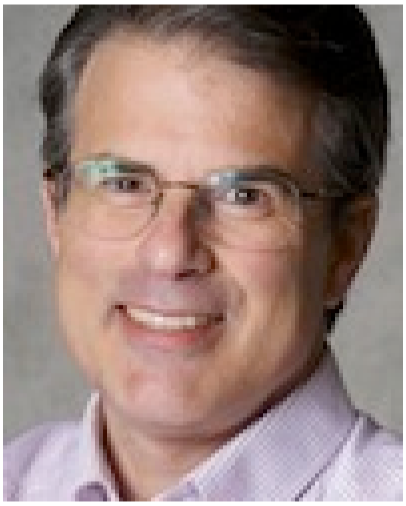
Making a Case for the COLA-SPIA

By Kerry Pechter *Thu, Jun 20, 2019*

'First optimize Social Security. If that 'paycheck' isn't enough, buy a SPIA. An inflation-indexed SPIA would be ideal. A COLA-SPIA may be the next best alternative,' Joe Tomlinson told me.



People tend to hyperventilate about the inflation of the 1970s. But the decade was exuberant for me, especially after the economy started to recover from the 1974-75 bear market. My take-home pay tripled in the 70s (from a very low base). My bachelor expenses (basement apartment, 10-year-old Beetle) were trivial.

So I don't have the inflation-related post-traumatic distress that someone who endured, for example, Israel's triple-digit inflation in the early1980s. As I look ahead to retirement, inflation risk isn't one of my primary sources of financial anxiety. Maybe it should be.

Recently I followed an email conversation between pension legend Zvi Bodie of Boston University, retirement blogger Dirk Cotton, Morningstar retirement researcher David Blanchett, and CFP/actuary Joe Tomlinson about inflation-adjusted income annuities, with the annual payout either indexed to inflation or increased each year by a fixed percentage (a cost-of-living-adjusted or COLA SPIA).

Bodie and Cotton felt strongly that buying an inflation-adjusted SPIA instead of a fixed SPIA (for those who buy SPIAs) is a no-brainer. No other contract provides stable purchasing power throughout retirement. And what good is *declining* purchasing power—as a fixed SPIA would deliver—over a 25-year or 30-year retirement?

Blanchett felt otherwise. If a retiree has other assets that can keep up with inflation—stocks, Social Security benefits—and if the SPIA represents only a fraction of the wealth on his or her household balance sheet, then perhaps the retiree could rely on those things to hedge against inflation. He may also have remarked that the Treasury yield curve doesn't reflect much in the way of inflation fears.

As I read their exchange of messages, I remembered that Bodie long ago rejected the idea that stocks are certain to out-perform in the long run and keep pace with inflation. If stocks were always a sure long-run bet, put options on equities should get cheaper as they get longer-dated, he has pointed out. But they don't. And what if inflation drives up interest rates and stocks collapse? That doesn't sound like the recipe for a safe harbor from inflation.

If stocks in fact are not reliable inflation hedges, then the argument for an inflation-adjusted SPIA is obviously much stronger. The more I think about it, the more sense it makes. We demand inflation-indexed Social Security benefits, so why shouldn't we insist on the same from our SPIAs?

Joseph Tomlinson

Tomlinson agrees with Bodie. "I'm not a fan of the stock market, in particular, as providing an inflation hedge. I don't think the history of stock market performance supports that," Tomlinson told *RIJ* in an email this morning. "And why shouldn't my goal be to have 100% (not 80%) of my money for retirement be in the retirement "currency," i.e., spending power."

But hardly anyone buys inflation-adjusted SPIAs because their first-year income is so dramatically lower than the income from a fixed SPIA. (Only company, Principal, offers a true inflation-indexed SPIA. About 15 companies offer SPIAs with various annual COLA adjustments.) The starting payout for a life-only COLA-SPIA for a $100,000 premium is currently about $4,200, according to CANNEX.

I couldn't help noticing that a $4,200 fixed SPIA with a cash refund (according to immediateannuities.com) costs only about $68,000. That's a big difference. It occurs to me that I might buy the fixed SPIA and stash the remaining $32,000 in a side fund (stocks or fixed-rate annuity or indexed annuities) and use the returns to top-up the purchasing power as needed. After all, inflation may turn out to be quite moderate in an aging America.

That's too high-maintenance an approach, Tomlinson counters. "I think the liquidity need should be kept separate from meeting a basic level of living expenses (that will likely increase with inflation). Unfortunately, if one uses the basic living expense money to fix the car or fix the roof, that money is no longer available to buy food," his email said.

But I can think of another reason not to buy COLA-SPIA: What if it doesn't generate enough income at the start of retirement to cover my essential expenses?

What if I need $6,200 a year at age 65, and only have $100,000 to spend? Then maybe I need to buy the fixed SPIA and figure out another way to maintain my purchasing power. If I believe that my essential expenses won't change much over the next 20 years (and some research shows that retirees spend less as they get older on everything but medical care) then maybe a fixed SPIA would fill the bill.

I started free-associating and considered the merits of spending $68,000 at age 65 on a fixed SPIA paying $4,200 and then applying $32,000 to the purchase of a fixed rate deferred income annuity paying $7,740 for life starting ten years later, at age 75. That would boost my income considerably, just when I'll probably need a boost.

Tomlinson ran some Monte Carlo projections to compare that strategy to the $100,000 COLA-SPIA at age 65 and found something interesting. The fixed SPIA/fixed DIA strategy outperformed the COLA-SPIA strategy until age 82 or 83 (almost exactly the average age of death for a 65-year-old). From then until age 90, the COLA-SPIA paid out more per year. Clearly, the longer you expect to live, the more sense the COLA-SPIA will make.

Either way, Tomlinson favors maintaining purchasing power in the most straightforward way. Personally, I don't believe in "best" solutions. There are only better and worse solutions for a particular retired household. Every retiree (or retired couple) will have idiosyncratic needs that demand flexibility and creativity from the advisor. The goal is—or I hope it would be, if I were the client—to create a custom collage of income-generating accounts, return-generating accounts and emergency spending accounts that mitigate the various risks in a way that prevents a financially stressful retirement.

"I'm for keeping things simple for people," Tomlinson said. "First optimize Social Security. Then if that 'paycheck' isn't enough, buy a SPIA. An attractively priced inflation-indexed SPIA would be ideal. But if markets don't provide the ideal, the COLA-SPIA may be the next best alternative."