Ready for a Reality Check

By Editor Test   *Tue, Jan 19, 2010*

A recent Journal of Financial Planning article on annuities was a bit perplexing.

The headline on the story in this month's *Journal of Financial Planning* hooked me right away: "Achieving Sustainable Retirement Withdrawals: A Combined Equity and Annuity Approach." Just the kind of thing I troll for.

But as I read, I found the paper to be unsettling. It was so perplexing that I asked several advisors to interpret it for me. They too were perplexed. One advisor, in fact, telephoned me before I called him, to ask me if *I* understood the article.

For those who have seen it, I can clear up one mystery immediately: a key piece of information was missing. As author David M. Cordell, Ph.D., CFA, CFP, told me, the fact that the study's hypothetical investor added $100 a year to savings (10% of his income) was accidentally omitted.

Here's the gist of the article: The authors compared five financial planning strategies to determine the one most likely to fund the future retirement of a certain hypothetical 45-year-old.

This imaginary middle-aged investor earns $1,000 a year and has $5,000 in invested savings. At age 65, he wants a retirement income of $1,265 (70% of current income, adjusted for 20 years of 3% annual inflation) that will last until age 100.

Of five proposed strategies, three involved systematic withdrawals from uninsured investment portfolios: an all-equity portfolio, a 50/50 balanced portfolio, and a portfolio with an equity allocation equal to 128-minus-attained-age. The investor funds the portfolios at age 45.

The other two strategies involved annuities. The first called for a variable annuity (holding equity portfolios only) with a five percent lifetime withdrawal guarantee. The second called for an all-equity portfolio with an option to buy a life annuity at a "trigger date."

The trigger date was defined as any date from age 60 onward when the all-equity portfolio became big enough to buy a life annuity yielding one percent above inflation that could produce the desired retirement income.

Each strategy's degree of success was defined as the percentage of 1,000 Monte Carlo simulations in which it could produce the target income until age 100. The winner: the all-equity annuity with an option to buy a life annuity.

Time out, I thought. An all-equity portfolio, from age 45 onward? That sounded risky, given the possibility of a bear market near retirement. The authors' assumption of a 12.9% return rate for the equity portfolio, with an 18.3% standard deviation, also seemed high. (It's based on the return of the Russell 1000 index from inception in 1986 to the end of 2008.) Nor had I ever heard of a 128-minus-age rule of thumb for equity allocations.

As for the life annuity, the paper seemed ambiguous. The authors didn't say the investor *should* buy the annuity, only that the method was deemed a success if the portfolio grew big enough to buy the required annuity at any time between age 60 and age 100.

I was confused, and I was not alone in my confusion. The advisors I consulted about the article generally shared my reaction. One said it "left me cold." Another said it was evidence of the eternal gap between academics and practicing advisors.

A third said, "This is just this is one more SWiP [Systematic Withdrawal Plan] article with a nod in the direction of annuities. I did not find it to be persuasive . . . and it doesn't address the idea of improving the efficiency of an equity portfolio with an annuity"—a concept that William Sharpe of Financial Engines has written about.

A fourth advisor said that age-based rules of thumb about asset allocation don't work, as a rule. A fifth advisor, like me, couldn't tell if the authors favored income annuities or not.

In the meantime, I also reached out to Cordell, a professor at the University of Texas-Dallas, and asked whether he advocated life annuities. Here's his e-mail reply.

"It isn't that we are recommending the income annuity," he wrote. "Rather, we are saying that the existence of that option gives us the possibility of locking in the needed life income if one chooses. We define success as making it all the way to age 100. If you have accumulated enough to buy the income annuity, you have succeeded.

"However, you may decide not to buy the annuity. In the long run, a 100% equity portfolio should accumulate more money than other asset allocations, and many people will choose to retain the portfolio rather than buying the annuity. Estate planning considerations and short life expectancy are obvious reasons not to buy the annuity.

"On average, you should be able to generate the same income as the annuity by maintaining the 100% equity portfolio and still retain (at least a portion of) the corpus, but there is still risk. The annuity is obviously a way to reduce the risk."

In the end, the authors seemed to use the same argument for maintaining an annuitization option that marketers of variable annuities with lifetime withdrawal guarantees do: if investors know they can convert to guaranteed income if necessary, they can stomach more equities. As they put it:

"By specifying the annuity purchase as a future alternative, the financial planner can encourage a higher-equities portfolio, which will likely lead to a larger accumulation in retirement."

It's the simultaneous endorsement of equities and annuities that leaves me at a loss, I think. If you read the article by Cordell et al, and would care to validate or contradict my reactions, please e-mail your comments to me at kerry.pechter@retirementincomejournal.com.