SPENDING
THE PRINCIPAL

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Spending the Principal

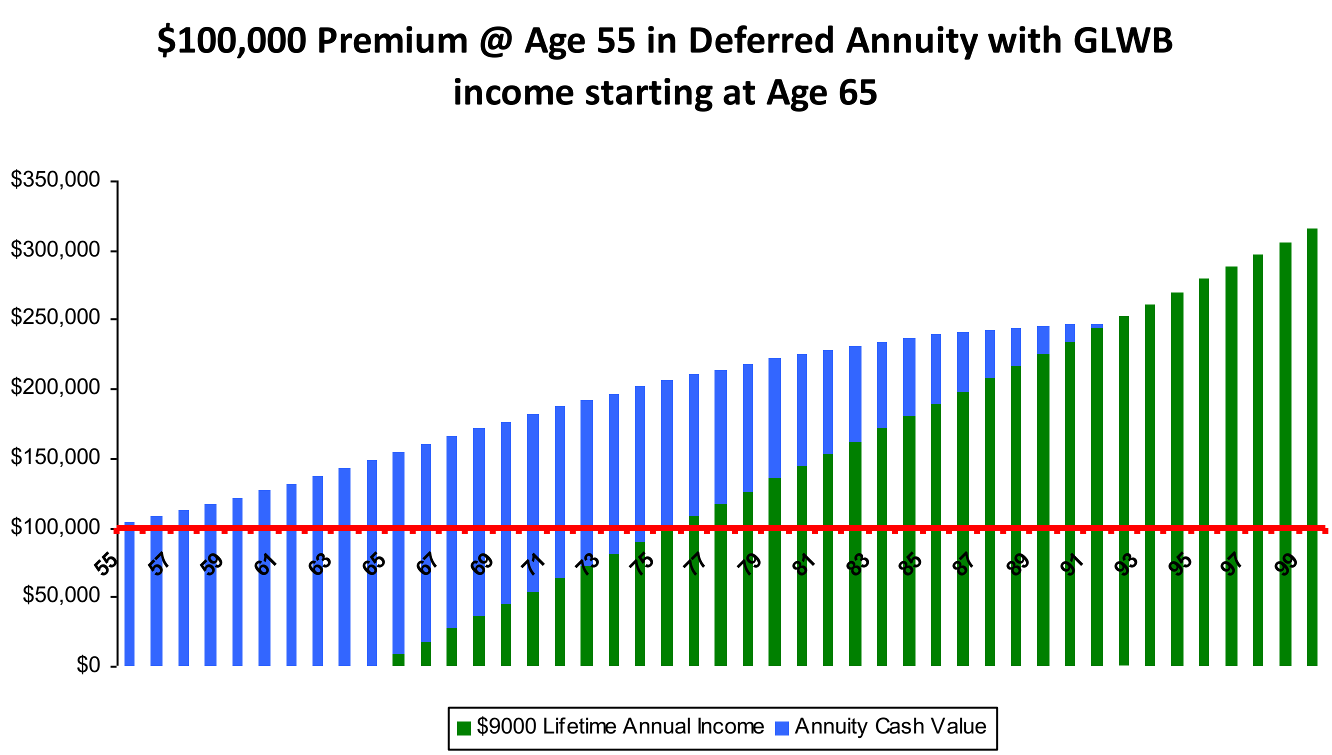
We are taught not to spend the principal of our assets. We can spend the interest, spend the dividend, but not the asset itself. After all, granddad said there won't be any eggs tomorrow if you eat the chicken today. This is a powerful belief and it runs contrary to the way annuity lifetime income is created. The result is often reluctance to purchase and use an annuity with a guaranteed lifetime withdrawal benefit (GLWB).

However, spending the principal is the basis of retirement income planning. Whether it is a "safe" withdrawal method or a target date fund or a GLWB the only goal of these methods is to have income that lasts as long as the retiree does. After legacy wishes are taken care of, if additional money remains at death that essentially means one did a poor job of planning because retirement income wasn't maximized. Even so, coming to grips with this reality is a difficult mental transition.

New retirees may see this as a win/lose situation. Either they go for income – and possibly run out of assets, or they preserve the assets – and settle for self-induced penury. There is another answer. Use part of the assets to build an income and set aside other assets to be held for emergencies or to leave a bequest. This changes the using principal for income dialogue from "keep or spend" to "how much".*

Stable Income

Study after study finds retirees want a stable income in retirement. A strong argument can be made that at least the essential expenses – however those are defined by the retiree – should be covered by an income source that is not subject to interest rate fluctuations, longevity risk, market risk and other uncertainties. The primary objective should be providing this stable income. The solutions are thus narrowed to Social Security, pensions and annuities with life income. The only solution that solves the stable income quandary and allows the retiree keep control of the asset is the annuity with a GLWB.



This does not mean the account value of the annuity with a GLWB will not go down; it should. After all, most GLWBs base the payout on an income account value that is far higher than the actual accumulated value. It's typically not a case of taking out 5% and earning, say, 4% each year – which by itself causes the account value to go down. It's more often a case where the 5% payout is based on the $100,000 income account value, but the 4% is being earned on the actual cash value of $80,000. In others words, you're earning $3,200 (4%), but taking out $5,000 (6.25% of the actual cash). The annuity is designed to pay out principal; the difference is with this stable income choice the retiree maintains control over the asset until the principal is used up. The difference between the annuity with a GLWB and uncertain income alternatives is the income level is guaranteed to both be stable and last until death, even if the principal is used up.

Uncertain Income

If the retiree wants to maintain a "don't touch the principal" philosophy they should be made aware of the income trade-offs and retained risks.

Fixed Annuity Life Income Risk Management

Risks Transferred Away	Risks Partially Hedged	Risks Retained
longevity risk market risk	behavioral risks cognitive risk health costs risks inflation risk liquidity risk principal risk provider failure sequence of return risk yield risk agent/advisor risks (the risk of fraud; making mistakes; receiving poor, expensive, and/or biased advice)	bounded rationality voluntary risks (lack of) knowledge risk

Dividends

Dividends are a time-tested way to generate a retirement income and a good many companies have a history of increasing their dividend, allowing dividends to also work as an inflation hedge. Granted, the value of the underlying stocks is fully exposed to market risk, but as long as the dividend is unaffected, life is good from an income perspective. The problem is sometimes it is affected.

Eastman Kodak and General Motors were often mentioned as time-tested dividend stocks you could hold forever. Both companies went bankrupt within the last decade, not only ending the dividend, but causing the loss of the investment. General Electric didn't pay a great dividend, but the stock was touted as one of the blue chippiest and sure to increase in value. However, in the current millennium the stock has lost value and its dividend was cut in 2018 to a penny a share.

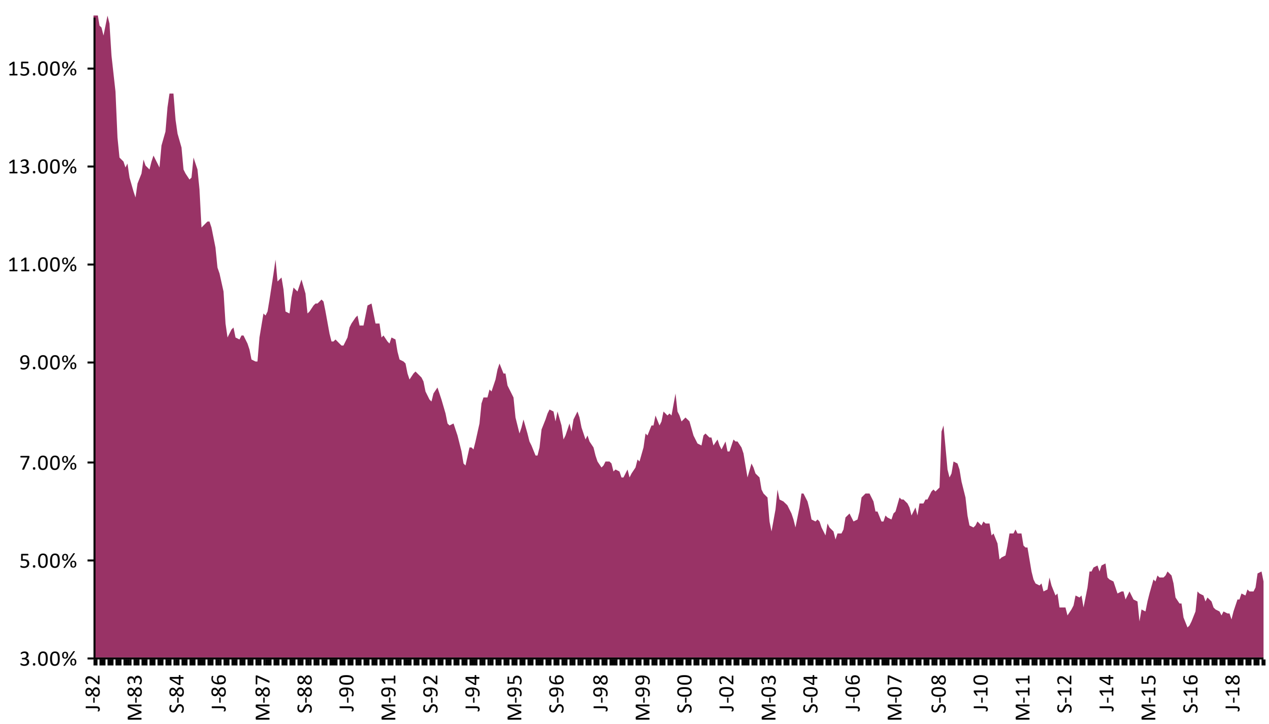
Even utilities are not immune. Ameren cut it's dividend by 40% during the 2008 financial crisis. Commonwealth Edison cut their dividend almost in half in 1992 dropping it from $3 to $1.60 a share during economic good times. The reality is dividends, even from companies with a long history, are not sacrosanct.

The other issue is dividends usually yield far less than one could get from a GLWB. The current yield on the S&P 500 stocks works out to 2%. If you narrow the field to value stocks you can average almost a 4% dividend yield. Contrast that to the 5% to 7% effective payout one can get from a GLWB. If the concern is growth of income, you can find GLWBs that are competitive with value stock dividends and guarantee the income will increase each year by a certain amount. Compared to dividends, annuities with lifetime income are more efficient, less expensive, and have guarantees that no stock dividend can offer.

<u>Bond Ladders</u>

The big problem with bond ladders is not the risk of default. Based on history, if you stick with investment grade bonds the risk of the bond not paying is extremely low. The problem is that in the real world bond ladders haven't worked very well.

The concept is nice. Assuming the yield curve is not upside down, longer maturity bonds will pay more interest than shorter term ones. If you initially buy bonds with a variety of maturities and then replace the matured ones with long maturity bonds, you wind up with a higher overall yield than only short-term ones provide and some principal freeing up on a regular basis. Wonderful theory; however, they forgot to take into account the possibility of a declining rate cycle.



Yield of a mix of investment grade bonds and 10 Yr U.S. T-Notes

The *Advantage Insurer Bond Yield Index* shows the new yield of a mix of long term corporate and government bonds. Let's look at a bond ladder constructed in the summer of 1995. If you had simply purchased a portfolio of longer maturity bonds you'd have enjoyed a long-term yield of 7.7%, but say you built a bond ladder instead. I don't know exactly what comprised your ladder, but I do know five year U.S. Treasury Notes were yielding 6% back in '95, so a good guess is the bond ladder was paying less than 7.7%. Interest rates were on a bit of a roller coaster ride, but heading down over the next several years. If, by the summer of 2005, you'd managed to replace all of your bonds with long maturity ones you were then earning 5.5% - rather than the 7.7% you could have kept by simply buying the long-term bonds a decade earlier.

Today we are in a period of modestly rising rates. If the pattern continues, a bond ladder approach could do well because it would benefit from both the yield curve and higher future rates. The question then becomes one of your ability to predict the future. Do you believe the long-term direction of interest rates is flat or up and can you deal with not knowing what your future income will be? Are you willing to bet your retirement on your predictive powers?

A Mix of Stable & Uncertain

For nonessential expenses, income uncertainty may be tolerable and even worth the risk. Letting financial markets decide whether you vacation this year in Paris, France or Paris, Texas may be acceptable, since, hopefully, the extra risk will result in higher returns and more assets in the future. As mentioned, the better approach for many will be to split assets and keep whatever is not required to safeguard essential income in whichever investments the retiree feels comfortable.

Summary

We are taught not to spend the principal, but the teachers forgot to finish the sentence which ends …until you enter retirement. Even so, it is difficult for many people to do this. Using an annuity with a lifetime income benefit helps because the retiree remains in control and the GLWB produces a regular check that, in our minds, quickly becomes appreciated as a stable essential income rather than the spending down of an asset.

For many people the real issue is not spending the principal, but maintaining a pot of money they can get to in an emergency. The solution here is to discuss what dollar amount of money would make the retiree feel comfortable and then work on producing the stable income with what remains.