On the Case: Income from a ‘Certified’ Used Annuity

By Kerry Pechter *Thu, Sep 14, 2017*

In this latest income solution for "Andrew and Laura," a real couple near retirement, Bryan Anderson of AnnuityStraightTalk and Nathaniel Pulsifer of DCF Exchange combine a secondary market annuity, an indexed annuity and equities for safety and upside.

Bryan Anderson and Nathaniel Pulsifer are two expert fly-fishermen in northwestern Montana who also sell annuities to investors all over the country via the web. Anderson leads AnnuityStraightTalk, their indexed annuity (FIA) business. Pulsifer heads up DCF Exchange, their secondary market annuity (SMA) business.

An SMA and an FIA are central to the retirement income plan they’ve submitted for Andrew, 64, and Laura, 63, the real-life near-retirement empty-nesters who have $1.25 million in a balanced portfolio, most of it tax-deferred, about $1 million in home equity. *RIJ* asked its readers to submit income solutions for them, and this is the fifth plan that we’ve published. (For more about Andrew and Laura, click here.)

SMAs, if you’re new to them, are the “used” contracts referenced in our headline. These are income streams or lump sum payouts that were originally awarded to individuals as monetary awards in wrongful injury suits. The recipients of these annuities have the option of keeping them or selling them to investors for lump sums.

Asset securitization firms like J.G. Wentworth are able, with court approval, to buy billions of dollars of such “structured settlements” at steep discounts. Smaller factoring firms, like DCF Exchange, also buy the income streams. They restructure and resell them to individuals for up to 25% less than the price of a comparable retail annuity.

Indexed annuities also figure in the income plan that Anderson and Pulsifer (right) created, but in a counterintuitive way. Instead of recommending that the couple buy an FIA and use a lifetime income benefit rider, they suggest purchasing an accumulation-only FIA and using the 10% annual no-penalty withdrawal option as a source of emergency income.

Quick takeaway

Anderson and Pulsifer noticed that most of Andrew and Laura’s $1.24 million in savings is in SEP IRAs. The couple can therefore expect to take required minimum distributions of at least $40,000 a year starting at age 70½. They advise the couple to spend about half of their qualified savings on two contracts: A fixed period-certain SMA to provide income roughly equal to their RMD for the first 15 years of retirement and an FIA for growth or contingent income.

The annuities, pension and Social Security will provide the couple with income that’s immune to market volatility. Since the couple won’t need to sell other assets for income, they can afford to invest most of the rest of their savings in equities. The anticipated growth from equities, plus home equity and long-term care insurance, can finance their lifestyle and medical expenses later in life. In the meantime, equity upside can help protect them from inflation risk.

AnnuityStraightTalk assumptions

- Andrew will work to age 70 (year-end 2022) to maximize his Social Security benefits.
- Laura’s will switch to part-time work, starting immediately. The couple will save less but will not need to dip into savings before Andrew fully retires.
- The couple’s income (Andrew full-time, Laura half-time or less) during the next five years will exceed expenses by $100,000 per year, but the surplus will largely be consumed by graduate school tuition for their daughters.
- The couple has a target pre-tax income of $140,000 starting in five years (in 2023), with $98,000 from a combination of Social Security ($81,000), Laura’s pension ($7,000) and net income from real estate ($10,000).
- Their projected income gap is $42,000 per year, starting in 2023.
- The couple will continue to make mortgage payments on their primary home ($1.23 million value; $248,000 owed, and November 2031 payoff date) and rental property ($435,000 value; $325,000 owed and October 2046 payoff date).

Advice point

Laura and Andrew need to be wary of sequence of returns risk. With about $1 million in tax-deferred accounts, including traditional and SEP IRAs, they will begin taking substantial required minimum distributions at age 70½. They also have a high equity allocation. “This can be a significant issue in volatile market years, with Uncle Sam forcing you to sell securities in down markets to satisfy RMDs,” Pulsifer and Anderson said. Their recommended solution provides guaranteed income to cover these RMDs and neutralize sequence of returns risk.

Advice point

With bond yields so low, the couple also faces interest rate risk. If they decided to rely on bonds or bond funds for income in retirement, they’d be exposed to the risk that rates might rise and reduce the value of their principal. If rates don’t rise, the low returns would stunt their portfolio growth. Anderson and Pulsifer’s solution, using the index annuity as an alternative allocation to their bond holdings, reduces this interest rate risk, and provides a safe protected growth vehicle.

Advice point

The two advisors considered and ultimately rejected single premium immediate annuities (SPIA), variable annuities (VA) and FIAs with living benefits, as well as the 4% withdrawal rule, as income solutions for Andrew and Laura. They chose a period-certain SMA instead of a retail SPIA because of its higher internal rate of return (IRR) and because the couple can buffer longevity risk with other assets. As for the guaranteed lifetime withdrawal benefits associated with VAs and FIAs, they found that an SMA cost less and offered higher monthly payouts. The SMA income was also more predictable than income from the VA. Regarding the 4% withdrawal rule (with annual inflation adjustments), they thought it carried little or no protection from sequence risk, market risk or longevity risk.

Advice point

Anderson and Pulsifer’s plan assumes a reallocation at age 85, rather than at the higher ages that other advisors have begun to use. “The surplus in their equity portfolio and in their two homes will be the couple’s longevity protection,” they told *RIJ*. “In our planning practice, very few people who have assets like Laura and Andrew need to annuitize or buy lifetime income. Longevity risk simply isn’t a concern for them. Their assets and other sources of income will be more than adequate.”

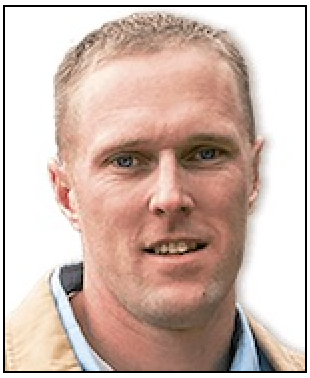
AnnuityStraightTalk/DCF Solutions recommendations

The optimal solution will allocate 40% of their combined qualified funds into two different annuity products. For guaranteed income, we use a period-certain guaranteed payment stream provided by a secondary market annuity from the DCF Exchange.

- For income during the first 15 years of full retirement, we pay about $368,000 (almost all of it from the bond holdings in Andrew and Laura’s SEP IRAs) for a deferred period-certain secondary market annuity from the DCF Exchange. Starting in 2023, this contract would pay $3,500 a month for 180 months for a total payout of $630,000 and an effective yield of 4.5%. (A comparable annuity from immediateannuities.com pays under $2,878 a month, as of September 12, 2017.)
- For additional income or growth, without the interest rate risk inherent in bonds or bond funds, we use $150,000 to purchase a fixed indexed annuity with a seven to eight surrender period and no income riders or added fees. “We see the index annuity as an ‘enhanced bond’ allocation. Principal is guaranteed and additional income can be drawn if and when needed through the free withdrawal provision of the contract. Left alone, this asset could may grow to about $350,000 at a 4% average yield until they reach age 85,’ Anderson said.
- AnnuityStraightTalk use FIA providers such as Great American, Integrity Life, or Midland National. The surrender period will expire only two or three years after Laura and Andrew retire, giving them options for rebalancing their portfolio along the way.
- We allocate Andrew and Laura’s remaining $746,000 in savings to equities, thus maximizing their chance for growth over the next 20 years, until they reach age 85. This will give them an overall

allocation of about 60% equities and 40% "safe money."

Bottom line



Adding $42,000 in guaranteed income from an SMA to Laura and Andrew's other safe sources of income (Social Security, pension and rent on their second home) will provide enough income to meet their income and RMD needs. This will maximize their peace of mind even as they devote the rest of their portfolio, almost $750,000 to equities or other growth-oriented investments.

"Rather than pay too much and lock themselves into a rigid paycheck for life, or let the markets rule their fate, Andrew and Laura should allocate a portion of their assets to two smart, safe-money assets that will protect their principal and create multiple sources of guaranteed income insulated from volatility. This relieves pressure on other investments, provides security, and allows for growth that will reduce their longevity risk and secure their inheritance goals," Pulsifer and Anderson (at left) said.

SMAs, it should be said, are in relatively short supply and require careful due diligence before purchase. The supply of secondary market annuities is only $800 million to $1 billion per year, according to Pulsifer. Large asset securitization firms buy an estimated 80% of that amount, leaving the rest for smaller factoring firms. Because the market is so small, investors need to be careful, and to work only with reputable agents who can document each link in an SMA's chain of ownership.