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.

41% of American workers lack confidence that they will have enough money for retirement.

13% think they’ll have to postpone retirement.

63% don’t believe that Social Security will be able to provide the same benefits that are available to retirees today.

45% have saved less than $10,000.

Source: EBRI 2015 Retirement Confidence Survey
Longevity

According to a study conducted by the Society of Actuaries in 2015, a 55-year-old man has a 76% chance of reaching age 90, while a woman of the same age has an 82% chance.

What’s more, the probability that at least one of them will reach age 90 is 96%. 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

Market Volatility

While we can’t predict or prevent market swings, we can utilize strategies that help protect our savings. 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 can have a profound impact on financial markets. That is because the nature of the markets themselves have 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

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

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 instance, can be particularly onerous. According to a 2015 study conducted by Healthview Services, the average lifetime retirement health care premium costs for a 65-year old healthy couple retiring this year and covered by Medicare Parts B, D and a supplemental insurance policy will be $266,589.\(^2\)

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2 Source: Healthview Services: 2015 Retirement Health Care Cost Data Report. Assumes life expectancy of 87 for the male, 89 for the female; and an MAGI income level below $170,000.
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.

**2015 Tax Rate Chart**

As you can see from this table, 2015 rates are similar to 2014. You pay up to 39.6% of income, interest and short-term capital gains to the IRS, and you also pay 15% or 20% of long-term capital gains and qualifying dividends.

<table>
<thead>
<tr>
<th>MARGINAL TAX RATE 2015</th>
<th>SINGLE</th>
<th>MARRIED FILING JOINTLY</th>
<th>TAX RATE ON QUALIFYING DIVIDENDS AND LONG-TERM CAPITAL GAINS</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>Over $0 but not over $9,225</td>
<td>Over $0 but not over $18,450</td>
<td>0%</td>
</tr>
<tr>
<td>15%</td>
<td>Over $9,225 but not over $37,450</td>
<td>Over $18,450 but not over $74,900</td>
<td>0%</td>
</tr>
<tr>
<td>25%</td>
<td>Over $37,450 but not over $90,750</td>
<td>Over $74,900 but not over $151,200</td>
<td>15%</td>
</tr>
<tr>
<td>28%</td>
<td>Over $90,750 but not over $189,300</td>
<td>Over $151,200 but not over $230,450</td>
<td>15%</td>
</tr>
<tr>
<td>33%</td>
<td>Over $189,300 but not over $411,500</td>
<td>Over $230,450 but not over $411,500</td>
<td>15%</td>
</tr>
<tr>
<td>35%</td>
<td>Over $411,500 but not over $413,200</td>
<td>Over $411,500 but not over $464,850</td>
<td>15%</td>
</tr>
<tr>
<td>39.6%</td>
<td>Over $413,200+</td>
<td>Over $464,850+</td>
<td>20%</td>
</tr>
</tbody>
</table>

Additional Medicare surcharge of 3.8% of net investment income applies if modified adjusted gross income exceeds $250,000 for couples filing jointly, $200,000 filing single and $125,000 for those who are married and filing separately.

Sources: Tax Foundation.org 5/15; IRS.gov 5/15
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 taxes 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 $6,000 annually, depending on your plan.

By contributing the annual maximum of $18,000, plus the maximum catch-up, here is what a 50-year-old could conceivably amass by the time he or she reaches age 65:

<table>
<thead>
<tr>
<th>Hypothetical Annual Rate of Return</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total (rounded up to nearest thousand)</td>
<td>$544,000</td>
<td>$592,000</td>
<td>$645,000</td>
<td>$704,000</td>
</tr>
</tbody>
</table>

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

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 possibil-
ity 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 life contingent income distributions. Depending on the specifics of the rider you select, you may be able to 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.

A Challenge Checklist

Unlike other income options, variable annuities can help you to meet 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, nonqualified 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. 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**
  Many individuals place a great deal of importance in being able to leave a legacy for their family. 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. Speak to your Financial Advisor to see if a variable annuity could be an integral part of your legacy planning.

3 Note that amounts not received as an annuity, for example, partial withdrawals, are generally subject to income-first tax treatment. Distributions from qualified annuities (i.e., annuities issued in connection with a qualified retirement plan or IRA) are fully taxable, except to the extent the distribution contains after-tax amounts, in which case a portion of your distribution will be taxable and a portion will be a nontaxable return of your after-tax basis until you fully recover your after-tax basis.
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.