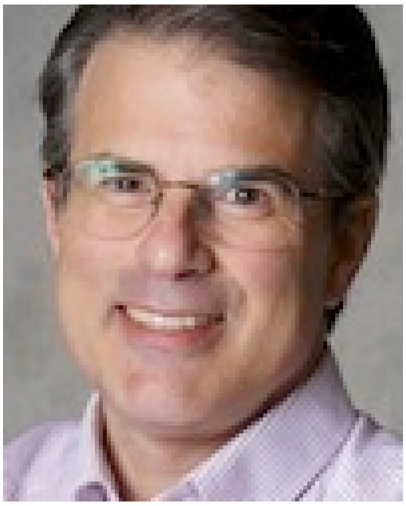
The One True Path to Income

By Kerry Pechter *Fri, May 16, 2014*

As we curse the low payouts of income products, it's worth remembering that the fault isn't entirely in our stars (low interest rates), but also in ourselves (insufficient savings).



Every May, when the lawn grows green and shaggy again and the John Deere roars to life after its six-month snooze, the word-scapers here at *Retirement Income Journal* return to one of their favorite subjects: Income annuities.

Last week we tried to deconstruct the "crowding out" effect of Social Security on retail income annuities. This week we'll examine that old-made-new product, the deferred income annuity, or DIA.

From a negligible sales base in 2011, when New York Life wrote the first modern DIA contract, DIA sales jumped to $1 billion in 2012 and then more than doubled, to $2.2 billion in 2013, according to LIMRA's Secure Retirement Institute. By comparison, sales of immediate annuities (SPIAs) grew by $600 million in 2013, to $8.3 billion.

Eleven insurers now offer DIAs in the race. (See today's cover story.) The sales leaders tend to be mutual companies (which like asset-liability matched products) with stellar strength ratings that assure clients that they'll still exist in 40 years. New York Life accounts for about half of annual sales. Northwestern Mutual, MassMutual and Guardian Life are in pursuit. But MetLife, Principal, and other publics just getting started.

Career agents sell 57% of DIAs, according to LIMRA. Full-service national broker-dealers sell 40% and banks sell the rest. Though those numbers hide it, New York Life, MassMutual, Guardian and Principal Financial are reported to be selling DIAs with great success through Fidelity's annuity platform.

Deferred Income Annuity Product Designs, By Issuer

Less product flexibility → More product flexibility

❐ Single premium. ❐ No ability to change income date.	❐ Single premium. ❐ Lower initial payout, but pays dividend in cash or additional income. ❐ 10-year payout window.	❐ Flexible or single premium. ❐ 10-year payout window. ❐ Up to six months of accelerated payments.		❐ Flexible start-date, premium. ❐ Three percent compounding death benefit. ❐ Commutation option.
AMERICAN GENERAL	NORTHWESTERN MUTUAL	FIRST INVESTORS	GUARDIAN	METLIFE
SYMETRA		LINCOLN	MASSMUTUAL	
		ONEAMERICA	NEW YORK LIFE	
		PRINCIPAL		

Source: LIMRA Secure Retirement Institute.

AIG and Principal DIAs are currently quoted and offered for sale on the Income Solutions web platform operated by the Hueler Companies, and other brands will soon join them, according to CEO Kelli Hueler. Established to give 401(k) plan sponsors with a direct, open-architecture, low-cost “out of plan” SPIA option they can offer to participants at retirement, Hueler now wants to offer DIAs as well.

Today’s DIAs, which typically start providing income five to 15 years after issue, are a hybrid of two earlier types of DIAs that never got much traction in the marketplace: the flexible premium annuity and “longevity insurance.”

People used those more traditional DIAs to buy future income at a steep discount. The discounts were funded by long years of compounding and by mortality pooling. But these products had little appeal in the marketplace because they lacked liquidity and, just as importantly, exposure to the equity premium.

The new breed of DIA is a more palatable compromise. The deferral period is usually just long enough to allow insurers to back them with longer and slightly riskier bonds, but the income doesn’t seem hopelessly distant. The latest designs remove the biggest barriers to sales.

Add a death benefit to allay fears of forfeiture and the product lends itself to the type of “best of both worlds” framing that helps producers close sales among retiring Baby Boomers who are looking for pension-like income. DIAs, along with fixed indexed annuities with income riders, may also be absorbing some of the demand left by the diminished supply of variable annuities with generous guaranteed lifetime withdrawal benefits.

The monthly payout of a single-life DIA purchased with a $100,000 premium by a man at age 59½ with a 10-year deferral and a cash refund of unpaid principal on death is comparable to the guaranteed payout of a variable annuity with a GLWB that offers a 10-year, double-your-benefit-base deferral period and a 5%

payout at age 69.

The highest current DIA payout for such a contract would be $990.80 per month, according to Cannex, which provides the most up-to-date DIA quotes. The hypothetical GLWB payout would be $1,000 a month for life. The GLWB, whose underlying assets would include equities, would have more upside potential than the DIA, but it would also have higher costs.

DIAs have an advantage over SPIAs. A 55-year-old investor who wanted to protect himself from sequence of returns risk during the run-up to retirement could, as an option, put money into a 10-year fixed annuity and wait until age 65 to decide whether to buy a SPIA. To provide liquidity, the insurer would have to back the product with short-term, high quality bonds.

The same investor could get a somewhat larger income stream with a DIA, all else being equal. "The mortality credit drives about a quarter of the difference and the rest comes from our ability to take advantage of the yield curve," an actuary at one of the DIA issuers told RIJ. "Besides going a little longer in maturity, to 10 or 15 years, we can also take some calculated credit risk. We're not talking about anything exotic, just double or triple Bs."

One obstacle to buying a DIA is that they tend to require planning ten or more years in advance of retirement, which most people don't do. People who are considering buying a DIA qualified money, such as rollover IRA assets, should probably start thinking about the decision before age 60.

That's especially true for people buying a DIA with qualified money. Several DIA issuers set the latest purchase age at 68, 68½ or 69, for qualified premiums, because the payouts must begin before age 70½, when required minimum distributions begin. People who are trying to leverage the higher mortality credits at older ages might find that restriction a bit confining.

Those who are buying a DIA with non-qualified, or after-tax money, face no such restrictions. Maximum-issue ages for these assets are as high as age 95. For such clients, DIAs can also help spread the income tax due on the interest earned on the principal over a period of many years. Once all principal has been distributed, however, the payments are 100% taxable as ordinary income.

DIAs are a useful new arrow in the product quiver of SPIA manufacturers. While SPIAs are mainly purchased by people in their late 60s or older, DIAs give issuers a product that they can offer to people in their 50s, thus broadening their market. Like SPIAs, DIAs can be positioned as a way for retirees to reduce risk in one part of their portfolios so that have more freedom to take risk with the rest of their assets.

As a risk-averse person approaching retirement without a defined benefit pension, I find the DIA concept appealing but the payouts still underwhelming. Low interest rates aren't the only reason for the unimpressive payout rates. Adverse selection—the tendency for healthy people to buy annuities and vice-versa—inflates the contract price by about 10%.

I try to rationalize the low-interest rate problem by telling myself that low rates have driven equity prices up. Ergo, if I sell inflated equities to buy my DIA, I'm not hurt by the low rates. It's a comforting thought, but not very.

I also tell myself that complaining about low rates is just a way of dodging the reality that I just haven’t save enough. Many of us still seem to expect growth and appreciation, as opposed to sheer saving (and the sacrifices it entails), to painlessly fund our retirements. That may turn out to be true for some, but you can’t count on it.