



Articles

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Retirees whose income equals or exceeds what they want to spend annually without using an income annuity should avoid them. . . .Income or immediate annuities are ideal for retirees wishing to maximize their lifetime income in exchange for giving up their--and their heirs'--principal.

What You Need to Know About Immediate Annuities

By Peter Katt

My [July 2006 column](#) went over annuities from soup-to-nuts, with two short paragraphs devoted to immediate (or income) annuities.

This column takes over where that two-paragraph effort left off, and also comments on a point-counterpoint about guaranteed living benefit variable annuities, also mentioned in my prior column that stirred some controversy.

Immediate Annuities

Retirement planning is a very popular issue in the financial press--and sellers of financial products, particularly annuities, are nearly in frenzy as the leading edge of the baby boomers enter their golden years.

A recent email solicitation captures this mood:

"Join the annuity machine and profit from the massive baby boomer rollover market."

I spent several days cranking numbers to either confirm or expose as false the pitch that income annuities provide considerable value to retirees.

My conclusion is that the annuity machine does appear to be a valuable retirement asset for retirees willing to exchange principal for guaranteed lifetime income.

In this article, I focus on a male 65, but the same principles apply for the ages 55 to 70 and females.

What They Offer

Income annuities exchange a single sum of money for a guaranteed stream of income over a time period.

Income can be guaranteed for a specified period, usually 10 years, or income can be guaranteed until death.

How do the different income streams compare? For a 65-year-old male, the difference between the 10-year guarantee and life-only is about 3.5%. That is, a single-payment of \$1 million will yield lifetime-only annual income of around \$80,000, compared to \$77,200 for a 10-year certain feature. There is about a 7% or 8% chance that a healthy 65-year-old male will die within 10 years, so either approach is logical.

Annuities vs. Bonds

How do the rates compare to straight fixed-income investments? The embedded yields for life-only income annuities (measured to life expectancy) appear to be around 5.5% to 6.0%. This is compared with yields for Treasuries of 4.5% to 4.75%, and 3.7% to 4.5% for AAA tax-exempt bonds, depending on maturities.

If a retiree chose to invest in bonds and withdrew a combination of income and principal, the dollars available (taking taxes into account) each year would fall considerably below the income available from an annuity of the same initial investment if the individual lives to life expectancy and beyond. Indeed, trying to match annuity income would cause principal to run out before life expectancy using the rates noted above.

Even if bond yields were equivalent to the embedded yields in income annuities, the annuities would have the advantage because the logic of acquiring one is to have lifetime income that can't otherwise be assured.

The Tax Angle

All of the income payments from annuities funded with qualified retirement plan monies are subject to income taxes.

When non-qualified funds are used, only a portion of income is taxable. For a male aged 65, 35% to 40% of the income is taxable and 60% to 65% is considered a recovery of principal from the single-sum paid into the annuity. However, after recovering all of the cost basis, income payments become fully taxable. Typically this will take around 20 years for a 65-year-old male.

A Changing Rate Environment

The embedded rate of an annuity is, of course, a function of the interest rate environment at the time an annuity is purchased. Once you buy the annuity, you are locked into that embedded rate. And if interest rates later rise, you can't take advantage of higher rates.

So what affect do changing interest rates have on annuities?

I tested the effect that increasing interest rates have on income annuities with 5.5% to 6.0% embedded interest rates.

One scenario has a retiree purchasing shorter-term Treasuries at first and then longer-term Treasuries instead of an income annuity. In this scenario, in the first three years this retiree earns 4.5%, then 6.0% for three years and 9.0% thereafter.

While investing in short-maturity bonds until rates take a decided upturn and then going long, as in my example, will leave you with about \$200,000 of principal through the end of your life expectancy period, this principal is gone if you live three years later than life expectancy-so in this instance, lifetime income is not covered.

The only scenario that provides a retiree with lifetime income that is equivalent to an income annuity, with the retention of principal, is if the long-term bond rate is high enough to match the after-tax annuity income and there is no reason to expect this to occur.

A retiree caught between the dual objectives of guaranteed lifetime income and leaving as much estate assets to children could delay retirement a few years to accumulate more of a nest egg, take a part-time job during the early years of retirement or readjust retirement income downward to match bond yields while retaining principal.

Where-and How-- to Buy

If there are no health issues, it is likely a no-load provider like Vanguard will have very competitive income that can be compared with a wider universe of companies that can be obtained on-line.

If you have health issues, your income annuity must be underwritten to take into account your health. You need to take responsibility for raising this issue, since annuity companies would just prefer to ignore it.

Less healthy annuitants can receive an age "rate-up" that will increase annual income because of a shorter life expectancy. For example, a 65-year-old male with relatively modest health problems might be age-rated to 70, with income increased from around \$80,000 to \$86,050. More significant health problems will result in greater rate-ups.

Judgment is needed to determine when health is poor enough to make an income annuity a bad choice because life expectancy is so short. I am a bit suspicious that medical underwriting for income annuities will be sensitive enough to fully protect those in poor health. My suggestion in this situation is to apply to multiple sources for both an income annuity and life insurance, because life insurance underwriting is very sensitive to poor health. This may give you better information.

The financial strength of the insurance company being considered for an income annuity should be considered. Overly aggressive pricing could be a solvency problem. Unfortunately, predicting which companies may get into trouble hasn't been very accurate because the cause of insolvency is often new and not well-understood by the rating services until the problem has become apparent.

A prudent course would be to stick with the major companies that have stellar financial ratings.

Who Should Use Annuities

Retirees whose income equals or exceeds what they want to spend annually without using an income annuity should avoid them. But in making this determination, it is probably unwise to calculate income from investments with volatile results, including years of big losses, by taking the arithmetic average. Especially avoid using variable annuity schemes that illustrate funds being withdrawn at, say, an 8% rate, with the principal going up at an average rate of 12%. Monte Carlo testing using appropriate levels of volatility show that relying on arithmetic average investment returns for the production of retirement income has

a high probability of failure, leading to retirement disasters.

Income or immediate annuities are ideal for retirees wishing to maximize their lifetime income in exchange for giving up their--and their heirs'--principal.

Variable Defenders

I found out that variable annuities with guaranteed living benefits are zealously defended by their sellers when my summary of annuities was also published as my November 2006 Journal of Financial column.

My column suggested that these products should be avoided because of their expense and inherent variable annuity problem of converting capital gains into ordinary income, and thus being subject to higher taxes. This prompted several critical letters to the Editor and I received a plethora of unpleasant emails on the subject.

Essentially, guaranteed living benefits guarantee an investor's equity investment regardless of market losses. What I hadn't contemplated in thinking and writing about these "heads-I-win-tails-I-break-even" products is that some sellers view them as the predominant or the only investment their clients need.

With the promise of no losses, why not?

Rather, I was thinking about equity investments as part of an overall portfolio. Based on comments from several investment advisors I discussed this with, I believe this issue exposes again the problem of financial planners who, as one advisor put it, "practice financial planning based on a path of least resistance sales strategy while avoiding the more difficult task of educating the client about investment choices."

What my column didn't have time to detail is that guaranteed living benefits are not without risk. Citigroup Smith Barney did a study of "The New Variable Annuity" in September 2004. This study points out that guaranteed living benefits are more risky than the variable annuities with death-benefit guarantees that caused havoc at Allmerica Financial and American Skandia in 2002.

The most popular and commonly selected guaranteed living benefit is the minimum withdrawal benefit, which the study says is the riskiest of the three. It appears that the strongest finger in the guaranteed living benefit dike is hedging, but experience tells us that such complex strategies always have blind spots within the universe of most-likely scenarios and are inadequate protection if we enter into historically unique circumstances whose probabilities are treated as very remote in hedging models.

An insurance company turned sideways because of aggressively promising "upside with no downside" variable annuities could face reserve-strengthening requirements that exceed their free surplus--the definition of insolvency. A feasible result would be that many investors would be stuck with their actual variable annuity balances without the guarantees.

This would be "merely" a big problem for an investor who had committed, say, 20% of their portfolio to a variable annuity with guaranteed living benefits, but it would be a disaster for someone persuaded to place all of their investment funds in such a product based on the pitch that it was fully guaranteed.

For those of you who think insurance executives wouldn't be so foolish as to expose their companies to such risk, please look up Baldwin United, Executive Life, Mutual

Benefit, Prudential, Confederation Life, Kentucky Central, and Mid-Continent Life.

[For the complete record on this "debate" please see the [February 2007 Life Insurance Perspectives](#).]

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Peter Katt, CFP, LIC, sole proprietor of Katt & Co., is a fee-only life insurance adviser located in Kalamazoo, Michigan (269.372.3497).
