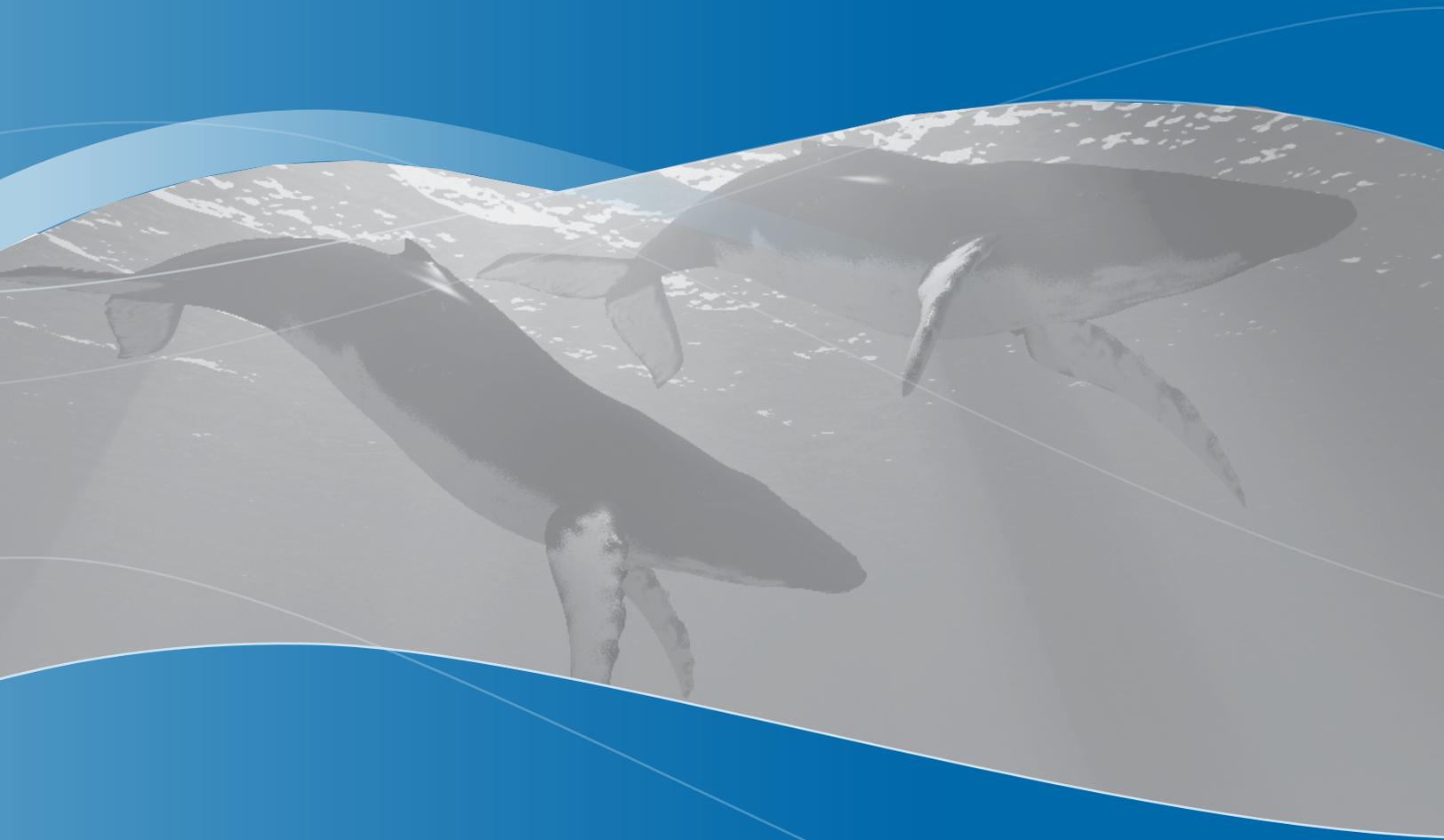




A “New Generation” Retirement Strategy

Today, Optimizing Retirement Income
Requires an Increased Focus on Efficiency



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Pacific Life Insurance Company commissioned Dr. Mathew Greenwald to write a report on the value of using a single-premium immediate annuity (SPIA) combined with an increased allocation in equities to help optimize retirement income.

Founded in 1985, Greenwald & Associates is a full-service market research firm with a breadth of capabilities and unique industry expertise. Its president, Dr. Mathew Greenwald, has achieved several honors, and the company's executive and senior teams have served many of the nation's top companies, associations, and consulting firms in the financial services and retirement industries.

Dr. Mathew Greenwald is not an employee of, or affiliated with, Pacific Life.

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The World Has Changed— So Should Retirement Strategies

A sometimes easy-to-overlook fact is that the foundation of a retirement strategy is to effectively produce the *income* that retirees need throughout their lives. Specifically, how can *enough* income be generated from a portfolio to provide for a comfortable lifestyle? And how can that income be *maintained* throughout the retirement years?

In considering those questions, keep in mind that the very concept of retirement “income” has changed. In generations past, many saw retirement income as: 1) their pension, 2) Social Security, and 3) the dividends and interest generated from their savings. The goal was never to touch principal. That was “emergency” and/or “legacy” money.

Times Have Changed

Today, Americans approaching retirement are very different from generations past:

- Most will have little or no guaranteed pension income.
- Medical costs have continued to soar.
- Many will carry mortgage debt into retirement.
- Average life expectancies are higher today than in the past.

To maintain a comfortable retirement lifestyle, today’s retirees need a strategy that will generate larger amounts of income over longer periods of time.

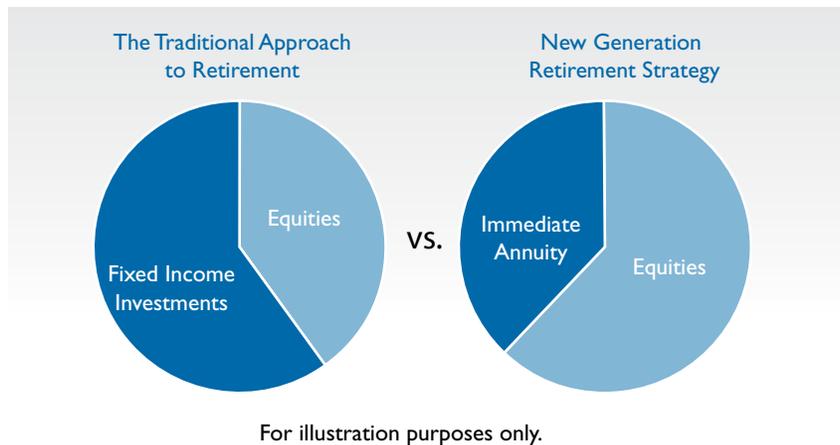
This brings an important concept to mind: *efficiency*. The key to producing more with less—and sustaining that over longer periods of time—is to be efficient. In terms of a retirement strategy, that means formulating an approach designed to produce the optimal amount of income for each dollar invested.

The increasing need for efficiency strongly suggests the adoption of a New Generation Retirement Strategy more suited to modern circumstances.

Taking a More Modern Approach

Currently, the tried and supposed true approach to retirement is to allocate 45% to 65% of assets to fixed income, the rest to equities. While this may have worked well in the past, the increasing need for efficiency strongly suggests the adoption of a New Generation Retirement Strategy more suited to modern circumstances—one in which both of the following should be considered:

1. Determining a portfolio allocation dedicated to producing guaranteed lifetime income through immediate annuities.
2. Increasing the amount that has been traditionally allocated to equities.



The New Generation Retirement Strategy:

- Helps produce more steady, pension-like income.
- Allows for greater benefit from equities, whose growth potential and liquidity will be needed by many who have under-funded retirement or need greater return to be prepared for expenses that are more prevalent among retirees (i.e., healthcare costs).
- Provides income guaranteed to *last for life*, an important strategic advantage in an era when average life spans have increased.

This paper details the case for this New Generation Retirement Strategy. It also provides examples of the strategy's benefits to today's retiree.

A New Challenge for Financial Professionals

Today, effective retirement income planning is a task that requires considerable skill and foresight. Compared to clients of the past, today's retirees are far less likely to have a lifetime pension or zero mortgage debt, their healthcare expenses will be higher, and average life expectancies have risen. In addition, the economic and global environment that today's retirees face is full of challenges, including:

- An investment climate that many experts predict will produce lower-than-historic growth in future equity returns.
- Equity values that are basically where they were eleven years ago, meaning about a 33% decline in real value. This means that clients who want to pile up savings “at the last minute” just prior to retirement—as many investors do—will be unable to accumulate as much as they want. They will look to financial professionals for ideas to compensate for the shortfall.
- Interest rates that are at historic lows and likely to remain that way for at least the next few years.
- Home equity will not be the cushion that many anticipated. Housing values have declined substantially from their highs of five years ago, and many borrowed against the higher values to sustain their lifestyles.
- Global de-leveraging is leading many financial experts to expect slow economic growth—at least in the United States and Europe—for several years to come.
- In the near-term, there is a real possibility that, at least for the affluent, entitlement programs will be cut back or subject to higher taxation.

In short, compared to past generations, the New Generation retiree needs:

1. To rely more heavily on his/her own portfolio to produce retirement income.
2. Sources of income that will last over a longer period of time.
3. A strategy that can provide adequate income despite an environment in which earnings from traditional investments are predicted to be relatively modest.

This is why maintaining the client's lifestyle during retirement will be an especially challenging task for financial professionals, requiring new approaches to portfolio allocation.

The New Generation retiree needs a strategy that can provide adequate income despite an environment where earnings from traditional investments are predicted to be relatively modest.

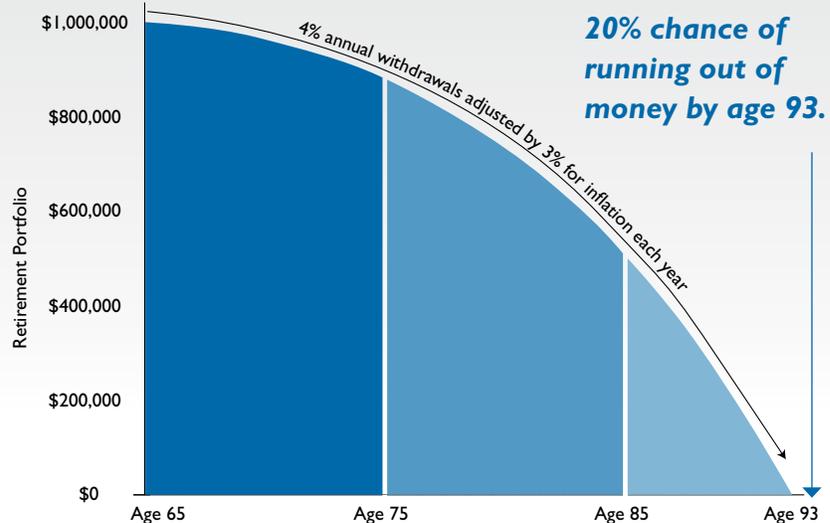
Rethinking the Traditional Retirement Strategy

As stated, in helping most clients meet the challenges of retirement, many financial professionals recommend a portfolio allocation strategy of approximately 45% to 65% in fixed income investments, and the remainder in equities. Since New Generation retirees may rely heavily on income generated from their portfolios, this strategy begs a key question:

How long will it be before I run out of money?

Consider the couple represented by Figure A below, with a retirement portfolio of \$1 million in the form of IRAs or other defined contribution plans. Monte Carlo analysis suggests that the couple start retirement by withdrawing 4%, and then increase withdrawals each year by 3% to account for inflation. This gives the couple a 20% chance of running out of money by age 93. At today's life expectancies, if both members of the couple are healthy at age 65, there is nearly a 25% chance that at least one of them will still be alive at age 93. And even if they don't totally drain their assets, many would likely see their savings going down significantly year by year throughout their 80s. This is not a scenario that most clients would consider acceptable.

FIGURE A *How Long Will \$1 Million Last?*



Add in the effect of taxation, and the scenario becomes even more questionable. A couple withdrawing an annual income of \$40,000 will pay an average of about

\$10,000 each year in federal and state taxes. This reduces their spendable income to \$30,000 per year. How many retirees who have accumulated \$1 million in retirement savings will be content with about \$2,500 a month in income to show for their efforts?

Another cloud darkens the horizon when we consider the fact that inflation is significantly higher for retirees than for working individuals.¹ This is because retirees spend a higher portion of their incomes on healthcare—and Medicare and Medigap premiums, along with other healthcare costs, will likely continue to rise faster than inflation. This puts even more pressure on clients' portfolios to generate more income to cover these expenses as they age, and further increases the chance they will run out of money.

Thus, the question becomes: Is there a better way to allocate portfolios for the New Generation's retirees so that retirement income is both:

- Optimized—creates as much income as possible
- Sustainable—likely to last over the client's entire life

The New Generation Retirement Strategy

Given the challenges faced by today's retirees and their financial professionals, a more effective approach to producing retirement income may be what we term the New Generation Retirement Strategy. This approach involves:

- Introducing immediate annuities into the portfolio allocation.
- Increasing the equity allocation of the overall portfolio.

The key to understanding the benefits of this strategy is this: **Immediate annuities are efficient.** They produce more income per dollar than traditional fixed-income instruments, such as bonds. Also, the income stream continues as long as the annuity owner lives, which can provide a great feeling of security and relieve the person of having to set aside more money for old age. This also allows a greater amount of money to be prudently invested in equities, which have the highest potential for return of all asset classes. If the equity market averages at least 5% per year over the long term, immediate annuities combined with a larger equity allocation can produce better results in terms of income sustainability than moving retirees substantially toward traditional fixed-income investments.

What if the market averages less than 5% per year? In that case, there are two more reasons to consider immediate annuities: 1) Clients will need the relatively high levels of income that immediate annuities produce, and 2) immediate annuity income is guaranteed for life.

The key to understanding the benefits of this strategy is this: Immediate annuities are efficient.

¹ Source: The Experimental CPI-E, Monthly Labor Review, 2008.

The New Generation Retirement Strategy in Action

To illustrate the advantages of the New Generation Retirement Strategy, let's look at a hypothetical example of a 70-year-old male (Figure B). For simplicity, we will not include the effect of taxes. We'll assume our 70-year-old male wants to supplement his Social Security income with \$1,000 a month (\$12,000 per year) that he can count on to pay for regular living expenses. Clearly, this is not an uncommon scenario.

Using a traditional retirement strategy, this client's financial professional may have recommended using bonds to achieve the client's goal of \$1,000 in monthly supplemental income. This is because many financial professionals do not want clients to take regular withdrawals from equities because they are concerned about being forced to sell equities in a down market, which is especially detrimental in times of extreme market volatility. You would not want to have to sell equities to produce income for your client right after the Dow Jones Industrial Average went down by 300 points.

At the time of this writing, 10-year AAA-rated corporate bonds paid an interest rate of 2.79%.² So, the client would need an investment of \$430,108 to generate the \$1,000 in monthly income over the next 10 years. At the end of 10 years, the bond would return the client's investment.

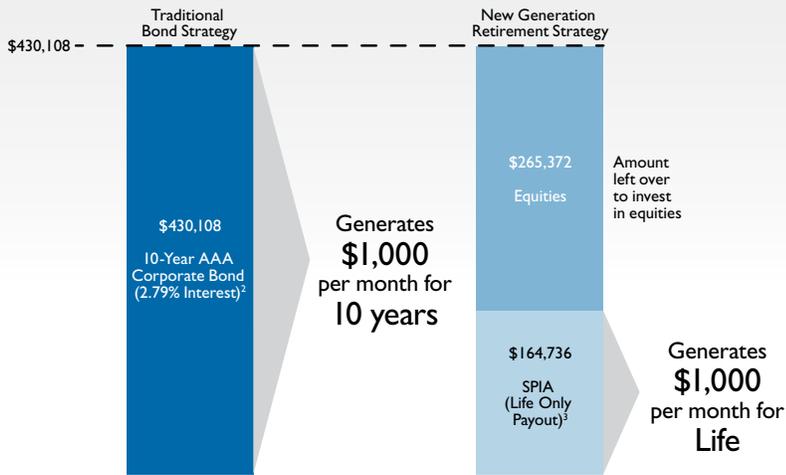
The New Generation Retirement Strategy would involve a much smaller amount to generate the same income. Currently, an immediate annuity using a Life Only payout of \$1,000 per month can be purchased for \$164,736.³ That's \$265,372 less (\$430,108 – \$164,736) than the amount the client would have invested in bonds, which frees him up to invest that difference in equities for long-term growth. Plus, the \$1,000 monthly income is now guaranteed for *life*, not just 10 years.

² Source: 6/16/13, Yahoo Finance; http://finance.yahoo.com/bonds/composite_bond_rates.

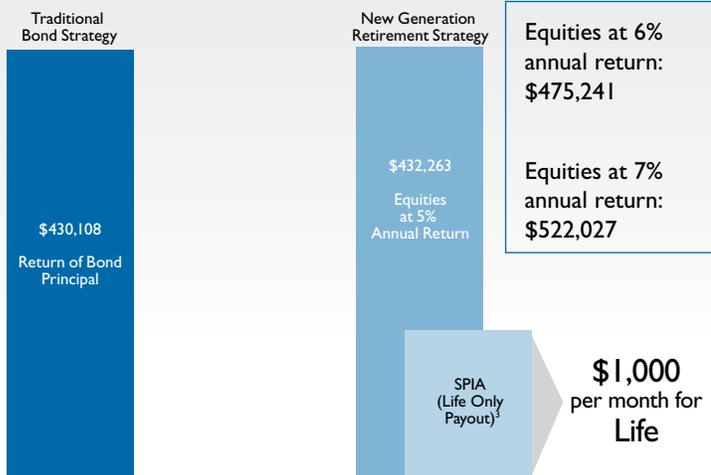
³ Pacific Income Provider® (contract form series 30-1181, ICC10:30-1181, 30-1181OR, 30-2181) SPIA illustration on 6/17/13. Single Life payout for a male, age 70 and age 80

FIGURE B Traditional vs. New Generation Retirement Strategy

Male, Age 70; Goal: \$1,000 per month supplemental income
\$430,108 investment



After Ten Years (now age 80)



As you can see, after 10 years, the client would have had more in available assets if he used an immediate annuity. He would also have continuing income of \$1,000 a month *for life*.

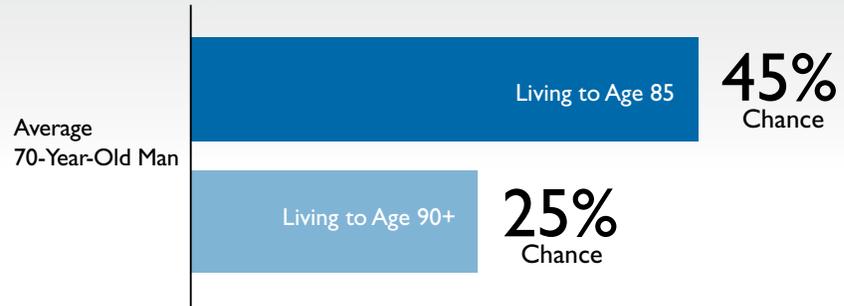
In addition, consider what would have happened if the client had needed emergency funds during the 10 years. With the bond strategy, the bond would have to be sold—and if interest rates had gone up over the years

(something which, today, experts expect over the next 10 years), it may be sold at a lower price. However, by purchasing an immediate annuity, the client wouldn't need to touch his \$1,000 income source. He has a side fund of equities available for emergency use.

Increasing Benefits Beyond 10 Years

Because it utilizes immediate annuities, the New Generation Retirement Strategy tends to have more financial benefits the longer a client lives. It wouldn't be unusual to expect that our hypothetical client—or any healthy, average male—might live beyond age 80. The average 70-year-old man today has a 45% chance of living to age 85, and a 25% chance of living beyond age 90.⁴

Life Expectancy



So let's examine how this strategy might work for the client beyond age 80. The key here is to remember that the client started out with a need for \$1,000 in monthly income. If inflation has averaged 3% over the last 10 years, he now has an income need of \$1,333 per month if he wants to maintain his standard of living. What's the best way to produce that income?

If the client continues on the traditional path, he could use a portion of his \$430,108 in assets to buy a 6% bond that would give him the \$1,333 per month he needs. The cost of this bond would be \$266,600,⁵ leaving the client with \$163,508 ($\$430,108 - \$266,600$) to invest in equities.

If the client continues on the immediate annuity path, he has \$432,263 from his investment in equities that returned 5% per year for 10 years. He already has \$1,000 in guaranteed monthly income being generated from his first annuity purchase. Thus, he needs \$333 more in monthly income to meet his \$1,333 need. At current rates, an immediate annuity using a Life Only payout of \$333 per month for an 80-year-old male would cost \$39,472.³ This leaves \$392,791 ($\$432,263 - \$39,472$) left over to invest in equities. This is considerably more than the \$163,508 he would have had using bonds.

⁴ Source: Mortality data from the Society of Actuaries Retirement Participant 2000 Table.

⁵ Assumes a bond was able to be purchased for \$266,600. Bonds are normally sold in \$1,000 to \$100,000 increments.

Using this example, several conclusions are clear. When clients consider how to invest for their long-term retirement income needs, those who use immediate annuities (and invest the surplus in equities) instead of committing a large portion of their portfolios to bonds:

- Are less likely to have to reduce their lifestyles for financial reasons as they age.
- Are more likely to do better overall than those who tie up a large portion of their money in bonds.
- Will have more liquidity because they don't need to disrupt their income flow should they need emergency funds.
- Increase their chances of leaving a larger estate if they live to average life expectancy—and increase their chances of leaving a considerably larger estate if they live beyond life expectancy.

Who Should Use the New Generation Retirement Strategy

It should be acknowledged that no retirement strategy fits every client. The good news is that the majority of clients will wind up better off with the New Generation Retirement Strategy than with the traditional approach to retirement income. Clients for whom the New Generation Retirement Strategy should be considered include healthy clients and those with \$150,000 to \$5 million in liquid assets.

Healthy Clients

As we've seen from the previous example, the longer a person lives, the more beneficial the New Generation Retirement Strategy will be. This is because the purchase of an immediate annuity takes money out of the client's portfolio in exchange for a stream of income. The major benefit of the annuity is that the income stream is steady and guaranteed for life. So the longer the client lives, the more payments he/she receives, resulting in a greater financial benefit.

However, even for clients who live relatively short lives, there are two ways to mitigate the difference between the strategies. The first is by purchasing an annuity with a Life with Cash Refund payout option. A Life with Cash Refund option guarantees that if the client dies before receiving payments of at least as much as they originally invested in the annuity, any shortfall will be paid to the client's beneficiaries. Of course, in exchange for a Life with Cash Refund option, the annuity payment would be less when compared to a straight life annuity. In addition, the annuity can be purchased so that it provides guaranteed income for the life of the annuitant, as well as the life of a spouse.

Clients with \$150,000 to \$5,000,000

While immediate annuities provide an income stream, they cannot be tapped for extra cash. This is why clients with adequate liquidity in their portfolios—usually, individuals with more than \$150,000 in assets—may be the best candidates for a New Generation Retirement Strategy. On the other end of the spectrum, very wealthy individuals may not need the guarantees and protection that immediate annuities provide. However, even these clients can consider a New Generation Retirement Strategy as a way to maintain a high level of spending during retirement.

One important consideration for clients who use this strategy is the financial strength and claims-paying ability of the company issuing the annuity. In buying a bond, clients would consider the credit risk represented by the bond issuer. Similarly, because the guarantees in an annuity are backed by the claims-paying ability of the issuing insurance company, the financial professional should help clients select an annuity from an issuer that has received strong financial strength ratings from several major independent ratings agencies.

Determining the Appropriate Immediate Annuity Allocation

How much should a client allocate to immediate annuities? In answering this question, financial professionals should take a close look at the client's liquidity needs. Immediate annuities are, by their nature, illiquid. Therefore, the amount allocated to these products should take the client's potential needs for emergency cash into consideration.

Immediate annuities also carry inflation risk. Once bought, they cannot be altered if inflation rises, although some companies do offer an option to increase the amount of the annuity income payouts either on a specific date or over a period of years. Or, another prudent approach may be to “ladder in” immediate annuities. This could involve a modest purchase when income is first needed—for example, 10% to 20% of the portfolio—and then periodically adding income through additional annuities as inflation rises.

Addressing Immediate Annuity Myths

Using a New Generation Retirement Strategy—purchasing immediate annuities for income and devoting a larger allocation to equities—clearly provides today's retirees with important financial advantages. However, some clients may have emotionally based objections to immediate annuities based on certain myths about the product.

Myth 1: A short life equals lost money.

Reality: A Life with Cash Refund payout option can protect assets.

Because purchasing an immediate annuity involves exchanging a lump-sum payment for a guaranteed stream of income, some clients fear they could lose money if they die before they've received income equal to that payment. However, certain issuers of immediate annuities offer a Life with Cash Refund payout option. If a client dies before receiving income equal to his/her purchase payment, the client's beneficiary will get every dollar that has not already been paid back. For example, you may remember that our hypothetical client purchased his first annuity at age 70 for \$164,736. If he had selected the Life with Cash Refund payout option instead of Life Only, he would have purchased it for \$188,537 to receive the same monthly income.⁶ If he had unexpectedly passed away at age 75, the annuity would have paid out \$60,000 in income (\$1,000 per month x 12 months x 5 years). The \$128,537 difference between the \$60,000 the client received and the \$188,537 that the annuity cost (\$188,537 – \$60,000 = \$128,537) would be returned to the client's beneficiary.

Myth 2: The shrinking estate.

Reality: Clients may increase the likelihood of leaving more to heirs.

Some clients believe that purchasing an immediate annuity inevitably means leaving a smaller estate to heirs. As demonstrated earlier in this paper, as long as the client lives to average life expectancy, the opposite is more likely. Healthy people who buy immediate annuities and invest the rest in equities, rather than using more cumbersome and inefficient ways to generate income, actually increase their chances of leaving more to their heirs.

Myth 3: Immediate annuities reduce total liquidity.

Reality: More often than not, the opposite is true.

Many mistakenly believe that immediate annuities reduce a portfolio's total liquidity when, often, the reverse is true from the moment the annuity is purchased. Let's take our example of the 70-year-old male who needed \$1,000 a month. As we saw in Figure B on page 7, the client had \$265,372 in liquid assets by purchasing the immediate annuity. If he had purchased the bond and then needed additional income, he could sell the bond but his income may drop. Also, he would face the risk that interest rates will rise, reducing the value of the bond, and he may face an adverse interest-rate environment in which selling the bond may lead to receiving less than the par value.

⁶ Pacific Income Provider® (contract form series 30-1181, ICC10:30-1181, 30-1181OR, 30-2181)
SPIA illustration on 6/17/13. Life with Cash Refund payout option for a male age 70.

Conclusion

The new generation of retirees faces tremendous challenges in realizing the dream of a secure financial future. Average life expectancies continue to rise. Healthcare costs are also trending upward. In the past, most retirees could count on guaranteed lifetime income from defined benefit pension plans and Social Security. But today, more employers are ceasing to offer defined benefit pension plans, and simply relying on Social Security to provide for the majority of a retiree's income needs is not feasible.

To help retirees maintain a comfortable lifestyle, financial professionals will need to employ strategies that make more efficient use of their clients' portfolios in order to produce long-term sustainable income. Compared to the traditional approach of allocating among bonds and equities, the New Generation Retirement Strategy—utilizing immediate annuities and a larger allocation to equities—can help a majority of clients by providing a more steady, pension-like income. It also offers enhanced opportunities to benefit from the growth potential of equities, income guaranteed to last for life, and value that increases the longer the client lives.



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