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Top story - Making the case for single premium immediate annuities

By WARREN HERSCH Published 5/27/2008

Sometimes, the least sexy of products is the right one for the client. That includes single premium immediate annuities--products that can provide annuitants with a guaranteed, fixed stream of income they can't outlive.

With the leading edge of 79 million boomers now entering retirement, sources tell Annuity Sales Buzz that they expect demand for this oldest of insurance products to rise.

"I think we'll see a significant increase in sales of immediate annuities because so many baby boomers are now leaving the workforce and many of them see that a SPIA can make good sense," says John Olsen, a chartered financial consultant and principal at Olsen Financial Group, Kirkwood, Mo. "The product is being perceived in a new light."

Demand will also be driven by uncertainties in the economy. Due to the prospect of recession, unsettled stock prices and still weak credit markets due to the sub-prime mortgage meltdown, many pre-retirees are looking for a rock-sold source of income to carry them through their golden years, say experts. The SPIA will have appeal because it can guarantee monthly payouts for a period of years or as long as the client lives.

But before buying a SPIA, clients also need to weigh the potential negatives, caution sources. These negatives include: loss of control of funds that might be needed to meet unanticipated expenses; loss of a death benefit (assuming a straight life annuity); and a locked-in fixed interest rate that could become an opportunity cost in a rising interest rate environment.

"There is a persistent belief among advisors and the public that purchasing a SPIA is a sucker bet because of the fixed interest rate and because the product binds clients to an irrevocable decision," says Olsen. "But these arguments miss the point entirely. The decision to purchase an annuity is never an investment decision; it's a risk management decision.

"The people who hate SPIAs say that [annuity buyers] are exchanging a stack of money, however invested, for an investment that provides an income stream and a low internal rate of return," he adds. "That's terrible logic. What you're actually doing is exchanging a stock of dollars for the risk management assurance that you won't run out of money."

Olsen is quick to point out that a SPIA is not for everyone. For instance, it is not well-suited to risk-tolerant clients who are looking for upside potential and are willing to bear the downside market risk inherent in a deferred variable annuity, he says. But it is appropriate for the client who has an immediate need for income, is risk-adverse, and has few if any other assets to draw on in retirement.

SPIAs can be especially attractive for those in ill health. Such individuals can seek a medically underwritten annuity that provides a higher income stream than is otherwise available, says Mai Luc, an annuity marketing manager at Brokerage Professionals, Scottsdale, Ariz. Because the individual has a shorter than average life expectancy, the payout (whether for a period certain or straight life annuity) will be greater.

"A medically underwritten annuity is a great way to provide greater bang for the buck," says Luc. "It can increase the monthly payout significantly, often by as much as 20%."

Olsen adds that some products avail clients of an inflation rider. These annuities can tie the payout to annual rises in the consumer price index or else to a fixed percentage increase that kicks in on the contract anniversary date. But he notes with "sadness" that few clients are buying inflation-indexed fixed annuities because producers are not making the case for them. That requires presenting illustrations of annuity distributions not in nominal dollars, but in inflation-adjusted dollars. Though yielding a lower payout than a standard SPIA in the early years, the inflation-indexed annuity looks more attractive over time, he indicates.

An oft-overlooked benefit of the SPIA is its ability to increase bequests for heirs, according to industry sources. Though the annuity itself may not come with a death benefit, it can provide the income—and the confidence—needed to keep other assets destined to be passed on to the next generation invested for the long-term growth.

A new report from NAVA, Inc., Reston, Va., concludes as much. The study says that including a SPIA in a retirement portfolio not only provides a guaranteed income for life, but increases the average bequest from retirees to heirs by up to 41% as compared with a mutual fund-only portfolio in which individuals take systematic withdrawals during retirement.

Conducted by Milliman, Inc., Seattle, Wash., the study analyzed several hypothetical case studies, including a middle-income couple, both age 65, with $500,000 in available retirement assets and a post-retirement income goal of $50,000 per year that increases by 2.5% annually. The report's authors assumed that $30,000 of the couple's income goal would be covered by Social Security, leaving an income gap of $20,000 per year.

Based on the analysis, if the spouses invested half of their $500,000 in mutual funds with a 75% equity, 25% bond mix, and the other half in a SPIA, they would increase the chances of meeting their retirement income goal from 77% to as high as 95%, based on an average life expectancy of 31 years in retirement and a 42% chance that at least one spouse would reach age 100. The study also found the spouses could have significantly more money available to leave behind to their family: $1,338,000, as compared with $945,000 for a mutual fund-only portfolio.

"The surprising piece of this report is that you could actually make a higher bequest by including a SPIA in the portfolio," says Tim Hill, a consulting actuary and principal at Milliman. "The SPIA provides a solid core of income, which allows the client's mutual funds to stay invested and do what they do so well: grow in value."

If still a larger bequest is needed, the SPIA can help here, too, according to Brokerage Professionals' Luc. He says that clients who don't need the income can use distributions from the annuity to fund a life insurance policy. This option is attractive among many young buyers of SPIAs.

“Life insurance companies love this option because they know the premiums will be guaranteed, which means no policy lapses,” says Luc. “For those people who are looking for a life insurance benefit, the SPIA can be a perfect funding vehicle.”

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