also love hearing about a great "get rich quick" scheme. It tantalizes our carnal desires for greed and gives us a sense of wonderment and possibility. Fixed indexed annuities, on the other hand, are about as exciting as watching paint dry. But what they are is stable and reliable. You'll get a check in the mail consistently and you'll know exactly what you're going to get. When it comes to retirement income, I think stable and reliable are some of the best qualities you can seek in an investment.

These days, some people will also think it sounds too good to be true. But nearly all the pensions in the world use annuities. Why? *Because they work.* That's why they use them. Social Security is an annuity. Nearly every pension is an annuity. Annuities work because it's income that you can count on. Actuary's methodically crunch numbers to determine what can and cannot be paid out. And since pensions no longer exist, the responsibility lies with individual investors to create their own pension. And they can! And they can do it two ways: one where it is guaranteed and one where it is not. When it's guaranteed, they'll know exactly what they're going to get. When it's not, there's no guarantee to what they're going to get, and so they can get more or they can get less. And they could actually run out of money.

Some people run from annuities because they don't trust insurance companies. I've had people tell me stories of Aunt Sally, who had an insurance policy that she paid regularly for twenty years, and then missed a payment, died and got nothing out of it. I hear all kinds of stories about why insurance companies are bad, but there's a reason these companies have lasted for a few hundred years. They're safe. And they are the creators of this safe money. So you can put your money in the bank and watch it run dry in ten years or less at the current yields, or you can give that money to an insurance company, which will provide a guarantee for the rest of your life.

Others will say that an annuity itself is bad. Somebody might have an Aunt Jane who got an annuity, received payments for one year, died and the money vanished. That is an example of an immediate income with a life only option. Witnessing this unfortunate situation would give somebody a bad taste toward annuities. It would give me a bad taste too. But in this case, Aunt Jane had an immediate annuity, where the principal is gone when the person who possesses the annuity dies. That's not the type of annuity that we suggest people consider. We offer a deferred annuity. So in our case, if Aunt Jane had a million dollars, it would have paid her $5,000 a month. And if she died a year from now, the remaining principal would go directly to her kids. When I educate people about deferred annuities, most people say that they didn't know that this was possible. I normally recommend deferred annuities over immediate annuities because the client can maintain control in a deferred annuity, as opposed to giving up control by giving away the principal in an immediate annuity.

These days, you're not usually looking at Aunt Jane's immediate annuity. A few years ago, the insurance companies realized that baby boomers were retiring, so they set out to redesign annuities. They surveyed large insurance producers like myself and put us together in groups of twenty to fifty people. Then the insurance companies asked us how to design the perfect annuity. When we told them how, they actually listened! They designed what we suggested and that's one of the main reasons why we have this type of deferred annuities today.

The new annuities were redesigned so that instead of annuitizing the money, there would be withdrawals of the money. When you annuitize, you give up control. When you have withdrawals, you maintain control. The insurance companies have always been able to do this, but they were unwilling to do so because more money would go into the investors' pockets. But they had the retiring baby boomers in mind. And they knew that baby boomers want control. They also knew that if they didn't cater to the baby boomers, they would lose out on a large generation of retirees. As a result, the agents offering this product were willing to take a hit in order to gain more business. As a tradeoff for being able to sell this new product with this great feature, our compensation was reduced a fair amount, about 30% or more. But those of us who are in this business for the long term recognize the benefits of having our commission reduced in order to give the clients better, more reliable benefits.

People often say that they're going to wait before creating their pension plans with these annuities. If you want to wait, you can do that. But while you wait, you're at risk of losing 40% of your money in as little as six months. How would you feel if you lost 40% in six months? The Fed may have pumped close to a trillion dollars into the market through its quantitative easing efforts, QE1 and QE2, but if the market goes down 40% again, the chances of a QE3, 4 or 5 happening are pretty slim. The Fed doesn't have another two trillion to pump in. Some people argue that the Fed could print money all day long, and it can, but that will devalue our currency and only cause an even bigger mess. If you already have a sum of money that you've worked hard to acquire and can't afford to lose, then why wait? Protect that money now.

For years, many people have been stubborn about annuities and pension plans. They've said, "I know that the economy has gone up and down, but if I just find the right fund, I'll make 12% a year and I'll be fine."

But the paradigm is shifting.

Retirees and those close to retirement have seen two 50% corrections over a ten-year time period. When I ask people to do the math on their pile of money and figure out how they'd feel if that pile got clipped by 50%, most of them cringe. And most of them have already considered this reality. They just don't know what to do. Nine out of ten people I meet say that protecting their retirement income is exactly what they were looking for. The other 10% of people are the ones who will find a problem with anything.

Another way I keep my clients safe is to ladder their money in fixed annuities and fixed indexed annuities. By 'laddering,' I mean diversifying the term lengths of the hold positions of their annuities with different companies. This way, some annuities mature two years from now, some five years from now, some seven and some ten. I do this to diversify and increase their yields. The tradeoff for liquidity is yield. So in a fixed environment, the longer an annuity is being held, the higher the return should be. That's why I want some short-term, some intermediate and some longer term annuities. Then as money comes due, it gets reinvested at the current rate so we always have money out for the next five to ten years. And because of the improvements in today's annuities, you can now get a higher yield immediately without even giving away the principal.

Most people believe that annuities still only come in one form. They think that if they give a company x number of dollars, then they will get paid $2000 a month until they die, at which point their wife will get only $1000 a month, which will die when she dies. But the annuities that are available today will pay you $2000 a month, and will continue to pay your spouse $2000 a month after you die, and then when your spouse dies, the kids will inherit the leftover principal. This market improvement makes annuities very palatable for people whose biggest knock on annuities was that it used to require that you essentially give away your principal. This is still true of immediate annuities. But you can reclaim control of your money through deferred annuities. And control is the number two thing that retirees want. Number one, of course, is not running out of money.

When I talk with people, I work with each client based on their own financial profile and their attitude toward risk. Just because I play it safe doesn't mean that some clients never play in the stock market, either on their own or with a broker. There are some people who love the stock market, and those people should always have a percentage in it. There are others who don't love the stock market, and in my opinion, they should never be in it. Then somewhere in between lies mostly everybody else.

Hypothetically speaking, if a guy has a half a million dollars and we run an analysis, we might find out that he needs a certain amount of extra income because he has no pension. That extra income could be satisfied with half of that $500,000. So let's say we take $250,000 of his money and create an income stream. He's very happy because all of his income needs are now met, and he's left with $250,000. Then we would probably suggest that he keep about $50,000 to $100,000 of that leftover money liquid. If he keeps $100,000 liquid, he's left with $150,000, which is extra money, and he can do whatever he would like with it. He could even decide to go with a balanced approach of stocks and bonds. So now he has all his income needs met, has liquidity, plus has money situated for growth. Doesn't that sound pretty good?

Other clients with that same starting amount of $500,000 may need $400,000 of that in an income stream. And still others may only need to put $60,000 in. In every case, we solve the income requirements first. Then we always factor in liquidity and solve that. The remaining money after that is what the client could decide to place in the equity markets.

In order to assess a person's income needs and take the first step toward helping him figure out how to pay himself a pension, we begin by doing a fact finder. A fact finder is basically a financial checkup. This assessment helps us ascertain information regarding your banking, your 401(k), your IRAs, your stocks, your bonds, your notes, your real estate, the debt on the real estate, your debt inside the house, your future or current pensions and your future or current Social Security. Basically, it gives us the overall snapshot.

From that snapshot, we put together what's called an asset summary. An asset summary is like a net worth statement, which shows all of your assets on one page. From there, we do an income plan and input your sources of income that we know of such as perhaps a small pension or Social Security or extra rental income. Then we factor in what your accumulated money can produce as an income stream.

In a fact finder, we always ask, "What are the expenditures needed on a monthly basis in retirement?" At this point, we factor in the net amount and also the current tax situation. Then we create an allocation or a proposed blueprint for your retirement.

I prefer to give people options. I show them options A, B and C and tell them that all three will meet their needs, but in different ways depending on how much safe money and money at risk they want.

Most people don't map out their income needs to the extent that we do. We not only factor out the income needs that you will have while you and your wife are both living, but we also factor in what you will need if your spouse dies first and how that could look different if you die first. Then we figure out what that would mean if a death happened today and if it happened five years from now, ten years from now, fifteen, twenty, twenty-five and thirty years from now. Oftentimes, when people consider what the surviving spouse's income will look like, they change their mind about whether they should choose option A as opposed to options B or C.

Most people don't face the fact that upon death, they might have a large drop in income. Let's say a husband has a pension of $50,000 and both he and his wife are making $20,000 a year in Social Security. From just those three income sources, they're at $90,000. But if the husband dies, his wife may lose half his pension and also one of the Social Securities. In this case, we lose $25,000 from the pension and $20,000 from Social Security, which drops the income from $90,000 to $45,000.

Statistically, if you're married and you're 65 or older, there's a 60% chance that either you or your spouse will live for thirty more years. In my seminars, I ask for a show of hands from the married people and then invite them to look at their spouse and determine who that person will be. They always laugh because we all know that some of us aren't going to make it to 95 and some of us will make it there with bells on.

In the scenario just mentioned, let's say the wife lives for another thirty years after the husband dies. Over thirty years, that $45,000 per year that she loses adds up to a loss of $1.35 million. Tack on a Cost of Living Adjustment and we're talking close to two million dollars or even $2.5 million. That's not a small sum of money!

When a couple considers this possibility, it might be suggested that we put together a plan that will kick in an extra $30,000 so that if the husband dies, the income will go from $90,000 to $75,000 instead of $45,000. That would be option B, which takes care of you in case something happens, as opposed to the basic option A. Then option C could put even more money away safely, or it could figure out a way to escrow money so that you can pay $10,000 a year for life insurance.

Developing a game plan for your pension is not something that you will do overnight. It requires several sober conversations, and you'll want to think about it because there are several ways you could map out your retirement income. There are also many different potential problems to solve.

The good news is that people who do not have pension plans can now create their own with the new fixed indexed annuity products now available in the marketplace. And they can create one that will guarantee a stream of income for life, for their life and their spouse's life, plus with a potential inheritance for any beneficiaries. And they can do this all without having to give up control of their saved principal. In my opinion, the newly designed annuity changed the annuity world. It is honestly the best new product I've ever seen in my career. And as I've said before, its positive repercussions will be enormous over the next several years.

So that's how you take care of your own pension. But what about those around you? What do you do for them, when, as the expression goes, you're out of the picture? I know it's unpleasant to think about. But what's even more unpleasant is what happens to our loved ones if we don't take care of them while we're still here. How to do that is the subject of the next chapter.