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The Role of Inflation-Indexed Annuities

by Paula Hogan

The decline of defined-benefit pension plans means that the average citizen is now responsible for building a personal portfolio, managing that portfolio, and then, in retirement, deftly withdrawing from that portfolio just the right amount of cash each year for living expenses.

Adding salt to the wound, increasing longevity means we can potentially expect to live several decades after leaving the workforce. These two facts put a lot of pressure on individual investment performance, turning retirement planning into a high-stakes game.

But none of us are born knowing how much cash can safely be withdrawn from a portfolio, and few of us know how to effectively manage investments over the long term.

Plus, the most cost-effective way to provide lifetime income in retirement is through large, pooled groups. (People who die early subsidize people who live beyond average life expectancy.) That's what a well-designed pension is all about. But that sharing of longevity risk is sorely missing from the 401(k)-type investment vehicles now underpinning most people's savings. As a result, most people have no intuitive sense of how much lifetime income they can truly expect to reap from their retirement portfolios.

Fortunately, trends are afoot to address this situation. For example, government policy shows signs of changing. One key provision in the proposed Lifetime Income Disclosure bill (S. 267) requires employers to disclose to workers annually, in a standardized format, how their retirement balances would translate into monthly lifetime income. (This data might surprise those investors who have been feeling rich because "I have a lot more investments than either Dad or Grandpa ever had." But those generations had defined-benefit pension plans, the present values of which were a lot more than the typical current 401(k) account.)

Financial planners are also updating their best practices. An emerging new best practice is "first get your flooring." In other words, in retirement, find a way to get a reasonable level of lifetime, inflation-protected income to cover at least your base standard of living before taking on stock market risk.

The financial industry is evolving to support this new best practice—e.g., by offering inflation-indexed immediate annuities, which, in essence, are inflation-indexed substitutes for pensions. Even better, because of evolving industry trends, retail investors are gaining access to the same competitive pricing for immediate annuities as institutional buyers have.

Another emerging trend is to gradually annuitize a portion of your portfolio using immediate annuity contracts from a variety of insurance companies. Thus, it is now possible to buy a pension substitute that is both inflation-protective and supported by a diversified group of providers.

Immediate Annuity Basics

What is an immediate annuity?
An immediate annuity is a contract in which an insurance company agrees to make a series of payments in return for a single premium payment. Payments begin within one year of the premium payment. The typical format is a guarantee that payments last the longer of the investor's life, the life of the investor's spouse or an agreed-upon minimum number of years.

Who would be a good candidate for an inflation-indexed immediate annuity?
Immediate annuities are designed for investors whose standard of living depends on drawing cash from the portfolio and who are concerned about protecting against the risk of longevity.

What are the characteristics of lifetime immediate annuities?
Immediate annuities diversify personal wealth by complementing financial portfolios with lifetime income. They also help address the risk of increasing longevity. Inflation-indexed immediate annuities offer inflation protection by paying income indexed to the consumer price index CPI or to a guaranteed rate of increase. Immediate annuities can also offer protection from the risk of deflation if payments are either fixed in amount or designed to increase but never decrease.

Immediate annuities offer higher cash flow than traditional portfolio withdrawals. In contrast to the traditional portfolio withdrawal rate of 4% per year, immediate annuities offer higher cash income because of the sharing of longevity risk and because of the gradual distribution of principal. In the current market, 10-year-certain inflation-indexed immediate annuities are available to a 65-year-old with close to a 5% first-year payment that grows with inflation each year and never declines. (These particular contracts have riders that provide payments to your heirs for 10 years from the date of the contract if you were to pass away after buying the annuity.)

How much should I annuitize?
Conceptually, this is an easy question. You'd like enough inflation-protected income to cover your base standard of living. The purpose of any remaining portfolio wealth would then be to pay for emergencies, personal extras, and bequests.

Practically, however, this answer is hard to implement. One's base standard of living is a moving target. No one has an exact answer for how much to annuitize.

A reasonable initial approach is to set a target for how much of your portfolio to annuitize and then begin to annuitize that amount gradually over a period of several years. A 20% target would get you into the game without putting too much of your wealth into one planning strategy at once. It also leaves room for annuitizing more: As is expected for most investors, you may find the need to annuitize more than 20% of the portfolio to create the minimum inflation-protected income for maintaining your base standard of living. In layman's terms, "base standard of living" means the minimum lifestyle that keeps you safe, not necessarily happy; it's the lifestyle you do not ever want to go below.

Note: The 20% suggested initial target is an accommodation to the newness of inflation-protective immediate annuities as a foundation for individual wealth. Most policy makers anticipate a much higher target to become the actual new norm. An alternative way to consider how much of your portfolio to annuitize is to calculate how much income you need in today's dollars to maintain a minimally acceptable standard of living, and to calculate in today's interest rate environment how much of your portfolio would need to be annuitized to meet that goal. Then, you can set about annuitizing that amount gradually, keeping the funds targeted for annuitization in inflation-indexed fixed-income securities in the meantime.

Choosing an Annuity Contract

What if the insurance company behind the immediate annuity fails?
The financial strength behind any investment product is critically important. The best strategy for dealing with insurance company risk is:

- Take it seriously by working only with strong companies,
- Diversify contracts across several companies, and
- Keep total contracts with each insurance company below the state insurance limit. (See www.annuityadvantage.com/stateguarantee.htm.)

How do I know if the income offered by the proposed contracts is competitive in the market?
You can create apples-to-apples price comparisons by searching out similar contracts online; just be sure to benchmark against prices offered on platforms where contracts are bid for in real time and from insurance companies prescreened for financial strength. Currently, Vanguard offers one such pricing platform for inflation-indexed immediate annuities, as do many employer-sponsored qualified retirement plans via the Web pricing platform at www.incomesolutions.com.

Why is real-time competitive pricing important in this market?
Insurance companies make daily decisions on how to price each type of contract they offer for sale. On any particular day it is not clear, until the bids are made, which insurance company will be offering the most appealing price. In a market that changes greatly on a daily basis, it is prudent to demand what is, in effect, a daily auction to ensure that you are paying a competitive, market-determined price.

Over what time period should I annuitize wealth?
There are several reasons to set a steady, gradual pace instead of annuitizing all at once:

- *The older you are when you annuitize, the higher the income stream, because expected longevity is shorter.* Plus, every year that passes reveals more information about your personal circumstances.
- *The immediate annuity industry is evolving.* Competitively priced, inflation-protective immediate annuities purchased from a diversified selection of top companies have their advantages. But whenever there is a big industry innovation, the first big product change usually opens the door for others down the road. Save some money for further innovations.
- *Interest environments change.* By spreading out annuity purchases over several years, there is a better chance of diversifying across a range of interest rate environments.

Immediate Annuities Questions and Answers

Are immediate annuities the same as deferred annuities?

No. Immediate annuities are a contract between you and the insurance company in which you agree to provide a lump-sum payment in return for (usually) lifetime income. Deferred annuities are used to accumulate wealth in a tax-deferred setting and are much more complicated products to evaluate.

How can I tell one immediate annuity from another?

Important factors include the insurance company behind the product, whether or not the payments are fixed or inflation-protective, and the amount of the promised monthly income. Also, contracts with income indexed to the consumer price index CPI can differ in how payments change when inflation goes down and then up.

What contract choices should I consider?

A typical rider is the joint and survivor option, which means payments will last for as long as either you or your spouse is alive. Another is the period certain option, which means payments will last for the longer of your life—or lives—but no shorter than the chosen period certain (e.g., 10 or 15 years). You can diversify inflation protection by purchasing a combination of contracts over several years, some of which are indexed to inflation and some of which go up each year at a set rate.

What is the best way to pay for an immediate annuity?

Usually, it makes sense to use wealth from tax-sheltered retirement accounts. (Retirement accounts create ordinary income, as do annuity payments.)

Portfolio and Risk Considerations

If I annuitize, don't I give up portfolio wealth?
Yes, annuitization—without a contract provision to the contrary—is an irrevocable decision to give up a sum of money, and if you die soon after annuitization, your heirs will have a smaller inheritance.

However, for many of us, the only reason we have a large portfolio is that there is no longer a pension plan. But unlike pensions, portfolios, even if well diversified, cannot offer any guarantees about lasting as long as you live. You are not really better able to pass on an inheritance because you have portfolio wealth instead of a combination of portfolio wealth and annuitized income—unless you die early.

If your goal is to be able to pay daily living expenses throughout your whole life, then inflation-protected immediate annuities, at least as a partial solution, offer more income, more inflation and deflation protection, and more safety than do individual portfolios—if you buy them with the right pricing. If you have a very strong bequest interest, that's what life insurance is all about.

Where does Social Security fit in with annuitization considerations?
Social Security retirement income is an inflation-indexed lifetime annuity backed by the full faith and credit of the U.S. government. In that context, planning carefully to maximize Social Security retirement income is fundamental to personal planning for retirement.

To maximize benefits, it is usually helpful to postpone drawing Social Security benefits until age 70, the age at which those benefits are maximized. The main exception to this rule of thumb is budgeting reasons: If you cannot fund daily expenses between retirement and age 70 without Social Security income you may need to trigger benefits earlier. Other exceptions arise from opportunities created through marriage: A spouse—whether currently married, married for at least 10 years before divorce, or married for at least nine months before being widowed—has access to benefits based on their own earnings record and on the earnings record(s) of their spouse(s). Sometimes starting survivor benefits before age 70 makes sense; in some instances, starting spousal benefits before age 70, and sometimes even before full retirement age, may make sense.

Effective Social Security planning is a key part of any annuitization strategy. Social Security retirement benefits can provide the first layer of funds to pay for your base standard of living. Because Social Security benefits are so valuable, it can even make sense to take advantage of the government rule allowing the return of benefits received in order to reset the age of onset for benefits.

What strategies can be used to protect against the risks of immediate annuities?
In order to protect against the risk of insurance company insolvency, buy a series of small contracts from more than one company, with purchases spread out over several years. Plus, keep the total amount purchased from any one company within the limit for your state's insurance pool limit.

Another potential risk is that the consumer price index or the fixed percentage increases you choose will not adequately match the actual inflation in your daily expenses. To reduce this risk, buy a blend of inflation protection: Purchase some contracts that go up with the CPI and some that go up a fixed amount, regardless of actual inflation. Contracts in which the income does not decline from one year to the next also help protect against the risk of deflation. Older investors can safely mix in a fixed-rate contract with their blend of inflation-protected contracts in order to increase cash income.

There is also the risk that you will not live long enough to fully recoup the initial purchase amount, thus decreasing wealth bequeathed to heirs. To protect somewhat against this risk, consider an annuity with a joint life income stream for you and your spouse with a guarantee period of at least 10 years. Then income will continue as long as either of you are alive, but at least for 10 years.

There is interest rate risk to consider as well. The interest rate environment prevailing at the time of purchase influences the annuity payout rate. Soften this risk by spreading the purchase of annuities over several years, when presumably there might be a variety of interest rate environments.

Another risk to consider is that products will be offered in the future that might be competitive with a diversified selection of inflation-protected immediate annuities. For example, some companies already offer annuity incomes based on medical underwriting: Investors with less than average longevity receive higher incomes. Another possible future product might combine inflation-indexed bonds with longevity insurance: You could lock in inflation-protected income up to age 85; if you are still living at age 85, the longevity insurance would begin lifetime income at that point. These are good ideas currently in development, but astute investors will postpone investing until they can be purchased with transparent pricing created in competitive distribution channels. As an example, longevity insurance as a product is in its infancy. At this point, we're waiting for competitive pricing and inflation-adjusted income in that product. Similarly, it is likely that there will soon be some welcome innovations for converting the equity in your home into retirement income via fair and transparently priced exchanges. In the context of this looming innovation in the financial markets and the unknown course of your own life, moving gradually into the inflation-indexed immediate annuity market is prudent.

Tax risk includes the fact that immediate annuities create ordinary income, an important factor to consider in tax planning. This risk is addressed in part by the fact that immediate annuities complement other portfolio withdrawals, some of which will be taxed at capital gains rates, not ordinary income rates. Tax considerations suggest that annuitizing funds held in tax-sheltered retirement accounts before taxable accounts is a reasonable default decision. Retirement accounts already create ordinary income, while taxable accounts allow the investor to maintain some control over annual tax planning decisions.

Conclusion

The points made here address some serious risks and opportunities that are worthy of careful consideration and discussion. They are best considered in the full context of your overall planning goals.

As a part of overall retirement planning, inflation-protective immediate annuities can offer compelling, risk-adjusted benefits when purchased wisely.

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