Kiplinger's
RETIREMENT REPORT
Your Guide to a Richer Retirement

VOLUME 18 ■ NUMBER 8 ■ AUGUST 2011 ■ $5.00

CHRIS SHARP

A Strategy For a Lifetime of Income

To win the battle for income that lasts a lifetime, a growing number of financial advisers and retirees have decided to divide and conquer. Their approach: Split portfolios into separate "buckets" designed to generate income for specific segments of retirement.

The buckets designated for the first few years of retirement will hold the most stable, secure investments, so retirees know their immediate income needs are covered. The buckets designed for later years, meanwhile, hold riskier fare meant to generate portfolio growth over the longer haul.

While some financial planners have used a basic bucket approach for decades, the strategy has gained popularity in recent years. That's partly due to the recent market swings. When retirees know their next five to ten years' worth of expenses are stashed away in conservative holdings, they gain confidence to remain invested in stocks through volatile times.

Norm Mindel, managing partner at Forum Financial Management in Lombard, Ill., says a bucket approach helped almost all of his clients stay in the market during the financial crisis. "They can sleep at night knowing they have money for the next ten years," he says.

The bucket strategy marks a significant departure from old retirement rules of thumb. By starting with an assessment of how much annual income the retiree needs, rather than how much can be "safely" withdrawn from the portfolio each year, it reverses the approach used in one of the most dominant, and hotly debated, drawdown strategies—the "4% rule."

Here's how the 4% rule works: In the first year of

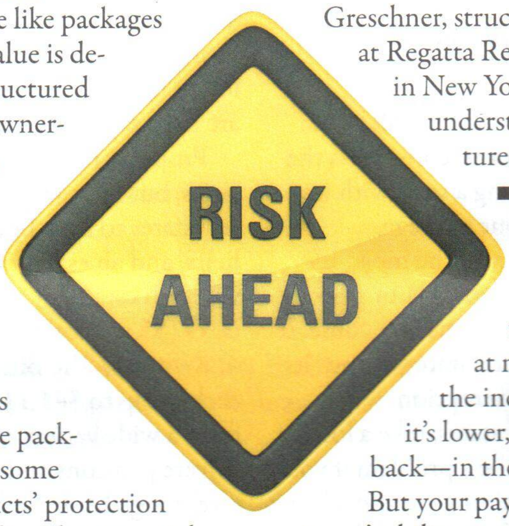
IN THIS ISSUE

Pitfalls in Promises to Limit Losses

PERHAPS YOU'D like to participate in stock-market gains but also want a buffer against big losses—or even a promise that you won't lose any of your original investment. With a pitch like that, it's easy to see why sales of "structured products" are soaring. But many investors are stumbling over their confusing trade-offs.

Structured products are often marketed to investors in or near retirement because they can offer attractive yields or some level of principal protection if held to maturity. Many of the products allow investors to make bets on the direction of stock-market indexes, currencies or commodities, while cushioning the potential downside in such investments.

Although they generally behave like packages of bonds and derivatives, whose value is derived from an underlying asset, structured products usually don't represent ownership of a portfolio of investments. Instead, these products are promises to pay made by the issuers, often big Wall Street banks. Investors in the products are typically buying the unsecured debt obligations of those banks.



Regulators are raising questions about how structured products are packaged and sold. They contend that some brokers have overstated the products' protection and understated their risks, including the potential for issuers to default on their obligations to investors.

The Financial Industry Regulatory Authority, which oversees the brokerage industry, in recent months warned investors about such pitfalls in principal protected notes, a common type of structured product that generally promises to return some or all of the initial investment at maturity. And the North American Securities Administrators Association recently formed a working group to help coordinate state enforcement actions if sales violate securities laws.

State regulators are concerned that "complex investment products are being offered to Main Street, mom-and-pop type investors," says Bob Webster, spokesman for NASAA. "They're hard for investors to pick apart and also hard for the sales force to understand."

Investors also are ringing alarm bells. This year through late June, there have been 94 FINRA arbitration cases involving structured products, compared with 159 for all of last year. In 2008, there were just four such cases, according to FINRA.

Despite the scrutiny, sales of structured products designed for small investors hit a record of nearly $55 billion last year, up 62% from 2009, according to StructuredRetailProducts.com, which tracks the industry. This year sales are on pace to hit another record, totaling nearly $29 billion through late June.

Some financial advisers say older investors should simply steer clear. Others disagree. Many structured products offer investors a way to beat the benchmark "in a low to moderate return environment," says Eric Greschner, structured-product portfolio manager at Regatta Research & Money Management, in New York City. Here are key points to understand before committing to a structured product.

■ **Credit risk.** In one basic principal-protected note, you might invest $1,000 today in a note linked to the Dow Jones industrial average. If the index is higher at maturity than it is today, you get the index return, excluding dividends. If it's lower, you get your original investment back—in theory.

But your payout at maturity depends on the issuer's ability to pay. Some investors in principal-protected notes issued by Lehman Brothers discovered this the hard way. Jacob Zamansky, a New York City securities lawyer, recently represented Pasquale "Pat" Croce Jr., former president of the Philadelphia 76ers basketball team, in an arbitration claim against UBS Financial Services, which sold the Lehman notes. Croce and his wife in June 2008 invested about $2 million in Lehman notes maturing in June 2013, according to the complaint. Less than three months later, Lehman declared bankruptcy and defaulted on the notes. The arbitration panel this year found UBS liable for $2 million, minus the remaining $480,000 value of the Croces' notes, plus interest.

FINRA also announced in April that it had fined UBS, saying it failed to emphasize the credit risk involved in the notes. UBS said in a statement that it "respectfully disagrees" with the arbitrators' decision. The significant majority of UBS's Lehman structured-product sales "were conducted properly and any client losses were the direct result of the unprecedented and unexpected failure of Lehman Brothers in 2008, which affected all Lehman investors," the firm said.

■ **Market conditions.** Low interest rates and market volatility can also make principal-protected notes less attractive. Such conditions make it more costly for issuers to build products, and to compensate, they may cap the notes' maximum payouts at lower levels or extend their maturities. Principal-protected notes issued today typically mature in roughly five and a half to seven years, versus three to five years for notes issued a couple of years ago, says Greschner.

Longer maturities reduce the benefit of principal protection, partly because inflation erodes the original investment value over time. What's more, structured products linked to stock indexes generally exclude dividends, which have accounted for a significant chunk of stocks' long-term total returns.

Any principal protection typically only applies at maturity. If you cash out early, you may get substantially less than what you paid for the notes.

■ **Complexity and costs.** Many firms are offering products with complex payoffs that provide some extra kick on the upside as well as a buffer against market downturns. But critics say investors could get similar performance from much simpler vehicles.

Buffered SuperTrack notes issued by Barclays Bank in spring 2010, for example, are linked to Standard & Poor's 500-stock index and are due in April 2015. If the index climbs over that period, investors can get 115% of its return. If the index is flat or declines up to 20%, investors get their principal back at maturity. If the index falls more than 20%, investors lose 1% of principal for every 1% the index declines beyond that 20% buffer—so they can lose up to 80% of their initial investment.

Investors who hold several such products may get performance similar to an index fund—just with higher costs and constraints on cashing out, says Craig McCann, president of Securities Litigation and Consulting Group, a Fairfax, Va., firm that provides expert testimony in securities cases. McCann compared a hypothetical portfolio of ten S&P 500 structured products against an investment in the Vanguard 500 Index Fund. If each were purchased in December 2009, the value of the structured-product portfolio at the end of each month in 2010 would have been less than the index-fund investment, he says. **K** —ELEANOR LAISE

MANAGING YOUR FINANCES

New Pension Rules Cut Lump Sums

If you're entitled to a pension from a former employer, don't be surprised if you receive a letter offering you a lump sum payout. New rules next year allow plan administrators to calculate lifetime benefits that will result in lower costs to them—and lower pension payouts to you.

Plan sponsors have eagerly anticipated the rule changes, which make it less expensive to offer lump sum payouts. Some sponsors anxious to trim their pension obligations are expected to offer lump sums to former vested employees, as well as to current workers on the verge of retirement.

Even pension programs that have not offered lump sums in the past may amend their plans to take advantage of the new rules, says Philip Waldeck, senior vice-president of Pension Risk Management Solutions at Prudential Insurance. "Former employees are a hassle to track," says Waldeck. Paying out a lump sum removes a worker from the plan roster and reduces an employer's future insurance costs. (Only pension plans that are at least 80% funded can offer a lump sum.)

The size of defined-benefit lump sum payouts will shrink next year because plan administrators will be able to calculate benefits assuming higher interest rates than have been used in the past. The higher the interest rate, the lower the payout.

Until 2008, the calculation was based on 30-year Treasury rates. Rules established by the Pension Protection Act of 2006 mandated a gradual transition to higher corporate bond rates. In 2012, this transition will be complete.

The reduction in lump sum payouts is significant. A 65-year-old who has $10,000 in annual accrued benefits will get a lump sum of $119,197 in 2012, compared with $127,059 calculated on rates before the rules were approved, based on projections by Vanguard. A 55-year-old retiring with $10,000 in annual accrued benefits will get $60,891 in 2012, compared with $78,617 under the old calculation.

The new rules may provide incentives for employers to terminate their pension plans. To terminate a plan, employers must be more than fully funded in order to cover the cost of payouts to participants who choose the lump sum and the cost of annuities for employees