Retirement Income
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Investments + Annuities = Healthy Retirement

By Kerry Pechter *Wed, Jul 15, 2015*

Many advisers still treat annuities and investments as apples and oranges--that is, not to be mixed up in a single retirement fruit salad. But experts Michael Finke, Wade Pfau and Mark Warshawsky offer recipes for combining them.

Some Americans have saved so much for retirement that they don't need an annuity, while many others have saved so little that they can't afford to tie up any of their money in an annuity. In between, however, are millions of retirees who could probably "maximize their utility" by holding a mix of investments and annuities.

Two recent articles by major retirement researchers offer fresh ammunition to advisers who believe that a combination of annuities and investments (sometimes separately, and sometimes within the same bundled product) could give many of their clients the most income and the most peace-of-mind in retirement.

Mark Warshawsky's paper is called "Government Policy on Distribution Methods for Assets in Individual Accounts for Retirees Life Income Annuities and Withdrawal Rules." Meanwhile, the prolific Wade Pfau and Michael Finke have co-authored an article, "Reduce Retirement Costs with Deferred Income Annuities Purchased Before Retirement" in the July issue of the *Journal of Financial Planning*.

Although they both advocate annuities, these two articles approach the retirement financing problem differently. Warshawsky think it would be good public policy to prescribe a ladder of immediate annuities, plus investments, to retirees in general. Pfau-Finke demonstrate that buying a deferred income annuity, up to 20 years before retirement, can buffer a retired couple's longevity risk and market risk.

But both articles offer useful starting points for advisers who are curious about embedding a guaranteed income product into their clients' retirement portfolios. The articles will appeal to advisers who aren't satisfied with the 4% withdrawal rule, and who doesn't want to fudge the risks of retirement by simply assuming that their clients will live to the average age and experience average market returns.

Annuity lamination plus investments

A blend of life annuities and withdrawals from an investment portfolio is recommended as the best policy not just for individual retirees but also as an exit strategy for participants in financially challenged public employee pensions, according to the paper by Warshawsky (right), which was published by the Mercatus Center at George Mason University.

Warshawsky's name should be familiar to retirement mavens. A former Assistant Secretary of the Treasury official and director of retirement research at Towers Watson, he wrote *Retirement Income: Risks and Strategies* (MIT Press, 2011). He recently founded ReLIAS LLC, a retirement consulting firm.

In the new paper, Warshawsky works toward his conclusions about the advisability of a hybrid annuity-systematic-withdrawal de-accumulation plan by first comparing Bengen's famous 4% rule (perhaps the most-analyzed rule-of-thumb in financial history) with the purchase of a joint-life immediate annuity with a 50% continuation of the benefit for the surviving spouse.

In isolation, each method has significant drawbacks, Warshawsky found. The 4% solution fails to protect fully against longevity risk; the immediate annuity fails to protect against inflation risk. So he recommends a compromise: Retirees should put part of their money in a ladder of annuities and the rest in a diversified investment portfolio.

In an interview with *RIJ*, Warshawsky said he envisions the ladder as "a sequence of purchases of immediate life income annuities." That, along with a "fixed percentage distribution from investment portfolio provide the flow of income to the retired household. The specifics of the sequencing and the percentage) would be customized to the preferences, goals and resources of each retired household."

Warshawsky is aiming at public policy recommendations, not just for individuals but also for the legions of workers in underfunded local public pensions. He advises cash-strapped municipalities to resolve their crushing pension liabilities with lump-sum buyouts that would be invested for each participant in a "structured account."

The lump sum would not be for the full present value of the pension, but something more affordable for the municipality. As for the structured account, it would be a "mix of systematic withdrawals from a dynamic portfolio of a mix of asset types, and gradual laddered purchases of immediate life annuities."

Dedicate half your bond allocation to a DIA

While Warshawsky leans toward immediate annuities as the raw material for his partial annuitization strategy, other researchers have been looking at the use of a newer type of lifetime income generator: the deferred income annuity, or DIA.

Writing in the July issue of the *Journal of Financial Planning*, Pfau, a professor at The American College, and Finke (left), who teaches at Texas Tech University, try to calculate whether, or under what circumstances, a 65-year-old couple could lower their cost of retirement at age 65 by substituting a DIA for half of their portfolio's bond allocation.

The authors use a lot of computing power to test this proposition under a wide range of possibilities: 50,000 different ages of death for the second-to-die; 50,000 sequences of asset returns; a DIA purchase date at age 45, 55 or 62; and 11 different overall stock allocations, from zero to 100%. The DIA is a joint-life contract with a 10-year period certain and a return-of-premium benefit if neither spouse survives to the income start date.

The tables they generated, which are reprinted in the journal, showed that the savings from using the DIA peaked when it was purchased at age 45, when the allocation to the DIA was 35% to 45% of the original assets, and when the total cost of retirement was high (i.e., when longevity was great and market returns were unfavorable). The maximum savings was about 11%.

In other words, the insurance did exactly what it was supposed to do: protect against calamity (long life, poor returns). It had the least value—in hindsight, as it were—when the owners had short lifespans, enjoyed bull markets, and maintained either a very high or very low allocation to stocks.

"A short-deferral DIA can be a valuable complement to a conventional portfolio withdrawal strategy," Finke and Pfau conclude. "Similar to the benefit of allocating bonds to single premium immediate annuities, this analysis shows that a short deferral DIA that provides lifetime income can lower the cost of funding retirement by softening the financial blow of a long lifetime or poor market returns.

“The tradeoff is lower wealth for retirees who do not live as long; however, this loss is reduced by the return of premium if the client dies before income begins and the 10-year period certain feature.”