The Franklin Prosperity Report
'A PENNY SAVED IS A PENNY EARNED'
Special Edition

How the "4% Rule" Became 3% — And What It Means for Your Retirement

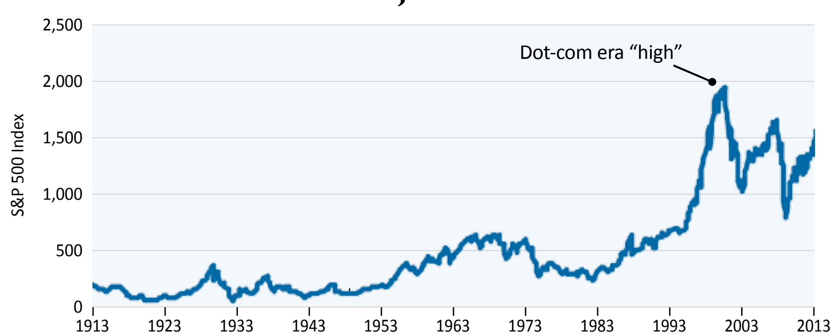
You worked hard your whole life, you saved and sacrificed, and if you were a little lucky, your stock holdings gave you a nice bump upward over time — at least keeping up with inflation and a little more — helping you to compound your way to a relatively nice nest egg. Sure, the markets fell apart a couple of times over the decades, but you stayed in and used declines to buy more.

Now your retirement is here — and you suddenly find there's no place to put that money. The stock market has been absolutely crazy, falling hundreds of points, recovering and falling again. Even the gains since the major crash in 2008 and 2009 feel unreal and unsustainable. Adjusting for the effects of inflation, you're falling behind and you know it.

Meanwhile, "safe" income opportunities seem to have disappeared completely. Long U.S. Treasury bills pay nearly nothing after inflation, and short-term debt pays even less. Municipal bonds are being called into question as cities creak from crisis to crisis while overwhelming demand pushes down yields. Money markets and certificates of deposit are safer but pay virtually zero.

There's a lot of money hanging in the balance. Total U.S. retirement assets at the end of 2012 reached $16.3 trillion, up from $15.1 trillion at the end of 2007, according to data from Spectrem Group. Private-sector defined contribution plans, most of which are tax-deferred 401(k) plans and

Inflation-Adjusted S&P 500



Dating back to the creation of the Federal Reserve, in 1913, it's easy to see the effects of inflation on stock returns. It took until well into the 1960s to erase the 1929 crash, then mild inflation and relative prosperity took over in the 1950s and 1960s. The 1970s were a tougher time as inflation soaked investors and savers. Then the boom of 1980s and into the late 1990s drove relative valuations skyward to a point they have since struggled to match, despite the nominal "recovery" in stock index percentage points.

SOURCE: St. Louis Fed, Newsmax graphic

Continued on page 2 ▶

Continued from page 1

individual retirement accounts, have surpassed the peak in value they saw five years ago.

That's a lot of money, but near-retirees are not encouraged. Spectrem reports that nearly half (46 percent) of survey respondents close to retirement, from ages 55 to 64, say that their household is not saving enough to meet their financial goals. In contrast, just 35 percent in that age group expect to have sufficient income to live comfortably during retirement.

"The 2008 economic crisis was a defining moment for most investors, and it continues to affect their investment decisions today," says **George H. Walper Jr.**, president of Spectrem Group. "The impact is especially evident in how they are managing their 401(k) assets and in their worries about being able to retire."

Birth of the "4% Rule"

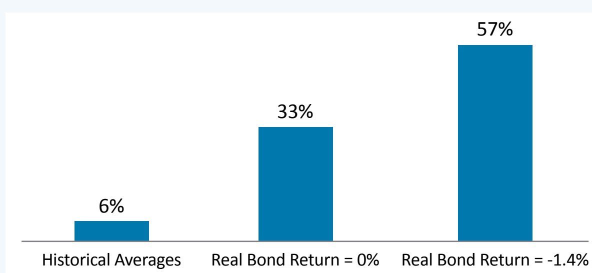
There seems to be no relief in sight. Some at the Federal Reserve System are talking about a decade or more of low rates ahead, while others predict change sooner. How can a retiree who played by the rules for decades manage to earn an income while not taking on extraordinary risk?

For a long time, the retirement withdrawal calculation was easy, perhaps deceptively so. A financial planner named **William Bengen** had it all figured out. Writing in 1994 in the *Journal of Financial Planning*, Bengen said that if a retiree spent no more than 4 percent of retirement savings in the first year, then 4 percent plus inflation every year thereafter, he or she would be fine. Your money would last at least 30 years, no problem. (He later revised that figure to 4.5 percent, but the "4 percent rule" name and parameters largely stuck.)

What does that mean in real numbers? Well, here's the 4 percent rule broken down. Imagine you control a portfolio worth $1 million. The first year you withdraw $40,000, no more. (Planners assumed you had Social Security payments coming in and, at least during Bengen's time, perhaps a pension, too.)

The next year, you could take $40,000 more plus inflation. If historical inflation of 3.1 percent held true that particular year, you took $41,240. Now repeat that for 30 years. Between those three sources of income — the portfolio, a pension, and Social Security —

Failure Rates Under 4% Rule



Assuming a 50 percent stock, 50 percent bond portfolio held over 30 years and using a 4 percent withdrawal rate, here's now a retiree would fare in three scenarios: Using past return averages; if bonds return zero after inflation; and if bonds show a negative inflation-adjusted return. Real bond return could turn sharply negative as a consequence of falling bond prices in a bond fund, rising inflation, or both.

SOURCE: Wade Pfau, The American College

you could sustain a reasonable retirement lifestyle, even enjoy life and travel if your cost of living was under control, the house was paid down, and you faced no chronic illnesses.

It was a simple answer to a complex question and one that could be mathematically proved. The reason it worked was because for a long period that's what you could expect from the markets. Bengen had found through his research that from 1926 through 1955, the formula was foolproof. All through those years, in rolling 30-year periods forward, the numbers were rock solid.

Specifically, an investor had to hold 60 percent large company stocks, names such as IBM, Procter & Gamble, Ford, and so on, and 40 percent in U.S. bonds. Sound familiar? Financial planners have been leaning on the 60-40 split concept for decades, in part because of Bengen's work.

New Risks, New Rules

So what has gone wrong? A number of problems have cropped up. First, the assumptions are not necessarily accurate anymore. Because stocks have a tendency to crash unexpectedly — 1987's Black Monday, the Asian and Russian financial crises of 1997 and 1998, the dot-com crash, and now the most recent credit crisis — there's an increased risk of having to spend more of your principal in the first few years of retirement.

Bonds are uncertain right now too. They are overpriced and paying negative yields, with the Treasury market now under pressure with the Federal Reserve's quantitative easing — money printing — programs coming to a possible end in 2014.

Retirees, who bought homes that may have subsequently lost value and who saw the massive proliferation of credit cards and the debt-driven economy, also don't necessarily have all of their debts paid, which could add to the asset squeeze at the start of retirement.

Because of those risks, the 4 percent rule is coming under serious scrutiny for the first time in years. "It may not work starting in 2013," says **Wade Pfau**, a finance researcher and professor of retirement income at The American College in Pennsylvania. "It's based on U.S. history from the 1920s to the early 1980s. Today, the market is different.

Wade Pfau is a finance researcher and professor of retirement income at The American College of Financial Services in Bryn Mawr, Pa.

"The stock market is at historic highs, but bond yields are at historic lows," Pfau explains. "In the worst-case scenarios, the 4 percent rule did work, but it could just as easily not have worked. It has about a 50 percent chance of working now."

The other big problem, Pfau says, is that the calculation doesn't include fees. The assumption of the calculations is that investors use very low cost index funds in tax-deferred accounts and that they use a stock-to-bond allocation

Once you factor in inflation, it's easy to see that bonds are a poor investment right now. Compounding the problem is that bonds could remain a loser for a very long period, damaging long-term returns for investors. However, if bond rates were to rise, the risk becomes twofold: a bond rout, in which panicked investors sell off bonds quickly at a loss; or alternatively, if bond yields rise slowly, inflation could outpace returns just the same. The Federal Reserve would then be forced to rescind its "quantitative easing" policy of lowering rates and instead raise interest rates, damaging long bond prices even more.

SOURCE: St. Louis Fed, Newsmax graphic

that is re-balanced every year on schedule. Also, investors are assumed to have made no mistakes, Pfau says, such as buying more of a stock after it goes up or selling out at the low.

"It's a really bad time to retire. Interest rates are low, and stocks are still over-valued. Either the stock market has to go down or it just stag-nates over time until earnings grow," he says. "It still could work. We could start a new, prolonged boom tomorrow, but you can't really rely on that."

So what's the solution, other than simply having more money in the first place? There are a number of answers to the problem, ranging from the tech-nical to the entrepreneurial to all points between.

Strategy No. 1: Transfer the Risk Away With Insurance

Building on several years of research by others, Pfau concludes that the best way to set a safe retirement withdrawal target under current condi-tions is to use a combination of stock investments and fixed single-premium immediate annuities (SPIAs).

The very word "annuity" probably sends shivers up your spine, and with good reason. But financial planners are quick to note that SPIAs are a differ-ent animal. Essentially, they are a form of insurance in reverse: If you buy a standard homeowner, car or life insurance policy, you pay small fixed premiums in exchange for coverage in the event of an expensive accident, catastrophe, or death.

In the case of a SPIA, you pay a single large premium all at once to the insurance company and then it provides a payout for the remainder of your life, much like a pension. Pay extra and you can get that adjusted for inflation, as well. If the market outperforms, the insurance company keeps the extra gains. If it falls short of expectations or crashes hard, the annuity holder is paid his or her income just the same.

To make a clear contrast here, a "variable" annuity is one in which the payout is determined by the relative performance of the stock market. Pfau specifically suggests a fixed annuity and one that is payable immediately, not at some point in the future.

There might be a variable annuity out there that's a good deal, but Pfau's research finds that the fixed immediate version is a better companion to a stock portfolio, in part because it provides a baseline of income that works as a counterbalance to the ups and downs of the stock market holdings. The other reason, simply enough, is that variable annuities are too expensive now, which could change.

Locking In Long-Term Income

Put another way, bonds are out because yields are too low and price risk — the risk of not being able to sell a bond later as interest rates inevitably rise — is too high. By transferring this risk to the insurance company, you are purchasing the ballast you expected from bonds that will offset the natural volatility of stocks.

Why would an insurance company do this? Because the company knows that some of its clients will die sooner and some will die later. They manage longevity risk by spreading it out over many thousands of customers. Thus, the risk to any single individual of outliving his or her income is diminished. It's insurance, plain and simple.

Pfau ran this kind of scenario across 1,001 product allocations, ranging from mostly stocks and bonds to mostly stocks and fixed SPIAs. He assumes a 65-year-old couple with a need to spend 6 percent of retirement assets each year, of which 2 percent is met by Social Security. The remainder is generated by the retirement plan.

The result suggests strongly that investors avoid bonds and use SPIAs instead, Pfau concludes in the *Journal of Financial Planning*. Based on pricing of products at the time of the study, investors did not have to consider inflation-adjusted SPIAs, variable annuities, or guaranteed living benefit riders, a type of guarantee against a very low outcome, which might occur with a variable annuity.

"The evidence suggests that optimal product allocations consist of stocks and fixed SPIAs, and clients need not bother with bonds, inflation-adjusted SPIAs, or Variable Annuities/Guaranteed Lifetime Withdrawal Benefits," Pfau writes in the *Journal of Financial Planning*. "Though SPIAs do not offer liquidity, they provide mortality credits and generate bond-like income without any maturity date, and they support a higher stock allocation for remaining financial assets."

Strategy No. 2: Run the Real Numbers

Pfau's conclusion is supported by what's known as a "Monte Carlo study." It sounds like a casino, and that's because it is based in part on the logic of measuring chance in a precise way. The method dates back to physicists who worked on radiation shielding during the mid-1940s.

The math gets pretty dense, but the idea is simple. Rather than leaping without looking, you take a really good, long look first. Monte Carlo studies take into account every possible variable in a situation and play out thousands and thousands of outcomes. With plotting on a graph, you can quickly determine how often a given strategy could fail.

You wouldn't be able to tell whether your plan works or fails, but you would feel more assured if you knew that the Monte Carlo results suggest that the likelihood of success is 90 percent or higher. Similarly, if a Monte Carlo study were to show that your plan had an uncomfortably high likelihood of failing, as is the case with the traditional 4 percent rule now, you would be wise to change it.

While Pfau's study is rigorous in its design, it's not personalized to anyone. It has to make assumptions about the ages of the participants, how long they need the money, and other factors. A financial planner, however, will review your actual situation, taking into account the real variables you face. Many planners have access to specialized software for this purpose, and the technically inclined can access similar software programs over the Web for a fee.

"According to a study done by Morningstar, the 4 percent rule is the worst way to determine distributions," says **David Williams**, director of planning services at Wealth Strategies Group in Cordova, Tenn. "The best method is annual review of a Monte Carlo study, which takes into account changes in longevity, actual past investment performance and distributions, and expected return and standard deviation."

Better Planning Through Better Data

Williams strongly suggests that retirees use a planner to design a Monte Carlo study for their portfolios and to update it annually. As the Morningstar study reports, one effective method for determining how much to take out is to rely on the same data used by the Internal Revenue Service when calculating required minimum distributions, the minimum amounts you will be required to take out of tax-deferred accounts such as a 401(k) and IRAs when you reach age 70½.

"These, at least, take into account changing longevity, and by using the current year-end balance, it reflects actual portfolio performance and distributions," Williams explains. "My reference to changing longevity is more than just decrementing years of retirement remaining. There is a 20 percent likelihood that a 65-year-old will live past age 90 (25 years of retirement).

"If the retiree survives until age 66 and wants to use the same longevity risk, his estimated remaining years of retirement aren't simply 24 (25 minus 1) but closer to 25 — that is, a 20 percent chance he will survive past 90.7." That is, as you get incrementally older, your chances actually rise a bit that you'll live longer, meaning your money must stretch further too.

Strategy No. 3: Truly Understand Bond Risk

The 4 percent rule is simply dead in the water, says **Michelle Ford**, a certified financial planner in Bridgewater, N.J. The bigger problem is how to invest for the new retirement reality, and that means facing up to the real risk in your portfolio — a high concentration of bonds.

"The present-day rule of thumb of a 4 percent drawdown on a retirement plan has an 18 percent failure rate," Ford says. "In other words, about one in five retirees will have their worst nightmare come true. They will run out of money before they die."

The "failure rate" was found by financial academics and published in the *Journal of Financial Planning*, Ford points out. Nevertheless, advisers continue to use it as if nothing has changed. "Tell me how this is acceptable. How many tickets would the airline industry sell if one in five airplanes dropped from the sky?" she asks.

After extensive study, the academics concluded that the "safe" withdrawal rate now stands at 2.52 percent. Put another way, for a couple with $500,000 in private retirement accounts and a typical Social Security withdrawal (assumes both couples earned), it would come to about $42,000 a year or roughly $3,500 a month.

Cutting to the Bone

Could you live on that? Would you be comfortable? Chances are, not really, unless you make a change in your lifestyle, such as moving to a much lower tax state and cutting costs to an extreme degree.

"Let's add some more perspective to this," Ford says. "Retirees are generally recommended to reduce their risk tolerance in retirement, right? So what does this typically mean? In classic portfolio management, this means increase your bond allocation and decrease your stock allocation."

All through our investment lives, we are told to consider stocks to be the "risky" portion of the portfolio and bonds "safe." Now both sides of the equation bring risk, Ford explains. The Financial Industry Regulatory Authority (FINRA), a private regulator, recently warned investors about bond risk, whether they own bond funds or bonds outright.

The key point is "duration risk," the sensitivity of the bond's price to a change in interest rates. Broken down, that means bonds that have longer maturities, such as a 30-year Treasury, are more likely to lose value if rates rise.

Why? Because fewer people will want to buy them (demand will fall, and so will prices) given that newer bonds of the same duration will pay a higher yield. If you believe that the government will issue new bonds (and they will, forever), the risk in the bond market has rarely been higher. High demand for safe money, along with Fed purchasing, has pushed bond prices high and yields very low. From a price perspective, long bonds are a historic market bubble.

Bond Risks by the Numbers

Put another way, a $1 million portfolio that's 40 percent bonds has $400,000 worth of bonds. If interest rates climb by just 1 percent, a bond fund with a 10-year duration declines in value by 10 percent, FINRA calculates. Your $400,000 is now worth $360,000.

"Seventy-nine percent of the general public does not understand the inverse relationship between yields and bond prices," Ford says. "It has been my experience that less than 2 percent of my clients, whose education levels range from high school to Ph.D., actually understand the inverse bond yield-to-price relationship."

Ford's advice is to "bubble wrap" your retirement with insurance products such as annuities. "The insurance industry has the law of numbers on its side, unlike the individual. Folks need to look into transferring the risk of their retirement portfolio failure away from themselves," she says. "There is only one correct answer to the question: 'How much money do I need to retire?' Answer: 'Enough till you die.'"

Charlie Gipple couldn't agree more. "I would argue that longevity risk is no longer a problem that can be solved as an investment strategy but as a risk management strategy," says Gipple, national director of indexed products for Genworth Financial in Des Moines, Iowa. "Shortfall risk — running out of money — is just as catastrophic as dying or losing your house in a fire or a car accident. And there are ways to insure against that."

Charlie Gipple serves as the national director of indexed products for Genworth Financial, Inc., a Fortune 500 financial security company.

If you redefine retirement as an insurance problem, the risks can be pooled in the same way, Gipple says. "It depends on the client's intentions. There are expenses involved in this product. I would never encourage people to put 100 percent of their money in this kind of product.

"Nevertheless, indexed annuities were launched in 1994 during what *Fortune* magazine called the 'great bond massacre.' They were created for times like these, and that's why we have seen record-setting sales."

Strategy No. 4: Keep It Simple

The trouble with much of the financial advice you might get is that it's math-heavy. While there's a tremendous comfort to be derived from doing a full Monte Carlo analysis or working out bond duration risk, it can be off-putting, to say the least.

For instance, how much is enough to retire? You hear all kinds of numbers, but probably the simplest calculation you can make is to take your maximum salary and multiply by 25. What that means is, if you think you need $100,000 a year to live comfortably, you should have $2.5 million in your portfolio, explains **Robert Margetic**, a financial adviser and author of *How to Survive the Coming Retirement Storm*.

Most people believe that they will rely at least in part on Social Security income. To account for that income stream, think about the "net money" you will need; that is, money after subtracting periodic income such as a pension or Social Security, Margetic says.

For example, if you expect $20,000 a year from Social Security and believe you will need $50,000 to live comfortably, that's a balance of $30,000 of "net money" that's missing from the income stream.

So take $30,000 and multiply by 25. The result is $750,000. To make up the balance, you should save up $750,000 before quitting work.

How Much Can I Safely Withdraw?

As for the withdrawal rate, that's another simple math problem, says **Adam Koos**, a certified financial planner in Dublin, Ohio. "I like dividing into one the years you have left. That gives you a really conservative withdrawal that is more sustainable," Koos says. "It's a good reality check. If someone is 55 and you assume they have 35 years, that's to age 90. So it's 2.9 percent."

Adam Koos is a certified financial planner and founder of Libertas Wealth Management Group, a financial planning firm based in Dublin, Ohio.

Broken down, you take the number one and divide it by a number of years (1 ÷ X = result). The result in this case is 0.0285, which rounds up to 2.9 percent. "The reason it works is it's obviously a more conservative number. The second reason is that, as investors get older, they'll be able to take out a larger amount of the portfolio," Koos says, because fewer years divided into one yield a rising percentage as time passes.

"When you're in that sweet spot in retirement age of 55 to 66, people want to use 5 or 6 percent," Koos explains. "The problem is, they spend too much or they didn't save enough." The divide-into-one rule flips that logic, forcing retirees to spend less early on in order to ensure that money is there later.

Strategy No. 5: Learn How to Buy Income

Retirees who don't want to buy an annuity and who rightly fear bond market risk still have room to build a portfolio that will work, says **John Graves**, a chartered financial consultant and author of *The 7% Solution: You Can Afford a Comfortable Retirement*.

"It's challenging to design a portfolio that produces a 4 percent distribution. That's because of the massive demand of money into the bond funds, something like $270 billion last year," Graves explains.

Challenging but not impossible, he says. To achieve a given income goal, that retiree could buy specific stocks and even a narrow selection of bonds to add up to the target income flow. Paraphrasing Mark Twain, you put all your eggs in one basket and you watch that basket very, very carefully, Graves says.

"The equities portion will be companies paying and sustaining a 6 percent dividend with very strong cash flow, very low price-to-book and very low debt-to-equity [ratios], and with a 10 percent stop loss," Graves says. At this writing, he says, "22 companies match those criteria."

John Graves is a chartered financial consultant and author of the book, "The 7% Solution: You Can Afford a Comfortable Retirement."

Investors should take care to apply all the factors. Finding companies with a fairly high dividend is pretty easy. But then you take a major risk of a price correction or a dividend cut. That's why price-to-book and debt-to-equity ratios matter. It's specialized finance language but not hard to understand.

The price-to-book ratio is the stock price of a given company compared to its actual value, measured as total assets minus liabilities. The debt-to-

A Range of Dividend Payers

The following sampling of stocks was culled by running a screen similar to John Graves' parameters (strong cash flow, and low price-to-book and debt-to-equity ratios) on FinViz.com. You would want to do your own due diligence on each to determine your comfort level investing in any of these, or run your own screen:

Company Name	Symbol	Sector	Industry
Apollo Investment Corp.	AINV	Financial	Diversified Investments
Anworth Mortgage Asset Corp.	ANH	Financial	REIT
Apollo Commercial Real Estate Finance	ARI	Financial	REIT
Atlantic Power Corp.	AT	Utilities	Electric
Alumina Ltd.	AWC	Materials	Aluminum
China Ceramics Co.	CCCL	Industrial	Building Materials
Colony Financial Inc.	CLNY	Financial	REIT
CYS Investments Inc.	CYS	Financial	REIT
Diana Containerships Inc.	DCIX	Services	Shipping
ECA Marcellus Trust I	ECT	Materials	Oil and Gas Drilling
Ellington Financial LLC	EFC	Financial	Mortgage Investment
Full Circle Capital Corp.	FULL	Financial	Credit Services
Gladstone Investment Corp.	GAIN	Financial	Diversified Investments
Gladstone Capital Corp.	GLAD	Financial	Asset Management
Horizon Technology Finance Corp.	HRZN	Financial	Asset Management
Invesco Mortgage Capital Inc.	IVR	Financial	Mortgage Investment
MCG Capital Corp.	MCGC	Financial	Asset Management
American Capital Mortgage Investment	MTGE	Financial	REIT
Nordic American Tankers Limited	NAT	Services	Shipping
NGP Capital Resources Co.	NGPC	Financial	Diversified Investments

equity ratio is a measure of how much leverage the company is using (borrowed money in one form or another) to achieve its corporate goals, compared to how much of the stock is owned by the public, i.e., the shareholders.

Applying these measures is tricky at times. A low price-to-book ratio can mean the company is undervalued, but it also might mean that the company's share price has been chased lower for a good reason: It's poorly run and investors want out.

Likewise, the debt-to-equity ratio is meaningful except in sectors where leverage is normal business practice or a good short-term strategy, such as when interest rates are very low.

Companies worth buying at low prices, few debts, and high yields do exist, although they might not be the well-known tickers your parents or grandparents owned over the years. As for stop loss, that's a broker's tool that simply sets a standing order to sell a given position if it declines by 10 percent.

Give Yourself Room to Move

You might think, "Well, I'll set it at 2 percent. I don't want to lose anything." Generally, however, a broader stop will leave room for a position to fluctuate up and down within reason while not triggering an unnecessary sale. Still, there's a floor underneath the position, an escape clause that means you don't have to watch the stock all day every day, just in case.

"On the bond side, that's the challenge," Graves says. "There are crumbs on the table, and we as individual investors have to be able to find those crumbs and pick them up."

It's much harder for individual investors to operate in the current bond market, Graves warns. "One has to have a degree of sophistication and a degree of harmony with your fixed-income trading desk" to make it work, he says.

In general, he looks for investment-grade bonds with a seven-year to 11-year maturity, with a yield to maturity of 5 percent or better, trading at par or below. These also are specialized finance industry terms but also easy to grasp.

"Investment grade" is a rating given out by multiple ratings agencies. It's the dividing line between "worth buying" and "stay away" for big pension funds and endowments. An adviser must do his or her own analysis of the relative risk of a given bond, but ratings agencies reduce the workload by pointing out the clearly bad choices.

"Maturity" is the length of the bond's life. Seven to 11 years is middle-of-the-road, depending on the entity issuing the debt. For instance, a 30-year U.S. Treasury is considered "long," but some corporations and universities have issued 100-year debt. On the short end, you can buy U.S.

Treasury bonds dated 30 days. All things being equal, the longer the bond, the higher the yield.

"Yield to maturity" is how much you would earn if you held the bond until the end of its life. "Par" means the bond is trading currently at its face value. Because bonds trade after being issued, it's possible to buy a bond that pays a lower interest rate than a similar bond just issued. In that case, the price of the old bond must fall to compensate the buyer for the lower payout.

Risks of an Exchange-Traded Bond Fund

Bonds that fit these requirements are few these days, Graves points out, while just a few years ago there were hundreds available. Because of massive demand, it has gotten much harder to build an income strategy in the current market.

One might be tempted to skip the homework of figuring out which individual bonds to purchase and instead buy a bond exchange-traded fund, where a manager does the heavy lifting for you. You can go that route, Graves says, but to get the return you want, the risks become greater.

"You are not going to find today an ETF with 5 percent or better yield. You're going to have to dip down to a lower grade. You're going to buy emerging markets," he says. "You will find a wide grade of ETF investments in the range of 4.5 to 5 percent.

"The problem is, as those bonds in the funds mature, they will be replaced with lower-yield bonds, as long as the Fed is in its accommodative state, so you take the ride down on yields," Graves continues. "The second ride down is when we have the reality of inflation, or the fear of inflation. Bond fund prices will be decimated, as they have in each of my 30 years of doing this." In 1994, for instance, bonds fell by 20 percent, he points out.

The answer, he says, is to build your own bond portfolio. "You can hold the bonds to maturity and, therefore, you're not exposed to duration risk," Graves explains. "You still have the same challenge of any ETF or bond fund manager, which is replacing an old coupon with a new coupon. When that stops, or the perception of that stops, all hell breaks loose. That's the challenge of owning bonds and bond mutual funds."

Meanwhile, a sophisticated investor could hedge against risk by taking 5 percent of his or her portfolio and buying high-yield stocks. Shipping companies, for instance, pay a 17 percent yield, he says.

"You get 10 percent more on that 5 percent, increasing your yield on the whole portfolio of half a percent, with a 10 percent stop loss," Graves explains. "Thus, you don't need to take as much risk on the rest of your portfolio."

Strategy No. 6: Take Bigger Risks With Smaller Slices

Many advisers recommend that retirees consider a variation on the "core and explore" concept, wherein, as Graves explains, some of your money stays in relatively low-risk investments, but some is allowed to run free.

"[Rather than draw down 4 percent], we use 5 percent in a plan we call the 'retirement enhancer,'" says **Matthew Tuttle**, a certified financial planner in Stamford, Conn.


Matthew Tuttle is the founder and CEO of Tuttle Wealth Management, LLC. He has written two books, including "How Harvard & Yale Beat the Market."

"We set aside seven years of income and put it into a tactically managed, lower-volatility portfolio. We draw that down over seven years. The remainder goes into a tactically managed growth portfolio and is untouched for seven years," Tuttle says. "Being tactical is the key here, as we can shift to areas of the market that have higher returns, lower risk, or both."

David Edwards, a wealth adviser and president of Heron Financial Group in Nantucket, Mass., tells his clients to stick with the "three bucket" retirement income strategy.

"We maintain 60 to 70 percent of a client's assets in volatile but higher-returning stocks and commodities. The excess return flows from the stock bucket to the bond bucket to the cash bucket, and then the client draws exactly the same amount every month," he explains.


David Edwards is a wealth adviser and the president of Heron Financial Group, based in Nantucket, Mass. He founded the firm in 1993.

"We have a year's worth of draw in the cash bucket and four years in the bond bucket, which means we can survive a five-year drought in risk assets, which is exactly what happened between 2008 and 2012," he says. "Now our accounts are at record levels again."

Being a 'True Investor'

The strategy allows his clients to draw between 5 and 6 percent in retirement without worry, thanks to portfolio diversification, Edwards says. That means owning a variety of bond types, including international developed markets and emerging markets, as well as commodities, corporate debt, and preferred stocks, plus the typical blue chips and domestic bonds.

"We re-balance back to our core allocations once per year, but the monthly draw is always paid out of short-term government bonds," Edwards says. Done correctly, past illustrations have shown that the portfolio can pay out a real income and yet be worth more at the end of 10 years than at the start, he notes.

The number investors should use is not 4 but 8 percent, says **Indira Amladi**, a chartered financial analyst and CEO and portfolio manager for Princeton Ivy Capital Advisors in New York, N.Y. "[The standard 4 percent rule is] quite similar to the way pension funds, endowments, and foundations are designed," Amladi says. "I see a major flaw in the whole concept. The flaw is that it forces everybody to think short term. It rules out all other possibilities."

Indira Amladi is a chartered financial analyst. She serves as CEO and portfolio manager for Princeton Ivy Capital Advisors, based in New York, N.Y.

The alternative, she says, is to break out cash for the next two years — say, 8 percent of your total portfolio — and leave the remaining 92 percent to invest at higher risk than a retiree might ordinarily take. "Once we frame it this way, it completely alters the investors' world. You have the cash to survive two years, and the 92 percent balance is available for longer-term investments. That would alter the risk profile of those investments.

"If you look at two or three years out, instead of buying bonds, which are extremely risky at this time, you could invest in companies with 12 percent total return, including a dividend return of 3 to 4 percent," Amladi says.

"It's about opening up the portfolio to be a true investor. You don't have to be a 'retirement investor' if you have the cash set aside. That's a huge breakthrough for retirees. If they invest in stocks that pay 5 to 6 percent dividends, that's income to reinvest," she says.

Strategy No. 7: Find Income Beyond the Markets

If you don't have the financial firepower to set aside 8 percent of your savings as cash for spending, there are alternatives. One way to generate the same outcome is to find alternative sources of income for the first few years of retirement, when many folks spend money too freely, advisers say.

That might be by working longer, but it also might be coming up with a short-term survival budget and cutting expenses, says **Jason Hull**, a financial planner in Fort Worth, Texas.

"To me, the answer lies in the fact that the biggest indicator of retirement success is what happens in that first 10 years, when you stop working and have to withdraw," Hull explains. "You're pulling out at the same time when you're portfolio is taking a hit, so it's a double whammy."

Jason Hull is a fee-only financial planner serving clients in Forth Worth and Dallas, Texas.He served in the Army as an armor officer from 1995-2000.

The solution is to avoid taking too much in those first 10 years, Hull says, so that you can avoid being forced to sell investments in a declining market. "Two options: Buy enough annuities to generate $40,000 in income; the rest is invested," he says. "If it does well, you travel around the world. If it doesn't, you take walks in the park and read books in the public library."

The second option, he says, is to open a reverse mortgage line of credit. "You don't need to draw it down in the beginning, and you use it as a financial buffer," Hull says. "With both those strategies, there are psychological biases: 'What if I buy an annuity and get hit by a beer truck tomorrow?' But that's irrational. You'll be dead. You won't know."

Create an Income Stream

Most retirees will run out of money in the first seven or eight years of retirement, says **Michael Fitzgerald**, a Houston wealth manager and Certified Public Accountant.

"There's not enough income, so they're spending principal and soon there's nothing left," he says. "You have to use other people's money. If you are a younger retiree, why not have income-producing real estate? You could have that be 20 to 30 percent of your portfolio and step right into cash flow."

Michael Fitzgerald is a wealth manager and certified public accountant. His firm, Fitzgerald Wealth Management, is based in Houston.

The point of long-term saving is not to rack up huge market gains but to have those savings in place when they're needed, Fitzgerald explains. "If you haven't been saving, don't expect growth to save you in the end. A retirement comes from savings, not from growth," he says.

The wealthy solve the problem in retirement by using their money to create income, the way a pension would. If your savings fall short of that target, you don't necessarily need to grow the pot, just find an income stream, he says. "Most financial advisers tell you to save more, grow, grow, grow. But your pile will never be big enough. Really, you should be concerned about retirement income," Fitzgerald says.

That could be real estate or starting a business in retirement, he says. "Five years before you retire, set up a retirement transition business. Make a loan from your 401(k) plan to set up the business and you can continue to pay yourself benefits," Fitzgerald advises.

"Seventy-two percent of people are taking Social Security early because it's their only reliable income stream. But 50 percent of every dollar coming out of your retirement plans is taxable."

Rather than a 30-year plan, have a series of five-year business plans, he says. "People look at the speedometer rather than the odometer. You should be looking at the destination, how much gas you need," Fitzgerald says. "At a job, you trade skills for money. Continue that in retirement. Do it for five years, then you can change it [in] five years, sell it, or wind it up, then move on to the next five-year plan."

Things Aren't Different This Time

Finally, you should consider perhaps the most contrarian viewpoint of all: Nothing is wrong and you should just continue to save for retirement.

"What I hear from my clients is, it's not different this time," says **Greg Carpenter**, a Certified Public Accountant and founder and CEO of Employee Fiduciary in Mobile, Ala.

"Over time, the differences will fade away. If 4 percent isn't happening, it's because interest rates are so low. Those aren't going to stay super low forever. Over a typical retirement of 25 or 30 years or longer, you're going to see structural changes that allow you to move back to 4 or 5 percent."

Greg Carpenter is a certified public accountant and the founder and CEO of Employee Fiduciary, a low-cost 401(k) plan provider based in Mobile, Ala.

Employee Fiduciary is a 401(k) record-keeping company that deals with lots of small businesses, often professionals such as doctors, dentists, and lawyers.

"A lot of them aren't flustered by what's going on in the economy and the market," Carpenter says. "A lot of them are plowing their money into passively managed, low-cost target-date funds such as Vanguard funds. They are not looking for alpha; they are set it and forget it."

Carpenter says he encourages his clients to adhere to an asset allocation because that's where they will get most of their return. Most of them do it with low-cost target-date funds, he notes. "Stick with it and make sure you're making appropriate allocations," Carpenter says. "If you're closer to retirement, don't take additional risk for alpha. You'll be subject to more risk and higher volatility."

— Reporting by Greg Brown

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