Nominal SPIAs Beat Nominal DIAs—But Perhaps Not for Long

By Kerry Pechter *Thu, Aug 28, 2014*

"DIAs may represent a more palatable hedge against longevity risk for retirees than traditional annuities, because they are cheaper and therefore provide more liquidity to retirees," writes Morningstar's David Blanchett in a Journal of Financial Planning article.

Retirement income planning is difficult and fascinating because it defies easy solutions. Although all retirees seem to want downside protection and upside potential, the right strategy for each particular retiree inevitably varies according to individual circumstances and preferences, not to mention changing market conditions.

Nonetheless, retirement researchers and academics have logged a lot of scuperomputer time trying to create useful planning heuristics—aka rules of thumb—for retirees and their advisers. One of the latest efforts was published by Morningstar's David Blanchett, CFP, in the August issue of *Journal of Financial Planning*.

The article documents Blanchett's comparison of nominal and inflation-adjusted single premium immediate annuities (SPIAs), which produce income within about a year of purchase, with deferred income annuities (DIAs), which produce income several or many years after purchase.

"The objective of this paper is not to determine whether or not a retiree should annuitize some portion of wealth, but rather, to provide insight as to whether a DIA or SPIA is the better choice," Blanchett wrote.

Blanchett's artticle is timely. Only two months ago, the U.S. Treasury Department expanded the potential market for DIAs by issuing new guidelines related to required minimum distributions. Under the new rule, people who buy DIAs with qualified (tax-deferred) money may delay the income start date until age 85. During the deferral period, they do not have to take the required minimum distributions (RMDs) that normally starting at age 70½. This type of DIA is known officially as a Qualified Longevity Annuity Contract. It may cost no more than $125,000 (or 25% of a person's tax-deferred savings, whichever is *less*).

Blanchett considered several variations of SPIAs and DIAs (life-only, life with period certain, nominal, real) and simulated their performance under eight different sets of assumptions or retiree preferences. These included a retiree's initial withdrawal rate, equity allocation, percentage of income need covered by Social Security, nominal returns, inflation rates, life expectancy, aversion to experiencing a financial shortfall, and desire to leave money to children.

Blanchett found that nominal SPIAs with a 20-year period certain (age 65 to 85) ranked the highest, with the ranking for each type of SPIA or DIA based on its performance in each of 6,561 hypothetical scenarios. In defining the criteria, Blanchett wrote, “The key objective of this preference model is to weigh the potential benefits of a given annuity type by way of a decreased likelihood of being destitute later in retirement, compared to the potential loss of wealth for the retiree from the purchase of that annuity.”

To people familiar with annuities, the victory by the nominal SPIA with 20 years certain may not be surprising. This type of annuity satisfies income for life without the risk of losing principal; the period certain guarantees that all or almost all of the premium will be returned to the client or the client’s beneficiaries. When TIAA-CREF participants annuitize all or part of their plan savings, for instance, this is the type of income annuity they often choose.

The study also showed that this type of SPIA performed especially well, relative to SPIAs with other contract options, for clients with low equity allocations and low mortality risk, in periods when nominal returns and inflation were low, and when bequest risk was low. (People with short life expectancies and/or big appetites for market risk obviously aren’t good candidates for SPIAs.)

The nominal DIA (without a period certain and without a cash refund of unpaid premium) performed almost as well as the SPIA. “If DIA rates were five percent higher, they would have been the most attractive annuity type, on average, in this study,” Blanchett wrote. In his hypothetical scenario, the DIAs were purchased at age 65 and produced income at age 85.

“DIAs may also represent a more palatable hedge against longevity risk for retirees than traditional annuities, because they are considerably cheaper and therefore provide significantly more liquidity to retirees.” He expects average DIA payout rates to rise as the DIA market matures and becomes more competitive.