**Income Planning for Clients Nearing Retirement** is a self-paced educational program for financial professionals. The overall program includes nine modules that cover the why, what and how of income planning. Each module also includes information on resources available to help you engage clients in the income planning process. The program is designed for you to review on demand and at your own pace.

You are about to begin Module 5, *Expanding the Scope of Investments*, which should take you approximately 30 minutes.

By reviewing modules 4-6 and successfully completing an online exam, you can earn 1.5 continuing education (CE) credits for the Certified Financial Planner Board of Standards (CFP® Board), Investment Management Consultants Association (IMCA®) and Cannon Financial’s Certified Wealth Strategist® (CWS). Your firm may also offer CE credits for successful completion of the program. (Please check with your Continuing Education Officer.)

Simply read the program modules, click the CE link online, fill out your information and take the exam. Please be sure to print out your final score for your own records.

You must achieve a score of 70% on the online exam to qualify for CE credit. Please allow 30-45 days for CFP Board and IMCA CE credits to appear in your diary. You must self report the CE credit you earn for CWS or for your firm's continuing education program. If you have any questions filling out this form, please contact retirement@pershing.com.
This module focuses on the potential need for financial professionals to expand the scope of investments they use as they focus on diversifying portfolios to address the risks that are unique to retirement income planning (for example, longevity risk, sequence-of-returns risk and inflation risk).

The investments discussed in this module may be appropriate for use in one or more of the retirement income strategies discussed in the second module of this series, *Framework for Retirement Income Planning*. 
Due to the risks associated with retirement income planning, investing during this phase is fundamentally different than in the accumulation phase (see Module 1 for more information).

Some of the key variables associated with investing for income during this phase include the ongoing need for long-term growth (to combat inflation and longevity risk), the longevity risk that arises from dealing with an unknown time horizon, the need to balance income flexibility with income security and the increased danger of market volatility through what is sometimes referred to as dollar-cost ravaging or sequence-of-returns risk.
Given the fact that investing for income requires financial professionals to help clients address a variety of risks that are not typically associated with the accumulation phase of retirement, many financial professionals find that they must expand their “tool chest” as they begin to focus on helping clients create an income strategy.

Put simply, many financial professionals find that the product set they commonly use to help clients build their retirement nest egg is not diverse enough to prepare these same clients for harvesting their retirement assets.
Now is the time to help clients better understand various investments and insurance products that may be appropriate for a retirement income plan. One way to start is to introduce them to the idea of three broad categories of investments that should be considered when designing a retirement income strategy:

- **Traditional investments such as stocks, bonds and mutual funds**
- **Products that contractually guarantee income withdrawals** (keep in mind that guarantees apply to certain insurance and annuity products—not securities, variable or investment advisory products—and are subject to product terms, exclusions and limitations and the insurer’s claims paying ability and financial strength)
- **Alternative investments designed to provide income while having low correlations with traditional asset classes**

**Mutual funds may not be available in all jurisdictions. Your clients should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. Contact your financial organization for a prospectus. Clients should read the prospectus carefully before investing.**

*Investing in alternative investments is not suitable for all clients. These investments are intended for investors who are willing to sustain the risks associated with these investments. Alternative investments often engage in leveraging and other speculative investment practices that may increase the risk of loss; can be highly illiquid; and often charge high fees.*

**Guarantees apply to certain insurance and annuity products (not securities, variable or investment advisory products) and are subject to product terms, exclusions and limitations and the insurer’s claims paying ability and financial strength.**
You are probably already familiar with traditional fixed income investments. However, for many of your clients who are nearing retirement, this may be new territory. These clients may need education on the diversification benefits of fixed income securities as well as the risks unique to this asset class, such as reinvestment, call and default risk.

Clients may also need assistance in understanding the relationship between economic events and bond prices. After decades of focusing on how a strong economy can be good news for stock prices, clients may need to understand that the bond market usually works the opposite way, taking a turn for the worse on positive economic news or rebounding on predictions of an impending recession.

The type and degree of impact of the economy on current bond prices varies with the type of bond. With **bond ladders**, temporary price fluctuations may make little difference; the assumption is that each bond will be held until maturity, then redeemed at face value to provide retirement income.

**Treasury Inflation Protected bonds**, or **TIPS**, are government-issued and government-guaranteed bonds meant to provide a hedge against inflation via their interest rates. As such, they are more sensitive to inflationary pressures than to the current state of the economy and, when inflation is low, may have low yields.

Generally speaking, **municipal bond** prices will fluctuate with prevailing yields and the economic strength of the issuing municipality or, for revenue bonds, the specific project they fund.
While your clients may be the most familiar with stocks, equity investing for income is different than investing for accumulation. Are your clients familiar with the dividend power of stocks and their ability to provide current income?

It is important to understand how much of the broad stock market’s total return (as measured by the common stocks in the S&P 500 Index) can be attributed to dividends. During the 20-year period ended December 31, 2012, reinvesting dividends raised the compound annual growth rate of the S&P 500 Index from 5.73% to 8.8%. In fact, reinvested dividends accounted for 35% of the index’s cumulative return during this period. ($5.22 – $3.41 = $1.81; $1.81/$5.22 = 35%)

Contrary to common wisdom, “dividend paying stock” is not synonymous with “dying business” or “lack of growth potential.” Companies without good opportunities to put earnings to work within the business will pay those earnings out as dividends. On the other hand, many companies that do have good opportunities to reinvest earnings to grow the business also pay dividends. A recent example of the latter is Apple Inc., which declared its first quarterly dividend for common shareholders in March 2012.

In a down market, dividends may help to offset the impact of lower stock prices.

Traditionally, the fixed dividends of preferred stock have generally been higher than the variable dividends of their common stock counterparts.

Adding dividend paying stocks to a portfolio at an early stage can potentially mean stronger accumulation before retirement, while the dividends may provide an income stream during retirement.
Real estate investment trusts (REITs) are also an option when considering income producing equity strategies. REITs are companies that invest in commercial properties or mortgages.

By law, REITs must pay out at least 90% of their taxable income to shareholders in the form of dividends. In 2012, the average dividend yield for domestic REITs was 4.11%; and for global REITs, 4.12%, or more than 100 basis points above the yield on 10-year Treasuries.

REIT prices can be volatile. However, diversifying a portfolio by adding REITs could also potentially reduce overall portfolio volatility, since REITs have historically had very low correlations with high-quality bonds and relatively weak correlations with the broad stock market. The 30-year correlation of the S&P 500 and NAREIT index was 0.56.
Perhaps the most versatile tools in your income toolkit are **mutual funds** and **exchange-traded funds (ETFs)**. High dividend and interest-paying funds are important for income planning, and both mutual funds and ETF offer numerous options from which to choose. Depending on the options chosen, the client may receive taxable income, tax-exempt income or long-term capital gains (either from distributions or sale of fund shares).

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**Clients should carefully consider the ETF’s investment objectives, risks, charges, and expenses before investing. The prospectus contains this and other information. Contact your financial organization for a prospectus. Clients should read the prospectus carefully before investing.**
The second group of retirement income products is **annuities**. It is worthwhile to help clients sort out the facts about different types of annuities and their features.

Annuities can be **immediate**, providing an income stream as soon as they are purchased, or **deferred**, allowing assets to compound, tax-deferred, for a period of time before income is paid out. Additionally, the rate of growth on the invested amount can be **fixed** or **variable**, and the annuity may be purchased with a **single premium** or, alternatively, allow the client the flexibility to make **multiple premium payments** at will.

Annuities are complex products with many different types of riders available. If your firm does not offer annuity products or it is not a focus for you, you may want to consider teaming up with an insurance professional in your area.

**Guarantees apply to certain insurance and annuity products (not securities, variable or investment advisory products) and are subject to product terms, exclusions and limitations and the insurer’s claims-paying ability and financial strength.**
Variable annuity sales have trended higher since the mid-1990s, in part because of specific guarantees that can be added to a basic variable annuity contract for a fee. As shown in the description on this slide, these policy riders may guarantee a return of principal, a minimum yearly withdrawal or minimum annual income. The variety of riders available allows clients to choose the benefit or benefits most important to them.
Even if an appropriate annuity product is selected for the client’s circumstances, it may not serve the purposes the client intends if the contract is not structured properly.

- For example, take the case of spouses who jointly own an annuity but don’t name each other as beneficiary. It is possible that at the death of one spouse, the death benefit will be paid to the designated beneficiary, and the surviving spouse will receive nothing.

- Naming a trust as beneficiary could force a spouse to take receipt of the death benefit over a period of less than five years. If the surviving spouse, rather than a trust, were the sole beneficiary, he or she could opt to treat the annuity as his or her own, providing more flexibility in when and how the benefits are paid out.

- The death of the owner and the death of the annuitant have different implications for the amount of the death benefit. So, if the owner and annuitant are not one and the same, the beneficiary might get less than the owner intended.

These are but a few of the possible ways that contract structure can thwart the client’s desired intentions or create unintended tax consequences. Rather than invest the time to become an expert on these matters, try working jointly with experts. To ensure that various benefits will be paid out as the client wants, ask the issuing insurance company if they have a expert or specialist who can provide guidance, or seek an attorney with knowledge of annuity contracts. A tax professional can ensure that the client understands the tax implications of owner, annuitant and beneficiary designations.
A variety of investments can be used for income that have historically demonstrated lower correlations with traditional stocks and bonds.

The first question to address in choosing among these is whether the client is better suited to liquid, publicly traded investments or has the wherewithal and tolerance to invest in largely illiquid private securities. Another important question is whether the investment generates taxable income that can be invested in a tax-deferred retirement vehicle such as an IRA, or is the income tax-advantaged and therefore suitable for the client’s taxable accounts? Clients should seek input from a qualified tax advisor before making any decisions.

Currently, alternative investments are in demand as portfolio diversifiers, because clients who were battered by the market crises are looking for ways to potentially manage volatility and risk. While diversification is important, another reason to own these kinds of investments is the long-term income potential.

However, compliance rules at many firms can impose serious restrictions on the use of alternative investments, because they may entail different risks than traditional investments, including their complex nature, limited regulations and relative lack of liquidity. Check your firm’s policies before discussing these types of investments with clients.

For clients who are best suited to more liquid investments, mutual funds that employ sophisticated investment strategies, similar to hedge funds, or funds that make commodity-related investments may be appropriate choices.

**Investing in alternative investments is not suitable for all clients. These investments are intended for investors who are willing to sustain the risks associated with these investments. Alternative investments often engage in leveraging and other speculative investment practices that may increase the risk of loss; can be highly illiquid; and often charge high fees.**
Other publicly traded income-generating investments with lower correlations to traditional securities include master limited partnerships (MLPs) and royalty trusts.

With a few exceptions, the income distributed at least quarterly from a master limited partnership derives almost exclusively from businesses engaged in the production or delivery of natural resources. The amount to be distributed quarterly is stipulated when the partnership is formed and must be paid; if not, the partnership may have an event of default and lose its primary tax advantages. Under the MLP structure, the natural resource-producing company is not required to pay corporate income tax, so more cash is left to distribute to the limited partners, making MLPs a potential source of relatively high and stable yields. For the limited partners, the income may be taxable at ordinary income tax rates or at capital gain rates when the partnership units are sold.

In contrast to MLPs, royalty trusts do not actually produce anything and have no operations or employees; income is generated when a company produces natural gas, oil or coal and pays royalties on those resources to the trust, based on then-current commodities prices, until the resources are depleted. The trust must pay out essentially all of its income to the owners of the trust units. Provided it does so, there is no corporate tax on the income. This lack of taxation at the institutional level means that more cash is available for distribution. The income is considered a capital gain and the tax obligation can be deferred until the units are sold.

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Clients with substantial investable assets may be able to generate income from the options shown here: hedge funds, limited partnerships, private equity and private mortgages. These investments entail higher minimum investments, considerable levels of risk and, as a general rule, allow the investor to cash out only at specific times. In return, they may provide attractive and, in some cases, tax-advantaged yields.

**Hedge funds** are pools of contributions from multiple investors that invest in various traditional securities and derivatives, usually with an eye to complementing traditional long-only investment strategies.

**Private limited partnerships** pool investors’ capital to purchase commercial properties or invest in certain types of businesses. In return for their cash, investors receive the right to pro rata shares of the tax benefits of the business (for instance, equipment leasing tax credits), the net income from operations, and capital gain or loss on sale of the asset.

Investors in **private equity** provide equity capital that is used to buy interests in privately held companies, or to buy out public companies and take them private. The business continues to be subject to corporate income tax, and business-level tax benefits are not passed along to the investors. However, investors have a right to the business’s annual net profits and any capital gains (or loss) when the business is sold.

**Private mortgage lending** used to mean families and friends helping each other with house payments. Today, it is common to see individuals making mortgage loans to unaffiliated persons. The individual investor takes on the risks and rewards typically assumed by mortgage lending institutions. Private mortgage may offer low risk if structured properly, because they are secured by the real property, the mortgage holder can receive interest rates that are higher than bank rates.

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Another way clients can potentially generate additional income from traditional investments is through a securities lending program.

Lending hard-to-borrow, fully paid-for securities in a brokerage account can help to create a new income stream for clients. Many programs are designed to be as unobtrusive to a client’s investment strategy as possible. In fact, generally clients maintain complete control of the securities and can sell loaned shares at any time without prior notice.

Clients maintain the position in their accounts for purposes of profit and loss, tax-lot accounting, hedges and holding representation; however, you should make them aware that they will not have proxy voting rights on the loaned securities or SIPC® coverage on the loaned securities. They will, however, maintain SIPC coverage on the cash collateral received for the loaned securities and will also receive substitute payments for dividends on loaned shares.
Securities lending is a common strategy used by institutional and sophisticated investors to generate additional income in their portfolios. Securities lending is when an individual or institutional investor (the lender) temporarily loans securities to a financial institution, such as a brokerage firm, bank or hedge fund (the borrower). The loan is usually facilitated by an intermediary, known as the lending agent or clearing broker. All parties enter into a loan agreement that covers the terms of the loan and how the lender is paid and how the revenue will be shared as well as other provisions that should be considered before entering into such an agreement.

For more information, visit: http://www.pershing.com/financial_business_solutions/fully-paid-securities-lending.html
Once you have a holistic view of all of a client’s assets, it should be easier to review the entire portfolio.

**The primary consideration should be the client’s goals and risk tolerance.** You can then recommend an asset allocation or investment adjustments designed to keep the portfolio in line with client’s risk profile.

For many clients, this will mean diversifying the portfolio, reducing their equity exposure in favor of investments that protect principal, generate income or provide a hedge against equity volatility.
Now is the time to help clients better understand various investments and insurance products that may be appropriate for pursuing various strategies during the income phase. One way to start is to introduce them to the idea of three broad categories of investments that should be considered when designing a retirement income strategy: traditional investments such as stock, bonds and mutual funds designed to generate retirement income; products that contractually guarantee income withdrawals; and alternative investments designed to provide income while having low correlations with traditional asset classes.

Clients with at least $250,000 in an IRA or taxable account may also want to consider additional sources of retirement income such as securities lending, to potentially create a new income stream.

Finally, you should help align clients’ asset allocations with their retirement income goals.

**Please keep in mind that investing in alternative investments is not suitable for all clients.** These investments are intended for investors who are willing to sustain the risks associated with these investments. Alternative investments often engage in leveraging and other speculative investment practices that may increase the risk of loss; can be highly illiquid; and often charge high fees.

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## Module 5 Expanding the Scope of Investments

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### Additional Resources

- FinancialprofessionalFX.com
- Standard & Poor’s (S&P) MarketScope®
- Morningstar®

Third party sites provided for convenience. Pershing does not endorse these sites or their content.

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Module 5 Expanding the Scope of Investments

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