Southward Financial Services, LLC
9165 Winston Road
Pickerington, OH 43147
614-864-0759
800-284-9516
E-Mail: SFSPlan@insight.rr.com
www.southwardfinancial.com

Managing Your Portico Account For Retirement Income

A White Paper to Assist ELCA Clergy and Laity In Their Retirement Planning

Prepared August, 2012

Roger E. Southward, CFP®

Southward Financial Services, LLC
9165 Winston Road
Pickerington, OH 43147
614-864-0759
800-284-9516
E-Mail: SFSPlan@insight.rr.com
www.southwardfinancial.com

Managing Your Portico Account for Retirement Income

In April, 2009, Portico Benefit Services, then called the ELCA Board of Pensions, closed the pension plan in response to the stock market losses of late 2008 and early 2009. This closure impacted those who had anticipated retiring under an annuity program managed by the Board. In subsequent actions, the Board of Pensions also reduced the income paid to retirees already covered by the old annuity program.

The Board instituted a new annuity program in August, 2011. This ELCA Participating Annuity Trust "provides a stream of lifetime variable annuity payments to ELCA retirement plan members."[1] While the income payments are guaranteed for the life of the retirement plan member and his or her beneficiary, this new plan makes it explicit that the amount of the payment will vary over time depending upon the investment experience of the plan. Retirees were moved into this new plan, and it is the only annuity option available to individuals seeking to retire under the plan.

This paper will examine the implications of the new plan and its variable income for members of Portico as they plan for their retirement. First, the paper will review what the plan is and how the annual adjustments to retirement income are calculated. Then, it will take an historical perspective to see what may be in store for retirees in the future. Next, the plan will be evaluated in light of different risks a retiree may face. Finally, different considerations will be offered as to how to best use the plan by presenting various scenarios for a retiring couple.

However, before proceeding, it is important to note what this paper does not attempt to do: It does not provide a single answer as to what any one retiree should do. As will become apparent, retirees are faced with a program that will require them to take more responsibility for their retirement income and to tailor that to fit their needs and attitudes about risk and lifestyle. This new plan does not lend itself to a "one-size fits all" solution.

<u>The ELCA Participating Annuity</u>

The ELCA Participating Annuity program (Annuity) is a variable annuity that is guaranteed by Portico Benefit Services (Portico) to provide a lifetime income stream to a retiree and other beneficiaries. While the income stream is guaranteed, the amount of monthly payment can and likely will change on an annual basis.

[1] Investment Memorandum for the ELCA Participating Annuity Trust, page i. August 1, 2011.

The initial monthly payment is based on three factors: the value of the pension account at retirement, the joint life expectancy of the member and spouse (if applicable) on the date of retirement, and an assumed investment return of 4.5 percent. If an individual outlives their life expectancy, Portico has guaranteed to continue to make payments, even though technically the original account balance has been exhausted.

How can they make this guarantee? The following example helps to explain: Two Portico members each retire at age 63 with $425,000 in their respective accounts. Both have spouses age 63.[2] Each Portico member will receive an initial monthly payment of approximately $2,090. The joint life expectancy would be approximately age 94.

However, assume that one member dies at age 68, and their spouse at age 72. When the 120 payments have been made to them and their beneficiary, their account still has approximately $280,000 left in it after making payments of approximately $250,000. That remaining money stays at Portico and is now available to pay other retired members who may outlive their live expectancies.[3] To take our illustration to the end, if the other member and spouse each live to 99, the extra five years will require an additional investment of approximately $125,000. That additional investment comes from funds remaining when other members die prior to their normal life expectancy, as was the case with the first member in the example.

This example assumes that the monthly payment stays the same for the entire life of the member and spouse. However, the monthly payment is now subject to an annual adjustment based on investment performance and how that relates to the on-going obligations of the Annuity. This is monitored by a Funded Ratio; this technique is a common one used in pension plans. The Funded Ratio compares the value of all the Annuity's assets and estimated investment returns to the sum of its current and future benefit obligations. If the ratio, which is assets divided by obligations, is equal to 1.0, then the Annuity has exactly enough money to meet all its obligations. A Ratio greater than 1.0 means assets are greater than obligations, and if it is less than 1.0, then there is a shortfall.

The Annuity will increase monthly payments if the Ratio exceeds 1.0 as of September 30 of the previous year. If the Ratio is less than 1.0 on that date, then payments will be decreased. The exact formula for the increases and decreases is:

> If the Ratio is greater than 1.0, the monthly payment increases by 1/3 of the excess.
>
> If the Ratio is less than 1.0 but greater than 0.85, the monthly payment decreases by 1/3 of the deficit.
>
> If the Ratio is less than 0.85 but greater than 0.75, the decrease will be 5 percent plus one-half of the shortfall below 0.85 percent.

---

[2]This example is based on information provided by Portico. It assumes that the member has selected the joint and 100% to either survivor option, with 15 year period certain. This means that should the member and their spouse not survive for 15 years, the balance of the payments due for that time period will be paid to a pre-selected beneficiary.

[3] The remaining funds must always go to other retired members; they cannot revert to Portico or the ELCA as they are held in trust specifically for retirement purposes. Once a member annuity converts an account to an annuity, the funds are pooled with all other annuity holders.

If the Ratio is less than 0.75, the decrease will be 10 percent plus 100 percent of the shortfall below 0.75.

Portico retains the sole right, at its discretion, to make adjustments at any time and without regard to the above formula. Currently, Portico uses September 30 to calculate the Ratio, the Board approves changes at its November meeting and the new amount takes effect with the January 1 payment.

Two quick examples may also help explain the formula.

- On September 30, the Funded Ratio is 1.09. The excess of 0.09 is divided by three to equal 0.03. The monthly payment is then increased by three percent.

- On September 30, the Funded Ratio is 0.88. The deficit below 1.0 is 0.12, which divided by three. This equals 0.04, thus producing a reduction in the monthly payment of four percent.

The Annuity invests its assets according to the following target mix of funds:

U.S. Stocks	30%
Non-U.S. Stocks	13%
Alternative Equity	7%
Core Bonds	20%
High-yield Bonds	15%
Inflation-indexed Bonds	10%
Real assets	5%

These investments are managed by Portico. "The investment strategies and target asset allocation for the Investment Fund are subject to change without notice; however, the current intent is to remain fully invested in the target asset allocation shown while maintaining minimal cash levels necessary for effectively managing the liquidity needs of the Investment Fund."[4]

Historical Review of the Annuity

While the new Annuity program has only been in place for less than one year, Portico does provide historical information that begins to give some perspective on what retirees may expect.

The Portico web site shows some limited history of the returns of the Annuity investment fund. The historical returns, as of May 31, 2012, are as follows:

Year-to-date for 2012	3.39%
Five years (annualized)	2.66%
Ten years (annualized)	6.38%

The site also shows the Funded Ratio at year-end for the last five years:

12/31/07	0.955
12/31/08	0.671

[4] Investment Memorandum for the ELCA Participating Annuity Trust, page 16. August 1, 2011

12/31/09	0.851
12/31/10	0.955
12/31/11	0.965

The first three months of 2012 had strong investment returns, followed by weaker results in the next two months. The Funded Ratio since December 31, 2011 has been:

January 31	0.993
February 29	1.017
March 31	1.021
April 30	1.021
May 31	0.979

Past performance is no guarantee of future results, and the last decade has been an extremely difficult time in which to invest. However, the historical pattern has shown a good deal of unfavorable volatility and does not provide a high level of confidence in the current Annuity plan being able to sustain an increasing level of income on a consistent basis.

The primary problem seems to be that even with good investment performance the Funded Ratio has a difficult time moving significantly above the 1.0 level necessary for Portico to declare an increase in monthly income. In 2007, the U.S. market as measured by the S&P 500 increased 5.49 percent, international stocks gained 15.8 percent and bonds added 6.97 percent. Yet, the Funded Ratio ended the year under 1.0. In 2010, U.S. stocks gained 15.06 percent, international stocks were up 10.69 percent and bonds returned 6.58 percent. Yet, the Funded Ratio improved only 0.10 from an admittedly low level after the 2008 crash and was still under 1.0.

The Funded Ratio must move significantly above 1.0 in order to offer a meaningful increase in income. As of April 30, 2012, if the Funded Ratio would have held until September 30, that Ratio would have allowed for a 0.70 percent increase. However, with one poor month, the Ratio fell to 0.979; that level would produce a reduction of monthly income of 0.7 percent. To achieve a three percent annual increase, one would need to have a Funded Ratio of 1.09 and for that level to hold.

In the press release dated November 11, 2011, where Portico announced the 2012 decrease, Vice President Brad Joern was reported as saying that “reductions are now likely to occur over a longer period of time.” The release was not specific as to what level of reductions or time frame.

In reviewing performance, it is important to note that the target investment mix for the Annuity is a relatively conservative one. A total of fifty percent is dedicated to some type of stock investment, and adding real assets to that shows 55 percent invested in what one would typically consider riskier investments. This leaves 45 percent invested in some type of bonds. This type of mix should offer the Annuity plan some stability in returns, because stocks and bonds tend to move it opposite directions, thus one investment can grow and potentially offset the losses in another one.

Retiree Risks

In evaluating a retirement plan, including the Portico Annuity option, retirees need to be aware of several different financial risks. Those risks are:

- Investment risk: The most obvious aspect of this risk is that almost all investments have some prospect for losing some or all of the initial principal. A second aspect of this risk is that the investment may not achieve the level of return that is desired or needed to meet a specific goal, such as retirement income. Investment risk can be adjusted by mixing different types of investments such as stocks and bonds in differing proportions. Such diversification offers the prospect of mitigating investment risk, but cannot eliminate it. As seen in 2008, the best-designed investment mix may still lose money under extreme conditions.

  Ideally, a retiree would seek to shift investment risk to someone else and not have their income subject to such risk. Fixed pensions from private employers or from state and local governments are examples of this shift. Another example is an immediate, fixed annuity purchased from an insurance company. The income is guaranteed to the retiree; the former employer, government or insurance company is responsible for seeing the income is produced.

  If it is not possible to pass this risk off to an institution, then the next best alternative is to have the retiree take personal responsibility for how the retirement funds are invested. By taking over investment decisions, a retiree may be able to select a mix of investments that matches their individual circumstances and attitudes towards risk. While not eliminating the risk, this would at least keep the investment mix from being more or less risky than the individual retiree needs.

- Inflation. A retired couple may have thirty years or more to live in retirement. During that time, inflation will continue to increase the costs of living. An ideal retirement income plan will attempt to account for inflation so that the retiree does not lose purchasing power.

  From 1914 through 2010, inflation in the United States averaged 3.4 percent.[5] If that would continue into the future, an item that costs $100 today would cost $272 in thirty years. If the retirement income is fixed, a retiree would see a significant reduction in their standard of living.

  Social Security is an example of retirement income which fights this problem. Under current law, benefits are increased annually by the rate of inflation. However, other retirement plans are often weak in this area. Normal pensions are often fixed or offer only small, annual increases.

- Longevity. Living a long, productive life in retirement is often a goal that can come back to haunt a couple if they outlive their income. A 65-year old couple has a 72 percent chance that one of them will live to age 85, a 45 percent chance of one living to 90 and an eighteen percent chance of one living to age 95. Our longer life spans increase the odds that we could outlive our money.

[5] www.inflationdata.com

Many retirement plans protect well against this risk. Social Security, pensions from private employers, government pensions and private annuities are all guaranteed for life.

Individual Retirement Accounts (IRA) do not protect as well against the risk of outliving one's money. Funds are withdrawn without any mechanism that guarantees future income. As discussed more fully below, it is possible to use strategies that mitigate this risk in an IRA, but it cannot be eliminated.

Using these three criteria in evaluating the Annuity from Portico shows a mixed picture. The Annuity offers protection against longevity risk; it is guaranteed by Portico for the life of the retiree, and depending upon the income options selected, offers income to beneficiaries. In our opinion, the longevity protection is the strongest feature of the Annuity plan.

However, this protection results in a significant trade-off. We believe the Annuity offers rather weak protection against inflation and forces the retiree to take on all of the investment risk without offering the retiree any choice in the investment choices.

As noted above, the Annuity will increase income only when the Funded Ratio exceeds 1.0 and then only offers increases equal to one-third of the excess above 1.0. In order for the Annuity to meet the long-term historical inflation rate of 3.4 percent, the Funded Ratio would have to be 1.102 or a level that has not been achieved since December 31, 2007. Further, it would have to maintain this level on an on-going basis to assure the increase annually.

The retiree assumes the total investment risk; it is not shared with Portico. If investments go up and increase the Funded Ratio, then income will increase. If investments decline, a portion of the decrease in the Funded Ratio is passed on to the retiree. The best example of this has been the last three years. Due to the market losses from 2008-09, Portico originally planned to decrease monthly income by 9 percent per year compounded in 2010, 2011 and 2012. The sharp rebound in the markets in 2009 and 2010 allowed the 2011 reduction to be adjusted to 6 percent. The first year of using the Funded Ratio, or 2012, produced a reduction of 3.8 percent as markets fell in mid-2011.

The lack of protection against poor investment returns and consequently from inflation is shown in the following table. This shows the growth of $100 of monthly income from Portico, beginning on January 1, 2009, compared with $100 of monthly expenses increased by the Consumer Price Index:

	Monthly Income	Monthly Expense	Difference
January 1, 2009	100.00	100.00	-
January 1, 2010	91.00	99.60	(8.60)
January 1, 2011	85.54	101.19	(15.65)
January 1, 2012	82.29	104.43	(22.14)

Even with the Consumer Price Index having an extremely rare decrease in 2009 due to the severity of the recession, retirees over this time frame saw a significant loss of purchasing power such that the differences between real income and expense increased from zero to $22.14 per month.

Lastly, the retiree has no voice or choice in the investment process. Portico has the responsibility for managing the investment of the retirement assets used to produce the monthly income.

Please note that this is not shown to scare potential retirees or to discredit the efforts of Portico. It has been extremely difficult for all investors to show strong returns in the last ten years. The past is no guarantee of future results. Rather, this information should indicate to retirees that the Annuity plan is not risk-free. An individual selecting the Annuity needs to be aware that while they are assured a lifetime income, there is no guarantee that the income will remain stable or that it will keep pace with inflation over a long time frame.

<u>Use of the Annuity Plan for Retirement Income</u>

When the time comes for an individual to retire, he or she will be faced with a decision as to how to best use their Portico account. Current rules at Portico offer a retiree a number of different options. As discussed here, those options can permit a retiree a good deal of customization in using the funds in their account to the best result for that individual.

First, it is NOT required that a retiree convert any of their account over to the Annuity when they first retire. Instead, a retiree may chose to never convert any funds to the plan; they have until age 80 to make the decision, at which time the option to enter the Annuity is closed. They may decide to start up to three different annuities at different times, with three different amounts and the possibility of three different beneficiaries.

If a retiree decides not to convert any funds to the Annuity upon retirement, they have the option of leaving the funds at Portico. Investments will continue to grow tax-deferred. They may elect to set up a monthly withdrawal plan, or may choose to make as-needed withdrawals. Once the retiree reaches age 70 ½, as with an IRA, they must then begin to take a set minimum annual withdrawal as calculated per IRS rules.

Finally, withdrawals from Portico receive special tax treatment in that they are considered to be 100 percent housing allowance. To the extent that the retiree can justify the housing expense, some or all of the withdrawal is thus income tax free. Only a church plan, as defined by the IRS, can offer this benefit. It is not available by using another plan such as Thrivent Financial.

As discussed with retiree risks, the Annuity is strongest in offering protection against longevity. Portico guarantees some level of income for life. If a retiree is extremely worried about this threat and their sole sources of retirement income will be Social Security and funds from Portico, then one can make a strong argument that converting the entire account balance to the Annuity plan makes sense.

Conversely, there may be retirees for whom longevity risk is not important. Families who have significant pension income from prior employment and/or significant retirement assets outside of Portico, along with Social Security, may see the Portico funds as a supplement to an already set retirement plan. These individuals would likely be those who had other careers prior to entering church service. For them, the advantages of converting to the Annuity plan may be minimal.

It seems to us that the vast majority of Portico members will fall in between these two extremes. They will see the Portico funds as a significant and important part of their retirement income and while concerned about longevity are also worried about that income keeping pace with inflation.

For those individuals, it seems most prudent to delay using the Annuity until later in retirement. The retiree should look to use other assets as well as the Portico account to provide investment income until such time that the Annuity makes sense within the overall financial plan.

This concept is based on significant research performed in the financial community over the last 18 years. In 1994, William Bengen, a Certified Financial Planner from Eastlake, California, first showed that one could withdraw four percent of the value of a retirement account and then proceed to adjust that amount by the rate of inflation; in doing so, the account could support withdraw for a thirty-year time period.[6] This work has been further refined by Jonathan Guyton, who proposed additional rules that would improve the potential longevity of the account or possibly permit a higher initial rate than four percent. The rules that appear most applicable to this discussion are when to eliminate an inflation-adjusting increase and the placement of a cap upon the maximum yearly adjustment.[7]

Finally, this research shows the need for the retiree to maintain a percentage of stocks in the retirement account to provide potential growth. The original Bengen work used 50 percent stocks and 50 percent bonds. Much work has been done in this area, with a range of 40 to 70 percent stocks proving to be adequate depending upon the willingness of the retiree to tolerate volatility in the account value.

Thus, the broad, overall outline of the strategy would be as follows:

- First, to withdraw from the Portico account an amount, at a minimum, equal to the housing expenses of the retiree. This amount can be withdrawn tax-free to the retiree. However, this withdrawal would not exceed four percent of the value of the Portico account at the date of retirement.

- Second, to withdrawal from other retirement accounts an amount equal to four percent of the value of those accounts at the date of retirement.

- Third, if needed, to withdraw any additional funds from the Portico account necessary to balance the retiree's budget, but when combined with the amount taken in the first step to NOT exceed four percent of the total account.

---

[6] Bengen, William. 1996. "Determining Withdrawal Rates Using Historical Data." *Journal of Financial Planning* (October).

[7] Guyton, Jonathan. 2004. "Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?" *Journal of Financial Planning* (October). Guyton, Jonathan and William Klinger. 2006. "Decision Rules and Maximum Initial Withdrawal Rates." *Journal of Financial Planning* (March).

- Annually thereafter, the retiree should elect how much to increase the retirement withdrawals. The limits would be:

    1. No increase: if the retirement investments have had a negative return over the prior year.

    2. Increase at the rate of inflation: if the retirement account has had a positive return, then the withdrawal may be increased by the rate of inflation. A retiree can add a refinement to this calculation by increasing the amount of the housing withdrawal by only what housing costs are estimated to increase, and then increasing all the remaining amounts by inflation. This refinement reflects the more fixed nature of the housing costs particularly if a mortgage is still being carried into retirement.

    3. Limit of six percent: if inflation exceeds six percent, then the increase for the withdrawals is limited to six percent.

- Annually, the retiree should review the investment performance and investments to see what changes are appropriate.

- Annually, the retiree should review the withdrawal rate from the Portico account to ascertain if some or all of the account should be converted to the Annuity.

The last calculation can be adjusted to meet the needs and attitudes of the retiree as to the concerns about longevity risk. For example, one “red flag” that the four percent withdrawal strategy may be failing is if the “current withdrawal rate” is moving too high. The current withdrawal rate is calculated by dividing the amount of money taken out in a given year by the investment account value at the end of that year. This current withdrawal rate will decline if investment returns are strong and inflation low, and will increase if returns are weak and inflation high. If the current rate exceeds five percent, then a correcting action should be taken.

One possibility to consider at that point is to convert some or all of the account to the Annuity. Each year that the retiree delays beginning the Annuity, it will potentially increase the monthly payment due to the increasing age of the retiree; said another way, the retiree is that much closer to the end of life and thus Portico can increase the amount currently paid. Further, while the retiree is exposed to the above-noted inflation and investment risks, those risks become less important the shorter the expected life span. In essence, this strategy uses the Annuity as a backup for protecting against longevity, but only starting later in life and only if necessary.

An example of the calculations may help in illustrating this strategy. We looked at a couple who were both age 65 when they retired on January 1, 2000. They had a $500,000 Portico account and withdrew $20,000 the first year. A portfolio of one-half Standard and Poors 500 stocks and one-half investment grade bonds had a return of 1.27 percent in 2000. This left the portfolio with $486,072.

Since the portfolio had a gain, the couple increased the withdrawal by the rate of inflation for 2000, which was 4.11 percent. Their new withdrawal for 2001 was $20,822. The portfolio fell 1.73 percent in 2001 and equaled $457,224 as of the end of 2001. The current withdrawal rate was 4.55 percent - $20,822 divided by $457,224.

The couple elected not to increase their withdrawal in 2002 because the portfolio lost money in 2001. The markets were again poor in 2002 and the portfolio lost another 5.93 percent. At the end of 2002, the couple had a current withdrawal rate of 5.07 percent. They decided to ride out one more year, and again elected to not increase their withdrawal.

The markets bounced back strongly in 2003 and showed gains each year until 2008. In those years, the current withdrawal rate fell below five percent each year. However, with the sharp losses in 2008 which drove down their portfolio15.88 percent, the current withdrawal ratio increased sharply to 6.17 percent.

At this point, the couple elected to annuitize $300,000 of their balance which was $388,744 at the end of 2008. The Annuity produced for them $23,224 in 2009. They elected to continue to withdraw four percent from the remaining funds at Portico, giving them a total annual income in 2009 of $27,066.

The decreases in the annuity payments in 2010, 2011 and 2012 reduced their annual income to $23,126. This compares to the income in 2008 of $23,057, the year before they converted to the annuity. The net impact for this couple was the maintenance of their actual income, the loss of some purchasing power and the security gained at age 74 that they would have an income for life.

As we have noted before, past results do not guarantee future results. Also, this couple's decisions were appropriate to them but may not have been to someone else. The purpose of this is to illustrate how such a plan may work and how it may function in what was a difficult investment period.

Concluding Thoughts

The immediate prior pages are meant to outline for potential retirees how delaying using the Portico Annuity plan may help them achieve a more stable lifetime income in a manner consistent with their needs and attitudes toward risk. This outline is NOT a recommendation; as can be seen, there are a multitude of variables that can be adjusted to meet an individual circumstance with varying results. No two plans for using the Portico account should look the same.

Rather, we hope that this paper prompts a potential retiree to think in a systematic way as to how the Annuity can best serve them and what issues an individual or couple need to consider in developing a plan.

We also hope that this paper illustrates a key, on-going fact: to make the Portico account work best, the retiree must be prepared to take an active role in managing the plan and have in place a set strategy for making key decisions. Advanced planning helps a retiree avoid the emotional response that can come with investment volatility and can serve as a touchstone for evaluating progress over the years.

Lastly, it appears to us that the Annuity plan places the responsibility upon the individual to begin to plan well before the day of retirement. Reviewing possible scenarios years in advance may point to critical decisions that may enhance life in retirement. Deciding how much extra to save, when to begin Social Security and selecting an actual retirement date all can, if done well, add many retirement dollars.

We hope this work is helpful to you as you continue the journey in your ministry, and may the Lord bless your work over the coming years.

Disclaimers

This report has been prepared as a service to the friends and clients of Southward Financial Services LLC. It has not been approved or reviewed by the Evangelical Lutheran Church in America (ELCA) or Portico Benefit Services. They have not endorsed this work or its conclusions and have not been asked to do so. Southward Financial Services LLC has received no compensation for the preparation of this report.

This report does not contain specific advice for an individual in managing their retirement account with Portico Benefit Services. No discussion of any strategy should be seen as a specific recommendation. Individuals are encouraged to develop their own strategy either on their own or with the services of a financial advisor.

No discussion of any investment or types of investments should be seen as a specific recommendation. There is no guarantee that any investment mentioned in this report will perform as expected or assumed. Past performance is no guarantee of future results.

There is no guarantee that the assumptions used in this analysis will be accurate. Minor changes in any assumption may have significant impacts upon final outcomes.