

# Immediate Gratification: New Studies Show That Immediate Annuities Add Both Income And Stability To A Retirement Portfolio.

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<?xml version="1.0"?>Immediate Gratification: New studies show that Immediate annuities add both income and stability to a retirement portfolio. Donald Jay Korn

Annuities may get more negative press than any other financial product. To hear the critics, they're overpriced and unfair to buyers.

Yet academics love them. Case in point: Two fellows at the Wharton Financial Institutions Center recently published a paper in which they assert that "it often makes sense to annuitize most of one's wealth at retirement." Why the apparent contradiction?

The annuities that receive harsh words are usually the deferred variety, which many deem too expensive. In their paper, professors David F. Babbel (Wharton School) and Craig B. Merrill (Marriott School) focused on immediate annuities, aka life annuities, income annuities or payout annuities. By any name, consumers of immediate annuities pay cash to an insurance company and receive an income that may continue for as long as they live. Study group

Historically, insurance companies have not heavily promoted immediate annuities (IAs) aimed at individual retirees. That may be changing. New York Life cosponsored the study on which the Wharton paper was based; MassMutual just came out with its own study, indicating that adding immediate annuities to a standard stock/bond retirement portfolio can improve results over time.

Increased insurance company interest in IAs isn't surprising. The oldest baby boomers are entering portfolio drawdown mode. "Boomers have consumed too much granola for their own good," says Chris Cordaro, chief investment officer at RegentAtlantic Capital, a wealth management firm in Chatham, N.J. "They've worked hard to live longer than any generation in history."

Most boomers will retire without pensions, and the maximum Social Security benefit at full retirement age (66) is less than \$2,200 per month. Therefore, they will depend on their investments to maintain their lifestyle. According to the Wharton paper, a chunk of that portfolio should be used to buy an IA and keep the elderly flush.

In their paper, Babbel and Merrill targeted "homemade strategies that mimic the behavior of life annuities." They're referring to the so-called 4% rule, which has become the default spend-down strategy advocated by many planners. According to this rule, clients withdraw 4% of their investment assets annually in retirement, then increase withdrawals to keep pace with inflation. Theoretically, this spending rate should minimize the chance of depleting funds.

The professors say this cost-effective approach is a "fantasy" and add that "phased withdrawal plans require an adherence to a strict discipline for the remainder of your life. They require you to consume at a substantially lower rate for many years than the life annuity withdrawal rate to maximize the probability that you won't run out of money."

Indeed, IA backers can point to impressive numbers. According to New York Life, a 65-year-old couple who placed \$500,000 into a straight lifetime annuity (fixed lifetime payout, no survivor benefits) would receive about \$3,400 a month, around \$35,000 a year, an annual return of about 7%, far ahead of the 4%-plus-CPI starting point. (A single 65-year-old male would receive \$41,000 a year, about 8%.)

Using a 4% withdrawal rate for that same \$500,000 would give the pair an income stream of \$20,000 a year at retirement. If inflation runs at 3% a year, that payout would grow to \$35,000 a year approximately 19 years later. Annuity allocation

With this boon, the academics suggest that retirees devote a chunk of their retirement assets to an IA. If they need \$45,000 a year for a base level of income and Social Security pays \$20,000, they need an IA that pays at

least \$25,000, which would require an initial outlay of \$360,000.

"Excess assets" might be deployed to fund an even larger IA. If our 65-year-olds have a \$1 million portfolio and allot \$360,000 to an IA, the excess assets would be \$640,000. Depending on their risk tolerance and concerns about future healthcare costs, some of that money might be moved into an IA. "Optimal annuitization of the excess assets ranges from 40% to 80%," posit the professors. Thus, another \$256,000 to \$512,000 (40% to 80% of \$640,000) could go into an IA, bringing the total IA commitment to between \$616,000 and \$872,000. With this approach, less than 5% would go to more familiar fixed-income investments, because the IA guarantees a steady income, and remaining assets can be allocated to high-growth-potential investments.

Getting Real

Few clients will put 62% to 87% of their retirement money in an IA. "Allocating 25% to 50% of a portfolio to an income annuity might be reasonable," says Paul Pasteris, senior vice president at New York Life. "The rest might be invested largely in stocks, where returns over a long retirement may be substantial."

MassMutual suggested an allocation starting with a "base case" of a 50/50 balance of stocks and bonds. It looked at an alternative portfolio, in which 33.3% of the money was shifted from fixed-income securities to an IA, and compared hypotheticals from 1980 through 2006, based on actual market returns and interest rates.

The hypothetical client was a single 65-year-old male; the same levels of retirement income were taken from the base and alternative accounts each year. Assuming that he reached his 19-year life expectancy, the portfolio with the IA would have been well ahead of the base case. The gap would have been larger if the man were alive near the end of 2006 to collect.

A cynic may say that 1980 was a great year to buy a fixed annuity: Interest rates were near peak, with 10-year Treasuries yielding more than 10%, and annuity payouts were high. A client buying today would not do as well.

MassMutual devised a portfolio, in which clients buy IAs over seven years. "Dollar-cost averaging might be a way to approach immediate annuities," says Cordaro. "If a 25% allocation to an immediate annuity is desired, a client might put 5% into one, each year for five years. That would shorten the life expectancy each time, resulting in a higher payout."

Laddering reduces the risk of buying in when rates are cyclically low. "Such a strategy provides the chance for higher payouts, if interest rates increase," says Cordaro. "It offers a chance to participate in improved products." The MassMutual study confirmed the appeal of dollar-cost averaging. Its laddered annuity case topped both the base and lump-sum purchase cases, over the investor's 19-year life expectancy and the 27-year study. Tough Sell

According to LIMRA, a research firm in Windsor, Conn., sales of immediate annuities totaled \$4.5 billion in the first three quarters of 2007. That was up 9% from last year, but still a tiny portion of the overall annuity market, reported as \$189.4 billion for the first three quarters of 2007.

And even when planners are receptive to IAs, clients may not be. But Cordaro believes they might be especially appealing to clients who anticipate surpassing average life expectancy. "The better you feel," he says, "the more you should like annuities."

Cordaro has suggested inflation-indexed IAs to clients to no avail. He says they're concerned about low interest rates and unwilling to give up control of their money. "Clients wonder, 'What if I need a lump-sum?'" he says. "If they choose an IA with some access to principal, the payout drops."

Insurers insist that IAs now have features that can overcome buyers' objections and be sold to retirees seeking steady, lifelong income. "We increased our sales of fixed immediate annuities by 75% a year, compounded, from 2003 through 2006," says Pasteris. "Last year was up significantly too." The vast majority of those sales has been to retirees, primarily in their late sixties to mid-seventies. "Once you reach that age," says Pasteris, "there's a noticeable bump in payouts."

The key, says Pasteris, is to go beyond the plain-vanilla annuity and explain the "modern income" one, with inflation protection, access to capital and money-back guarantees.

"Our best seller," says Pasteris, "is a cash-refund annuity." With this annuity, if a client invests \$500,000 and dies after receiving only \$80,000, a beneficiary would get the \$420,000 shortfall. With such a provision, our 65-year-old male would get about \$38,000 a year on a \$500,000 outlay, versus \$41,000 with a no-refund IA (see

"Annuity Alternatives" on page 94).

At MassMutual, super fudge chunk has been taking over vanilla. "Our fixed-income annuity generally allows multiple purchases, over a number of years, with a single contract," says Jerry Golden, president of MassMutual's income management strategies division in Springfield, Mass. "That helps you ladder annuities. There's also a cost-of-living adjustment, the ability to design your own benefit structure up front and actuarially determined valuation on investors' statements. You even have the ability to modify the annuity in the future: You might want to increase your income stream, for example, and provide a reduced guarantee for your beneficiary."

#### PRIME PROSPECTS

Golden doubts that many IAs will be sold as standalones. "We offer a 'retirement management account' with model portfolios that do not require income annuities," he says. "About 75% of our clients elect to include some income annuities. Those who are over age 70 tend to put 30% to 40% of their portfolios into these annuities, either in a lump sum or through multiple purchases." Younger clients may opt for an IA. Rick Bonifant, who heads the Bonifant Financial Group in Bryantown, Md., has a client who is a 57-year-old retiree. This man had been a longtime worker at the local power company. "He was used to guarantees," says Bonifant, referring to the client's experience with wages and benefits. "He was retiring with a pension and would start Social Security soon; he also had a large 401(k) account and was anxious about investing that money."

Building on the client's wish for security, Bonifant suggested fixed-income annuities and a managed investment account. After the first IA buy-in, the plan calls for immediate annuities added in the future.

"He chose a joint-and-survivor annuity with a COLA [cost-of-living adjustment]," says Bonifant. "That protects his spouse, if she is the survivor, so the client decided on a single-life pension from his former employer, to maximize the fixed payments. Social Security benefits, his pension and these annuities will give him more income than he had while he was working."

Blue-collar retirees are not the only IA prospects. "I recently worked with a client who had a \$7 million IRA," says John Schwan, a New York Life agent in Aberdeen, S.D. "He's 70, his wife is several years younger, and he wanted a portfolio that was well-balanced between equities and fixed income."

Schwan suggested the client invest \$3 million of his IRA in a 100% joint-and-survivor IA contract, meaning that the payout (nearly 7%, which comes to about \$200,000 a year) will last as long as either spouse lives. "They liked the joint annuity," Schwan says. "They also liked the refund feature." If both spouses die before \$3 million has been paid out, any shortfall will go to a charity they selected.

"The other \$4 million is invested in equities," says Schwan. "We hope that money will grow, long term, so we didn't suggest an inflation-indexed annuity. Every few years, if the equities gain value, we might take some profits inside the IRA and buy additional income annuities." Planning for immediate annuities can go past the present to help avoid future shock. (c) 2008 Financial Planning and SourceMedia, Inc. All Rights Reserved. <http://www.Financial-Planning.com> <http://www.sourcemedia.com>

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