

PRINTER-FRIENDLY FORMAT SPONSORED BY:



Should clients use immediate annuities in retirement?

By Charlie Farrell

April 20, 2010

Let's take a look at a simple example and see under what circumstances an immediate annuity might be appealing.

Assume we have a married couple, age 65, with \$1,000,000 of retirement assets. If they buy a joint and survivor annuity today, the estimated payment would be about \$62,600 per year for as long as they live (this quote was obtained from one of the highest-rated, direct annuity issuers in the industry).

That sounds like a pretty nice income stream at about 6.26% of their portfolio. But in exchange for the payment, the investors must give up ownership of their \$1,000,000. That money goes to the insurance company in perpetuity. The only thing the investors receive is the \$62,600 a year. So if they only live 15 years, it was a bad deal. If they live 30 years, it's a pretty good deal; or is it?


Instead of buying the annuity, let's assume the investors buy a portfolio of long-term corporate bonds from companies that have credit ratings similar to those of most large insurance companies. Some of the bonds in the portfolio could even be from the same insurance companies that issue annuities.

In today's market, an investor could buy \$1,000,000 worth of 25 to 30 year corporate bonds and receive interest payments of somewhere between \$57,000 to \$58,000 a year. That's almost as much as they can get from the annuity, and they get to retain ownership of their \$1,000,000 of retirement assets.

Now, it gets even more interesting if you ask for an annuity that guarantees 30 year's worth of payments, just like you would get from the bonds. In that case, the annuity payment drops to about \$58,000, almost exactly what you could generate from a portfolio of comparable corporate bonds.

In each case, the income stream is fixed, so economically there is no difference. Yet with the

InvestmentNews Reprints

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Reprints tool or the Reprints link at the top or bottom of any article, respectively.

- [View reprint options](#)
- [Order a reprint article now](#)

bond portfolio, you retain ownership of your principal. With the annuity, you don't.

Moreover, with a portfolio of corporate bonds, you have much more control over the credit risk. You can allocate your money among 25 or more companies, and you can buy bonds from companies in multiple industries. With the annuity, you might be able to split your funds among four or five annuity carriers but that is still much less diversity than you could get with corporate bonds. And with the annuity, your credit risk is always concentrated in the financial services sector.

Plus, the client has control over the bond portfolio, and can decide to sell or exchange bonds at any time during that 30 year cycle.

So does it make sense under the above example to buy an annuity? The income stream from a comparable corporate bond portfolio is almost the same; you retain ownership of your principal, and flexibility in managing your assets over the next 30 years. Maybe I am missing something, but the annuity doesn't seem that appealing.

Let's look at another scenario to see if the annuity becomes more appealing.

Let's assume the same clients in the above example were healthy and 80 years of age. Well, at 80, the joint and survivor payout on a \$1,000,000 annuity would be about \$87,500 a year, or 8.75% of the portfolio. That income stream is well above what the client could generate from similar long-term corporate bonds. But then again, the reality is that the client isn't likely to collect too many of those \$87,500 a year payments.

If, however, you think you'll live 30 years, with the annuity, you would get \$2.62 million in payments; definitely worth it. So for older clients who are concerned they will live many years beyond their life expectancy, an annuity later in life is more compelling.

Charles Farrell is a principal with Northstar Investment Advisors, LLC in Denver. He is the author of Your Money Ratios: 8 Simple Tools for Financial Security, and the developer of the Farrell-Northstar Retirement Income Index.

To ask other questions concerning retirement, go to our [retirement planning forum](#) and click "Start new discussion."