'Safety First' Income Plans, Per Wade Pfau

By Kerry Pechter *Thu, Oct 10, 2019*

Pfau's new book shows the benefits of replacing bonds with annuities for less risk and more income in retirement.

Wade Pfau, Ph.D., who directs the Retirement Income Certified Professional (RICP) designation program at The American College, recently spoke with *RIJ* about his new book: 'Safety-First Retirement Planning." It's a follow-up to his two previous self-published books, about investment-based retirement planning and reverse mortgages.

The new book explains the synergy that can be achieved—in terms of reduced risk and increased consumption in retirement—by more or less substituting income annuities (or the income benefits of deferred variable and indexed annuities) for the bond portion of a retirement portfolio. I asked Pfau which type of annuity vehicle he recommends for retirees. There is, of course, no black-or-white answer.

"Any form of risk-pooling is better than none," Pfau told *RIJ*. "The starting point would be to look at the level of income you could get from a life-only SPIA (single-premium immediate annuity), and then compare it with the income from a variable annuity (VA) or a fixed index annuity (FIA).

Wade Pfau

"Then you have to ask if you're willing to accept their lower level of starting guaranteed income [offered by VAs and FIAs], and whether their upside potential is enough to offset that. Psychologically, some people might be more comfortable with the deferred VA or FIA because they don’t want to give up liquidity.

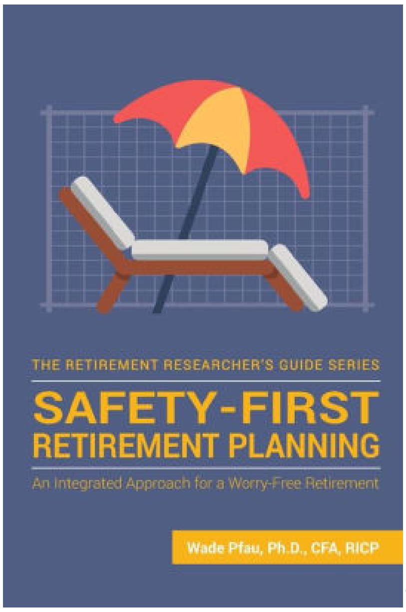
“With the VA, too, if the product makes them feel more comfortable about investing in stocks, they might be more comfortable with the fees in those products.” (Note: All annuities have fees. But the fees of VAs are more explicit and visible than the fees of indexed and immediate annuities, most of which are reflected in the price or payout rate of the product.]

Even among those who have accepted annuities as part of a retirement income strategy, tactics are still widely debated. For instance, some advisers recommend a bucketing-like strategy that uses, perhaps, a guaranteed period-certain or life-contingent income annuity for the early years of retirement and keeps stocks simmering on the back burner (the better to control sequence risk, which involves the negative impact of a major downturn in stocks during the first five years of retirement on portfolio sustainability).

Others invert that strategy and recommend spending from an investment portfolio in the first five or 10 years of retirement and buying a deferred income annuity (DIA) that doesn’t start paying out until age 80 to 85 (the better to control longevity risk at the lowest cost).

What does Pfau think? First, he says, “I’m not a big fan of bucketing. It’s probability-based.” But if he had to choose between using guaranteed income products first or last, he would put them first.

“A reasonably strong case can be made for starting income right away,” he said, speaking by phone from an American College conference in San Diego. “While it’s true that the longer you wait, the harder it is to beat the yield of an annuity with other safe investments [because the mortality credits become a larger factor in the payout as the annuity cohort shrinks over time]. But even at age 65, the implied longevity yield of the annuity is already good enough. To beat it, you have to take more risk.



“So I’d put the insured income first and put stocks at the back end. Longevity insurance [another term for DIAs] is better than nothing, but if you buy longevity insurance and take income from an investment portfolio at the beginning of retirement, then you’re opening yourself up to sequence risk.

“Also, if you follow the strategy of combining of longevity insurance with a 20-year bond ladder, you will probably be selling stocks to buy the annuity. But you really should be selling *bonds* to buy the annuity. When you sell bonds to buy the annuity, then any level of partial annuitization should improve your long-term outcome.”

Many advisers say that immediate income annuities aren’t attractive at current interest rates. But Pfau doesn’t consider low rates a deal-breaker for SPIAs. On the contrary.

“For someone who has retired, the case for an income annuity actually becomes stronger with low interest rates,” Pfau said, “because mortality credits are not impacted by rates.” He also doesn’t believe that low rates are necessarily a signal that stock prices are destined to rise in the future.

Rather, he subscribes to the precept that if equity returns are equal to the risk-free rate plus an equity risk premium then, all else being equal, a lower real risk-free rate will presage *lower* equity returns.

To assume that equity returns will go higher when real interest rates go down forces you to assume that the equity risk premium will be higher in the future, he reasons. “So I’m not comfortable building that into my analysis,” Pfau said.

“The problem with bucketing strategies,” he added, “is that they don’t explain how [the transitions between buckets] should work. So you can end up creating more risk for the plan rather than less. Even if you use an automatic bond ladder where you have ten years of bonds and buy a new bond every year, you're still creating interest rate risk."

In addressing the question of which is better—a fixed or inflation-adjusted income annuity—he said, "I don't think it's necessary to build inflation protection into the annuities. For a lot of people, spending needs will decrease with age. Or they can revisit the question and make an additional purchase of annuity income.

"The other issue involves sequence risk. If you don't buy the inflation-protection, a SPIA will cost less. That means you won't need to withdraw as much from your liquid investments to cover your discretionary needs. The lower withdrawal rate compensates for the impact of inflation."

I asked Pfau about the "annuity puzzle": Why don't more people who don't have pensions buy them?

"Part of it can be explained by how the tax laws work in the US," he said. "Under those laws, annuities became used as a tax deferral tool. Because of that, annuity and pension have evolved to mean two different things. Also, annuities are complicated," he added. In the new book, he observes that Americans already have a lot of inflation-adjusted, joint-and-survivor annuitized wealth in the form of Social Security.

More importantly, "People think that annuities are too expensive in part because they have a hard time understanding how much they can spend from a given asset base. They're not comparing [SPIA payouts, which are about 6% a year] to the level of spending that investments can support," Pfau said.

He was referring to the fact that a 65-year-old can spend only about 4% a year from a balanced portfolio without fear of running out of money. Yet the 4% "safe withdrawal" rule remains the most popular retirement income-generating strategy among financial advisers.