The Annuity Imperative

BY ROBERT P. SEAWRIGHT, J.D.

Retirees and near-retirees often wonder whether they should purchase an annuity to provide sustainable lifetime income – in effect, a guaranteed retirement paycheck – that they cannot outlive. Most do not. That's almost always a big mistake. This "white paper" will explain why.

Executive Summary

Income annuities – whether an immediate annuity or the annuitization of a deferred annuity – are incredibly powerful tools for providing sustainable lifetime income and are almost surely the most underutilized financial asset in the market today. As reported by *The Wall Street Journal*, "income annuities can assure retirees of an income stream for life at a cost as much as 40% less than a traditional stock, bond and cash mix."[1] In effect, this means that retirees who need a given amount of savings to provide for themselves throughout retirement can live the same lifestyle with as little as 60% of that amount through the use of an income annuity. Prof. David Babbel of the esteemed Wharton School at the University of Pennsylvania sets forth the value of annuities clearly and unequivocally:

"Lifetime income annuities may not be the perfect financial instrument for retirement, but when compared under the rigorous analytical apparatus of economic science to other available choices for retirement income, where risks and returns are carefully balanced, they dominate anything else for most situations. When supplemented with fixed income investments and equities, it is the best way we have now to provide for retirement. There is no other way to do this without spending much more money, or incurring a whole lot more risk coupled with some very good luck."[2]

The Retirement Crisis

We face a retirement crisis of epic proportions. Beginning in 2011, 77 million baby boomers will start turning 65 and begin what they expect will be a comfortable retirement.

Are those expectations grounded in reality?

Due to dramatic advances in life expectancy, new retirees can look forward to nearly two decades of retirement or more. A large and growing number of retirees will spend three or even four decades in retirement. Indeed, according to the Census Bureau, the number of Americans 65 and older is projected to increase to 69.4 million in 2030 from 35.5 million in 2000. Some retirees will spend their last years financially secure, able to concentrate their time and energy on family, friends, personal growth, enjoyment and the building of their legacies.

But many will not.

For most retirees, their retirement plans have been built upon three major components.

1. Social Security

Most retirees rely heavily upon Social Security and related government programs. Social Security, which provides, on average, about 40% of retirement income,[3] will face increasing financial pressure. Because there are so many more baby boomers than succeeding generations, the ratio of people in the retirement years (65 and older), compared to those in the working years (20 to 64), will rise from 20.6% in 2005 to 35.5% in 2030, according to the Census Bureau. That will put an increased strain on the system to pay the benefits of current retirees. Moreover, huge projected deficits,[4] expanding Medicare, **Medicaid and health care costs,[5] together** with exploding debt [6] make many Americans nervous about the prospects of Social Security over the long haul. Indeed, a recent report from the Congressional Budget Office shows that for the first time in 25 years, Social Security is now collecting less in taxes than it is spending on benefits.[7]

2. Traditional pensions

With a traditional pension, the saving and investing is done by employers, and these employers bear the risk that retirement assets will fall short of promised benefits. According to the most recent numbers from the Employee Benefit Research Institute, the number of workers who are covered by a traditional pension has declined dramatically and continues to decline.[8] Moreover, a growing number of company pensions are winding up in the hands of the Pension Benefit Guaranty Corp., a government agency and payer of last resort when pension funds go under. The PBGC is underfunded to the tune of billions of dollars.

3. Home equity

For many people, their primary residence is their biggest retirement asset. In retirement, people can cash in on the value of their homes by selling them and then either buying less expensive houses, renting or moving in with their children. More people are also using reverse mortgages to extract equity from their homes in retirement. But the recent real estate bubble and long-run housing data show why relying upon home equity for retirement is a risky endeavor. Yale economist Robert Shiller looked closely at the history of home prices since 1890 and found that except for two spectacular booms – the first after World War II and the second starting in 1998 – real estate appreciation has been unimpressive after figuring in inflation.[9] Moreover, with millions of mortgages "underwater,"[10] the prospects for having a lot of home equity to use for retirement have worsened dramatically.

Concerns and problems with these traditional retirement funding mechanisms mean that more retirees and near-retirees will need to rely upon their personal savings to get by – whether in defined contribution plans such as 401(k)s and IRAs or in other available savings alternatives. Based upon a variety of sources, including the National Retirement Risk Index, calculated by the Center for Retirement Research at Boston College, it is clear that we are not saving nearly enough for retirement. Indeed, a record 51% of U.S. households are now considered at risk of not having enough money to sustain their standard of living in retirement. Explicitly including health care in the index drives up the share of households at risk to 61% and incorporating long-term care costs further increases the index to a whopping 65%. The analysis "clearly indicates that this nation needs more retirement savings," the center's report says.[11]

Since we all tend to deal with the world less as it *is* than as we *wish it to be*, far fewer than those acutely at risk may even recognize that they have a problem. Even so, the 2009 Retirement Confidence Survey from EBRI shows that only 54% of Americans surveyed are "somewhat" or "very confident" that they will have enough money to live comfortably in retirement, down from 61% just a year earlier and 70% two years prior. And according to the 5th annual Wells Fargo Retirement Fitness Survey, those 50-59 years of age expect to spend 10% of their assets per year in retirement, an amount that is obviously unsustainable, and expect their savings to grow 8.7% per year, an amount that is far higher than any investor has a reasonable right to expect.[12]

> "**65% of U.S. households are now at risk** of not having enough money to sustain their standard of living in retirement."
> —The Center for Retirement Research at Boston College

There is hope, however.

Finding Solutions to the Retirement Crisis

Americans' increased reliance on defined contribution pension plans and personal savings, and the trend away from defined benefit pension plans and other guaranteed sources of retirement income raises serious sustainability challenges. A study prepared by Ernst & Young on behalf of the non-profit Americans for Secure Retirement entitled Retirement Vulnerability of New Retirees has found that those with guaranteed retirement income beyond Social Security, such as income annuities, are much better prepared for and in retirement. It also found that middle-income Americans entering retirement without a guaranteed source of income beyond Social Security, such as an annuity, will, on average, have to reduce their standard of living by 32% to minimize (but *not* guarantee) the likelihood of outliving their assets. This reduction will be necessary even when assuming that retirees can maintain the same standard of living with income equal to only 59-71% of their pre-retirement wages.

The problem only gets worse with time. The study also found that the next wave of retirees (5-10 years from now) will have an even higher risk of outliving their financial assets than those currently at retirement age.[13] *That's why income annuities are so vital.* As the report states:

"Without additional guaranteed lifetime income streams, such as income provided by an annuity, middle-income Americans are at high risk of outliving their financial assets and living their final years in poverty."[14]

The New Retirement Challenge, a study by Prof. Jeffrey R. Brown of the University of Illinois on behalf of ASR, reaches a similar conclusion:

"[T]omorrow's retirees will need access to an additional, reliable source of guaranteed retirement income. Financial products are available to help ensure that an individual can have adequate income at advanced ages, even if she lives to age 100 and beyond. In particular, *life annuities* provide a guaranteed source of monthly income that cannot be outlived."[15] (Emphasis in original).

"**Without additional guaranteed lifetime income streams**, such as income provided by an annuity, middle-income Americans are at high risk of outliving their financial assets and living their final years in poverty."

—Retirement Vulnerability of New Retirees, a study prepared by Ernst & Young on behalf of the non-profit Americans for Secure Retirement

As always in financial planning, there is no singular, one-size-fits-all solution to a given set of circumstances. Yet we would surely all be better served by saving more for retirement and for the retirement planning crisis we face, income annuities are our best and most powerful retirement planning tool. Nearly every retirement solution demands the use of an income annuity.

1. Almost every retiree needs an annuity

In the overwhelming number of cases, the proper question isn't whether or not retirees should purchase an annuity, but rather how much of their assets they should use to purchase an annuity. Retirement requires cash flow. With so many retirees needing more cash than Social Security provides and with pensions provided by defined benefit plans going the way of the dinosaur, providing adequate cash flow efficiently is a crucial objective for good retirement planning. That usually requires an annuity, as the experts agree.[16]

Indeed, experts who agree on little else have collectively concluded that income annuities need to play a crucial role in retirement and that they are seriously underutilized. As noted by Prof. Babbel of Wharton:

"I have reviewed over 70 academic studies that have appeared since 1999, analyzing lifetime income annuities vs. other alternatives, and coauthored another major study. . . . The consensus of the literature from professional economists is that lifetime income annuities should definitely play a substantial role in the retirement arrangements of most people. How great a role depends on a number of factors, but it is fair to say that for most people, lifetime income annuities should comprise from 40% to 80% of their retirement assets under current pricing. Generally speaking, if a person has no bequest motive, or is averse to high risk, the portion of wealth allocated to annuities should be at the higher end of this range."[17]

As another Wharton study points out:

"[E]conomists have come to agreement from Germany to New Zealand, and from Israel to Canada, that annuitization of a substantial portion of retirement wealth is the best way to go. The list of economists who have discovered this includes some of the most prominent in the world, among whom are Nobel Prize winners. Studies supporting this conclusion have been conducted at such heralded universities and business schools as MIT, The Wharton School, Berkeley, Chicago, Yale, Harvard, London Business School, Illinois, Hebrew University, and Carnegie Mellon, just to name a few. The value of annuities in retirement seems to be a rare area of consensus among economists."[18]

Good planning typically looks to secure a retiree's cash flow needs using a portion of total assets. A retiree who is afraid of dying before the actuarial tables suggest ought to consider obtaining life insurance or including a "period certain" on an income annuity, which guarantees payment for a set period of years (most often, 10) irrespective of death (in exchange

for a lower monthly check). Accordingly, those who want to be sure that they will have sustainable lifetime income must make sure that they get the guarantees that annuities provide. Otherwise, their financial well-being depends, in effect, upon a roll of the dice. One might win, as those who oppose annuities hope. But others will lose, and the results of losing in this way are catastrophic – being broke and wholly dependent upon others for survival.

On account of this ongoing and growing problem, the federal government has said that it wants to find ways to encourage people to invest at least part of their retirement savings dollars in annuities, so they can be assured of a steady stream of income for the rest of their lives. U.S. Labor Secretary Hilda Solis outlined her top regulatory goals for 2010 in a webcast in January, and increasing public awareness about the need for annuities stood out in her remarks. "Increasingly, retirees will have to live on lump sum distributions from 401(k)-type plans," Solis said. "This increases the likelihood that they will run out of assets during their retirement years. Our goal is to reduce the chance that workers will outlive their retirement by increasing public awareness of the need for annuities, and encourage employers to offer annuities as an option."[19] Independent academic and government experts all agree on the value and importance of annuities.

2. Alternatives to an annuity are far riskier

Some retirement planners abide by what they call the "4% rule," which holds that if a retiree invests in a portfolio (50-60% stocks and 40-50% bonds), the retiree need not purchase an annuity and can initially withdraw 4% of the assets to provide income, increase that amount in subsequent years to keep pace with inflation, and still have what is claimed to be a 90% probability of their money lasting over a 30-year retirement. The proponents of this approach assert that it is a conservative one, but it is not and has obvious major flaws. Most fundamentally, such income is not guaranteed. Indeed, it is often unsustainable.

Losses in the early years of retirement, tacked on to regular withdrawals, raise the chances of failure dramatically. T. Rowe Price has done some good research in this area,[20] based upon a 55% stocks/45% bonds portfolio and 4% annual withdrawals, rising with inflation. The study concludes that with negative annualized returns for the first five years of retirement, there is a whopping 57% chance of running out of money within 30 years. Moreover, such significant losses are not as aberrational as some might think, as *The Wall Street Journal*, among others, has pointed out.[21]

When these "black swan" events happen early-on during retirement in an individual retiree's portfolio which is also providing income, the personal costs are often catastrophic. The crucial risk to investing in stocks isn't the chance that a retiree's rate of return might vary from historical averages; it is the possibility that stocks might wipe him or her out. That risk never goes away, no matter how long the investor stays in the market. A longer horizon provides more opportunities to recover from "extreme market conditions," but it also provides more opportunities to experience them. It's when the hypothetical becomes real that the magnitude of the problem becomes especially clear. Working with portfolio probabilities is fine – until the negative and failure statistics have names and faces. Since the retiree's life and livelihood are at stake, a failure rate of 10% is much too high to accept. How many homeowners would forego fire insurance if the chance of a devastating fire was "only" 10%? Moreover, a better handle on the actual statistics suggests that the failure rate may be much higher than 10%. That's why insurance guarantees make so much sense – retirees should guarantee the income they really need through the use of an income annuity.

3. Quantifying the risks

(a) *Don't ignore inflation.* Most purported "analysis" in this area assumes a flat income withdrawal over the full term of retirement and doesn't account for inflation. The T. Rowe Price research in this area, referenced above, uses an annual inflation rate of 3%, which is lower than historical inflation.[22] As the Wharton study noted previously advises, an annuity can and should be purchased to guarantee retirement income; this annuity can and should be inflation-protected.[23] They are readily available from many carriers.

(b) *Don't ignore longevity risk.* Most retirement planning scenarios and analysis assume a 30-year retirement. But what if it lasts longer? Actuarial tables suggest that the likelihood of a longer retirement is surprisingly high, even without anticipating what medical advances might be made going forward.[24]

Today there is a 23% chance that at least one member of a 65-year-old couple will live to age 95. And with improving health care, even more people will live to 95 and beyond in the future, according to the Society of Actuaries. Indeed, a recent analysis of data from more than 30 developed countries reveals that death rates among people older than 80 are still falling. In 1950, the likelihood of survival from age 80-90 was 15-16% for women and 12% for men, compared with 37% and 25%, respectively, in 2002, and there's no sign of this longevity growth slowing down.[25] As the Ernst & Young study referenced above demonstrates:

"Households approaching retirement face an environment where the possibility of living to age 90 or 100 and the volatility of inflation and investment returns put them at high risk of outliving their assets. This study shows that the presence of a significant guaranteed lifetime income stream beyond Social Security can help. Increased focus on both increased retirement savings and the importance of a guaranteed lifetime income stream will reduce the retirement vulnerability of retirees in the future."[26]

(c) *Don't ignore market risk* (or assume a given annual return). A key problem with hypothetical modeling is that it still assumes historical data going forward (*e.g.*, stocks will earn 10% and bonds will earn 6.5%), while mixing up the return sequences. As the commercials say, past performance is not indicative of future results. There is no reason to expect that historical return assumptions will continue to hold up. One can readily anticipate multiple scenarios actually much worse than the historical averages over significant periods of time. Indeed, the most recent *Quantitative Analysis of Investor Behavior* from Dalbar, Inc., issued in March, 2010, found that over the most recent 10-year period, despite a 32.2% gain by the S&P 500 in 2009, both the index and the average stock investor actually ***lost money*** on an annualized basis.[27] Moreover, the glowing projections of future market gains, so prevalent in the financial industry, typically don't take costs into account, meaning that a retiree needs a return significantly higher than the assumed return actually to get the assumed return. Indeed, dramatic predictions of "doom and gloom" pale in comparison to *bona fide* reasons to be worried. We'd all love for the market to become a juggernaut again (perhaps due to some great new unforeseen technology, or a fix for global warming, or…). But as baby boomers age, they will be taking money out of the system rather than putting it in, which suggests a lessening of demand and some long-term price pressure on the market. Huge projected deficits, expanding Medicare, Medicaid, health care and Social Security costs, together with exploding debt may well be a major drag on the economy. Propping up poor performing companies isn't likely to help either, despite the jobs it saves in the near-term. We simply cannot know what the future holds. Retirees should not bet their lives on the presumption that the market will perform well into the future. A guaranty of sustainable lifetime income is a much safer and better approach.

(d) *Don't ignore "investor risk."* Assuming that an investor can get a presumed level of return even in generally favorable markets is a fool's bargain. The annual *Quantitative Analysis of Investor Behavior* from Dalbar, Inc. (referenced above) routinely demonstrates that the average investor earns significantly less than mutual fund reports suggest. The most recent report found that while the S&P 500 showed an average annual gain of 8.20% over the most recent 20 year period, the average equity investor only earned a paltry 3.17% over that same time frame.[28] Like Yogi, we all like to think that we're *smarter than the av-erage bear*. But the stark reality is that most investors dramatically underperform the market, and those failures conclusively establish that financial vehicles with guarantees are the smart play for the vast majority of retirees, especially when the costs of failure are so high.

(e) *Don't ignore "return sequence risk."* Typical retirement planning return scenarios are dangerous because they smooth out volatility. Indeed, assuming any *average* annual return is very deceptive because the *sequence* of returns matters so much when a portfolio is providing income.[29] If a retiree underperforms early and outperforms later to get to a presumed average return, that retiree will be left with much less money than the typical analysis assumes, with a dramatically higher failure rate. A new retiree who decides to follow such advice and not use an annuity to guaranty sustainable lifetime income before the recent market meltdown would have seen his or her dreams shattered by suffering losses to the account balance so early in retirement, while eroding the account value by taking income over the same period. Once that kind of downward spiral begins, it's exceedingly dif-

ficult to get out due to the "arithmetic of loss" (a 10% loss coupled with a 5% income distribution at year-end requires a 17.6% return just to get back to break-even, a 25% loss coupled with a 5% income distribution at year-end requires a 42.9% return to get back to break-even...). With a big cushion, an investor is almost surely an economic loser without some sort of guarantee. Without a big cushion, a new retiree is most likely already in huge financial trouble and looking for a job again. That isn't the retirement most people have envisioned and surely isn't the retirement anyone wants.

4. Don't make a major estate planning mistake

Some claim that ignoring annuity guarantee options and relying upon the market alone makes sense from an estate planning perspective when retirees want to pass some assets on to their children and grandchildren. They assert that with the immediate life-only annuity, they lose that right.

Such scare tactics are foundationally erroneous, because good planning doesn't purport to place all or nearly all of a retiree's assets into an income annuity. Rather, using some of one's assets to provide an income guarantee is particularly useful for an investor looking to maximize wealth for inheritance. The view that one should continue to play the market and self-fund income needs can only work in the unlikely event that the retiree guesses right in terms of investment choices and guesses right in terms of life expectancy. Because of longevity risk, the portfolio selected by such a self-funder needs to be conservative enough so that the portfolio doesn't crash and burn. Many investors ignore that issue and focus, as they so often do, exclusively upon return.

By affecting a "lock-in" of income needs with a portion of the entire portfolio, a retiree can guarantee sustainable income for life; the retiree can also do a better job of creating an inheritance since the cash flow needs cannot eat up the full portfolio. That means that the retiree won't have to risk becoming destitute, and relying upon those to whom the proposed legacy was designed just to get by. That's not the way most people want to be remembered and another reason why it makes such good sense to put guarantees in place. Moreover, since this lock-in can be accomplished with 25-40% less capital than the self-funding approach, doing so will provide more money for the retiree to work with, allowing for much more investment freedom with the non-guarantee balance and leaving a much bigger legacy for future generations.

Conclusion

Effective retirement planning requires meaningful risk management and, even more importantly, risk avoidance. That means it can't be a "wish and hope" strategy. The plan actually has to work. Simply put, retirees and near-retirees must avoid the mistake of risking what they cannot lose.

During the "retirement transition window" (5-10 years on either side of retirement), it is more important to avoid mistakes than to reach for the highest investment returns. The key risk during this period is a deviation from purpose. Like Odysseus passing the Sirens and hearing their enchanting songs, investors during this time need to be "tied to a mast" to protect them from giving in to the temptation to seek "just a little bit more" return. Put another way, retirement planning has two key objectives, which are often in competition: to maximize the rewards of success and to minimize the consequences of failure. During the retirement transition window, at least, the second must take priority over the first. Accordingly, during this time period, return *of* capital must trump return *on* capital.

If there could be doubt about the need for guaranteed income vehicles generally, the recent market turmoil has clearly established that there is much more to obtaining a secure retirement than merely accumulating a large retirement savings nest egg. True retirement security requires a sustainable strategy for preserving that nest egg and allocating it in such a way as to meet its owner's goals, plans and dreams. Such a strategy demands the use of income annuities for nearly all retirees. Those approaching retirement with substantial retirement savings ought to consider preparing for retirement and preserving their principal through the use of a deferred annuity, which may be annuitized upon retirement to guarantee a sustainable income that cannot be outlived.

The needs of the future suggest that greater risk, greater uncertainty and greater volatility are all likely.

We will be forced to navigate new and unforeseen challenges going forward in a more complex and interconnected world. Annuities provide a powerful foundation for any retirement portfolio and are crucial for providing a guaranty of sustainable retirement income for life in an efficient manner. Those who claim otherwise are simply shoveling smoke and should not be countenanced. Good financial planning demands that income annuities become and remain a crucial imperative. Every retiree needs the sustainable lifetime income annuities provide.

Robert P. Seawright, J.D.

Robert is *Director of Suitability, Compliance & Legal Affairs* for Asset Marketing Systems in San Diego, California and a frequent writer on financial planning and related matters. He was educated at Duke University, where he received his J.D. in 1981. He holds securities and insurance licenses as well as a number of industry designations.

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