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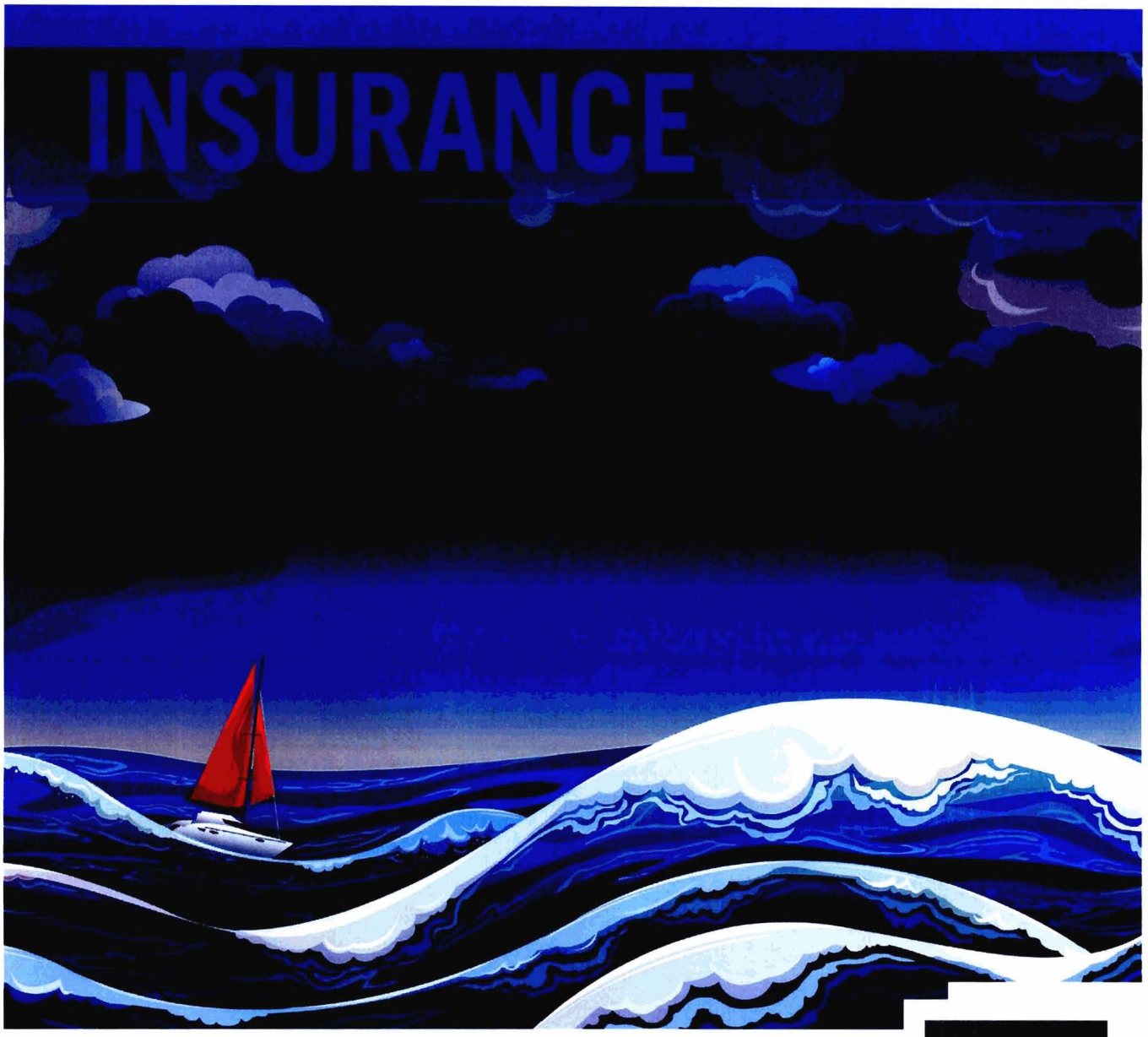

Smooth Sailing on Uncertain Waters

Using life insurance to steady the ups and downs of retirement assets.

By Mark A. Teitelbaum, JD, CLU®, ChFC®

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Timing is everything. Clients buying assets during a market low have the potential to benefit from a market increase. A client buying the same asset at a market peak may need years to dig out from a hole following a market drop. During a client's accumulation years, this is a common challenge; however, at retirement that challenge begins all over again.

As clients begin retirement, their planning resets. All the past years of market ups and downs no longer matter; clients begin retirement with a pool of funds, and everything

now depends on how the market performs from that point forward. Starting at retirement clients again face the same starting-at-a-peak-or-trough issue. Retire in a stable or up market and clients have the potential to preserve or possibly grow their retirement assets. Retire in a down market and clients may find they are eroding their retirement assets faster than they planned. According to Edward Siedle in his Forbes online article, "The Greatest Retirement Crisis in American History" (March 20, 2013), many recent retirees facing the 2008 market crash found they had to either delay retirement or unexpectedly return to the workforce, often at reduced salaries. Cash value life insurance offers a possible solution for these clients.

THE PROBLEM

Tom is 65 and has accumulated $1,000,000 for his retirement. Like many people today, he knew he had to build a retirement pool of his own. He needs $100,000 a year in retirement and there is little coming in to support him from other sources:

- Social Security: $20,000
- Pension: $10,000
- Tom's savings: need to make up the other $70,000

Tom knows he needs to draw down on his $1,000,000 retirement fund at $70,000/year. However, he's concerned that if the stock market is unstable he may not have sufficient funds. He works with his financial professional and they look at a 20-year return for the market, long enough to carry him to age 85. They don't look to the 1980s and 1990s, where markets saw increases in most years. Instead, they look to what the market experienced in the 1970s and 1980s, when there was a mix of gains and losses.

This is the result Tom might see (assuming the same market returns as in the 1970s and 1980s). Notably, this is the result of *only* five "down" years over a 20-year period and assuming a very low 1 percent inflation.

Chart 1

Retirement Account Assuming 1% Inflation
No Life Insurance Planning

Age	Beginning of Year Balance	Annual Withdrawal	Post Withdrawal Balance	Hypothetical S & P 500 Return*	End of Year Balance
65	$1,000,000	($70,000)	$930,000	-14.66%	$793,662
66	793,662	-70,700	722,962	-26.47%	531,594
67	531,594	-71,407	460,187	37.20%	631,377
68	631,377	-72,121	559,255	23.84%	692,582
69	692,582	-72,842	619,740	-7.16%	575,366
70	575,366	-73,571	501,796	6.56%	534,713
71	534,713	-74,306	460,407	18.44%	545,306
72	545,306	-75,049	470,257	32.50%	623,090
73	623,090	-75,800	547,290	-4.92%	520,363
74	520,363	-76,558	443,805	21.55%	539,445
75	539,445	-77,324	462,122	22.56%	566,376
76	566,376	-78,097	488,280	6.27%	518,895
77	518,895	-78,878	440,017	31.73%	579,635
78	579,635	-79,667	499,968	18.67%	593,312
79	593,312	-80,463	512,849	5.25%	539,773
80	539,773	-81,268	458,506	16.61%	534,663
81	534,663	-82,081	452,583	31.69%	596,006
82	596,006	-82,901	513,105	-3.11%	497,147
83	497,147	-83,730	413,417	30.47%	539,385
84	539,385	-84,568	454,818	7.62%	489,475
85	489,475	-85,413	404,061	10.08%	444,791

TOM'S RESULTS WITHOUT LIFE INSURANCE

Starting Balance at Age 65
$1,000,000

Annual Retirement Fund Withdrawals Before 1% Inflation
$70,000

Tom's Retirement Fund Balance at Age 85
$444,791

The problem is simple. By taking funds out of his retirement savings year in and year out, Tom is forced to sell into loss years. In effect, Tom locks and exacerbates his losses during down market years. This is detailed in Chart 1.

A POSSIBLE LIFE INSURANCE SOLUTION

Tom has one advantage that his financial professional brings to his attention. In his 40s, Tom bought a cash value life insurance policy. At the time, the idea was to protect his family if something happened to him during his working years. Now, at age 65, the policy has a reasonable cash surrender value that Tom can access to help supplement

Chart 2

Retirement Account Assuming 1% Inflation Using Life Insurance Cash Values Following Down Market Years						Life Insurance Policy			
Age	Beginning of Year Balance	Annual Withdrawal	Post Withdrawal Balance	Hypothetical S & P 500 Return*	End of Year Balance	Premiums	Death Benefit	Withdrawal Loan	End of Year Cash Value
65	$1,000,000	($70,000)	$930,000	-14.66%	$793,662	$6,967	$500,000	$0	$233,000
66	793,662	–	793,662	-26.47%	583,580	0	450,000	(50,000)	195,000
67	583,580	–	583,580	37.20%	800,671	0	400,000	(50,000)	155,100
68	800,671	(72,121)	728,550	23.84%	902,237	0	400,000	–	165,000
69	902,237	(72,842)	829,394	-7.16%	770,010	0	400,000	–	176,000
70	770,010	–	770,010	6.56%	820,522	0	350,000	(50,000)	133,000
71	820,522	(74,306)	746,216	18.44%	883,818	0	350,500	–	141,000
72	883,818	(75,049)	808,769	32.50%	1,071,618	0	349,000	–	148,000
73	1,071,618	(75,800)	995,819	-4.92%	946,824	0	349,000	–	156,000
74	946,824	–	946,824	21.55%	1,150,865	0	297,900	(55,000)	111,000
75	1,150,865	(77,324)	1,073,541	22.56%	1,315,732	0	296,600	–	115,000
76	1,315,732	(78,097)	1,237,635	6.27%	1,315,235	0	295,300	–	120,000
77	1,315,235	(78,878)	1,236,357	31.73%	1,628,654	0	294,000	–	125,000
78	1,628,654	(79,667)	1,548,987	18.67%	1,838,183	0	293,000	–	130,000
79	1,838,183	(80,463)	1,757,720	5.25%	1,850,000	0	291,300	–	135,000
80	1,850,000	(81,268)	1,768,732	16.61%	2,062,519	0	289,000	–	140,000
81	2,062,519	(82,081)	1,980,438	31.69%	2,608,039	0	288,000	–	146,000
82	2,608,039	(82,901)	2,525,138	-3.11%	2,446,606	0	287,000	–	153,000
83	2,446,606	–	2,446,606	30.47%	3,192,087	0	234,600	(60,000)	106,000
84	3,192,087	(84,568)	3,107,519	7.62%	3,344,312	0	232,100	–	109,000
85	3,344,312	(85,413)	3,258,899	10.08%	3,587,396	0	229,500	–	112,000

By turning off access to retirement funds in five critical years (the years following market drops) the client is able to preserve assets by not selling into losses and allowing funds time to recover. The life insurance policy offers a source of funds to support the client in those five strategic years. The client's assets have now shifted from $444,791 to $3,587,396.

TOM'S RESULTS ADDING LIFE INSURANCE

Starting Balance at Age 65
$1,000,000

Annual Retirement Funds
$70,000

Years Life Insurance Cash Values Were Accessed
5

Tom's Retirement Fund Balance at Age 85
$3,587,396

his retirement. This same policy and its cash surrender values afford Tom a possible alternative approach. Rather than draw on the policy cash values each and every year, his financial professional shows him how accessing these values following down market years he can avoid selling into market losses.

In effect, Tom preserves his traditional retirement funds and allows them time to recover. Adding life insurance policy cash values to the mix avoids selling in down years and locking in losses. The combination, including using life insurance — an asset with different taxation — might enhance Tom's retirement and allow him to leave a legacy to his family. See the detail in Chart 2.

HOW LIFE INSURANCE BENEFITS CAN HELP

In this example, Tom purchased permanent cash value life insurance in his 40s to protect his family in case something happened to him during his working years. By purchasing permanent cash value life insurance instead of term insurance, Tom (perhaps without realizing it) provided for his family in multiple ways:

- He has the death benefit during his working years to protect his family.
- At retirement he has a reasonable cash value that he can tap into, as needed.
- He has an asset with special tax treatment. (See sidebar on next page for further explanation.)
- Tom is also able to potentially provide his family with a legacy by not depleting his assets in retirement.

Most retirement approaches showing cash value life insurance use a maximum funded life insurance policy to maximize the tax advantages offered by cash value accumulation. In retirement, these maximum funded policies are usually illustrated showing withdrawals and loans over 20 years. However, with the

Chart 3

Retirement Account Assuming 1% Inflation Using Life Insurance Cash Values Following Down Market Years								Life Insurance Policy			
Age	Beginning of Year Balance	Annual Withdrawal	RMD Divisor	RMD in Down Market Years	Post Withdrawal Balance	Hypothetical S & P 500 Return*		Premiums	Death Benefit	Withdrawal Loan	End of Year Cash Value
65	$1,000,000	($70,000)			$930,000	-14.66%	$793,662	$6,967	$500,000	$0	$233,000
66	793,662	0			793,662	-26.47%	583,580	0	450,000	(50,000)	195,000
67	583,580	0			583,580	37.20%	800,671	0	400,000	(50,000)	155,100
68	800,671	-72,121			728,550	23.84%	902,237	0	400,000	–	165,000
69	902,237	-72,842			829,394	-7.16%	770,010	0	400,000	–	176,000
70	770,010	0			770,010	6.56%	820,522	0	350,000	(50,000)	133,000
71	820,522	-74,306	27.4		746,216	18.44%	883,818	0	350,500	–	141,000
72	883,818	-75,049	26.5		808,769	32.50%	1,071,618	0	349,000	–	148,000
73	1,071,618	-75,800	25.6		995,819	-4.92%	946,824	0	349,000	–	156,000
74	946,824	0	24.7	-38,333	908,491	21.55%	1,104,271	0	309,900	(38,225)	12,400
75	1,104,271	-77,324	23.8		1,026,948	22.56%	1,258,627	0	308,900	–	129,000
76	1,258,627	-78,097	22.9		1,180,530	6.27%	1,254,549	0	307,850		13,500
77	1,254,549	-78,878	22.0		1,175,672	31.73%	1,548,712	0	306,800		141,000
78	1,548,712	-79,667	21.2		1,469,046	18.67%	1,743,317	0	305,700		147,600
79	1,743,317	-80,463	20.3		1,662,853	5.25%	1,750,153	0	304,600		154,000
80	1,750,153	-81,268	19.5		1,668,885	16.61%	1,946,087	0	303,500		161,000
81	1,946,087	-82,081	18.7		1,864,007	31.69%	2,454,711	0	302,300		169,000
82*	2,454,711	-82,901	17.9		2,371,809	-3.11%	2,298,046	0	301,200	–	178,000
83	2,298,046	0	17.1	-83,730	2,214,316	30.47%	2,889,018	0	300,000	Covered with RMD	186,000
84	2,889,018	-84,568	16.3		2,804,450	7.62%	3,018,149	0	298,800	–	196,000
85	3,018,149	-85,413	15.5		2,932,736	10.08%	3,228,356	0	297,500	–	207,000

Here RMDs are built into the planning. It's assumed RMDs are taken in all years as part of the withdrawals, but we are only highlighting these in years when there is a loss to show what needs to come out of the life insurance policy. The RMDs will not exceed the inflation adjusted income until age 82.
**At age 82 the RMD amount exceeds the client's inflation adjusted income needs. Only the income need is shown. It's assumed that any excess amounts are reinvested in a non-retirement account.*

"smooth sailing" method, Tom is only making strategic withdrawals in selected years (the years following down stock markets). As a result, he doesn't need to maximum fund his life insurance policy. He simply needs to adequately fund it to build some cash values. In this example, Tom has a modest $500,000 policy, and he funded it at $7,000/year (about $580/month).

SOME COMMON QUESTIONS

Many planners might comment that the 7-percent withdrawal rate is overly aggressive. For some individuals it may be. However, in truth, many clients cannot always retire at a 4-percent withdrawal rate and maintain their standard of living. Such is the case with Tom. Moreover, the 4 percent may not apply to all clients. Scores of articles have been written on the appropriate rate that retirees should use when they draw down on their retirement assets. There is no clear answer and the debate will continue for years. Although some financial professionals typically recommend a 3- to 4-percent withdrawal rate, others believe clients might be able to manage a 5- to 7-percent rate, and that the 3- to 4-percent rate is only for those who are risk adverse. This is

TAX TREATMENT OF PERMANENT CASH VALUE LIFE INSURANCE

Under current federal tax rules, you generally may take federal income-tax-free withdrawals up to your basis (total premiums paid) in the policy or loans from a life insurance policy that is not a Modified Endowment Contract (MEC). Certain exceptions may apply for partial withdrawals during the policy's first 15 years. If the policy is an MEC, all distributions (withdrawals or loans) are taxed as ordinary income to the extent of gain in the policy, and may also be subject to an additional 10 percent premature distribution penalty prior to age 59, unless certain exceptions are applicable. Loans and partial withdrawals will decrease the death benefits and cash value of your life insurance policy and may be subject to policy limitations and income tax. In addition, loans and partial withdrawals may cause certain policy benefits and riders to become unavailable and may increase the chance your policy will lapse. If the policy lapses, is surrendered or becomes an MEC, the loan balance at the time would generally be viewed as distributed and taxable under the general rules for distribution of policy cash values.

the position taken by authors Wade Pfau, Michael Finke and Duncan Williams in their article, "Spending Flexibility and Safe Withdrawal Rates," in the *Journal of Financial Planning*.

That the preceding example does not take required minimum distributions (RMD) from qualified plans into account is also questioned. That was deliberate. Tom's example was designed to show a concept: what will happen if a client can eliminate drawing down on assets at the time of a loss. As a practical matter, every client will be different. Some may have all of their assets in accounts that mandate RMDs. Other clients may have little or no assets in these accounts. Moreover, the mandatory distributions from these qualified accounts will vary widely, particularly with the advent of Roth IRAs and Roth 401k accounts. Even though most clients will have at least some assets that require RMDs, in most instances these required distributions can be kept low in the early years following retirement, according to Walter Updegrave in his article, "How to Manage Your Retirement Withdrawals" (*The Wall Street Journal*, June 6, 2014). Keep these items in mind:

- **Assuming a client retires at age 65, the RMDs won't be** required until the year following a client's age 70 ½. That would likely be six years after the start of retirement. In Tom's example, RMDs wouldn't come into play until after three of the five years of losses.
- Because of the way the RMD calculation works, the mandated withdrawals in the early years are low because of the high divisor offered by the Treasury and IRC regulations (IRS Publication 590). As a result, minimal dollars might need to come out of a retirement account in these early years.

Because of these two items, a meaningful but not significant impact will occur in the calculations. Chart 3 shows how Tom's example would look if he took his RMDs in the loss years starting after age 70 ½. By taking RMDs from assets during down years, the legacy to his family is reduced from $3,587,396 to $2,932,736, an 18-percent lower amount.

OTHER CONSIDERATIONS

- **If clients are able to actually** achieve strong early year returns, they won't have the same risk related to their retirement funds, but they will have a life insurance benefit and its cash values to enhance their overall financial goals. This strategy is intended to address the concerns clients might have if they don't receive strong early returns, as was the case in much of the 2000s.
- A surrender charge that varies by type of policy usually applies. These charges usually run 15 years or longer and will affect the available amount clients have to withdraw or borrow from their policy at any given time. Cost of insurance and other policy charges also will impact the cash value.
- The strategy presented here is intended to reflect a broad concept and individual situations will be different. In certain cases, clients will not have complete flexibility with all assets. In many instances, IRA and qualified plan assets will require minimum distributions after age 70 ½. This will force assets out of retirement funds even in years following market losses.
- How much life insurance clients can purchase and at what price will depend on medical and financial underwriting. Clients' results will vary based on their underwriting offer.
- To make this effective, clients will need a long-term buy and hold strategy with a cash value life insurance policy.

IDEAL CLIENT

- Has a life insurance need
- Is in the 35-55 year old range
- Is already funding traditional retirement options (IRAs and 401ks) but has a need for additional funding
- Is concerned about what will happen to his or her retirement funds in the event of a market drop while he or she is in or approaching retirement age

CONCLUSION: TIMING IS EVERYTHING

Clients will never know if they will retire into an up market or down market. Yet market performance in the earliest years of retirement can make or break a client's long-term retirement. In Tom's case, retiring in a down market drove his retirement assets down from $1,000,000 to $444,791, a 56-percent reduction. And that was at only 1-percent inflation. Had he retired in a different market, his results would have been remarkably different. Assuming the market return from 1990 – 2010, his $1,000,000 starting point would have grown to $2,195,599. This timeframe arguably included one of the market's best decades followed by one of the market's worst decades. Despite the negative and flat returns of the 2000s, the strong performance in the 1990s would have given Tom a strong cushion even a decade into his retirement. The point: clients never know what they will face when they retire.

Permanent cash value life insurance helps offer a client multiple protections. Not only does it offer clients protection for their families during their working years, but the cash values offer clients multiple options in retirement. In the smooth sailing approach, the cash values allow a client to make selective withdrawals to help avoid selling into market losses. Even without maximum funding a life insurance policy, the cash value life insurance helps a client meet multiple goals of protection, retirement funding and wealth transfer.