Perspectives

The 4 C's℠ of **successful retirement income strategies**

Allianz Life Insurance Company of North America
Allianz Life Insurance Company of New York

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Table of contents

Introduction – A framework for income planning strategies 1

Clarity – gathering facts 4

Comfort – determining wants and needs 6

Cost of living – evaluating inflation impacts 10

Certainty – delivering solutions 12

Please note: This document was accurate at the time of release and reflects the responses and interpretation of findings for that period in time. For more information on this and other studies, please visit our website at www.allianzlife.com or www.allianzlife.com/new-york.

The 4 C's℠ of successful retirement income strategies

Introduction – A framework for income planning strategies

Retirement today looks and feels very different than it did for previous generations. As the financial landscape continues to shift, so must the way Americans think about money and retirement. People nearing retirement need to be ready to take control of their financial futures; for many, this involves working with a financial professional to plan income strategies.

Plan for the
TRANSITION PHASE
five to 10 years before retirement.

For financial professionals, working with consumers who are approaching the income phase of retirement can be rewarding because their clients are reaching the end of a long road of sacrifice and commitment. At the same time, it can be challenging because the income planning process is often overwhelmingly complex.

One way to approach a seemingly complicated decision process is through the use of a simple framework, such as the "4 C's," devised by the diamond industry to assist consumers in systematically identifying the various attributes of gems. Each of the 4 C's – clarity, color, cut, and carat – describes aspects of the quality of a gem and impacts its value and price.

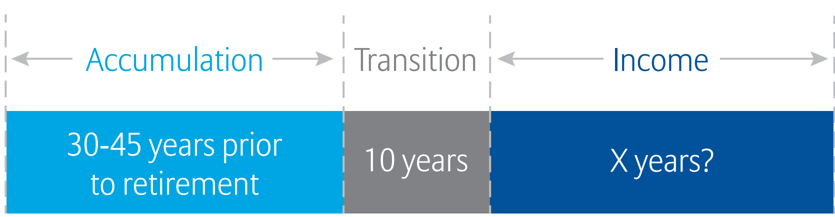
Over time, the diamond industry *trained* consumers to think about diamonds using its 4 C's framework. Descriptive and easy to remember, the 4 C's created a framework for understanding this substantial, infrequent, and often emotional purchase.

The 4 C's framework is brilliant in its simplicity and its ubiquity; as a tool, it breaks down a complex concept (i.e., judging the quality of diamonds) into simpler and easier-to-remember pieces. It does all of this without advocating any particular brand or manufacturer.

With millions of baby boomers transitioning to retirement each year, the financial industry could benefit from a retirement income framework modeled after this simple, descriptive, and memorable concept – one that identifies the critical retirement questions facing consumers.

Before diving into the 4 C's, it is worth reviewing retirement planning at a macro level. The financial planning industry has traditionally divided retirement planning into two phases – the accumulation and income phases. But what is often missing is an important third phase in between these two called the "transition phase" that is roughly five to 10 years before retirement.

EXAMPLE:



The 4 C's can help in the pivoting process from **ACCUMULATION TO INCOME.**

Many financial professionals have worked diligently and successfully to help their clients through the accumulation phase. But few have consciously navigated clients through this crucial transition phase – a period when putting together the building blocks for long-term guaranteed income in retirement is so important.

Below is a snapshot of how objectives change in the income phase of retirement. The transition phase is an ideal time to begin the pivoting process from accumulation into income.

The 4 C's is a helpful framework to think through and build what is needed during this transition phase, a period that was labeled "The Great Transition" in the *Journal of Financial Services Professionals* (January 2012).

	ACCUMULATION PHASE:	**INCOME** PHASE:
FINANCIAL OBJECTIVE:	Have enough money to retire	Not outlive assets
ASSET ALLOCATION:	Investment strategy allocation	Withdrawal strategy allocation
TIME HORIZON:	Known to retirement	Unknown life expectancy

The 4 C's revolve around a person's needs, wants, **CONCERNS, AND ATTITUDES.**

The 4 C's℠ of retirement income strategies

Like its diamond counterpart, the 4 C's retirement income strategies framework provides an uncomplicated process to help individuals ask questions and – with the help of a trusted financial professional – work through the complexities of retirement income planning. The retirement version would use the following 4 C's:

1. Clarity
2. Comfort
3. Cost of living
4. Certainty

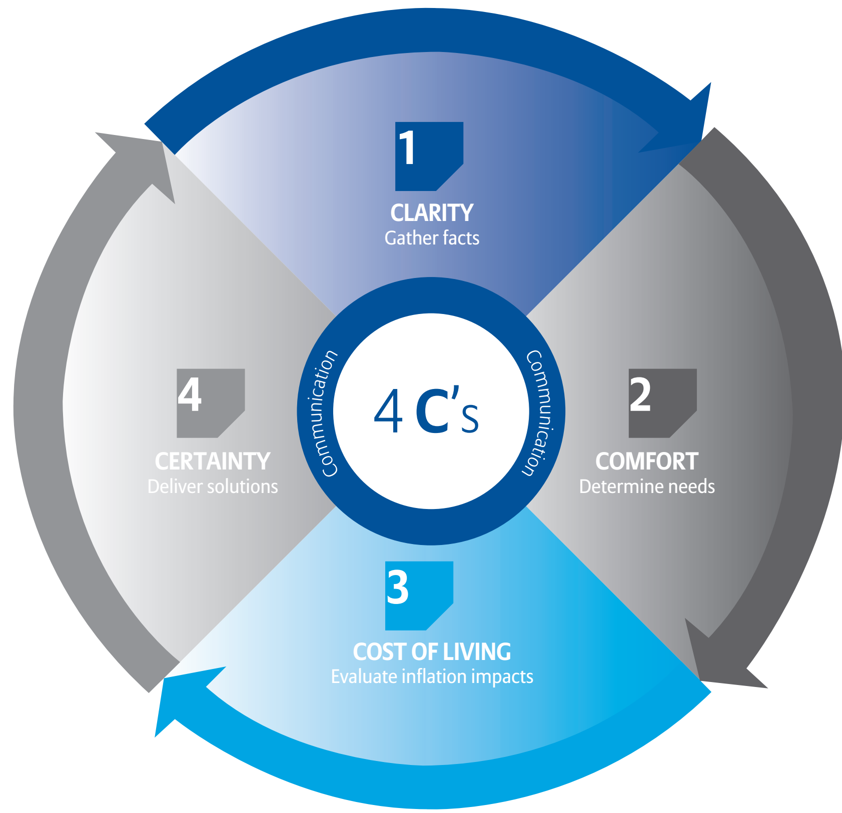
As consumers and financial professionals work through the list, the conversation naturally orients around the person's needs, wants, concerns, and attitudes, all of which are important aspects of choosing a retirement income strategy.

The 4 C's framework is progressive. Starting with clarity, the fact-gathering part of the process, individuals look at the realities of today and then address some basic questions about their future.

Comfort, the second of the 4 C's, involves identifying the desired lifestyle for what could be multiple decades of retirement living.

The next C, cost of living, evaluates the impact of inflation on retirement savings. While inflation is beyond the control of any individual, it is a tangible risk that will erode personal savings.

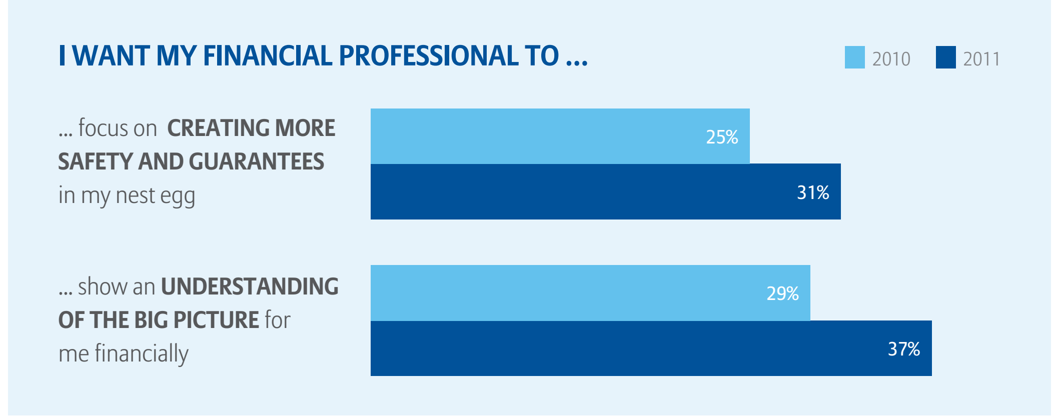
Certainty, the final C in the framework, identifies solutions based on proven data. By accepting the financial realities, clients can live with the knowledge that their short- and long-term retirement income strategies may be realistic and manageable.



1 Clarity – gathering facts

Clarity involves gathering facts, allowing the financial professional to paint a picture of how overall assets saved during the accumulation phase of a client's financial strategy will come together to fund retirement. Consumers typically want to be clear on the sources of present and future income and how that income flow will continue. They also need to hear how longevity, inflation, and other risks could affect their retirement savings. This is where the knowledge and experience of a trusted financial professional are invaluable, especially when placed in a readily understood framework.

In a 2011 Allianz Life Insurance Company of North America (Allianz) study, when asked what they most wanted from their financial professional in the context of today's volatile market environment, 439 survey respondents (ages 44 to 75) listed *creating more safety and guarantees* along with *understanding the financial big picture* as their top "wants." In fact, between 2010 and 2011 these responses increased by 6% and 8%, respectively.[1]



Source: Allianz Life Insurance Company of North America, The Allianz ***Reclaiming the Future*** Study: One Year Later, 2011.

[1] Allianz Life Insurance Company of North America, The Allianz ***Reclaiming the Future*** Study: One Year Later, 2011.

As retirement approaches, financial professionals provide value by helping shift clients' perspective from accumulation to income. They discuss investment objectives, portfolio strategies, and time horizons appropriate for individuals transitioning to retirement.

By answering these basic questions, individuals can better understand their evolving financial objectives and strategies. With clarity achieved, individuals can then focus on comfort, or what they will want and need in retirement.

FINANCIAL PROFESSIONALS SHOULD ALSO ASK KEY "CLARITY" QUESTIONS:

- **HOW MUCH** income do you need in retirement?
- **WHAT SOURCES** of guaranteed income do you already have?
- What is your **RISK TOLERANCE**?
- **HOW MANY YEARS** could you live in retirement?
- **DO YOU WANT TO LEAVE** anything to your heirs or organizations?

Bringing **clarity** to financial needs and desires helps consumers better plan for retirement.

[1] Allianz Life Insurance Company of North America, The Allianz ***Reclaiming the Future*** Study: One Year Later, 2011.

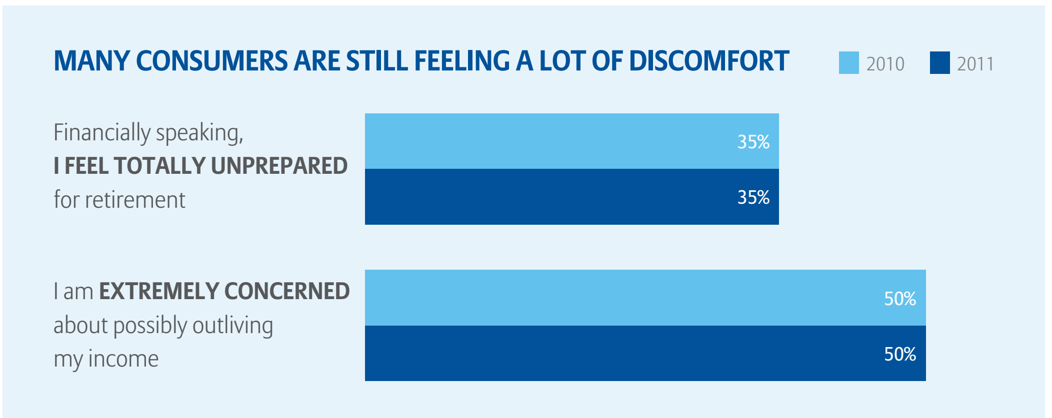
Comfort – determining wants and needs

50%
OF BOOMERS
are extremely concerned about outliving their income.[1]

Comfort, the second of the 4 C's, is emotional, personal, and at the heart of determining wants and needs in retirement. Individuals do not want retirement to force changes to their lifestyle due to monetary concerns. They want to live comfortably.

Most importantly, they want their money to last. Thirty-five percent of baby boomers surveyed felt totally unprepared for retirement and 50% were extremely concerned about the possibility of outliving their income.[1]

These dramatic results show that many consumers are feeling considerable discomfort when it comes to their retirement readiness.

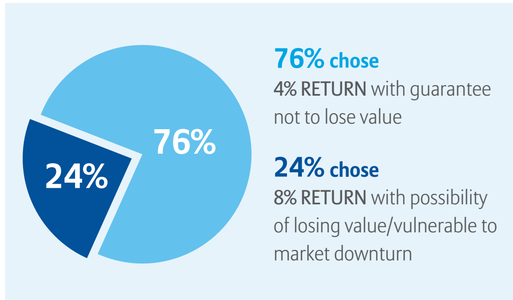


Source: Allianz Life Insurance Company of North America, The Allianz ***Reclaiming the Future*** Study: One Year Later, 2011.

The survey also asked the baby boomers to choose between two products: one with an 8% return, but with the possibility of losing value and being vulnerable to market downturn; and another with a 4% return, but guaranteed not to lose value. Comfort won out with 76% of the respondents choosing safety with a guaranteed option over return.[1]

Given previous volatile markets and economic environments, consumers clearly want the comfort of a guarantee.

COMFORT IN RETIREMENT, SAFETY OVER RETURN



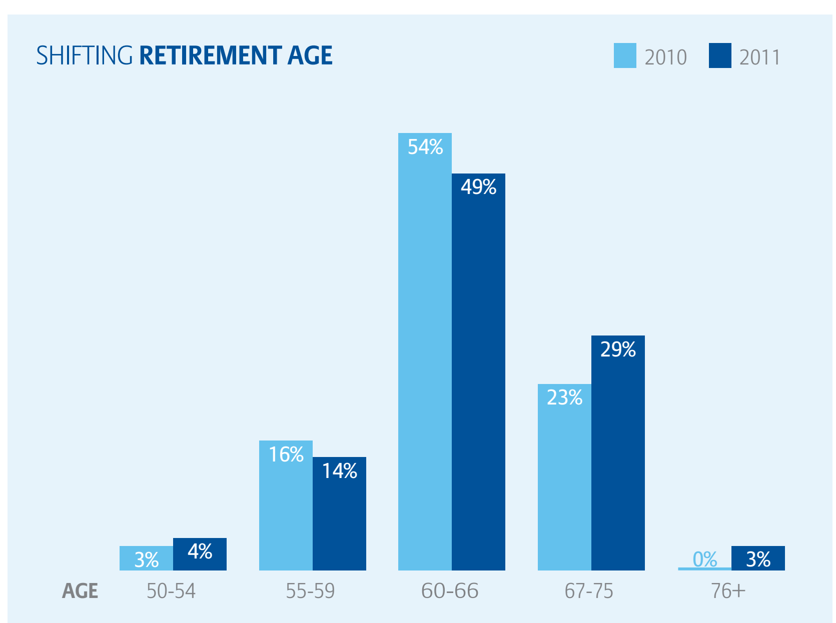
Source: Allianz Life Insurance Company of North America, The Allianz ***Reclaiming the Future*** Study: One Year Later, 2011.

[1] Allianz Life Insurance Company of North America, The Allianz ***Reclaiming the Future*** Study: One Year Later, 2011.

Many are
SHIFTING RETIREMENT
from age 60-66 to age 67-75.

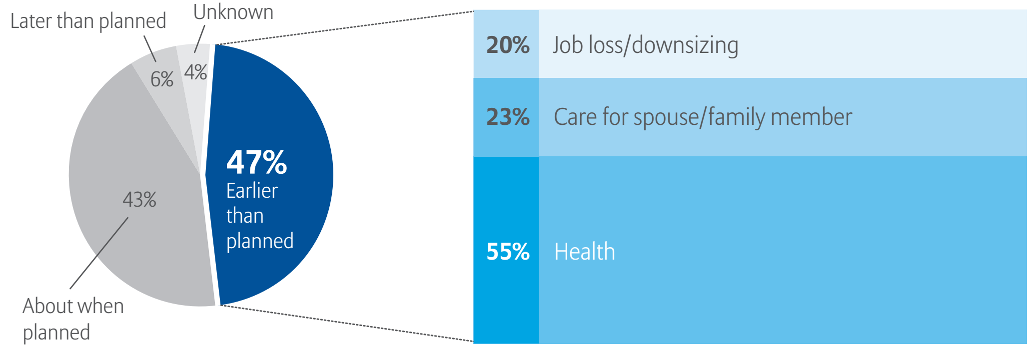
Today, a growing number of people are delaying the age at which they expect to retire. They are extending their worklives for a variety of reasons. For some, including a sizeable segment of baby boomers, a shortfall in retirement savings is the prime motivator for working beyond age 66. These boomers may have come to terms with the fact that they will have to work longer. They believe (perhaps mistakenly) that more years in the workplace will translate to increased comfort in retirement and offset insufficient planning or adverse market conditions.

While delaying retirement may seem like a logical backup plan to shore up retirement savings, it is actually fraught with risk. Adverse economic conditions, job loss, health concerns, and family issues often force retirement before a person expects it.



Source: Allianz Life Insurance Company of North America, The Allianz *Reclaiming the Future* Study: One Year Later, 2011.

DELAYING RETIREMENT IS NOT A BACKUP PLAN



Source: "The 2013 Retirement Confidence Survey: "Perceived Savings Needs Outpace Reality for Many," Employee Benefit Research Institute Issue Brief, March 2013, N. 384.

A study by the Employee Benefit Research Institute (EBRI) found that 47% of retirees retired earlier than they had planned. 55% of those retirees were compelled to retire due to their own poor health, 23% retired early to care for a spouse or another family member, and 20% retired early due to a job loss or downsizing.[1] This demonstrates why it may be a mistake for pre-retirees to assume they will be able to work longer.

Many retirees are extremely fearful of outliving their money, so they work with their financial professionals to carefully project how much they'll need in the future. Popular financial planning wisdom says that without the costs associated with day-to-day work (e.g., commuting, daily lunches, wardrobe expenses, etc.), retirees will save money – about 20% of their pre-retirement expenses. But this doesn't always happen.

[1] "The 2013 Retirement Confidence Survey: "Perceived Savings Needs Outpace Reality for Many," Employee Benefit Research Institute Issue Brief, March 2013, N. 384.

Identifying a consumption gap

Pre-retirees often underestimate their **RETIREMENT INCOME NEEDS.**

An accurate sense of a person's needs and wants is required to credibly project how much money it will take to achieve comfort in retirement. Pre-retirees who estimate retirement income from a formula that combines today's expenses and tomorrow's wishes often find themselves facing a shortfall.

A more conservative approach puts today's income – not expenses – at the forefront. First, multiply pre-retirement *income* by 70% to 80%. This figure is the foundation for retirement spending (i.e., expenses). Next, deduct guaranteed sources of income, including annual Social Security, annuity, and/or pension income. The remaining amount is the consumption gap (or surplus).

A hard look at income data minus projected guaranteed income sources can identify a practical, specific dollar amount for retirement needs that the planning process must address.

Retirees seek the **comfort** of knowing their income will support their choice of lifestyle.

Retirees want the comfort of knowing that their income will be sufficient to meet their needs and wants throughout their lifetime. It is common for individuals to adapt their lifestyle over time to accommodate retirement living, but changes should always be initiated by choice, not by lack of choice or fear of the future.

Feeling financially secure, regardless of market and economic conditions, is among retirees' top concerns. Retirement income planning with the help of a trusted financial professional can help individuals define and achieve comfort in retirement. Thoughtful income strategies can also fend off some threats to comfort in retirement, including the risk of rising inflation.

Cost of living – evaluating inflation impacts

As retirees' purchasing power diminishes, SO CAN THEIR **QUALITY OF LIFE.**

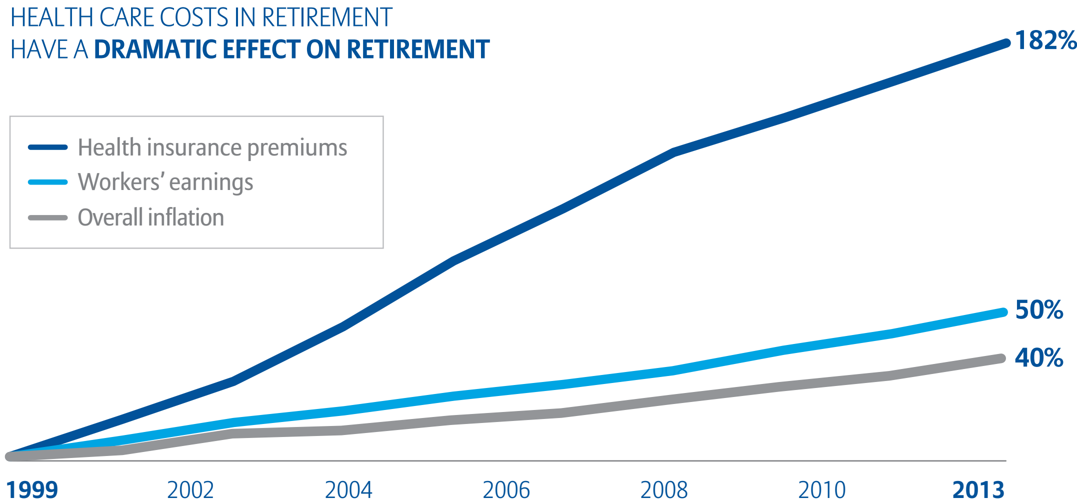
Cost of living, the third of the 4 C's, gauges the impact of inflation on retirees' savings. Inflation is a persistent and measurable rise in the general level of prices. While this definition is simple, inflation is not. Inflation is a complex economic concept that not only fuels cause-and-effect debates among economists and market pundits, but also kindles uncertainty among investors and consumers.

At the consumer level, inflation hurts savers and people with cash balances. Inflation will chip away at the purchasing power of the retiree dollars over time, perhaps a period of decades. Without actively managing this very real risk, retirees may see purchasing power – and perhaps quality of life – diminish over the course of retirement.

The meteoric jump in the cost of health care in recent years has also caused considerable angst for retirees since, as people age, their health care expenses tend to rise.

Over the 14 years depicted in the chart below, inflation increased by approximately 3% each year, eroding purchasing power by 40%; during the same period, workers' earnings increased by 50%. But the most telling data traces the cost of health care premiums. Within that same time period, health insurance premiums increased by 182% for consumers, far outstripping their rise in wages.

HEALTH CARE COSTS IN RETIREMENT HAVE A **DRAMATIC EFFECT ON RETIREMENT**



Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999-2013. Bureau of Labor Statistics, Consumer Price Index, U.S. City Average of Annual Inflation (April to April), 1999-2013; Bureau of Labor Statistics, Seasonally Adjusted Data from the Current Employment Statistics Survey, 1999-2013 (April to April).

Spending patterns for retirees

The Consumer Price Index, familiar to Americans as the most widely used measure of inflation, is known as the CPI. The CPI-U represents the spending habits of the urban or metropolitan area population, which is about 80% of the population the United States. However, for several decades, the Bureau of Labor Statistics, an agency of the Department of Labor, has also calculated an *experimental* Consumer Price Index, the CPI-E, representing Americans 62 years of age and older. These two indexes clearly show the difference in spending patterns over time between the general population (CPI-U) and seniors (CPI-E). Seniors spend more in categories most affected by inflation (medical care and housing). According to the U.S. Department of Labor, Bureau of Labor Statistics, from 2000-2010, medical care inflation increased more rapidly than other goods and services over that same period (5.6% annually for medical care compared to 2.9% for other items). In addition, older Americans spend relatively more on shelter, which during that same time period has modestly outpaced overall inflation.[1]

Because inflation can be a substantial risk to individuals nearing and in retirement, financial professionals increasingly face the challenge of helping their clients manage the impact of inflation on retirement assets. Strategies to consider include diversifying assets to minimize inflation risk and allocating a portion of assets to products that offer inflation-protection features.

Keeping pace with the effects of inflation

Some guaranteed income sources provide a cost-of-living adjustment (COLA) to help keep up with inflation. However, many retirement-savings vehicles, including 401(k)s, personal savings, and most private pensions, offer no inflation protection. Even Social Security has, at times, forgone annual cost-of-living increases. Without periodic COLAs, keeping up with inflation is placed solely on the shoulders of retirees. For that reason, retirees should consider shifting some assets to a financial vehicle that provides some inflation protection.

Spending patterns

	Spending All ages: CPI-U, 2011*	**Spending** Seniors: CPI-E, 2011*
Food/beverage	15.0	12.8
Housing	40.2	44.5
Apparel	3.5	2.4
Transportation	16.5	14.5
Medical care	6.9	11.3
Recreation	5.9	5.3
Education	6.7	3.8
Other	5.3	5.4

*"CPI relative importance for selected expenditure groups, December 2011 (based on 2009 – 2010) Consumer Expenditure Survey weights," CPI Detailed Report, March 2012.

Over time, inflation's effect on **cost of living** can diminish retirees' purchasing power – and possibly their quality of life.

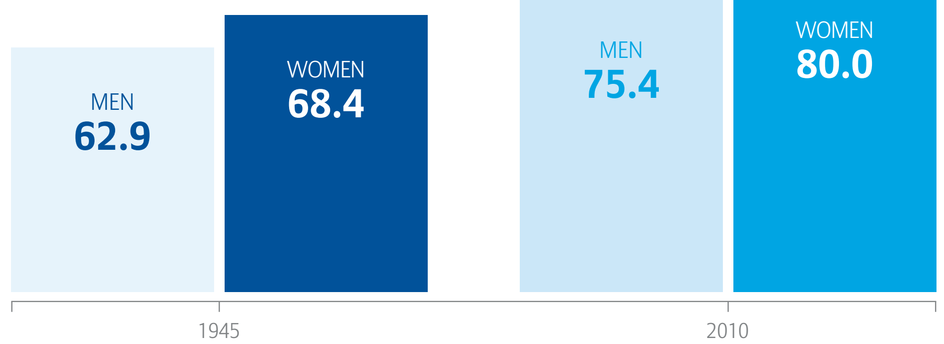
[1] AARP, The Effects of Rising Healthcare Costs on Middle Class Economics Security, 2013.

Certainty – delivering solutions

The last of the 4 C's is certainty, or managing those things we know to be true about the future. As people approach retirement, there are two certainties. First, people are living longer. Second, there will be market volatility.

Life expectancy in America has steadily increased for both men and women. In 1945, American women lived an average of 68.4 years and men 62.9 years. In 2010, life expectancies for women and men, respectively, were 80 years and 75.4 years.[1]

LONGER LIFE EXPECTANCY



Source: Life Tables for the United Sates Social Security Area 1900-2010 – Actuarial Study No. 120.

People are living longer than before, so the length of time spent in retirement will be longer – considerably longer than many baby boomers are prepared to fund.

[1] Life Tables for the United States Social Security Area 1900-2010 – Actuarial Study No. 120.

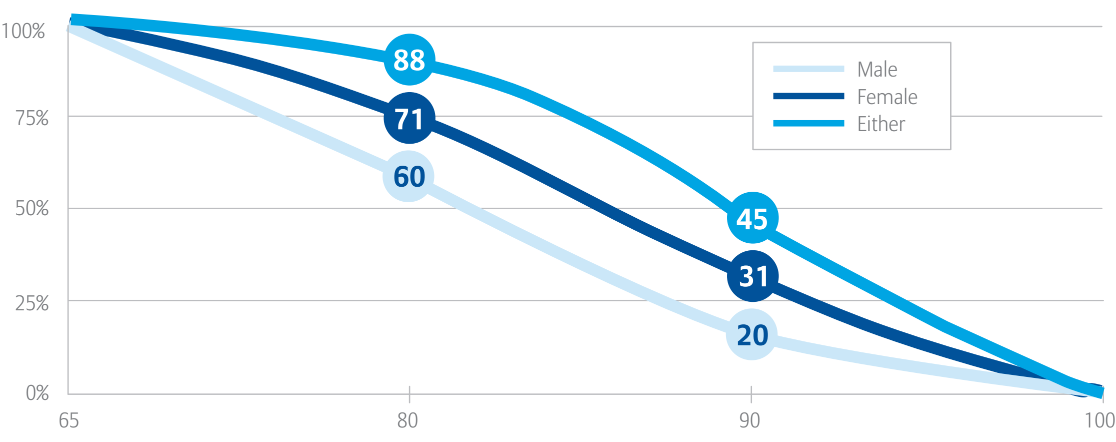
Data shows that for a married couple age 65, there is an 88% chance that at least one of the two will reach age 80, and there is a 45% chance that one will survive to age 90. In other words, that couple faces a one-in-four chance that one of them will be in retirement for three decades or longer.

These illustrations underscore the need to have adequate assets and plans in place that can span a retirement of multiple decades.

How many Americans are prepared to fund **THEIR RETIREMENT** for this length of time?

Retirement will last longer

Probability of 65-year-olds surviving to select ages



Note: "Either" assumes lives are independent.
Source: LIMRA, "The Retirement Income Reference Book," 2012, 77.

Extreme volatility is one reason consumers may be looking at **THEIR PORTFOLIOS** a bit differently.

Another certainty for people in or nearing retirement is market volatility. Markets are by nature inherently volatile, so some degree of movement is expected, as evidenced by the 20-year performance of the S&P 500® Index. For example, the average annual return of the S&P 500® Index from 1993 to 2012 was 10.01%.[1] Yet the range of returns varied dramatically from 37.6% in 1995 to -37.0% in 2008. Averages do not account for the variability of investment performance.

Given the extreme volatility of recent history within the stock market, many consumers may be looking at their portfolios a bit differently.

As a matter of course, investors – retired or not – should periodically consult with a trusted financial professional about retirement assets. Market volatility and the investor's level of comfort with it should be among the topics discussed. As noted, market volatility is a certainty. When volatility is better understood and clearly anticipated, it can be managed along with other market-related risks.

[1] "The Callan Periodic Table of Investment Returns," Callan Associates, 2013.

The S&P 500® Index measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX and NASDAQ. The weightings make each company's influence on the Index performance directly proportional to that company's market value.

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Sequence of returns

Investors focused on accumulation of retirement savings often have time on their side. They have more time to weather volatile markets. However, for retirees who are drawing down assets or taking income from their holdings, market volatility and its variability on investment performance can have a huge impact.

MARKET VOLATILITY can have a big impact during the distribution phase.

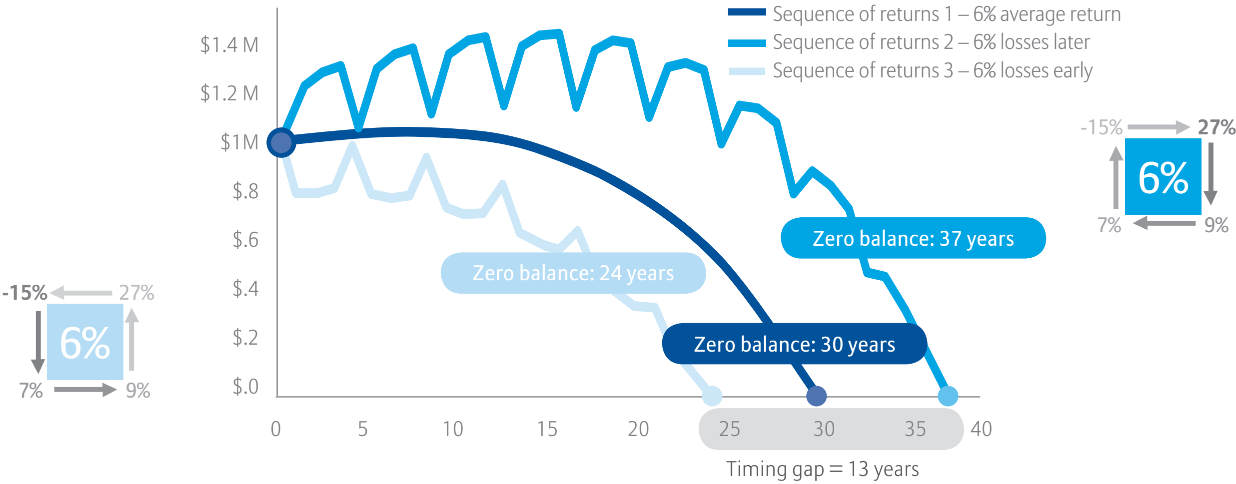
Consider the scenario of a retired couple with a $1 million nest egg, as illustrated in the graph below. The couple plans to withdraw 5% per year ($50,000), adjusted for inflation (3.5%) each year. If the portfolio generates a steady annualized return of 6% each year, the couple could expect their distributions to last for 30 years (see sequence of returns line 1 below).

However, volatility is inherent to financial markets and can have significant impact on short- and long-term performance. How would the couple's expectation of a 6% annual average return fare over 30 years of volatile markets?

It depends on the sequence of returns. Assume four distinct hypothetical rate-of-return values cycling every four years. The four values would show the couple's portfolio earning 27% in year one, 9% in year two, 7% in year three, and -15% in year four. The rotation begins applying these market returns to the portfolio while withdrawing an inflation-adjusted $50,000 per year until the value hits zero (sequence of returns line 2). Then consider the reverse sequence rotation starting with -15%, then 7%, 9%, and 27% (sequence of returns line 3). Just this different sequencing of returns results in a 13-year difference in how long the couple's money could last.

This illustrates the profound impact that sequence of returns can have on retirement savings. Money can run out more quickly than anticipated or could be extended depending on investment performance in the early distribution years. Unfortunately, it is impossible to forecast specific market returns to determine how a distribution strategy could benefit. It is, however, advisable and prudent to manage downside risks associated with sequence of returns.

SEQUENCE OF RETURNS MATTERS FOR INCOME



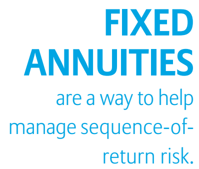
This is a hypothetical example and is not intended to project the performance of any specific investment or index. It is not possible to invest directly in an index. If this were an actual product, the returns would be reduced by certain fees and expenses. Withdrawals are subject to ordinary income tax and, if taken prior to age 59½, a 10% federal additional tax.

Financial professionals can use certain retirement income strategies to provide more certainty to consumers. One option is to convert a portion of the consumer's volatility-prone assets to guaranteed products. This helps manage risk, including sequence-of-return risk, while providing a level of certainty to the consumer.

Managing the sequence-of-returns challenge can play a big part in providing retirees a level of **certainty** that their money will last.

Cost and time considerations

Fixed annuities continue to be a relevant potential solution for consumers wanting to mitigate sequence-of-return risk and also seeking guaranteed income.



As a rule of thumb across the financial industry for fixed annuities, the ratio of the current annuity premium to retirement income amount will factor in cost and time. For example, for every $20,000 paid today into an immediate variable annuity, the qualifying consumer would receive $1,000 in income; that is a ratio of 20 to 1. The ratio shrinks considerably when the time horizon grows. A consumer who buys a fixed annuity, but will not take income for 25 years, will invest $9,000 for every $1,000 received in retirement income, a ratio of 9 to 1.

What is your annuity ratio?

Years prior to income	Ratio of premium ($) to income (ratio +/- 1)
Immediate	20:1
5 years	15:1
10 years	12:1
15	10:1
20	9:1
25	9:1

This is a hypothetical example for illustrative purposes only. All dollars are present-value dollars. This information represents data calculated by Allianz and is intended for discussion purposes only. The information is not a guarantee as to future annuity performance and should not be used to calculate actual annuity returns. **Annuity guarantees are backed by the claims- paying ability of the issuing company.**

Conclusion: the 4 C's of retirement income strategies

A simple 4-step process to begin
PLANNING FOR LIFETIME INCOME.

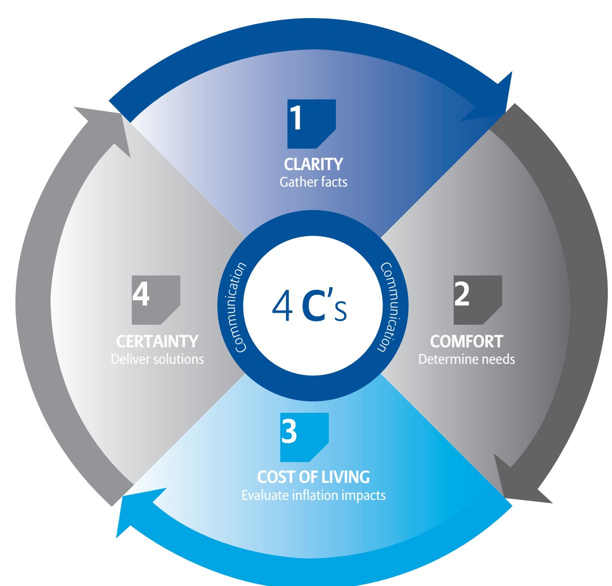
Many pre-retirees are experiencing a major shift from accumulation of assets to retirement income planning. As more baby boomers transition to retirement, the need for income planning will become even greater.

For many who are quickly approaching retirement, the difference between a more secure future and a more uncertain one is the success of their retirement income strategies. While the process of determining income for life can be daunting, the framework of the 4 C's provides an easy-to-understand structure for the income planning process.

Like its diamond industry counterpart, *this* 4 C's framework is a tool that breaks down a complex concept (i.e., retirement income strategies) into easy-to-remember pieces:

1. Clarity – gathering facts
2. Comfort – determining wants and needs
3. Cost of living – evaluating inflation impacts
4. Certainty – delivering solutions

For financial professionals, the 4 C's framework is not about selling products or promoting brands. The framework is offered to help them talk about retirement income strategies in a way that helps clients take control of their financial future. For pre-retirees and retirees, the 4 C's framework is a tool that helps them look realistically at the present and then plan for the future.



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