ANNUITY ANALYTICS

BY BOB SEAWRIGHT

The Annuity Imperative

RETIREES AND NEAR-RETIREES often wonder whether they should purchase an annuity to provide sustainable lifetime income — in effect, a guaranteed retirement paycheck — that they cannot outlive. Most do not. That's often a big mistake. No other financial tool converts lifelong savings into lifelong income as efficiently or as safely.

Since at least the publication of the "Trinity study" (published by three Trinity University professors in *The AAII Journal* in Feb. 1998), the financial planning community has focused considerable effort trying to create a "safe withdrawal rate" — the amount which may be withdrawn per year for a given period of time, including adjustments for inflation, without leading to portfolio failure. A "4 percent rule" is the advice most often given for managing this period of portfolio distribution. The analysis commonly assumes something like a 60/40 equities/bonds portfolio with annual returns in the 7-8 percent range, 10 percent volatility and 3 percent inflation.

Such assumptions are highly optimistic, obviously, in that an annual Dalbar study, based upon mutual fund flows, shows that the average investor's return on stocks is dramatically less than the return of the S&P 500 index. Professionals have similar difficulties in both the equity and credit markets. Nearly everyone tends to buy high and sell low.

Of related concern is that the rule and its variants are explicitly designed to finance a consistent spending plan using a volatile investment strategy. Consequently, retirees will accumulate unspent surpluses when markets outperform and face spending shortfalls when markets underperform. Moreover, the success of this approach is highly dependent upon portfolio performance early during the distribution period.

Perhaps most importantly, if obviously, a "safe" withdrawal rate is dependent upon what one's definition of *safe* is. Most results assume safety as something like a 90 percent success rate over a set period of time, commonly 25 to 30 years. Unfortunately, with the consequences of failure being so high — being destitute at a time in life when vulnerability is at a peak — a 10 percent failure rate hardly qualifies as anything like safe.

Limiting the analysis to a set period of time is similarly deceptive on account of longevity trends. Indeed, according to the Society of Actuaries, there is a 39 percent chance that at least one member of a 65-year-old couple today will live to age 90 and a 15 percent chance that one will live to age 95. Those statistics suggest that a 25-year plan isn't remotely good enough for anything like real safety. The reality is that there will be a significant number of catastrophic outcomes using the 4 percent rule. This alleged safe withdrawal rate is anything but.

On the other hand, income annuities are incredibly powerful tools for providing sustainable lifetime income and are almost surely the most underutilized financial asset in the market today. As a Wharton Financial Institutions Center (WFIC) study has shown, annuities can assure retirees of an income stream for life at a cost as much as 40 percent less than a traditional stock, bond and cash mix. As a different WFIC study points out:

"Lifetime income annuities may not be the perfect financial instrument for

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retirement, but when compared under the rigorous analytical apparatus of economic science to other available choices for retirement income, where risks and returns are carefully balanced, they dominate anything else for most situations. When supplemented with fixed income investments and equities, it is the best way we have now to provide for retirement. There is no other way to do this without spending much more money, or incurring a whole lot more risk coupled with some very good luck."

The traditional "three-legged stool" of retirement — Social Security, private pensions and personal savings — is becoming increasingly difficult to sustain. Americans' increased concerns about the viability of Social Security and the trend away from defined benefit pension plans raise serious retirement sustainability challenges. A study prepared by Ernst & Young on behalf of the nonprofit Americans for Secure Retirement found that those with guaranteed retirement income beyond Social Security are much better prepared for and in retirement. It also found that middle-income Americans entering retirement without a guaranteed source of income beyond Social Security will, on average, have to reduce their standard of living by 32 percent to minimize (but not guarantee) the likelihood of outliving their assets.

Beginning January 1, 2011, 77 million baby boomers began turning 65, the traditional American retirement age. The Insured Retirement Institute notes that an average of 7,000 people will be turning 65 each day this year, and that by the beginning of 2012 more than 41 million Americans will be age 65 or older. According to the Census Bureau, the number of Americans 65 and older is projected to increase to 69.4 million in 2030 from 35.5 million in 2000. Some of these retirees will spend their last years financially secure, but many will not.

Those who want to be sure that they will have sustainable lifetime income must make sure that they obtain the guarantees that annuities provide. Otherwise, their financial well-being depends, in effect, upon a roll of the dice.

That's why income annuities are so vital. As the Ernst & Young report starkly states:

"Without additional guaranteed lifetime income streams, such as income provided by an annuity, middle-income Americans are at high risk of outliving their financial assets and living their final years in poverty."

In an overwhelming number of cases, the proper question isn't whether or not retirees should purchase an annuity, but rather how much of their assets they should use to purchase an annuity. This approach has been dubbed "product allocation" (as opposed to asset allocation) by retirement expert Moshe Milevsky. A retiree who is afraid of dying before the actuarial tables suggest (a common excuse for avoiding annuities) ought to consider obtaining life insurance or including a "period certain" on an income annuity, which guarantees payment for a set period of years irrespective of death (in exchange for a lower monthly check).

Accordingly, those who want to be sure that they will have sustainable lifetime income must make sure that they obtain the guarantees that annuities provide. Otherwise, their financial well-being depends, in effect, upon a roll of the dice. Some might win, but others will lose, and the results of losing in this way are particularly dreadful — being broke and wholly dependent upon others for survival.

Effective retirement planning requires meaningful risk management and, even more importantly, risk avoidance. That means it can't be a "wish and hope" strategy. The plan actually has to work. There is no margin of error in this regard, especially for the elderly. Simply put, retirees and near-retirees must avoid risking what they cannot afford to lose.

Retirement planning has two key objectives, which are often in competition: to maximize the rewards of success and to minimize the consequences of failure. As retirement nears, the second must take priority over the first. Accordingly, during this time period, return *of* capital must trump return *on* capital.

The needs of the future suggest that greater risk, greater uncertainty and greater volatility are all possible and perhaps likely. Annuities provide a powerful foundation for any retirement portfolio and are crucial for efficiently providing a guaranty of sustainable retirement income for life. Good financial planning demands that income annuities become and remain a crucial imperative.

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