What Annuities Can (and Can’t) Do for Retirees

With proper handling and expectations, annuities are powerful retirement income tools

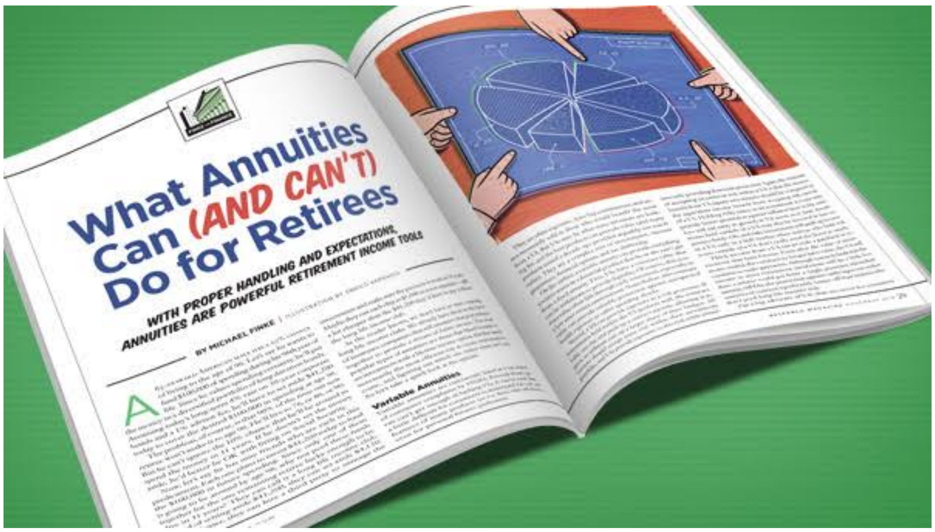


Illustration by Enrico Varrasso

A 65-year old American male has a 10% chance of living to the age of 96. Let's say he wants to fund $100,000 of spending during his 96th year of life. Since he values spending certainty, he’ll put the money in a diversified portfolio of long duration bonds. Assuming today's long-term 4% rate on 30-year corporate bonds and a 1% advisor fee, he’ll have to set aside $41,200 today to cover the desired $100,000 in spending at age 96.

The problem, of course, is that 90% of the time our new retiree won't make it to age 96. He’ll live to 76, or 86, or 90. But he can't ignore the 10% chance that he’ll be around to spend the money in 31 years. If he doesn't set the money aside, he’d better be OK with living on Social Security.

Now, let's say he has nine friends who are each in this predicament. Each one plans to invest $41,200 today to fund the $100,000 in future spending. Since only one of them is going to be around by age 96, why not pool these funds together for the one remaining retiree lucky enough to be alive in 31 years? They can call it a long life income club. Instead of setting aside $41,200, they can set aside $4,120. Even better, they can hire a third party to manage the investments and make sure the payment is made in 31 years. Maybe they can each chip in $5,000 to cover expenses — still a lot cheaper than the $41,200 they'd have to pay without the long life income club.

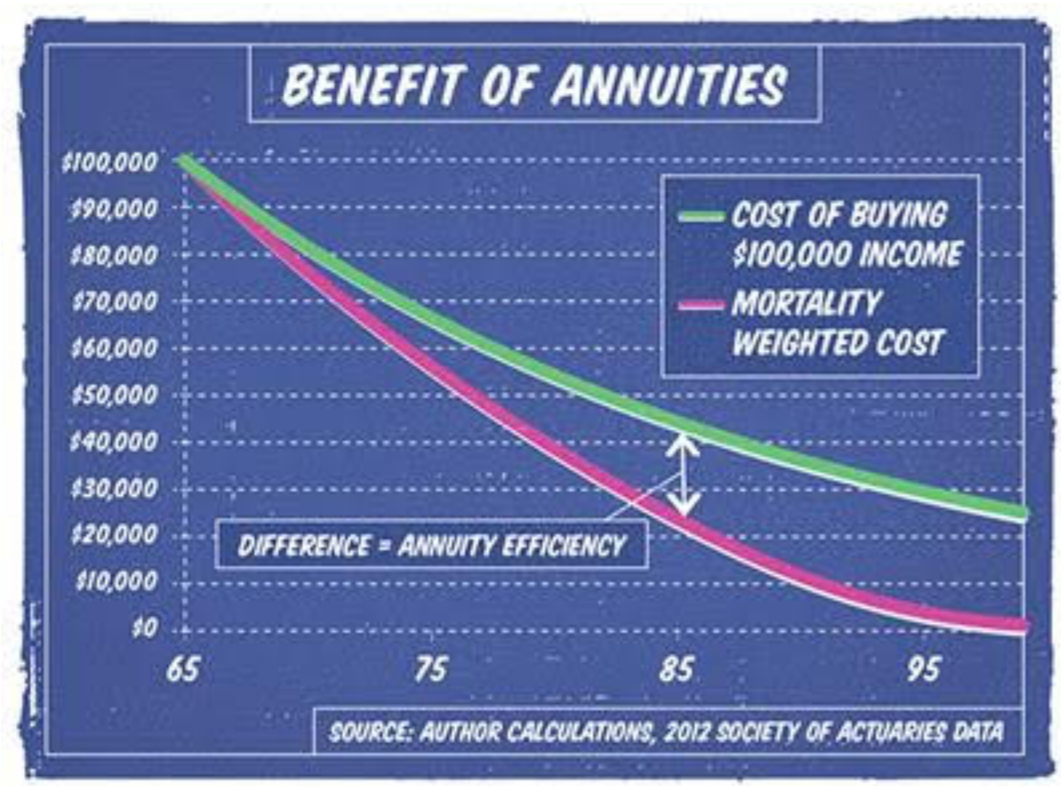
As the reader knows, we don't have to start creating long life income clubs. We already have them in the form of insurance companies that sell annuities that pool retirees together to provide a stream of future income. The most popular types of annuities are those that blend features of an investment with a lifetime income option. But they aren't necessarily the most efficient way to create retirement income, and figuring out which one makes sense isn't easy. So let's take a quick look at the options.

Variable Annuities

Variable annuities are consistently listed as a top source of consumer complaints by the Financial Industry Regulatory Authority. Personal finance gurus can't get enough of bashing VAs. It can be more than a little difficult for consumers to understand the costs and features of many products (or for those who sell them or even for personal finance professors).

They are often expensive, have big commissions, and are not necessarily sold to those who would benefit the most from a VA. But VAs may be what some investors are looking for, and the best products can provide value (and many products issued a decade ago provided arguably too much value). They are a complex mix of investments, income guarantees, financial options and tax sheltering.

On the surface, a variable annuity can provide everything a retiree wants in a financial product that he or she can't get from a fixed annuity. First, VAs have a contract value that can be withdrawn to provide liquidity. Of course, this contract value often falls through early retirement, especially in a low asset return environment. Nonetheless, this contract value can provide valuable protection against unexpected health expenses or other spending shocks.



Second, a VA can provide exposure to a risk premium. If investments held within the VA perform well, the contract value can rise and push up a retiree's income allowing it to grow as inflation eats up a larger share of their budget. All retirees should accept some risk within their investment portfolio, and VAs provide exposure to this risk while simultaneously providing downside protection. Again, the criticism of accepting investment risk within a VA is that the income benefit from VA equity investments should be compared to the equivalent income benefit from accepting risk outside of a VA. Holding risky assets in an investment account may provide better protection against inflation later in life since fees will eat away at growth in VA assets over time. Investments held outside of a VA may also be invested in less expensive funds. Oh, and risky investments will push up income in a VA only in a bull market when retirees who hold risk assets outside of a VA don't really need the boost as much.

Third, income from a VA can provide a paycheck in retirement that lasts forever. Even after the value of investments within the contract no longer have value, the VA will continue to make payments. Although research finds that the income in most retirement simulations will be a little less than a retiree could get from a single premium immediate annuity (SPIA), the protection against outliving assets makes annuitized retirees significantly better off than retirees who don't pool long life income risk.

I’m a big advocate of VAs that are easier for consumers to compare, and that are structured in ways that will provide the greatest value to retirees. Sheltering savings for the purpose of buying income, providing competitive investment options, and creating a pathway to annuitize these assets with some optional downside protection shouldn't be that complicated.

I don't fault companies for developing products that consumers will buy and agents will sell. But a little bit of clarity in disclosure and, more importantly, standardization in product features would go a long way toward increasing confidence in the product. Today's imperfect market has limited demand for what could be the target date fund of the decumulation stage.

Fixed index annuities have become an increasingly popular hybrid option that provides some liquidity benefit like a VA with more limited upside potential and more generous income guarantees. Moshe Milevsky, writing in Research magazine's July 2013 issue, provided a generally positive evaluation of a fixed index product as an alternative to a plain vanilla fixed annuity.

In a conversation I had with Brian Kroll, senior vice president of annuity solutions at Lincoln Financial Group, he noted that “a fixed indexed annuity will generally provide a better floor guarantee (or minimum income level) than a variable annuity,” but will sacrifice the upside potential that a variable annuity provides from uncapped participation in the market.

Deferred Income

Let's return to our 65-year old retiree who cut his cost of funding retirement income at age 96 by 90% by pooling assets with nine other retirees. I cheated a little bit by choosing 96, an age that really makes annuitization look good. If I’d chosen 100, it would have made annuities an even better deal. If I’d chosen age 70, annuitization wouldn't have looked so great.

That's because the value of pooling retirement spending increases when your chances of reaching a given age go down. If you got together with 99 65-year old retirees and pooled savings to fund income at age 66, only one of you wouldn't make it. So it would cost almost as much to fund income through an annuity versus not pooling at all. Each year the pooling benefit goes up, meaning that paying for income through a bond ladder becomes more and more expensive compared to pooling through an annuity. This is the magic of mortality credits. Deferred income annuities (DIAs) let you choose when to turn on the income spigot. Wait longer and it will cost you less to buy a dollar of income since your money has more time to grow at the current fixed-income rate (not much) and mortality credits (can be a lot at older ages). And the government now permits retirees to avoid paying required minimum distributions on DIAs that meet certain conditions, providing a modest tax sheltering benefit particularly for those in higher tax brackets. These so-called qualified longevity annuity contracts, or QLACs, are a new product that opens up new opportunities for cheaper and safer withdrawal strategies.

In a new study conducted with graduate students Tao Guo and Jacob Williams, I estimate the cost of funding a bond ladder during age 85–100 versus the cost of buying a QLAC to provide an equal income over these same years. Since quite a few retirees won't be alive to receive payments in later life, the QLAC can cut the cost of buying income for a 65-year old male by half at today's interest rates. In addition to allowing a retiree to buy later-life income at a much lower price, a QLAC also provides an income for the 3% of men who will live past age 100. Cheaper and safer income is a good thing.

QLACs are limited to $125,000 (although the size of DIAs purchased with taxable dollars is not limited). This provides about $40,000 of income at age 85. While $40,000 may not be enough to sustain a retiree's lifestyle, the income provides important protection against the risks of drawing down an investment portfolio later in life. In our simulations we find that the risk of depleting assets later in life can be reduced by 50% for retirees who invest in a 50/50 $1 million portfolio in which $125,000 of bonds are used to buy a QLAC.

A simple QLAC strategy for clients with significant IRA assets is to purchase a $125,000 QLAC (assuming you have at least $500,000 in the IRA) and treat the $125,000 as if it were still a part of the bond portfolio. For a $1 million portfolio, this will shift the stock allocation from 50% to 57% in the remaining portfolio. For a larger portfolio, the allocation will shift even less. We find that this strategy provides protection against outliving assets and reduces shortfall risk (or, equivalently, increases the safe withdrawal rate) without any drop in average bequest. In fact, bequests are higher in simulations in which retirees live a long life with modest asset returns — or when they need it most.

Another DIA strategy with important behavioral benefits is to turn the income spigot on at one's expected retirement age, but to buy the income before retirement in order to lock in a future paycheck. This strategy can be particularly appealing for boomer retirees who’ve experienced a big run-up in their investment portfolio, but are anxious about how near-term volatility will impact their retirement security.

An advisor can take some gains off the table at age 55 or 60 and buy a guaranteed income that begins in five or 10 years through a DIA. Although they'll lose the liquidity of that portion of the portfolio, most near retirees weren't planning on spending these assets anyway. Some might even value not being tempted to spend the money. The annuity then starts paying income at retirement and provides many of the advantages of a single premium immediate annuity.

Immediate Income

Single premium immediate annuities are a tough sell these days. While economists predict that retirees should be lining up at insurance companies to buy SPIAs, few even consider buying these simple and theoretically valuable private pensions. Why? First, there's not a huge incentive for agents and brokers to sell them. And these are financial products that need to be carefully explained to a consumer. Second, they lock in the very depressing reality that today's low interest rates will result in a more modest retirement. When workers who have diligently saved an amount that seems obscenely large to them — say $500,000 — are told that they can buy an income of $30,000 a year or less with a SPIA, they are understandably underwhelmed.

In a comparison of various types of retirement annuities, SPIAs were the most efficient product, according to a recent analysis by David Blanchett, Morningstar's head of retirement research. Why? The simplicity of the product led to stronger price competition, which resulted in a higher guaranteed income per dollar spent. There's also nowhere to hide the commission, which increases efficiency but limits incentive to push sales.

What is simple about a SPIA is that you are trading a lump sum for a specified income today. Consumers can pick the highest guaranteed income from among highly rated annuity providers without worry about opaque fees or product characteristics.

SPIAs are simply a long-duration bond portfolio in an annuity wrapper. In my own simulations of retirement efficiency, it will always be cheaper and safer to shift bond investments from an investment account into a SPIA. SPIAs are just supercharged bonds — they provide a return competitive with a bond mutual fund while adding mortality credits and, most importantly, provide income for as long as you live.

The disadvantages of buying a SPIA are a loss of liquidity and the need to lock in today's historically low long-term bond rates. The bond rate argument in reality is not that convincing if an investor would have otherwise owned a portfolio of long-duration bonds. If inflation rises more quickly than the market expects, the SPIA payments will seem less attractive. But your long-term bond portfolio will also lose money.

If there is a bottom line to buying annuities in retirement, it is that they are the best retirement income option. But, today's low return environment means that a retiree needs to first acknowledge that buying retirement income today is going to be a lot more expensive than buying retirement income in the past. And many aren't willing to accept that reality, which adds to the appeal of products that promise historical upside and a more modest downside income. Even if the reality is that retirement is far more likely to look like the downside.