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An Immediate Life Annuity as Part of a Client's Retirement Income Strategy

If your clients are retired or nearing retirement, and have accumulated some retirement savings, they probably worry about how much income they can safely take from their portfolios. After all, those savings must produce income for as long as they live, cope with inflation and market downturns, and provide money for emergency medical expenses or long term care. With so many people retiring early, and with medical advances and lifestyle improvements increasing life expectancy, it's a worry many people have.

Yet many financial planners approach the retirement income problem the same way they approach the retirement savings problem: choose a well-diversified portfolio, be patient and remain invested even when markets go down. This strategy works well when a person is saving money, but not as well when that person is taking income. The reason is because an added risk people face when taking income is longevity risk.

Understanding Longevity Risk

Longevity risk is the risk that you may run out of money before the end of your life. As people retire earlier and live longer, the risk that they will run out of money increases. Currently, a retired couple, both aged 65, have a 45% chance that one of them will reach age 90, and an 18% chance of one of them reaching age 95.[1] That means that there's a chance that at least one of them will need income for at least 25 years, maybe 30. Can an investment portfolio last this long?

In a landmark study, "Making Retirement Income Last a Lifetime",[2] John Ameriks, Robert Veres and Mark Warshawsky considered that very question. They examined four sample portfolios – conservative (bonds, stocks and cash), moderate (more stock, less bonds and cash), growth (even more stock), and aggressive (mostly stocks, but with some bonds) – to see how well those portfolios lasted over long periods of time (ranging from 20 to 40 years). Each portfolio had to produce an income equal to 4.5% of the initial portfolio value, withdrawn annually and adjusted for inflation. The first portfolio began on January 1, 1946, with new portfolios starting every month thereafter, with the last beginning on January 1, 1979 (almost 400 samples for each portfolio over 33 years).

Many of the portfolios failed to survive for long periods of time. All conservative portfolios failed on average before 30 years. The aggressive portfolios did best, but had the most volatile returns. But even though they were the best, their performance was not great: one third of all aggressive portfolios failed within 30 years.

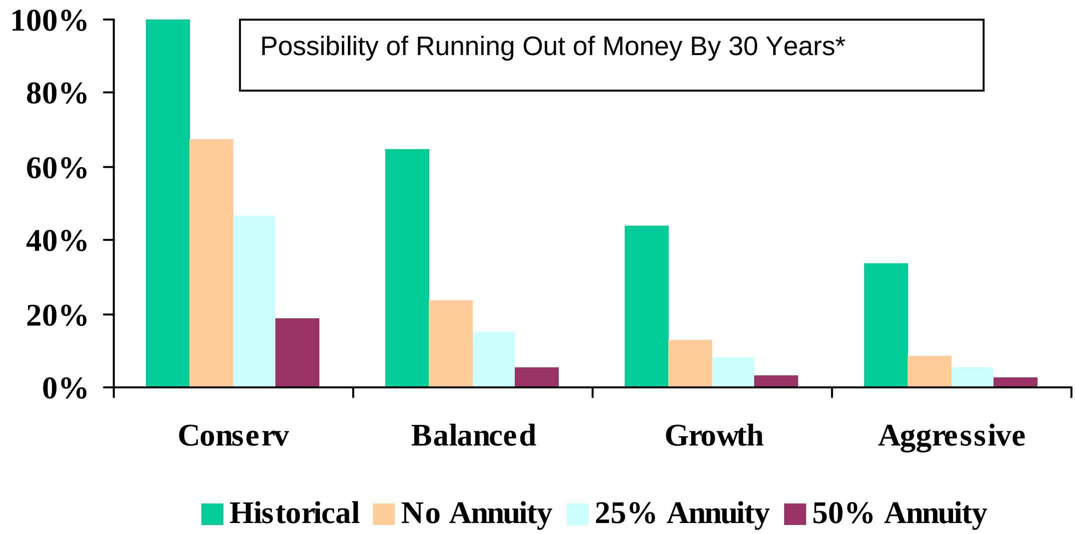
How could this be? One strategy that many of us were taught about asset allocation appears to be untrue – that you should move to more conservative investments as you get older. But the strategy that replaced it, that you should invest your retirement funds in equities for long term growth, looks only a little better. Not many retirees would be happy with a plan that fails on average one third of the time.

According to the study, the conservative portfolios' returns simply could not keep pace with inflation, even during the high interest rate days of the 1970's and 1980's. But the equity portfolios got higher returns. Why did so many of them fail? One reason is that their returns were highly volatile, and many of the failed aggressive portfolios suffered a major market downturn early in their lives.

Market downturns have a greater impact on portfolios that are distributing money than on those that are accumulating money. For portfolios that are accumulating money, dollar-cost-averaging works in their favor. As market values fall, the same money buys more units this month than last. When markets recover, the investor has more units than he would have been able to buy had market values remained high.

But dollar-cost-averaging does not apply to those taking income. To maintain a constant income during a falling market, you must surrender more units this month than last. As a result, your portfolio shrinks faster than it would from a decline in market values because you are surrendering more and more units each month as the decline continues. Even after portfolio values recover, too many units may have been lost to maintain the same pre-retirement level of income for the retiree's life.

The study showed that if you relied on investment performance for retirement income, success largely depended on when you retired. Those who retired into bear markets (like those prevailing during the 1970's) did poorly compared with those who retired into growing markets (like those prevailing during the late 1940's and 1950's). Since you don't know in advance what type of market you will get when you retire, you need something different to help your portfolio last.



*Source of data: Ameriks, et. al.

Conservative Portfolio:	20% equities, 50% bonds, 30% cash
Balanced Portfolio:	40% equities, 40% bonds, 20% cash
Growth Portfolio:	60% equities, 30% bonds, 10% cash
Aggressive Portfolio:	85% equities, 15% bonds, no cash

Equities are represented by the Standard and Poor's 500 Index, bonds by intermediate-term government bonds, and cash by 30-day Treasury bills.

Including a Life Annuity in Your Retirement Portfolio

That "something different" may be a fixed immediate life annuity, like the SecureLiving℠ Income Provider single premium immediate annuity (SPIA) or SecureLiving℠ Income Provider NY.[3] The Ameriks study suggested that when you used some of a portfolio's assets to buy a fixed immediate life annuity, the odds of running out of money declined. For example, when 50% of a retiree's income came from a life annuity, and 50% from an aggressive portfolio, the possibility of exhausting the portfolio fell to about 2.5% from 8.4% without an annuity.[4]

The study also suggests why this strategy may work, assuming that the client has saved enough for retirement. At age 65, depending on annuity rates, it generally takes only about one third of an investment portfolio's value to buy a fixed immediate life annuity paying one half of one's initial retirement income. That leaves about two thirds of the retiree's savings in investments to provide the other half of the retiree's income. As a result, the demands on the portfolio's investments early in retirement are lighter than they otherwise would be, allowing the investments to grow if markets perform well.

If markets perform poorly early in retirement the investment portfolio shrinks less than it otherwise would because the investment portfolio does not have to surrender as great a proportion of its assets to provide its share of the retiree's income. Income from a fixed immediate life annuity, of course, is unaffected by market downturns.

On the other hand, if markets perform well early in retirement, investment returns may exceed the amount the portfolio must distribute – the investment portfolio grows. Of course, inflation will require increasingly larger distributions, and a serious market downturn at some point remains a possibility.

If that happens, the life annuity will be able to provide proportionately less help than it could have provided earlier in retirement (because life annuity income is fixed). But any growth the portfolio gained early in retirement, combined with an ever shrinking time during which the portfolio must provide income, gives the portfolio a better chance of providing retirement income than if the retiree were to rely on investments alone.

There is no guarantee that clients' investment portfolios will last as long as their lives. But by including life annuities in their portfolios, your clients may be able to hedge the risk of outliving their money, and improve their chances of having a retirement income that lasts all their lives.

[1]National Vital Statistics Reports, Vol. 54, No. 14, April. 19, 2006, p. 3

[2]John Ameriks, Robert Veres and Mark Warshawsky, "Making Retirement Income Last a Lifetime", Journal of Financial Planning, December 2001.

[3]SecureLiving Income Provider single premium fixed immediate annuity is issued by Genworth Life Insurance Company subject to policy form series 37117 et al. and GEC6012 et al. and by Genworth Life and Annuity Insurance Company subject to policy form series 39847 et al. and GNWLA6012 et al. Not available in all states. Features and benefits may vary by state.

SecureLiving Income Provider NY single premium fixed immediate annuity is issued by Genworth Life Insurance Company of New York, 666 Third Avenue – 9th Floor, New York, NY 10017; subject to policy form series 37117NY and GENY-6012. Available only in New York. Only Genworth Life of New York is licensed to conduct business in New York.

[4]The study used Monte Carlo analysis to compare portfolios that had no annuities to portfolios where 25% and 50% of initial income was derived from a fixed life annuity. The Monte Carlo analysis drew on historical investment returns (equity, bond, and Treasury bills) and inflation data, then created 10,000 random runs to test how well the portfolios performed, with and without a life annuity. The study did not compare historical returns using a life annuity to historical returns without a life annuity.

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