Two Client-Centric Income Strategies

By Kerry Pechter *Thu, Jan 10, 2019*

We compare two easy-as-pie annuity strategies: Income starting at age 80 versus guaranteed income for the first 10 years of retirement. One hedges longevity risk, the other hedges sequence risk, and neither ties up more than 25% of savings.

Assume that your clients, a 65-year-old married couple with $1 million in savings, are too risk-averse to rely entirely on the traditional “4%” withdrawal method for retirement income, but too risk-hungry to commit half their money to a single premium immediate annuity (SPIA).

To give them maximum flexibility, you could recommend a variable deferred annuity or an indexed annuity with a guaranteed lifetime withdrawal benefit (GLWB). That would keep all their options open. But, at 65, they’re already past the ideal age for buying that type of product and maximizing its 10-year deferral bonuses.

So let’s consider two other, less orthodox ways to use annuities. I’ll call them the “Safety Last” and Safety First” approaches. The Safety Last approach uses an annuity to guarantee income over the last stage of retirement. The Safety First approach, by contrast, guarantees income over the initial stage.

In this informal thought-experiment, I compare these two strategies. But not in the usual way. Instead of trying to assess them by the amount of annual income they might generate or the final wealth they might deliver, I’ll introduce the ida that they target different risks, and suggest that the “best” method may be the one that eliminates the clients’ biggest financial anxiety. It’s a primarily client-centric approach to income planning.

Safety Last?

The Safety Last approach insures the latter part of life through the purchase of a deferred income annuity (DIA) or its pre-tax cousin, a qualified lifetime annuity contract (QLAC). Suppose that your clients use a quarter of their savings ($250,000) to buy a joint-life DIA or QLAC with a cash refund that returns unpaid premium to their beneficiaries. (Adding a cash refund feature to a joint-life contract doesn’t appear to reduce monthly income as much as it would for a single-life contract.)

Based on data from **immediateannuities.com**, $250,000 would buy a $40,000 annual income stream beginning at age 80. The clients would invest the remaining $750,000 as you recommend and spend it down by about $30,000 (4%) a year. Assume that $30,000 plus Social Security will cover their essential annual expenses.

A newly-published **report** from the Employee Benefits Research Institute (EBRI) in recent years offers evidence that people who use between 5% and 25% of their 401(k) balances to buy a DIA or QLAC can raise their personal Retirement Readiness Ratings (a benchmark EBRI created) and reduce their risk of running short of money in retirement. EBRI set the start date of their hypothetical DIA at age 85 in that study.

The study showed that DIAs, as expected, favor the people who live the longest. Anyone who died or fell seriously ill before receiving benefits would lose their premium if the DIA has no cash refund feature, early-distribution-for-illness clause, or flexible start-date. The study also showed that people with very little savings or a ton of savings don’t have much to gain from buying a DIA or QLAC. The poorest people tend to need all their money for current expenses, while the wealthiest aren’t at great risk of running out of money.

But for the so-called mass-affluent, especially those in good health and those who might take comfort in knowing that they’ll have a safe income stream at a time when they might face mental or physical decline, then DIAs or QLACs could make a lot of sense.

Safety first?

Now let’s reverse that strategy and consider buying guaranteed income for the first decade of retirement rather than the latter stages. Instead of applying one-quarter of the couple’s savings to a DIA starting at age 80, they could apply that $250,000 to the purchase of a 10-year period certain annuity paying about $28,000 a year or a comparable 10-year bond ladder.

This was more or less the strategy presented by advisor Dana Anspach, founder of **Sensible Money** in Scottsdale, AZ, and the principals at **Asset Dedication**, J. Brent Burns and Stephen J. Huxley, during an Investment & Wealth Institute (IWI) conference for Retirement Management Analysts near Jacksonville, FL, in early December. They used a bond ladder; I use a period certain annuity as a proxy. It’s easy to price with an online calculator.

This strategy eliminates sequence risk. It assures clients that even if their investments go bust during the first few years of retirement they wouldn’t need to sell depressed assets in order to generate income. It appeals to investors who believe in “stocks for the long run,” and who like the idea of giving 75% of their assets ten years to grow undisturbed. At the IWI conference, Burns and Huxley strongly recommended putting part of that money in small-cap value funds, which, they argued, perform best over the long run.

Clients who choose this strategy don't necessarily face a risk "cliff" when the bond ladder or the period certain annuity ends. Over the initial ten years of retirement, they can harvest gains from their at-risk assets and extend the bond ladder or purchase more years of annuity income.

Where life-contingent annuities can introduce new elements of uncertainty—Will we die early? Will the beneficiaries feel cheated?—into the income planning process, a period certain annuity with a death benefit adds true certainty. (Period certain annuities do not provide mortality credits, however, unless the contract is a "temporary life annuity," where the payments stop if the annuitants die before the end of the term.)

The larger point

We've now looked at two strategies that are driven by two of the risks that concern retirees the most: The risk of outliving their money and the risk of experiencing a market crash early in retirement. In that sense, they're starkly different from each other. But they're similar in one way. Both call for annuitizing only 25% of the client's portfolio while leaving plenty of assets for extraordinary expenses, additional income or aggressive investment. (This example includes annuities with cash refund features so clients have no reason to worry about forfeiting assets if they die early.)

More to the point, these strategies represent a client-centric, risk-driven approach to retirement income planning. Advisors often look for the technique that generates, say, the most monthly income, the lowest taxes, the most final wealth, or the lowest failure rate. Or they may recommend strategies that suit their own habits or revenue models. But, if a client's sense of security in retirement is the goal, the best solution (all else being equal) might be the one that addresses the risk that worries the client the most.