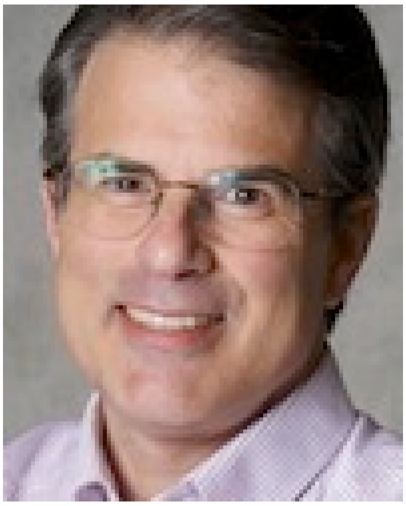
Offer Life Annuity and Whole Life in Tandem: Pfau

By Kerry Pechter *Thu, May 14, 2015*

Retirees might be more willing to buy a life annuity if it's part of a plan that also includes whole life insurance, says retirement guru Wade Pfau in a paper written for OneAmerica.



Does whole life insurance make sense for income-hungry retirees? In a paper written for mutual life insurer OneAmerica and released this week, retirement planning expert Wade Pfau (below left) claims that it can—not just for the sake of producing a big legacy but also to enhance income.

Thanks to its tax advantages, life insurance has long served as an estate-planning tool for wealthy investors. But most contemporary heads-of-households elect to "buy-term-and-invest-the-rest," and then drop their term coverage at retirement, when the parental nest is empty and there's not much human capital left to replace.

In the past, a few advisers, notably Burlington, Iowa-based Curtis Cloke, have designed custom retirement solutions that combine income annuities, life insurance and investments. Now comes Pfau, a co-editor of the *Journal of Personal Finance* and professor at The American College, to test the desirability of such a strategy.

His conclusion is that a household's breadwinner can, starting at age 35, increase his family's income at age 65 by a median 40% and increase his legacy by as much as 228% by using a combination of investments, a whole life policy and a single-premium immediate annuity, relative to the income and legacy accruing from investments and term life insurance coverage alone.

To find out how he arrives at those numbers, you'll have to read the **whitepaper** that he produced for OneAmerica. But we'll try to summarize his two hypotheticals: one involving 35-year-old Steve and Susie, and the other involving 50-year-old James and Julie.

In the first case, Steve is working and Susie is a homemaker. They have $65,000 in their 401(k) and they can afford to save $15,000 a year. Steve has three options:

- **Scenario 1.** He can buy term-life and invest $14,281 a year in his 401(k) with the intention of taking 3.5% inflation-adjusted systematic withdrawals at age 65 or
- **Scenario 2.** He can buy term-life and invest $14,281 a year in his 401(k) with the intention of buying a single-premium, joint-and-survivor life income annuity with $738,000 of his 401(k) accumulation, dropping his term coverage, and taking 3.5% inflation-adjusted systematic withdrawals at age 65 or
- **Scenario 3.** He can buy whole-life for a taxable $6,000 per year and invest $9,000 a year in his 401(k) with the intention of buying a single-premium single-life income annuity with $738,000 at age 65 and taking 3.5% inflation-adjusted systematic withdrawals at age 65.

Pfau ran Monte Carlo simulations and found that the strategy in Scenario 1 would produce median income of $58,556 from SWPs at age 65 while Scenarios 2 and 3 would produce median income of $81,434 and $82,034, respectively, through a combination of SWPs and income annuity payments.

Looking at the median legacies under the three strategies, Pfau found, not surprisingly, that Scenario 2, where the term insurance was dropped at retirement, lagged. If Steve were to die at age 66, he would leave $1.69 million under Scenario 1, $940,551 under Scenario 2 and $1.46 million under Scenario 3. If he were to live to 100, those numbers would be $649,780, $217,897 and $2.13 million, respectively.

In a second hypothetical, Pfau considers James and Julie, two 50-year-olds who plan to retire in 15 years. Even though their time horizon is shorter than Steve and Suzie's, they experience the same benefits—higher income thanks to the SPIA, and higher legacy thanks to the life insurance.

Much of this is intuitive. Life annuities characteristically enhance annual income, relative to SWPs with average returns. Whole life insurance enhances legacy values, especially compared to a legacy without life insurance. But don't the cost of whole life and the slow growth of the cash value combine to create a lot of drag on the potential investment accumulation?

Not as much as you might think, Pfau explains. That’s because the investor rebalances his 401(k) in favor of equities to offset the bond-like character of the whole life cash value. “The 401k piece is more aggressive when whole life is used,” he told *RIJ*. “This is explained in the article because it is an important point.” Therefore the median accumulation, based on Monte Carlo projections, is higher. Perhaps more importantly, the presence of the whole life policy allows Steve to buy a single life instead of a joint-life SPIA at age 65, thus raising the payout rate for the same premium by 17%.

Pfau suggests that the inclusion of whole life in a retirement income plan has psychological value: it can make the purchase of a single premium immediate annuity more palatable.

“Behaviorally, Scenario 2 presents a difficult strategy for many retirees to accept. Despite potential improvements to their retirement income, retirees generally do not like to annuitize their assets in such a way. Meanwhile, Scenario 3 uses a single-life SPIA and maintains a death benefit with life insurance, which can essentially protect or “refund” the assets used for the annuity purchase,” Pfau writes.

“This combination should be more palatable for retirees. And when we compare Scenarios 2 and 3, we can observe that the available income is similar, while the legacy value is substantially different. The lack of a death benefit with Scenario 2 means that legacy assets are substantially less. Psychologically, many retirees will find it easier to contemplate adopting Scenario 3 over Scenario 2.”

Fee-based advisers who are not accustomed to selling insurance products may not even consider this type of strategy. If nothing else, it would deprive them of billable assets. But that doesn’t mean the strategy isn’t smart, says Curtis Cloke. “When you are not biased to a product type or to how financial professionals are paid (fee vs. commission),” he told *RIJ*, “it becomes obvious that the true “best in class” planning solutions cannot be created efficiently without the inclusion of both insurance based and traditional investment product allocations.”