How Income Annuities Help Build A Personal Pension

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Is it finally time for fixed income annuities to shine in the retirement marketplace?

Also known as immediate annuities when purchased with a lump sum at retirement, these products offer many of the same comforts and rewards that traditional pension plans do, such as consistent monthly income payments, guaranteed income for life, potentially more income than typical systematic withdrawals from savings, no hassle, and protection for loved ones. Some annuities also offer "longevity insurance" to reinforce the retirement safety net.

One strategy advisors can use to help clients understand the benefits is to approach the income annuity as a "do-it-yourself" pension--their own guaranteed steady stream of income in retirement.

The good news is that there are several ways to obtain income annuities. The choices can include purchasing a deferred income annuity during the working years, using a lump sum distribution at retirement to purchase an "immediate" income annuity that starts right away, or purchasing a deferred income annuity upon retirement that provides a future income stream starting at around age 85, or even earlier.

Advisors can help clients navigate all available options to help determine the best approaches to creating lifetime income. Here are some points to make:

--Note that, like traditional pension plans, a fixed income annuity provides guaranteed consistent payments that won't change, even with fluctuations in the market.

--Encourage clients to look at their annual fixed costs such as food, housing, and medical and insurance expenses to assess how much they'll potentially need to cover those. Then, take into account any regular income such as Social Security. Any gap can be filled by an income annuity, ensuring the monthly expenses are covered.

--Note, that like a pension, an annuity can cover fixed monthly payments, but clients should consider keeping some savings liquid for emergencies. They may also want to keep other assets invested for growth to combat inflation.

--Factor in the fact that longevity is a risk that all retirees face. The average life expectancy for today's 65-year-old man is 82.2 years, and for a woman it's 85, according to 2005 data from the National Center for Health Statistics. That's great news, but it also poses some daunting financial issues.

Like a pension, annuities can help to protect clients against running out of money in retirement. Clients can choose annuities that guarantee income payments no matter how long they live, or annuities that pay out for a specific period.

Another point to make: Income annuities provide potentially higher payouts than individuals could withdraw on their own.

Example: A 65-year old man with $500,000 in savings and investments, using what many experts believe to be a safe withdrawal rate of 4%, would receive $20,000 annually before taxes. But if the man allocates $165,000 of the $500,000 to an immediate income annuity, using the Annuity 2000 Mortality Table with a 4% interest rate assumption, the annuity would produce guaranteed income of $11,900. If the man then withdraws from the remaining $335,000 at the 4% rate, this would provide an initial annual income of $13,400.

This way, the total annual income would be around $25,000 ($11,900 + $13,400) before taxes, or 25% more.

Essentially, the client gets a "LEG up" with fixed income annuities, by creating more income from what may well be a shrunken asset base. (See box.)

Longevity insurance, mentioned earlier, helps too. Here, a deferred fixed income annuity is used to protect against the risk of not knowing how long the client will live (i.e., the longevity risk). The client purchases the annuity when he or she retires, say at age 65, with the payments set to start later, maybe at age 75 or 85.

This product acts as a catalyst to the whole LEG concept—because the investment is relatively small in comparison to that for other products, but it produces significant income at the older ages.

Some clients may be concerned that if they die before age 85, they could get nothing from their longevity insurance. Here are some ways to respond:

• Having longevity insurance in place can shorten the planning horizon for using other retirement assets. This can help provide a sense of well-being for the client, knowing that his or her remaining assets may only have to last until age 85.

• Some versions of longevity insurance stipulate that if the income payout is never triggered, the benefit can be realized as either a death benefit to a beneficiary or a commuted lump sum to the owner.

By following the “do-it-yourself personal pension” approach, advisors can overcome many barriers to selling income annuities.

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