

Retirement Planning: Coping with Higher Health Care Costs

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ABSTRACT

Longer lives—not disease—are driving current and projected increases in health care costs that will exceed general inflation, placing the budgets of many retirees, now and in the future, under tremendous pressure. The headline trend is nuanced, however; demographics as well as generational, gender, and geographic differences all play a role in the equation. To help clients meet runaway health care costs, financial advisors will need to rethink their advice on how to accrue retirement income. Growth investment strategies can help retirees, while leaving properly funded legacies.

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Planning for the Expected

As older Americans progress through their retirement years, they are likely to find themselves spending less money on certain aspects of living—for example, travel, dining out, and many other forms of entertainment.¹ With some exceptions, they probably will be long past saving for a house or for their children's college education or weddings. In short, a fair number of big-ticket expenditures will either be fading from view or simply no longer on their balance sheets.

Except for one: health care.

If not planned for well in advance, the cost of health care may overwhelm a retiree's budget and destroy his or her long-held expectations for the golden years, golden years that, to the surprise of many, can now last almost as long as a career itself, as advances in health care and greater insight into healthy living extend life expectancy.

It is no easy task to overstate the challenge health care costs represent for Americans of just about any age—today's retirees and tomorrow's—most anywhere in the country. For all but a few wealthy families, health care costs are already significant budget-eaters and are accelerating at a rate of inflation that vastly exceeds that of consumer goods in general. Prescription drugs, medical care, and hospitalization cost a great deal of money, meaning health insurance that absorbs the blows is vital, if only to protect against a catastrophic health event and the catastrophic bills that often follow. But the cost of health insurance, both public and private,

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is soaring at a rate well above growth in wages and salaries. For retirees living on a fixed income, cost-of-living adjustments to Social Security—when they occur at all—are not keeping up, nor is the interest income a retiree receives from a classic, ultraconservative late-life portfolio of cash and bond market investments. At the same time, the traditional American solution to caregiving—a family member—is becoming more and more impractical for a host of demographic and financial reasons, a harbinger of higher caregiving costs.

Given that no letup in these trends is expected, it is incumbent upon financial advisors to help prepare their clients, prior to and during retirement, for a future of dramatically higher health care costs. Clients should be ready emotionally, physically, and financially. They should be urged to save more, but financial advisors may also want to adopt a different way of thinking about the deployment of those savings: Growth-oriented investment strategies before and then throughout a client's retirement may be more appropriate than the currently accepted wisdom. This approach—tilting more toward capital appreciation than capital preservation and involving a wider variety of investment instruments and life insurance products—will require the application of nuance to be successful. Men and

women face different challenges when it comes to funding their health care, and many preretirement clients are reluctant even to acknowledge the trials and tribulations related to health care costs that lie ahead.

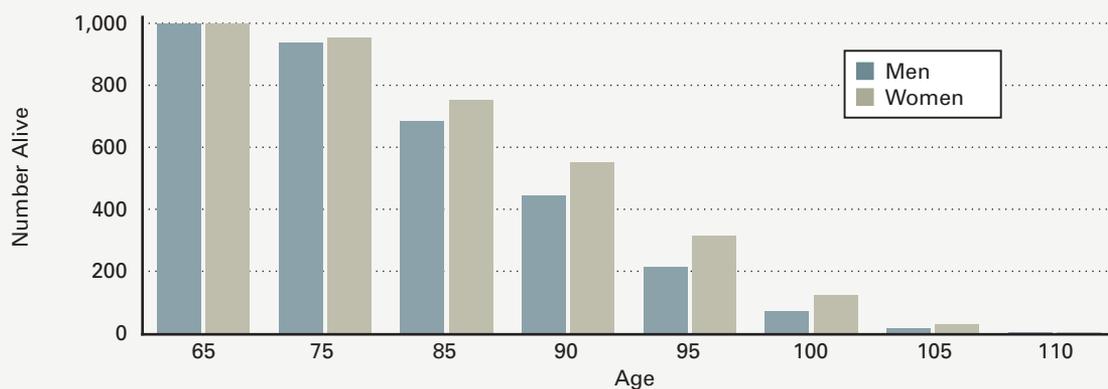
The Problem: Behind the High Cost of Health Care

Why exactly are health care costs rising?

Certainly, in the pantheon of diseases, it is cancer and cardiovascular disease and their attendant therapies that grab media headlines. No one is disputing that these common and often fatal illnesses are costly to treat. In fact, the purchase of some medicines can tally more than \$100,000 a year, and Medicare beneficiaries are often responsible for paying part of this cost out of pocket.² But people who suffer from these diseases often die years, even decades, earlier than many in their birth-year cohort. As counterintuitive as it might sound, health care costs are rising because people, generally speaking, are healthier (in many ways thanks to a recent, deeper understanding of the role of diet and exercise) and thus living longer.

Life expectancy in America has certainly rocketed higher. While the outer boundaries of an American's life span may not stretch too many more years into the future

FIGURE 1
Expected Longevity of 1,000 Healthy 65-Year-Old Individuals



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than it does today, many more people are living a longer time. How many, for how long? For healthy Americans aged 65 today, almost five in 10 men and six in 10 women will reach age 90. Nearly one in five of them, combined, will make it to 100 years old (Figure 1).³

Good Health Is Costly

There is, however, a price to pay even in good health. Projected out-of-pocket health care costs during retirement for a couple retiring at age 65, excluding the cost of chronic illness care, can range from \$158,000 to \$392,000 (2015 dollars).⁴

Looked at a different way, compare the lifetime costs of two American women: one aged 55 with type 2 diabetes and a life expectancy of 80, filing for Medicare benefits at age 65, the other the same age but with no conditions and a life expectancy of 89. The former would need \$267,878 (future dollars) to cover her Medicare Part B (medical insurance), Medicare Part D (drugs), and supplemental insurance premiums, plus out-of-pocket costs; the latter, while facing lower annual costs but also living 9 years longer, would in fact be confronted by \$523,737 (future dollars) in such bills—almost double.⁵

Health, of course, is a relative concept, especially as one ages. As Americans approach the higher edges of life expectancy, as many people are now and more will be in the future, illness will surely take over. One might be so fortunate—and healthy—as to escape a heart attack or leukemia but not be quite so lucky or healthy as to avoid a debilitating illness. More than half of 65-year-olds will likely need chronic illness care later in life, excluding short-term, post-acute-care services, based on the definition of long-term care in the Health Insurance Portability and Accountability Act.⁶

Chronic Illness Care

The risk of chronic illness should be considered in the context of other financial challenges before and during retirement. Because people are living longer, their parents and in-laws may be in frail health and need attention, both physical and financial. Some peo-

ple have children later in life and find they are putting kids through college while trying to catch up on retirement savings and pay off the mortgage. Adult children or grandchildren may need financial help as well. Add to this the chronic illnesses that occur with aging and often require long-term care, such as Alzheimer's disease, strokes, crippling arthritis, brain and spinal cord injuries, and degenerative neurologic conditions, and the nest egg can be stressed far more than expected.

“Long-term,” meanwhile, can mean just that: 18 percent of women and 10 percent of men turning 65 from 2015 to 2019 are expected to someday need chronic illness care of 5 years or more. In this age cohort, for those who need care, the average duration of care is projected at 3.2 years for men and 4.4 years for women.⁷

A look at Alzheimer's disease crystallizes the problem. More than 5 million Americans have Alzheimer's disease today.⁸ Some 15 million family and friends provide 18 billion hours of unpaid care to those with Alzheimer's and other dementias, an amount valued at \$221 billion.⁹ Additionally, almost one in four of those caregivers has children that need attention as well.¹⁰ And, one in three senior citizens will die with Alzheimer's or another dementia.¹¹ For Alzheimer's and dementia in general, there is no cure. These modern-day plagues are not going away, and in fact, as baby boomers—those born from 1946 to 1964—enter their 70s, 80s, and 90s, the number of people suffering from Alzheimer's and dementia is sure to rise markedly in absolute terms.

Compounding this adverse situation, demographic trends suggest the current heavy reliance on family caregivers (73 percent of care for adults aged 65 and older is unpaid) is unsustainable.¹² Currently, a very large generation of baby boomers is caring for a much smaller number of 80-year-olds in the silent generation, but the boomers will be followed by the smaller Generation X. Because of these demographic changes in future decades—relatively more older people and fewer who are middle-aged—there will be fewer people aged 45 to 64 who are potential caregivers for someone aged 80 or older. Instead of seven potential caregivers for seniors who turned 80 in 2010,

people aged 67 in 2017 will have only four potential caregivers when they turn 80 in 2030, while people aged 47 in 2017 will have only three potential caregivers when they reach age 80 in 2050.¹³

Separate Struggles of Women

Women are set to suffer the most should these predictions come true. Because they typically live longer than the man does in a heterosexual relationship and are usually younger to begin with when they marry or partner, women commonly lose their spouse or partner, who would be their primary caregiver, before they need care themselves. Widowed women often have to fill that gap by hiring paid help. At that point, a woman has lost her life partner/caregiver, her health, and at least some of her money. Plus, if there is a mortgage on the house, she now has to make the payment with likely diminished levels of Social Security and pension income. Absent the loss of the life partner/caregiver, a single woman (or man, for that matter) would be affected similarly. Projected average lifetime additional out-of-pocket costs for chronic care alone are 44 percent higher for women turning 65 during the 2015–2019 period than for men who will need care (Figure 2).¹⁴

The Crisis in Caregiving

This crisis in caregiving—just the combination of increasing baby boomer demand for care and the lack

of caregiver supply alone—will almost certainly result in upward pressure on the cost of such care, otherwise known as inflation. It will not be the first time health care costs have risen for retirees; inflation in health care costs has run rampant for years, for a variety of reasons, and is expected to gallop ahead of consumer inflation for decades and decades more.¹⁵ That is not news, but this is: Such inflation will no doubt hasten the government's shift toward having retirees pay a higher percentage of their health care costs than they do today.

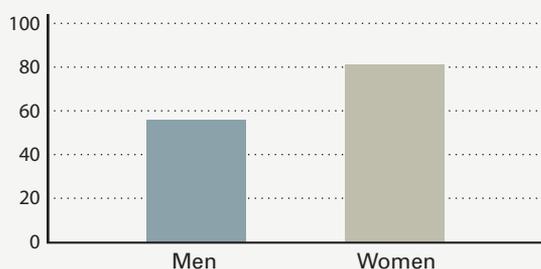
In just one example germane to retirees, many of whom live on fixed incomes, monthly Medicare Part B premiums rose more than 16 percent in 2016, amid a zero Social Security cost-of-living adjustment. Another: In 2017, the average monthly Medicare Part D premium is expected to rise 9 percent from 2016, with the corresponding deductible increasing 7 percent.¹⁶ One more: From 2017 to 2024, the cost of Medicare Part D premiums could accelerate an annual average of 8 percent, and supplemental insurance premiums could speed ahead 3.8 percent a year on average.¹⁷ And means testing, in which higher-income Medicare beneficiaries pay an additional premium for Medicare Parts B and D based on their modified adjusted gross income, would leave still more people paying those higher premiums. The percentage of Medicare beneficiaries who pay extra premiums is expected to grow from 5 percent today to 10 percent in 2019.¹⁸

Eventually, if health care inflation outpaces cost-of-living adjustments to Social Security for long enough and by a large-enough margin, some retirees may end up having to pay more in medical expenses alone than they receive from the government for Social Security in total.¹⁹

Geographic Cost Caveat

To be sure, where a retiree lives will have a lot to do with how much health care costs, and this reinforces how important it is for a financial advisor to tailor his or her counsel on such costs to the individual. It is the states, not the federal government, that actually regulate Medigap (Medicare supplemental insurance)

FIGURE 2
Risks and Financing of Long-Term Services and Support for Older Americans



Data Source: U.S. Department of Health and Human Services

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and prescription drug policies, and that is why, for example, supplemental premiums are so much lower in Hawaii than in Massachusetts (Table 1).²⁰

What state control of such policies does not guarantee, however, is that premiums in Hawaii, for example, will not accelerate faster than general inflation in the future. While it is impossible to accurately predict exactly how fast health care costs will rise, and how much faster that rate will outpace the general inflation rate, it is not an unfair leap to say this is what will probably occur based on recent and projected trends. If that is the case, then with every year that goes by from now until retirement (and through retirement), Americans will find themselves deeper and deeper in the hole when it comes to financing their future health care needs.

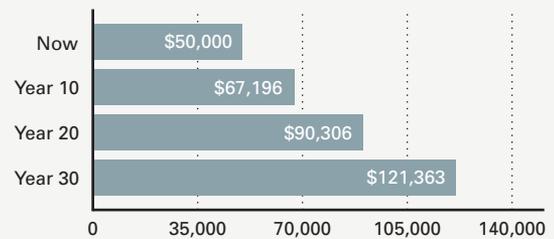
Generation X and the Millennials

Furthermore, this paradigm will have its greatest effect not on the baby boomers, who are either in retirement or see it on the horizon, but rather on the generations that follow them, particularly Generation X and the millennials, the cohorts born from 1965 until the late 1990s to early 2000s. For one thing, because these cohorts are the children of the extremely large baby boom generation, there are simply more of them in the population now. And with the youngest members barely in their teenage years, they still have a lifetime of runaway health care costs in front of them, but also little education—or warning—about what they are up against. This is not to mention that with student loans, weddings, and sav-

ing to buy a house, they will have even less capacity to do something about it now. And yet now is the time for action. Imagine annual increases in health care costs over their adulthood of just 5 percent, and the numbers get mind-boggling, especially if increases in wages and salaries do not follow suit. Even at 3 percent a year, health care inflation would quickly erode a nest egg or put a giant crimp in a household budget. In 30 years, it would take \$121,363 to purchase what \$50,000 does today (Figure 3).²¹

Under this scenario, members of the Generation X and millennial cohorts will have to work longer, save more, and invest very wisely. First and foremost, though, they need to recognize the difficulty of the path ahead. Faced with such daunting figures, there has been some emotional resistance, and truthfully, it is hard to blame them. The vast majority of Generation X and

FIGURE 3
Estimated Impact of Health Care Inflation
over 30 Years



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TABLE 1

Supplemental Insurance State-to-State Premium Cost Comparison for 55-Year-Old Female in Future Dollars

State	Age	Life Expectancy	Retirement Age	Coverage	Total Health Care Costs
HI	55	89	65	Supplemental Insurance (Policy f)	\$121,228
MA	55	89	65	Supplemental Insurance (Policy f)	\$180,179

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the millennial generation is in good health due to their young age alone. Of course, as discussed, while it may seem counterintuitive, “living right” only supports the need for members of these generations to be proactive in saving and investing for future health care costs early in their careers. The longer they live, the more they will pay for Medicare, and that expense is a constant one, unmoored from the state of a person’s health. While they may be correct to envision a personal future without, say, cardiovascular issues or diabetes, it does not necessarily mitigate the chances of a chronic illness later in life (or two or three, simultaneously, with attendant medicines needed and costs).

Another common misperception when it comes to planning for retirement health care costs revolves around the accuracy of the retirement calculators that financial advisors often recommend for their younger clients. The calculators focus on income replacement levels: If a client is on course to replace 80 percent of his or her preretirement income, that would meet with favor. But health care costs are generally relatively neutral when it comes to income. A poorer person would face roughly the same costs in dealing with a major illness as a richer person would, but would have a lot less absolute income to pay for it, even if he or she is at that magic 80 percent figure.

Still, there are advantages to being a millennial or a member of Generation X; chief among them: Forewarned is forearmed. For their parents—who are retiring now; faced with fixed incomes while caring for aging parents and in-laws; helping adult children and grandchildren for decades after they should have been independent; and, often, coping with widowhood—reality is either here or right around the corner. But while that reality can look bleak and overwhelming, the problem is not insurmountable.

The Solution to Longevity Risk: Unconventional Wisdom

The solution to the quagmire that is health care costs begins attitudinally. Once a financial advisor has shown a client the road ahead and the client un-

derstands the challenges, the advisor can show the client ways to technically navigate that road. “Navigate” suggests a proactive approach, and that is an important distinction, since the anticipated rise in the cost of health care is not a problem that will be solved by thinking or acting passively.

The conventional wisdom for preretirees and retirees is that they should adopt a financially conservative way of thinking, that is, shifting a portfolio to cash and fixed-income instruments versus growth investments (often code, however simplistically, for certificates of deposit, money market funds, and bonds, versus equities, whether purchased directly or through mutual funds or exchange-traded funds). But to counteract the rampant acceleration in health care costs, clients and their financial advisors may want to look more closely at a more growth-oriented investment strategy. Every client is different, naturally, with different resources and needs, but in general, portfolios will require more than the modicum of growth currently offered by cash and fixed-income investments to offset health care cost inflation and increased longevity. Being too conservative in this regard may prove just as dangerous as being too aggressive.

There are risks with this shift in thinking. In practice, a more aggressive portfolio can fall, and fall hard, and caution is always advised. But, pressured by the seemingly inexorable rise in health care costs, a too-conservative portfolio can diminish how long a client’s money will last, and that money may need to last an exceedingly long time without any major fresh injection, while the client lives on Social Security and investment income. Managing against this phenomenon, known as longevity risk, is quickly becoming more important than protecting against a possible diminishment in the value of a client’s portfolio. A balanced approach is clearly appropriate for people approaching or already in retirement.

When deploying that balanced approach, financial advisors should consider three core objectives: 1) that clients are provided with a predictable stream of money for daily needs, such as food, clothing, and shelter; 2) that they achieve portfolio growth for lon-

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ger-term needs; and 3) that there is enough flexibility in the portfolio to refine the plan over time, given that retirements can now easily last 30 years or more.

Predictable Income Streams

There are a variety of ways to achieve a predictable income stream—a “foundation”—in the years one lives without a wage or a salary.

Social Security is the obvious one, and while not what one would call a lot of money, it is steady, and the program appears to be stable in at least the short to intermediate term. As of 2013, it provided the largest share of retirement income in the United States (Figure 4).²² Defined-benefit pensions, while clearly on the decline in corporate America, are still available to some workers. Buying an income annuity, as another resource, can bridge the gap between retirees’ daily financial needs and the money they receive from their Social Security and other such “pensions.”

And then there are the required minimum distributions out of a 401(k) or other retirement investment accounts, even as contributions to such accounts come under pressure from high health care costs. In a recent survey, 28 percent of workers reporting an increase in the cost of their health plans in the past year have cut back on the amount they are contributing to their retirement plans, and 48 percent have cut back on contributions to other savings plans.²³ Because retirement plans can be used for non-health care costs, it is generally a good idea for a retiree to first use a tax-deductible health savings account (HSA).

Long-Term Needs

After establishing that foundation, one can focus on long-term needs, such as health care. If offered at work, an HSA is a good way for a client to start saving for long-term needs while still employed. HSAs have other tax advantages and come along with high-deductible health insurance plans as a way of offsetting medical costs. The funds within them can be deployed in the financial markets or in alternative asset classes, giving a holistically managed portfolio

that often-missing and necessary kick of growth.

As an added feature, employers often contribute funds to an employee’s HSA. Better still, unlike the money in flexible spending accounts, the funds in an HSA can accumulate in perpetuity (they are portable from job to job and then into retirement), and without tax owed if eventually used on qualified medical expenses.

Qualified medical expenses include long-term-care insurance premiums; health insurance during COBRA or after the age of 65 under Medicare; and premiums involved in a company-sponsored retiree health program. All of these uses protect against catastrophic health care costs.

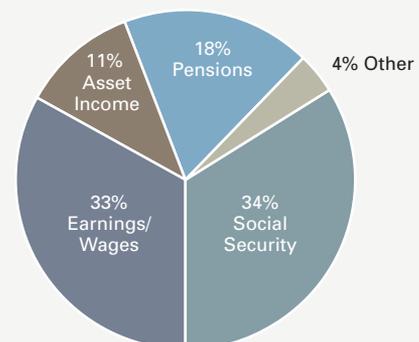
Also, during the normal retirement years, the funds can be withdrawn for any reason, and while income tax would be owed on money not used for health care, a penalty would not be assessed.

Using Life Insurance

Life insurance can help manage the challenges clients may face in addressing higher health care costs in at least three ways.

First, life insurance can help secure an amount of money to implement the client’s overall legacy goals and, by doing so, help the client in ways that may or may not seem intuitive or apparent. For example, a client may be more willing to take on a more growth-oriented

FIGURE 4
2015 Total Aggregate Retirement Income by Source



Source: U.S. Social Security Administration

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approach to investing with respect to his or her portfolio when he or she has established a properly funded legacy plan with life insurance. With the overhanging issue of the legacy plan cared for, the client may be less conflicted, anxious, and tense about taking a more aggressive approach toward the investment or spending on expenses such as health care in retirement.²⁴ Of course, this will depend upon the client, and no one type of plan will fit every client. Nevertheless, this strategy may be attractive to clients and is worth exploring in the overall planning conversation.

Second, certain cash value life insurance policies can also act as a supplemental retirement income tool to help offset rising health care costs. Ultimately, a death benefit—leaving the right amount of money to the people one wishes to give it to—is the core function of life insurance, but as policyholders age, their needs may evolve, and the supplemental cash value accumulation may become an important tool for income during retirement. The main point is that this versatility offered by cash value is significant. It helps complement flexible planning and is an essential part of today's planning environment.

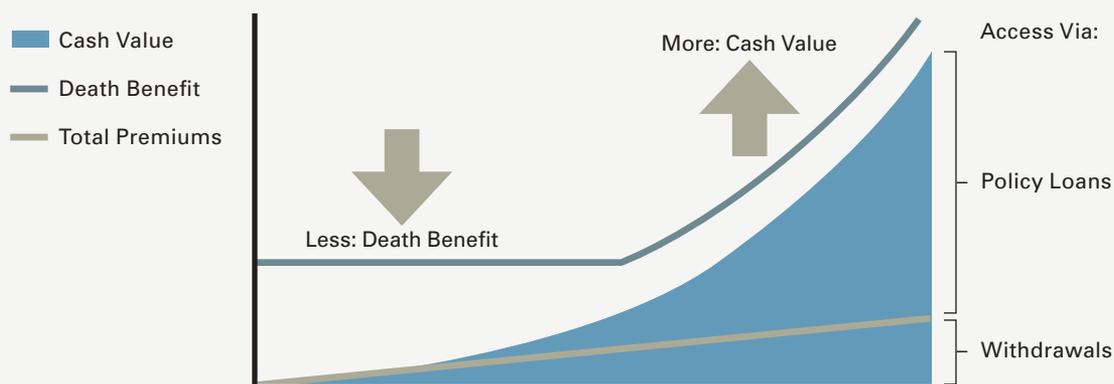
Some financial advisors, especially those who are not familiar with all of the features and benefits life insurance products can provide, may see a conflict

between the legacy benefit and the potential cash value accumulation benefit. It is equally important to think strategically about planning as it is about the products a client employs in the planning. Advisors should remember that a client does not have to try to solve all needs with one policy, nor does the advisor need to try to achieve all goals with one policy. A client may choose to buy one policy to primarily serve a legacy goal and purchase another policy that will help serve the legacy goal, while also providing cash value accumulation potential when cash is needed for supplementing retirement income. The additional cash value accumulated may be used for a variety of purposes, including offsetting health care costs. In this way, the advisor helps the client build a portfolio of insurance products to efficiently manage the client's risks, similar to building portfolios of other products to serve the client's other financial goals.

One of the flexibilities that life insurance cash value accumulation can offer is that it may be more advantageous to take a withdrawal or loan from a life insurance contract than from another source.²⁵ This is because sometimes, growth-oriented investments decline in value, and withdrawing from these investments when they are in decline may not be beneficial to the client.²⁶ Using a cash value life insurance policy less exposed to,

FIGURE 5

Illustration of Potential Savings Accumulated through Cash Value Life Insurance Policies



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say, the stock market, takes on extra importance at these junctures, when a client least wants to cash out of his or her equity investments.²⁷ If a policy has grown in tax-deferred value, there will be additional “savings” to deploy (often via a federal tax-advantaged withdrawal or loan) toward big-ticket items, including, for example, an unexpected catastrophic health event, although the death benefit will decline accordingly (Figure 5).²⁸ Assuming that a policy is not a modified endowment contract (MEC), withdrawals are taxed only to the extent of gain in the policy, and loans are usually free from current federal income taxation. A policy loan could result in tax consequences for the client if the policy lapses or is surrendered while a policy loan is outstanding. Distributions from MECs are subject to federal income tax to the extent of gain in the policy. Any taxable distributions are also generally subject to a 10 percent penalty when such distributions occur before the taxpayer reaches age 59½, with certain exceptions. For these reasons, financial advisors should carefully help clients manage distributions from their insurance contracts.

Third, certain riders on particular life insurance products provide accelerated death benefits in the event of chronic illness or a need for care on a long-term basis. While these riders do not provide a mechanism to trigger benefits to produce an income stream to offset all types of health care costs, the riders can trigger benefits, often free of income tax, to help offset some of the costs associated with chronic illness, thereby helping clients preserve other assets rather than liquidating them to pay for this type of care.²⁹ This may help clients preserve the assets they wish to pass on as a legacy or use other assets to offset other expenses during retirement. In either case, the benefits available under chronic illness riders may be invaluable in a client’s plan.

Of course, there are many other ways clients can use the versatile features of cash value accumulation life insurance, depending on the client’s particular circumstances. For example, flexible premium products can provide flexible premium payment patterns, allowing clients the flexibility to pay more when they have more cash and, in some cases, pay less when they need to deploy resources

in other ways, including payment of health care expenses. In sum, financial advisors would do well to bear in mind that life insurance can be a multidimensional product that can help their clients prepare in a myriad of ways.

Conclusion

If one thing is clear from an examination of health care needs and how Americans can meet them, it is that financial advisors are going to play an ever-more-important role in the future. Few clients have a grasp of all the ways health care costs can rise and the speed at which they are inflating; fewer still are aware of all the strategies and tactics available to help overcome the obstacles. And many, unfortunately, will be unable to maintain their preretirement level of financial literacy deep into their retirement years, just when one could argue they need it the most. Financial literacy, as measured by knowledge about money, debt, credit, investments, and insurance, begins to decline around age 60, and it does not come back. In fact, it just gets worse, and dangerously, confidence in one’s financial literacy does not decrease concomitantly.³⁰

The fact that financial literacy will wane should not come as a surprise. Cognitive aging occurs in everyone and it is no more a disease than is the need for glasses or a hearing aid because of aging eyes and ears, respectively. The degree of cognitive aging is different for every individual, and some cognitive functions can even improve with age.³¹ But struggling with a crossword puzzle is not quite the same as failing to grasp financial concepts. It will take sound and savvy financial advice to see clients successfully into and through their golden years. ■

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(19) HealthView Services (2016), endnote 5: 13.

(20) "2017 Retirement Health Care Costs Data Report," HealthView Insights, HVS Financial (2017). "HealthView Services: 2016 Retirement Health Care Costs Data Report," HealthView Insights, HVS Financial (2016): 8.

(21) The graphic shown is hypothetical for illustrative and educational purposes only. Amounts calculated using a 3.0 percent compound interest rate.

(22) "Fast Facts & Figures about Social Security, 2015," Social Security Administration, September 2015; accessed at: https://www.ssa.gov/policy/docs/chartbooks/fast_facts/2015/fast_facts15.pdf.

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(25) Unpaid loans and withdrawals reduce cash values and death benefits; may reduce the duration of the guarantee against lapse; which may lapse the policy and may have tax consequences.

(26) Wade Pfau, "The Hidden Peril in Sequence of Returns Risk," *Advisor Perspectives*, March 10, 2015, at <http://www.advisorperspectives.com/articles/2015/03/10/the-hidden-peril-in-sequence-of-returns-risk>.

(27) Greg Iacurci, "Life Insurance Helps with Retirement Planning, but Beware of the Pitfalls," *InvestmentNews*, May 29, 2016; accessed at: <http://www.investmentnews.com/article/20160529/free/160529950/life-insurance-helps-with-retirement-planning-but-beware-of-the>.

(28) The graphic shown is hypothetical for illustrative and educational purposes only to describe the impact of possible premium and death benefit designs on cash value potential. It does not represent the cost or performance of any specific life insurance product.

(29) Pursuant to Internal Revenue Code Section 101(g)(1). Robert Pokorski and Brett W. Berg, "Overview of Recent Research on Longevity Risks in Retirement and Some Practice Considerations for Life Insurance Planning," *Journal of Financial Service Professionals* 68, No. 5 (2014): 90.

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