FRANKLIN TEMPLETON INVESTMENTS

SAVINGS AND INCOME FOR A LIFETIME

"Life's tragedy is that we get old too soon and wise too late."

—Benjamin Franklin

Highlights

- With average life expectancy on the rise, generating enough retirement income to live comfortably for an extended period of time has become a complex undertaking. Increasingly, finding sources of retirement income is left to the individual and society's track record for self-management of savings and investments has been decidedly mixed.
- Stock market volatility, combined with 30 years of falling interest rates, have left many people unable to meet their investment goals. Guidance from a financial professional, preferably someone with special expertise in retirement planning, is advised.
- Meeting income requirements throughout a lengthy retirement may require looking beyond traditional short-term and fixed income assets and considering equities, global investments and specific strategies such as product allocation to broaden retirement income sources and matching sources of retirement income to expenses.

It's Complicated

With average life expectancy on the rise, generating enough retirement income to live comfortably for an extended period of time can be a complex and somewhat daunting undertaking. Recognizing that a growing percentage of the population will have to provide for themselves financially to age 90, governments and the financial industry have stepped in to provide a flood of retirement investment tools and programs.

For highly sophisticated investors, this proliferation of investment choices may represent a "golden age" of retirement planning possibilities. More often than not, however, people are simply overwhelmed.

Guidance from a financial professional—ideally someone with special expertise in retirement planning—can be invaluable in both the planning and implementation stages of a disciplined retirement savings and investment program. Services typically include:

- Creation of a retirement strategy
- Development of a written plan
- Selection of investments
- Monitoring and reporting on a regular basis
- Rebalancing investments or revising the plan over time to ensure best results

Advisors may also act as gatekeepers, coordinating the various components of a retirement plan. Since investors are frontline participants in the process throughout their retirement, becoming familiar with the issues and challenges surrounding the financial aspects of retirement income planning may increase the effectiveness of the partnership.

The Issue: Funding Longer Lives

When Social Security was introduced in 1935, average life expectancy in the United States was only 61.3 years.[1] Today, average life expectancy is over 84 years.[2] Today's growing cohort of centenarians testifies to the very real possibility that significant numbers of those entering retirement in the years ahead will spend more of their adult lives outside the workforce than in it. Given the rapid pace of advances in geriatric medicine and other age-related research, prudent retirement planning for tomorrow's retirees should include a strategy to generate income for 30 years or more.

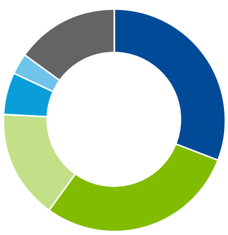
1. Source: Social Security Administration, Office of the Chief Actuary, Table 9 – Life Expectancy at Birth and Age 65 by Sex, Calendar Year, and Alternative, 2016. https://www.ssa.gov/OACT/NOTES/AS112/tab9.html
2. Source: Social Security Administration, 2016 OASDI Trustees Report, Table V.A5 – Cohort Life Expectancy. https://www.ssa.gov/oact/TR/2016/V_A_demo.html#221776

The proliferation of registered and non-registered savings vehicles over the past decade is sending a powerful message that finding the sources of retirement income increasingly will be up to the individual. So far, however, society's track record for self-management of savings and investments has been decidedly mixed. Figure 1 compares the changing face of retirement income sources over a 50-year period[3] between 1962 and 2013 for people aged 65 or older. While private pensions (401k and others) showed solid growth, personal savings (represented by "other") and asset income actually declined during this period. More recently, despite a brief spike in the personal savings rate following the 2008 financial crisis, it has since resumed its downward trend.[4]

Figure 1: Past Imperfect

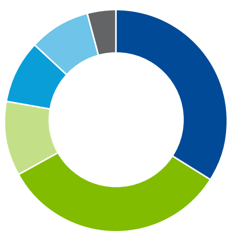
Swelling Private Pensions, Diminished Savings and Asset Income for People Aged 65 or Older

1962[5]



- Social Security 31%
- Earnings 29%
- Asset income 16%
- Government employee pensions 6%
- Private pensions 3%
- Other 15%

2013[5]



- Social Security 34%
- Earnings 33%
- Asset income 11%
- Government employee pensions 9%
- Private pensions 9%
- Other 4%

Nevertheless, signs of a change for the better are beginning to emerge. A recent survey commissioned by Franklin Templeton Investments examined individual retirement strategies and expectations (RISE survey).[6] The survey revealed that when ranking their top three primary retirement vehicles, use varies by age (Figure 2). Even so, limiting the focus of investing to the years preceding retirement may not be enough, especially for those entering retirement with insufficient assets and, increasingly, household debt. Investing throughout retirement, to preserve capital, generate income, sustain cash withdrawals and perhaps even obtain a measure of growth, will be a necessity for many if they are to address the most pervasive fear about growing old: outliving their retirement savings.

What's Next: Turning Savings into Retirement Income

The human brain is hardwired with numerous thinking processes (known to behavioral finance psychologists as behavioral biases) that can hinder sound financial decision-making. One bias, however, may be especially helpful in tackling the particular challenges of retirement income planning. Mental accounting is a behavioral finance term that describes how individuals divide their current and future assets into separate, non-transferable portions. This already-ingrained ability to compartmentalize can be of tremendous help when developing a workable income structure.

During the working years, retirement income sources—whether based on salary, commissions or royalties—tend to be relatively limited in number. In contrast, retirement income is typically generated in a more piecemeal fashion from multiple sources, including a variety of government programs, supplemental work, company and private savings plans, private pensions and other investments that may provide dividends (equities) or distributions (fixed income).

A common misconception is to view all retirement income streams as one lump sum; but every source of retirement income is different, and those differences can work to the retiree's advantage. One effective strategy matches each income stream to a type of retirement expense (Figure 3).

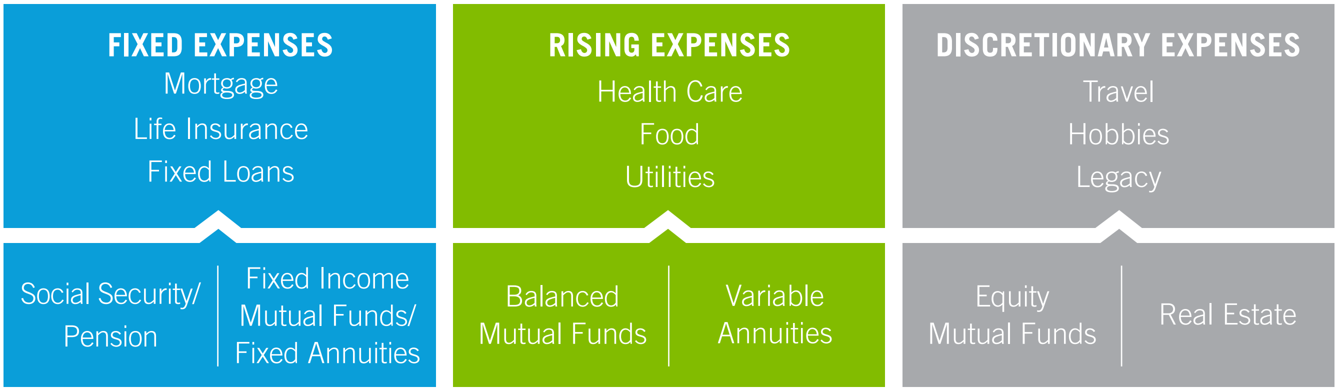
Figure 2: A Diversified Future[6]

Ranked as primary retirement savings	18–54 years of age	55–64 years of age	65–74 years of age	75+ years of age
Workplace retirement plan respondent funds through salary deferral (i.e. 401(k), 403(b), etc.)	67%	67%	48%	44%
An employer-provided pension benefit (i.e. Defined Benefit, STRS, PERS, etc.)	51%	67%	80%	68%
A traditional IRA or direct Roth IRA respondent funds	38%	30%	31%	34%
Mutual funds, stocks, bonds or exchange trade funds (ETFs) NOT held in a retirement account	26%	30%	35%	35%
Life insurance, annuities	20%	21%	18%	19%
Money market account, checking account, savings account	14%	13%	7%	9%
Certificates of deposit (CDs)	23%	2%	0%	17%
Checking account/savings account	42%	18%	15%	10%

Percentages for each row are based off of those who have included the particular retirement savings vehicle as part of their current retirement savings plan.

3. Social Security Administration. Income of the Aged Chartbook, 2012 on page 16. Income of the Population 55 or Older, 2012 on page 303 (Table 10.1).
4. As of March 31, 2013. Source: U.S. Department of Commerce: Bureau of Economic Analysis.
5. Source: Fast Facts & Figures about Social Security, 2015.
6. The 2015 Franklin Templeton Retirement Income Strategies and Expectations (RISE) survey was conducted online among a sample of 2,002 adults comprising 1,001 men and 1,001 women 18 years of age or older. The survey was administered between January 8–22, 2015 by ORC International's Online CARAVAN®.

Figure 3: A Match for Every Retirement Income Source



This approach contemplates grouping retirement expenses into three categories, or buckets:

- **Fixed** – Basic expenses that are less likely to be affected by inflation, but more so by income volatility, such as fixed mortgages and life insurance premiums.
- **Rising** – Basic expenses that are likely to be affected by inflation and income volatility, including costs for health care, food, and utilities.
- **Discretionary** – Non-essential expenses that are more likely to be affected by inflation but less affected by income volatility, including such "nice-to-haves" as hobbies, travel, and dining out.

The next step is to determine which retirement income sources most closely mirror the retirement expenses. Generally, fixed expenses such as shelter (mortgage payments, property taxes, rent, etc.) should be matched to a stable retirement income source that is protected as much as possible from the effects of volatility. Indexed government programs like Social Security, survivor benefits and disability payments are suitable sources but may be inadequate on their own.

Stability options can be customized to meet specific needs. For those looking for high levels of stability, guaranteed income choices such as annuities and bank products may be appropriate. If a guaranteed amount is not critical—as in the case of a grandparent helping to fund a grandchild's education—systematic withdrawals from an investment portfolio can be considered; however, in situations where a guarantee of the same payment at regular intervals over the long term is essential, product allocation may be a more suitable strategy.

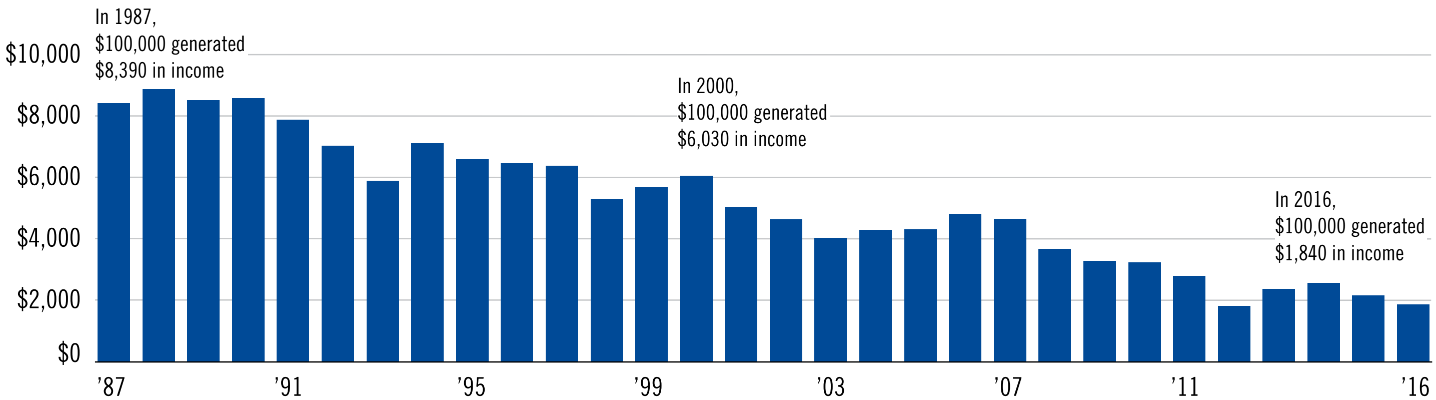
The Issue: 30 Years of Falling Income

In response to stock market volatility, investors often tend to shift into cash and the perceived stability of traditional fixed income investments. Unfortunately, over the past 30 years or so, the movement into fixed income investments has coincided with a steady drop in interest rates, which for many has resulted in less income than may have been anticipated (Figure 4).

Figure 4: Low Bond Yields Can Equal Low Income

Falling income over the past 30 years

The following hypothetical chart shows the income generated by yields on 10-Year U.S. Treasury Bonds from January 1, 1987 to December 31, 2016.



Source: Board of Governors of the Federal Reserve System H.15 Report, Historical Data; Market yield on U.S. Treasury securities at 10-year constant maturity.
Performance data represents past performance, which does not guarantee future results.

What's Next: Rethinking Asset Allocation

Asset allocation refers to the percentages of a portfolio devoted to asset classes such as equities, fixed income and cash; it is arguably the most important influence on the growth of an investment portfolio's value.

As retirement approaches, assets are typically rebalanced to reduce the proportion of higher-risk investments in favor of income-generating investments; but asset allocation does not cease upon reaching retirement. Retirement income investments may also need to be rebalanced with the passage of time. Moreover, no one can be absolutely certain what will happen over a 20- or 30-year period. Even investors who entered retirement in relatively solid financial shape could find living to a ripe old age more expensive than expected.

Depending on individual needs, creation of a strategy capable of meeting income requirements through a lengthy retirement may require looking beyond short-term and fixed income assets to a portfolio that includes a component of equities and global investments. Equity investments such as preferred shares, which provide both income and potential for an increase in value, may help retirees avoid being trapped in a downward spiral of diminishing returns and may allow them to maintain assets for the spike in expenses that typically accompanies the last few years of life.

Figure 5 illustrates how augmenting a portfolio of fixed income investments with a component of stocks may work to sustain withdrawal rates over an extended period.

Figure 5: A Case for Equities in Retirement

Setting Realistic Expectations

Based on historical data, this table illustrates the probability of sustaining annual withdrawals over a 30-year period ended December 31, 2015, assuming a 3% annual increase to adjust for inflation.

Initial withdrawal rate with a 3% annual increase	100% U.S. Bonds	100% U.S. Stocks	80% U.S. Bonds 20% U.S. Stocks	40% U.S. Bonds 60% U.S. Stocks	40% U.S. Bonds 40% U.S. Stocks 20% Global Stocks
4%	89%	>95%	>95%	>95%	>95%
5%	61%	88%	79%	87%	90%
6%	31%	75%	47%	63%	71%

IMPORTANT: The Monte Carlo projections or other information generated by Zephyr Associates, Inc., regarding the likelihood of various investment outcomes are hypothetical in nature and should not be considered investment advice. They do not reflect actual investment results and are not guarantees of future results.

Asset Class Indexes Used: U.S. Bonds: Ibbotson U.S. Long-Term Corporate Bond Index (1955–12/31/2015); U.S. Stocks: S&P 500 Index (1955–12/31/2015); Global Stocks: MSCI EAFE Index (1970–12/31/2015). Source: Zephyr Associates, Inc. Indexes are unmanaged and one cannot invest directly in an index. **Past performance does not guarantee future results.**

It's important to remember the preceding Monte Carlo simulation uses historical data for asset classes, including arithmetic mean (return), standard deviation (risk) and correlation, to estimate a range of possible outcomes. Past performance does not guarantee future results. Note that other investments not considered may have characteristics similar or superior to those being analyzed.

Each Monte Carlo simulation generates randomized scenarios consistent with the historical characteristics of the asset classes. The simulation survival rates (probability of a portfolio supporting withdrawals over the indicated periods with a positive balance at the end of the period) are based on 10,000 simulations of possible market scenarios. These projections are only estimates based on the simulations and assumptions, and do not guarantee or predict future investment results.

There can be no assurance that the simulation survival rates will be achieved or sustained. Actual results will vary and may be better or worse than the probabilities indicated, which only present a range of possible outcomes based on the simulations and assumptions. Consequently, it may be prudent for you to be more conservative with your withdrawal rates, especially early in retirement, given the unpredictable nature of market performance.

This type of Monte Carlo simulation also assumes that the distribution of returns is normal. A normal distribution means that returns are concentrated near the average (arithmetic mean) and decrease in frequency as the distance from the average increases. Should actual returns not follow this pattern, results may vary significantly.

Results also may significantly vary over time and each time the simulation is run.

This simulation does not take into account taxes on withdrawals, nor early withdrawal penalties.

Indexes are unmanaged, include reinvestment of dividends and, as they are unmanaged, do not include any fees and expenses. A mutual fund, or other managed account, will include investment management fees and other expenses, which will reduce returns. One cannot invest directly in an index. These calculations are based on a limited collection of asset classes and some of these asset classes may have relatively short histories.

Other asset classes may be more appropriate for your individual situation.

Periods of significant market volatility may increase the chances that actual results will differ, possibly significantly, from the examples provided.

With advancing age, investors show a marked preference for investments perceived as safe. According to our 2016 RISE survey[7], only 14% of those currently retired would advise those not yet retired to consider more growth-oriented investments. What they may not realize, however, is that in addition to legitimate concerns about their ability to recover from losses and the need to preserve capital, loss aversion may also be impairing their judgment.

Loss aversion is another behavioral finance term that describes the intense emotions triggered by financial loss. Studies have determined that the pain associated with such loss is far deeper and longer-lasting than the pleasure associated with financial gain.[8] Individuals need to realize that this emotional response can lead to potentially detrimental financial decisions such as panic selling or remaining exclusively in low-yield investments that generate a negative return.

What's Next: The Value of Product Allocation

Increasingly, retirement planning experts are encouraging clients to expand their perspective from asset allocation in the years leading up to retirement to product allocation during retirement. The goal of the product allocation strategy is to group a range of mutual funds, banking, insurance and other financial products into a sustainable source of income, allowing investors to turn a portion of their retirement portfolio into what is essentially a private pension. Options are broad and varied, but can include:

- Equity and fixed mutual funds
- Managed payout funds
- Target-date funds
- Zero-coupon bonds
- Bond ladders
- Laddered certificates of deposit (CDs)
- Treasury inflation-protected securities (TIPS)
- Traditional fixed-income lifetime annuities
- Variable annuities

Products linked to the capital markets, including mutual funds (stock, bond and money market funds), annuities, standalone stocks, bonds or Treasuries, can fluctuate in value and are not insured against losses by any government agency. Some products, such as deferred fixed annuities, may offer a guaranteed rate of return for a specified period of time regardless of market conditions;[9] however, only checking accounts (including money market deposit accounts), savings accounts and certificates of deposit (CDs) are covered by the Federal Deposit Insurance Corporation (FDIC) to a limit of $250,000. Consequently, many investors maintain a "cushion" of other assets (such as cash) so they will not be placed in the position of having to draw money from their investments in down markets.

Investments designed to provide lifetime income and protection from volatility tend to have higher up-front costs than those without the guarantees, but if the RISE survey is any indication, many investors would happily absorb the cost to ensure protection of their retirement nest egg.

Overall, some 49% of survey participants were willing to pay for protection against outliving their retirement savings or retirement asset volatility. That number increased even further with rising income levels. Of those with an annual household income of $100,000 or more, 59% indicated they would be willing to pay either to protect themselves from outliving their retirement savings or to protect their retirement assets from volatility.

Household incomes of $100,000 or more are willing to pay for protection against outliving their retirement savings.

Household incomes of $100,000 or more are willing to pay to protect retirement assets from volatility.

Source: 2015 RISE Survey.

Planning for the Unexpected

Our 2016 RISE survey[7] indicated a higher level of stress and anxiety 11–15 years before retirement (77%) compared to total respondents (70%). This could stem from a number of causes:

- Response to market volatility
- Overspending while saving for retirement
- Onset of health concerns
- Caring for an aging parent
- Paying for children's post-secondary education while saving for retirement

Every retirement plan should include a contingency plan for unexpected events. For some people, the most unexpected development is that they are still alive far beyond the ages at which their parents died. One of the most pressing issues in medical care today is quality of life for the millions of people with chronic illness who in the past would have died at an early age, but who can now expect to live a normal lifespan with their illnesses, including the expensive treatments they will need. Health and medical issues were the number one concern for survey participants.

7. The 2016 Franklin Templeton Retirement Income Strategies and Expectations (RISE) survey was conducted online among a sample of 2,019 adults comprising 1,011 men and 1,008 women 18 years of age or older. The survey was administered between January 4–18, 2016 by ORC International's Online CARAVAN®, which is not affiliated with Franklin Templeton Investments.
8. Daniel Kahneman and Amos Tversky. 1979. "Prospect Theory: An Analysis of Decision under Risk." *Econometrica* 47: 263–291.
9. Annuity guarantees are subject to the claims-paying ability of the issuing insurance company.

The financial implications of inadequate planning for retirement can be life-altering during a time of great vulnerability Numerous vehicles are available that can be used to help preserve the nest egg and help generate a lifetime of reliable income, but success is likely to be largely dependent on decisions made in the preceding decades. With advance planning, a solid understanding of the issues, help from financial experts and a little bit of luck, happiness in retirement is an eminently achievable goal.

Our 2016 RISE survey suggests that people who take action and work with a financial advisor to create a written retirement income plan are happier and experience less stress and concern when thinking about retirement income planning. The good news is that there are three easy steps that may help you become one of those people:

THREE STEPS TO RETIREMENT CONFIDENCE

1 | **Know Your Situation.** Define your individual goals and concerns.

2 | **Work with a Financial Advisor.** Professional advice can make a difference.

3 | **Write Your Plan Down.** Having a plan in your head may not be enough.

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Franklin Templeton Distributors, Inc.
One Franklin Parkway
San Mateo, CA 94403-1906
(800) DIAL BEN® / 342-5236
franklintempleton.com

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