Morgan Stanley

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Surmounting Your Five Biggest Retirement Planning Challenges

SUMMARY

You've always tried to do the right thing. You've spent much of your career attempting to accumulate enough assets for retirement. You've participated in your employer's 401(k) or other retirement plan and perhaps you've even established an IRA or other account specifically earmarked for retirement.

As retirement approaches, however, your focus must change. Instead of accumulating assets, you must begin to think about how you're going to convert those assets to income – enough income to last the rest of your life.

It's not easy. Other than Social Security, you probably have no source of guaranteed income. Unlike previous generations, you may not be covered by a pension plan at work, so chances are you're going to have to rely on your own efforts to meet the following challenges and finish the job you started so many years ago.

49% of American workers lack confidence that they will have enough money for retirement.

22% think they'll have to postpone retirement.

69% don't believe that Social Security will be able to provide the same benefits that are available to retirees today.

46% have saved less than $10,000.

Source: EBRI 2013 Retirement Confidence Survey

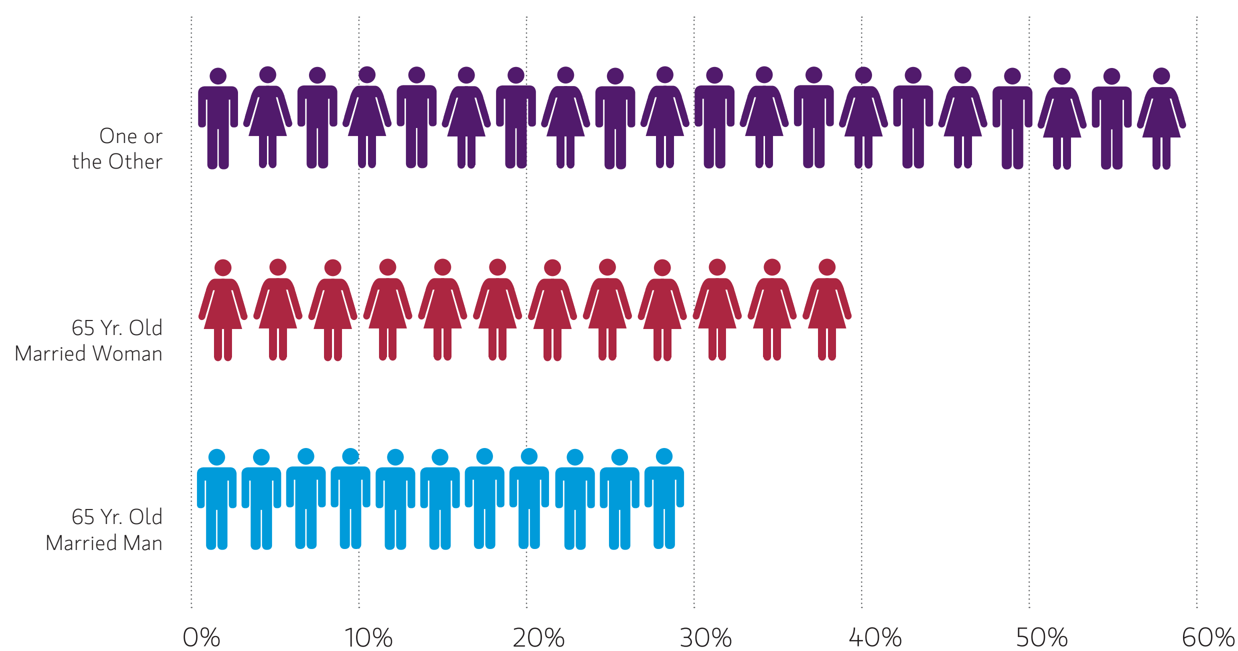
CHALLENGE NO. 1

Longevity

According to a study conducted by The American Academy of Actuaries in 2013, a 66-year-old man has a 30% chance of reaching age 90, while his wife has a 42% chance.

What's more, the probability that at least one of them will reach age 90 is 60%. What all this means is that you may very well spend as many years in retirement as you did during your career. If so, you're going to have to generate enough income to meet day-to-day expenses for possibly 30 years or more – an especially daunting challenge in an environment where few sources of guaranteed income are available to you.

The Probability of Reaching Age 90



Source: American Academy of Actuaries, "Risky Business: Living Longer Without Income for Life," June 2013.
Figures assume a person is in good health.

CHALLENGE NO. 2

Market Volatility

Fortunately, markets seem to have calmed down a bit since the recession of 2007–2009. As the chart below illustrates, four of the five biggest single-day declines in the history of the Dow Jones Industrial Average took place during the last four months of 2008.

At the same time, we have been plagued by a number of what are called "Black Swan" events over the past 15 years that have contributed greatly to market volatility.

Black Swan events are named for a species that was once thought not to exist. These events include 9/11, earthquakes and tsunamis, and the real estate bubble that led to the recession of several years ago. In short, Black Swan events are those that defy our ability to predict them. When they occur, they generally affect financial markets profoundly, perhaps more so than they have in the past. That is because of the nature of the markets themselves. They've changed over the years.

No longer is there one dominant exchange on which most trades are made. Trading is often conducted electronically at lightning fast speeds among numerous participants around the world. In addition, trading doesn't stop when the market closes and the advent of social media has accelerated the speed at which decisions are made. Put it all together and the climate is conducive to greater volatility than we've experienced in the past, even if we've enjoyed a relative respite over the past few years.

Dow Jones Industrial Average: Top 5 Largest One-Day Losses

Rank	Date	Net Change	Percent Change
1	9/29/08	-777.68	-6.98%
2	10/15/08	-733.08	-7.87%
3	9/17/01	-684.81	-7.13%
4	12/01/08	-679.95	-7.70
5	10/09/08	-678.91	-7.33

Source: Wall Street Journal; http://online.wsj.com/mdc/public/page/2_3024-djia_alltime.html; December 2013

CHALLENGE NO. 3

Inflation

It's hard to believe, but on January 1, 1981, the US inflation rate was a whopping 13.9%. Fortunately, it's declined considerably since that time and in recent years, it's been hovering between 1% and 3%.[1]

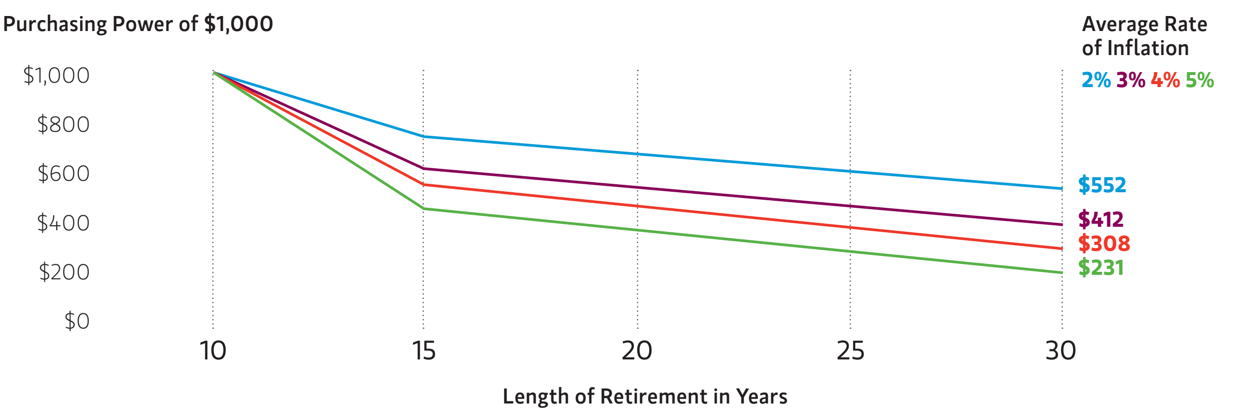
Inflation, of course, is the rate at which the prices of goods increase on an annual basis. Even today's relatively low rate can have a harmful effect on your purchasing power over time.

As the chart below illustrates, $1,000 today will only be able to purchase $552 in goods 30 years from now with a 2% annual inflation rate. With a 3% rate, that $1,000 will only buy you $412 worth of goods. And if inflation goes up to 5% or 6%, the results could be far more drastic.

Certainly, no one knows what the inflation rate will be in the future, but with the US economy recovering and interest rates almost certain to rise from their historic lows of the past few years, chances are it will increase from its current modest levels. For retired people, higher inflation is especially onerous because they may be living on a fixed income that can't support rising costs. In addition, many of the goods and services most often used by retirees are already experiencing greater-than -average price inflation.

Health care costs, for example, increased almost twice as much as the US inflation rate last year.[2] In 2013, the Washington Post reported that a couple, both 65, retiring in 2013 would probably need $220,000 to cover health-care expenses, if the husband lives to 82 and the wife to 85, their average life expectancies.

Inflation Risk



For illustrative purposes only. Does not reflect any specific investment.

1 Consumer Price Index (CPI), U.S. Department of Labor Bureau of Labor Statistics, 2014
2 CNBC: "Health-Care Cost Inflation on Track to Slow in 2014: Report," June 2013 (http://www.cnbc.com/id/100822251)

CHALLENGE NO. 4

Taxation

Income tax is inevitable, but that doesn't mean you can't do anything to avoid paying more than your fair share.

If you're in a high tax bracket, you have to be especially aware of how your assets are invested. Many hedge funds and mutual fund managers, for example, fail to consider taxes when they're seeking profits. Portfolio turnover can be high and short-term capital gains, which are taxed as ordinary income, are often generated in abundance.

Mutual funds may also throw off what is sometimes called "phantom income." These are distributions of dividends and/or capital gains that are reinvested in additional fund shares. You never really see them, but you're taxed on them anyway. In fact, many investors find themselves paying taxes on capital gains distributions even while their fund shares have declined in value for the year.

Tax Rate Chart

As you can see from this 2014 tax table, you may pay up to 39.6% of income, interest and short-term capital gains to the IRS, and you may also pay 15% or 20% of long-term capital gains and qualifying dividends. In addition, you may pay a 3.8% surtax on your Net Investment Income if your Modified Adjusted Gross Income exceeds $250,000 for married filers and $200,000 for single filers. There is also a new Medicare tax of 0.9% for married filers whose wages (or earnings from self-employment) are greater than $250,000 and for single filers whose wages (or earnings from self-employment) are greater than $200,000.

MARGINAL TAX RATE 2014	SINGLE	MARRIED FILING JOINTLY	TAX RATE ON QUALIFYING DIVIDENDS AND LONG-TERM CAPITAL GAINS
10%	$0 – $9,075	$0 – $8,150	0%
15%	$9,075 – $36,900	$8,150 – $73,800	0%
25%	$36,900 –$89,350	$73,800 – $148,850	15%
28%	$89,350 – $186.350	$148,850 – $226,850	15%
33%	$186,350 – $405,100	$226,850 – $405,100	15%
35%	$405,100 – $406,750	$405,100 – $457,600	15%
39.6%	$406.750+	$457,600+	20%

Plus a 3.8% net investment income surtax if Adjusted Gross Income exceeds certain levels.
Source: Forbes; http://www.forbes.com/sites/kellyphillipserb/2013/10/31/irs-announces-2014-tax-brackets-standard-deduction-amounts-and-more/

CHALLENGE NO. 5

Leaving a Legacy to Loved Ones

Technically, this challenge has nothing to do with whether or not you'll be able to retire as anticipated. For people who have enough income to meet retirement expenses, however, leaving a legacy often becomes a primary concern.

If you're concerned about the effects of income tax on your assets, consider what estate tax can do. Federal estate tax alone can reduce the legacy you hope to leave someday by as much as 40%. Depending on which state you live in, erosion can be even more profound.

Fortunately, there are strategies you can pursue to minimize estate tax liability. The key is to explore them while there is still time to implement them effectively.

Meeting Your Challenges

Retiring as anticipated is no small feat in today's complex business environment. Often, people don't have a choice about when to retire. They might find themselves downsized years before their planned retirement date, or they may simply realize that the challenges outlined here have left them with little choice but to work longer or temper their retirement ambitions.

Surmounting the barriers that stand between you and a comfortable retirement may depend on your ability to:

ACCUMULATE SUFFICIENT ASSETS

If you've been contributing to a 401(k), 403(b) or other retirement plan at work, you've made a great start. Depending on the provisions of your plan, your contributions may be made with pre-tax dollars and be allowed to grow on a tax-deferred basis until you begin making withdrawals at retirement when you may find yourself in a lower tax bracket.

Tax-deferred earnings tend to accumulate faster than investments that require you to pay taxes on income and capital gains every year.

If you're not contributing the maximum to your 401(k), 403(b) or other retirement plan, now may be the time to accelerate your efforts. If you're age 50 or older, you may be eligible to make an additional catch-up contribution of $5,500 annually, depending on your plan. By contributing the annual maximum of $17,500, plus the maximum catch-up, here is what a 50-year-old could conceivably amass by the time he or she reaches age 65:

Hypothetical Annual Rate of Return	5%	6%	7%	8%
Total (rounded up to nearest thousand)	$571,000	$626,000	$686,000	$753,000

CONVERT ASSETS TO INCOME

Accumulating as much as you can for retirement is only part of the story. As we discussed, you're going to have to switch gears when you retire and focus on converting those assets to income. How much income will you really be able to obtain from the savings you've worked so hard to compile?

Years ago, retirees often reallocated their portfolios from predominantly equities to predominantly fixed income and lived on the interest generated by their holdings. With today's interest rates near record lows and life expectancies expanding, this strategy may no longer be viable.

Many retirees rely on a strategy known as the 4% solution. By withdrawing 4% a year from their retirement assets, they hope to avoid depleting their nest egg for approximately 25 years. The 4% comes from a statistical analysis technique called Monte Carlo simulations. This strategy, however, is not foolproof. There's always the chance that the retiree could live longer than 25 years and run out of money at age 90 or so. Or there's also a possibility that the retiree could lose his or her job, retire earlier than anticipated and begin making withdrawals years before age 65.

In a time when guaranteed retirement income for most people is limited to Social Security, this 4% Solution may not be viable for every investor. Certainly, it offers a number of benefits. You can invest in whatever you want and withdraw more than 4% on occasion, if your investments are performing well. But will you have the discipline to reduce withdrawals in years when the market declines? And will you be lucky enough to avoid losses in the early years of your retirement?

IDENTIFY SOURCES OF GUARANTEED INCOME

Variable annuities are another idea that might make sense for at least part of your retirement nest egg. Issued by insurance companies, variable annuities offer a variety of professionally managed investment options. Like a 401(k) plan or IRA, assets in a variable annuity grow tax-deferred until they are withdrawn by the contract owner. When the time comes to retire, you can elect to receive income distributions that are calculated according to your life expectancy. In other words, you can receive income that is guaranteed to last for as long as you live.

There's More Than One Way to Surmount a Challenge

Variable annuities may be a valuable tool, but they aren't necessarily the right one for every retiree. Talk to your Morgan Stanley Financial Advisor about the challenges most likely to derail your specific retirement aspirations and how to counter them effectively. Or visit Morgan Stanley's website for basic information on our annuity offerings.

A Challenge Checklist

Unlike other income options, variable annuities can help you to meet all five of your biggest retirement planning challenges:

LONGEVITY

With a variable annuity, you can receive income payments guaranteed to last a lifetime. You can also arrange for your spouse to receive payments, if you predecease him or her.

TAXATION

In addition to tax-deferred growth, variable annuities offer another important benefit. When you receive lifetime income distributions at retirement, you pay tax only on the portion of the distribution that is considered investment earnings.[3] The rest is considered principal which was previously taxed before you used it to purchase your annuity. The IRS has established tables to calculate an exclusion ratio that reflects exactly how much of each payment you receive will not be subject to taxes.

MARKET VOLATILITY

Some variable annuities offer what are called "living benefits" that enable you to lock in gains and achieve a specific level of guaranteed growth, even if your investment options don't perform as anticipated. These benefits vary from annuity to annuity and are available at additional cost when you purchase your contract. As you can imagine, living benefits have become popular with retirement-conscious investors since the recession of 2007-2009. They provide a level of guaranteed income that most people simply don't have anymore.

INFLATION

One type of living benefit offered by many variable annuities offers the ability to increase your guaranteed lifetime income payments every year, even if markets turn against you. Again, this benefit is available at additional cost when you purchase your contract.

LEAVING A LEGACY TO LOVED ONES

By establishing a properly structured trust and funding it with a variable annuity, you remove those assets from your estate and avoid subjecting them to taxation upon your passing. Many wealthy families fund their trusts with variable annuities instead of stocks, bonds or other assets because of the tax advantages they offer. Rebalancing or changing your asset allocation, for example, generally triggers tax liability. With a variable annuity, you can change investment options with no taxation on gains.

3 Note that amounts not received as an annuity, for example, partial withdrawals, are generally subject to income-first tax treatment.

Variable annuities are sold by prospectus only. The prospectus contains the investment objectives, risks, fees, charges and expenses, and other information regarding the variable annuity contract and the underlying investments, which should be considered carefully before investing. Prospectuses for both the variable annuity contract and the underlying investments are available from your Financial Advisor. Please read the prospectus carefully before you invest.

Variable annuities are offered in conjunction with Morgan Stanley Smith Barney LLC's licensed insurance agency affiliates.

All guarantees are based on the financial strength and claims paying ability of the issuing insurance company.

Variable annuities are long-term investments designed for retirement purposes and may be subject to market fluctuations, investment risk and possible loss of principal.

Withdrawal and distributions of taxable amounts are subject to ordinary income tax and, if made prior to age 59½, may be subject to an additional 10% federal income tax penalty. Early withdrawals will reduce the death benefit and cash surrender value.

If you are investing in an annuity through a tax-advantaged retirement plan such as an IRA, you will get no additional tax advantage from the annuity. Under these circumstances, you should only consider buying an annuity because of its other features such as lifetime income payments and death benefit protection.

Tax laws are complex and subject to change. Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors do not provide tax or legal advice. Individuals are urged to consult their personal tax or legal advisors to understand the tax and legal consequences of any actions, including any implementation of any strategies or investments described herein.

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