

RISE 2013

Retirement Income Strategies and Expectations

The Pursuit of Happiness: Investing for Post-Career Living

"There are two ways of being happy—we may either diminish our wants, or augment our means—either will do—the result is the same; and it is for each man to decide for himself, and do that which happens to be the easiest."

-Benjamin Franklin

Great Expectations

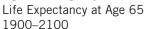
It is said that money does not buy happiness. Most people would agree, however, that insufficient income is a road to misery. The conditions that promote happiness—vitality made possible by proper nutrition and exercise, the comfort and security of a safe living environment, the ability to stay connected to each other and the world—are sorely compromised when funds are limited. Yet at no other time in life are these conditions more difficult to fulfill than during retirement.

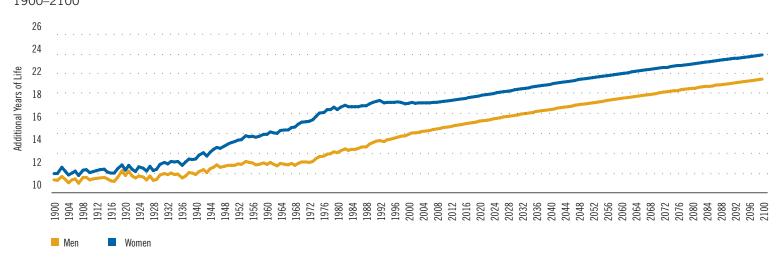
Until recently, retirement was not an overly worrisome societal issue, simply because much of the population never made it to that point. When 65 became the official age for collecting social security in 1935, average life expectancy in the United States was only 61.7 years. Few people could conceive of the possibility of

living for decades without paid work. Nor was it necessary, as a large and relatively young workforce existed that could easily support the few who managed to live to a ripe old age.

By 2008, however, average life expectancy for a 62-year-old was 21.1 years longer. 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 (Figure 1). As for tomorrow's retirees, advances in geriatric medicine, stem cell research and other health-related sciences currently in their infancy hold the potential for further increases in longevity.

Figure 1: Longevity on the Rise





Source: US Social Security Administration, Office of the Chief Actuary, Life Tables for the United States Social Security Area 1900–2100 (Actuarial Study No. 120).

1. Centers for Disease Control and Prevention/National Center for Health Statistics, National Vital Statistics System.

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If life is to be longer for many more people than in the past, maintaining an adequate income throughout those years will be essential. Considerable discussion has been generated about the baby boomers reinventing retirement. Popular terms like "unretirement," "phased retirement" and "encore career" harbor within them the expectation that retirees will somehow continue to earn income to fund a happy, healthy, active and engaged "third age."

Preparing for the Retirement Financial Transition

The Franklin Templeton Retirement Income Strategies and Expectations (RISE) Survey² examined the retirement strategies and expectations of more than 2,000 participants. Results from the survey suggest that while there is general awareness of the lifestyle transition that occurs immediately before and after retirement, another transition period—the financial transition—actually occurs much earlier. Without question, the success of the financial transition will largely determine future lifestyle.

Finding ways to generate a reasonable income for 20 or 30 more years may seem like a herculean task, which could be why so many people are ill prepared. Even thinking about retirement is, for many reasons, an intense emotional experience. All too often, emotional thinking triggers behavioral biases that can seriously interfere with an individual's ability to make sound decisions, especially those of a financial nature. Understanding these biases and how they interact with expectations—yours and those around you—can help reduce the paralyzing stress that prevents too many people from taking positive action toward achieving their retirement goals.

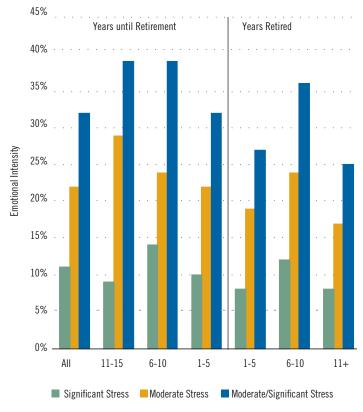
Thinking about Retirement Is Stressful; Living in Retirement Is Not

One of the more surprising results from the survey was the age at which retirement-related stress levels peaked. As early as 15 years before retirement, fears associated with the financial consequences of growing older appear to spiral upward (Figure 2).

The top three concerns for survey participants were health and associated expenses, longer lifespans and outliving their money. Although the vast majority (93%) indicated a solid grasp of the expenses involved, they were at a loss as to how to pay for them. Some 62% of participants had saved less than \$50,000 toward their retirement, including 20% who

Figure 2: Worry, Worry, Worry

Emotional Intensity of Investment Stress: Investors' Emotional Responses to Financial Situation Peak Prior to Retirement



Source: Franklin Templeton, Retirement Income Strategies and Expectations (RISE) Survey, 2013.

had saved nothing at all. Less than 25% were financially prepared for retirement with savings of more than \$500,000.

In response to a lack of savings, 62% stated they would retire later if unable to retire as planned. That may be an unrealistic expectation. Job layoffs, illness or taking early retirement to look after an ill loved one all become more common with advancing age. In the survey, roughly 50% of participants who had left the workforce before age 65 had not retired by choice.

Research conducted by the Employee Benefits Research Institute (EBRI) confirms that a considerable gap exists between workers' *expected* age of retirement and retirees' *actual* age of retirement.³ Figure 3 compares patterns of workers' expected retirement ages with actual retirement ages over a 22-year period. While the age at which workers expected to retire gradually increased over the period, the vast majority continued to retire either before or around age 65.⁴

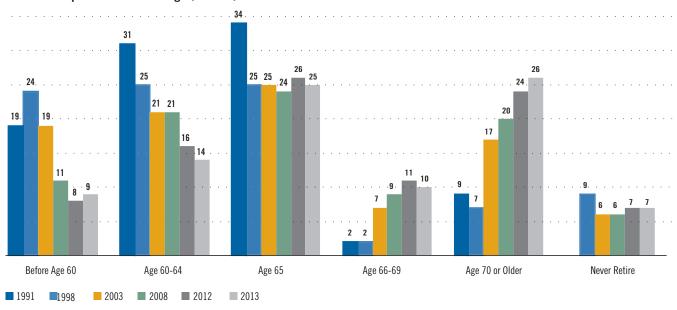
^{2.} The Franklin Templeton Retirement Income Strategies and Expectations (RISE) Survey was conducted online among a sample of 2,002 adults comprising 1,001 men and 1,001 women 18 years of age or older. The survey was administered between January 10 and 22, 2013, by ORC International's Online CARAVAN.®

^{3. &}quot;2013 Retirement Confidence Survey," EBRI/MGA, March 2013 EBRI Issue Brief (www.ebri.org).

^{4.} Ibid.

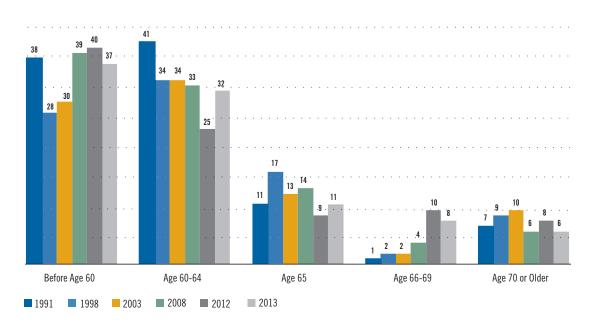
Figure 3: The Gap between Expectations and Reality 1991–2013

Trend in Workers' Expected Retirement Age (Percent)



Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 1991–2013 Retirement Confidence Survey.

Trend in Retirees' Actual Retirement Age (Percent)



Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 1991–2013 Retirement Confidence Survey.

Retirement: A Midlife Crisis

Perhaps the retirement stress evident 11 to 15 years before retirement is not so surprising after all. At that point, the mind is consumed with solving pressing financial issues related to family, house, children's educations and countless others common to middle age. Midlife is a time when responsibilities can seem overwhelming and dissatisfaction with life looms large. Economists studying the shifting patterns of contentment throughout life refer to the U-bend theory: Happiness declines from young adulthood to a nadir sometime in the mid-40s, and then begins to rise again with advancing age. Some economists invert the "U" with worry peaking in middle age and falling sharply thereafter. Either way, it is fully conceivable that thinking about finding the resources to finance retirement could lead to considerable stress.

Interestingly, the RISE survey found that financial stress dropped substantially in the years immediately preceding and following retirement. Neuropsychologists posit two theories about the human brain that may account for the decline:

- The brain is hard-wired to focus on the present. In psychological terms, this is known as *hyperbolic discounting*. When considering a retirement that may be decades away, many people are unsure of what they may have to sacrifice along the way. Moreover, it all seems too far in the future to care about. It may be that once retirement is imminent, the brain accepts the new "present" and continues to solve near-term challenges without undue anxiety.
- The brain may harbor not only one, but several selves that compete for attention at different times. Multiplicity of selves is an ancient concept dating back to Plato that has been receiving renewed scientific attention. The short-term self focuses on what it wants now, loudly and clearly; but as any parent knows, the adult self—the one involved in long-term planning—needs to be firmly in control of the decision-making process.

How Best Intentions Can Go Astray

Psychologists in the field of behavioral finance are familiar with the brain's ingenuity in creating behavioral biases capable of derailing long-term planning. Dan Ariely, a professor of behavioral finance at Duke University, refers to these behaviors as "predictably irrational." Even when

provided with a reasonable argument and ample context, the human brain nevertheless often has a strong tendency to make decisions based on irrational emotion.

Even in a healthy brain, age-related changes in the hippocampus and prefrontal cortex may affect the ability to apply past information to decisions about the future with accuracy and relevant context. The following two behavioral biases can be particularly problematic:

Mental Accounting

The phrase "mental accounting" describes how people treat money differently depending on where it comes from, where it is kept, and how it is spent. From the perspective of retirement investing, mental accounting in its more benign form can assist self-discipline by separating assets earmarked for retirement from other investment capital. It also plays a central role in turning savings into income, when multiple income streams must be matched to expenses.

Mental accounting requires high executive functioning in the areas of logic and planning. Declines in these cognitive areas can become apparent at around age 50 and tend to drop noticeably after age 70. Impairment can be further aggravated by various forms of dementia such as Alzheimer's and, in the very elderly, senility. Having a plan in place before these changes begin can prevent later counterproductive, emotionally based decisions such as retiring early without a proper financial base, rapidly depleting the nest egg by overspending in the early years or conversely, refusing to spend to the point of compromising emotional or physical well-being.

Loss Aversion

Loss aversion refers to the deep pain investors feel upon taking a loss and the lengths to which they will go to avoid that pain. Those approaching or in retirement often have legitimate concerns about losing significant assets, especially if the losses occur just as an individual is leaving the workforce. Investors learned firsthand about the destructive potential of market volatility on their retirement nest eggs following the technology bubble of the late 1990s and the global financial crisis a decade later. Although the market recovered from these periods of exceptionally high volatility, newly retired investors beginning annual withdrawals in the year 2000 found their assets depleted at a much faster rate than anticipated, as shown in the hypothetical example (Figure 4).

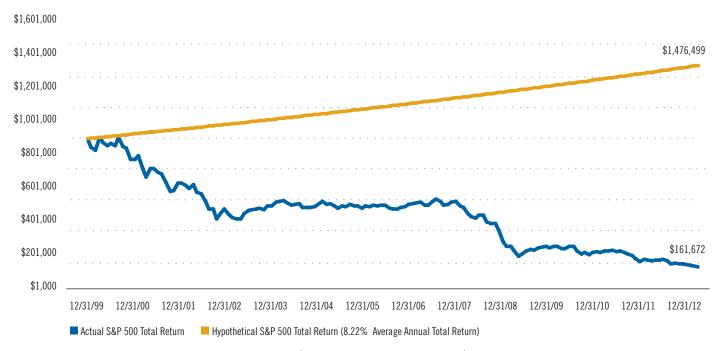
^{5.} The Economist, "Age and Happiness: The U-bend of Life," December 16, 2010.

^{6.} Dan Ariely, Predictably Irrational: The Hidden Forces That Shape Our Decisions, 2008.

^{7.} Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision Under Risk," Econometrica 1979, 47:263–91.

Figure 4: Why Planning Is Critical

Expected Growth of the S&P 500 Index December 31, 1999–December 31, 2012



Note: Assumes a yearly withdrawal rate of 5% based off the original investment of \$1 million, paid in equal monthly payments of \$4,166.67 during the first year increasing 3% for each of the following calendar years.

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A FIVE-STEP RETIREMENT PLAN

Simply having a plan for accumulating money is not enough. Knowing the expected size of the nest egg at retirement is a relatively simple calculation; developing a strategy for turning that number into a meaningful income stream is another matter that requires self-examination and careful planning. The following steps provide a guide to the process:

- 1. Think retirement. Retirement investing has its own set of priorities that may require solutions that are unfamiliar to investors who have focused on wealth accumulation. From an emotional perspective, this change of direction can be difficult as people tend to become attached to the familiar (familiarity bias). Professor Ariely cautions that although the emotional system of the brain can provide useful information in terms of likes and dislikes, it should not be confused with the decision-making system. Decisions based on emotions are likely to be unsuccessful.⁸
- **2. Set realistic goals and address concerns.** Prioritizing goals and concerns at the beginning of the process can help identify a realistic lifestyle expectation. Some participants in the RISE survey expected never to retire; however, the majority indicated that the idea of retiring later held less appeal with advancing age, preferring to reduce expenses or otherwise alter their lifestyle.

- **3. Develop a strategy for dealing with volatility.** Although volatility is a normal part of market activity, retirement investments' volatility-management tools and strategies can be incorporated into the overall plan to help protect assets.
- **4. Create a simple, executable plan and write it down.** The importance of a written plan cannot be overemphasized. Studies consistently show that investors with a written retirement plan amass a larger nest egg than those without one. To ensure the strategy can be easily followed and will not gather dust in a closet, it is important to avoid information overload. Remember, the US Constitution is only 4,400 words long.
- **5. Fine-tune the plan to accommodate changing circumstances.** While annual reviews are beneficial, it is especially important to review the strategy in the five years preceding and following the retirement date. Has the plan met expectations? If not, what can be done to regain lost ground? Should lifestyle plans be revised? A common pattern for the newly retired is to spend more than average on leisure activities and travel. Although spending tends to decrease in the middle years, it spikes again in the last few years of life, with higher medical expenses and end-of-life care accounting for much of the increase. ¹⁰
- 8. Dan Ariely, Predictably Irrational: The Hidden Forces That Shape Our Decisions, 2008.
- 9. Reproduced with permission from *The Future of Retirement, The Power of Planning*, published in 2011 by HSBC Insurance Holdings Limited, London.
- 10. S. Banerjee, "Expenditure Patterns of Older Americans", EBRI Issue Brief. Feb. 2012, (368): 1-25.

Loss aversion tends to linger long after conditions have changed, which may steer investors of all ages away from the very investments they need to secure an adequate income in retirement. The RISE survey confirmed ongoing loss aversion among participants, with only 11% expressing interest in using growth investments in their retirement plans. Moreover, loss aversion typically increases with age, and willingness to consider growth investments further diminishes. Just as the best time to develop a will is when a person is healthy, the best way to prevent mistakes associated with the possibility of impaired judgment in financial decision-making during retirement is to develop a retirement plan while still in the workforce.

Older, Wiser...

One advantage to growing older is the realization that seeking advice from those with greater knowledge and experience is a sign of wisdom, not an admission of failure. Some 61% of RISE survey participants were prepared to consider using the assistance of a financial advisor for the first time, or switching advisors if the development of a written retirement income strategy was included in the service.

Working with a qualified financial advisor helps people better understand their sources of retirement income. When asked how much they expected to withdraw on an annual basis, only 37% of survey participants with an advisor did not know, compared with 63% of those without an advisor.

...and Happier

The exercise of planning ahead is not generally perceived as contributing to happiness. On the contrary, thinking of the future (or past) has been shown to increase meaning but lower happiness, ¹¹ which may reflect the brain's focus on the short term. What does increase happiness is the knowledge that having a plan in place means people can stop worrying about the future and enjoy the present.

It would be presumptuous to imply that the happiness attained by addressing the financial aspect of retirement is the only requirement for a satisfying life outside the workforce. Nevertheless, RISE survey participants overwhelmingly indicated that saving for retirement had a significant impact on their personal happiness. When asked to describe the level of happiness with their retirement plan, 82% of those who had saved for retirement said they were completely or somewhat happy, compared with only 34% of those who had not yet started. Across the scientific, spiritual and philosophical domains, those who have studied the pursuit of happiness would agree that, as the Dalai Lama has observed, "Happiness is not ready-made. It is a result of our actions."

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11. R. F. Baumeister, K.D. Vohs, J.L. Aaker, E.N. Garbinsky, Some Key Differences between a Happy Life and a Meaningful Life.

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