Income Risk and the Use of Immediate Annuities

What is income risk?

Income risk is the chance you will deplete your assets and not be left with enough income to support your lifestyle through retirement. Depending on income needs, retirement goals, and life expectancy, income risk can be one of the major issues individuals face in retirement.

How can you manage retirement income risk?

You can manage income risk through asset allocation, annuitization, and a disciplined approach to portfolio withdrawals.

The traditional way to develop a retirement income plan is to set up a systematic withdrawal program from your retirement assets, which may involve dividends, interest, and principal. You also need to think about a tax-effective sequence of withdrawals from tax-deferred, tax-free and taxable accounts. A drawback with a systematic withdrawal program is that your withdrawals are based on the assumption you'll live to a certain age, often your life expectancy. If you live longer than expected, your withdrawals would most likely deplete your assets too early.

Immediate Annuities: A product for Managing Income Risk

An immediate annuity is sometimes referred to as a single premium immediate annuity (SPIA) or a lifetime income annuity. It is a financial product that enables you to create a personal pension similar to what some of our parents enjoyed – a source of lifetime income that can protect against income risk. An immediate annuity should not be confused with a tax-deferred variable annuity, which is a very different product.

How immediate annuities work

With an immediate annuity, you pay a lump sum of money to an insurance company in return for a periodic income payment (typically monthly) over a specified period of time. How much income you receive in exchange for a given lump sum depends on your age, gender, the length of time payments will be received, whether survivor benefits are included, whether the annuity is fixed or variable, and whether a cash refund is available at death.

Immediate annuities can play an important role in a retirees' portfolio, especially when combined with an effective asset allocation. Some financial planners believe that, if their clients are in good health, the question is not should they

annuitize some of their portfolio, but instead, how much of their portfolio should be annuitized.

Common Immediate Annuity Product Features

There are many types of immediate annuities, but generally, they can be categorized according to the following three decisions:

Fixed vs. Variable

Immediate Fixed Annuity – The monthly payment stream you receive is fixed and does not fluctuate based on the performance of the market. Some fixed annuity products include a feature that adjusts the payments periodically for inflation.

Immediate Variable Annuity – The monthly payment stream you receive fluctuates based on the performance of the underlying investments (stock, bond, and money market portfolios) you choose. This option may appeal to retirees who are willing to accept uncertainty in exchange for the possibility of receiving higher payments.

Single Life vs. Joint and Survivor

Single Life – You receive regular income payments for as long as you live. This option provides a bigger monthly payment than the joint and survivor option.
Joint and Survivor – Payments are made as long as you or the joint policy holder, typically your spouse, are living. When you or your spouse die, the amount of the remaining annuity payments will be a percentage (typically 50% to 100%) of the amount that was payable while you were both alive.

3. Lifetime vs. Lifetime with Period Certain

Lifetime – This provides payments for as long as you live, or in the case of a joint annuity for as long as either you or your spouse live.

Lifetime with Period Certain – This provides payments for the longer of your life or some fixed period (generally 5, 10, 15 or 20 years). If you die before the period ends, your beneficiaries receive the remaining payments. Typically, the guarantee period can't be longer than your life expectancy.

There are several things you should consider when evaluating whether to purchase an immediate annuity.

The Pros

Manage Longevity Risk – An immediate annuity is essentially an insurance policy against the danger of outliving your money.

Attractive Income Yields – Immediate annuities can offer attractive yields for retirees who live beyond their life expectancy. The reason for this is that your money is being pooled with money from other investors. Because some investors will die before their life expectancy, money that would have been distributed to them is available for distribution to the surviving investors. Because of the pooling of investments, the income you receive from an immediate annuity, assuming you live at least to your life expectancy, will likely be higher than what you would earn from more traditional investments designed to generate income, such as CDs or bonds.

The Cons

Permanent Decision – With most immediate annuities, you can't get your money back once you convert a portion of your nest egg into the annuity. Furthermore, each dollar annuitized won't be available for your heirs or other financial needs.

Solvency Risk – The monthly annuity payments you will receive represent a promise by the insurance company to provide you with an income stream for as long as you live. This promise is only as good as the financial strength of the insurance company making the promise.

Inflation Impact – If the annuity isn't indexed for inflation, you may need to withdraw an increasingly large percentage of your remaining nest egg each year to keep pace with inflation.

Summary

Questions to ask your advisor:

Is an immediate annuity right for my situation, given my essential and lifestyle income needs, my estate goals, and my risk tolerance?

What type of immediate annuity (fixed vs. variable, single vs. joint and survivor, lifetime income vs. lifetime with period certain (is right for my situation?

How much of my nest egg should I convert into an immediate annuity?

Which accounts should I annuitize (my 401(k), IRA, taxable account, other accounts), and what are the tax implications of each?

Does it make sense to buy an immediate annuity now or later?
What insurance company should I buy a fixed annuity from, and why?

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