

Generating Income When You Retire

Is it better to self-manage your retirement money or to take an annuity? The answer is anything but simple, the ramifications can be huge, and it is made even more perplexing by the conflicting and often biased advice on the subject. True, some pension plans make it easy: they don't give you a choice, requiring you to take an annuity when you retire, period. On the other hand, many company-funded plans allow you the option of taking a lump-sum payout.

If you're one of the majority of workers whose employers don't offer a traditional pension plan, you still can make the same choice—managing the funds or annuitizing the funds for any retirement plans that you have contributed to, such as 401(k) and 403(b) plans and IRAs, as well as any other nonretirement money that's lying around.

Key considerations. Here are the key considerations when making the manage-it-yourself versus annuity decision:

- 1. Investment risk.** If you decide to manage the money yourself, what happens to it is your business. If you lose it through unwise investments—or even “wise” ones that go sour—there's no recourse but to suffer in silence and, perhaps, cut your spending. Unless you are confident of your investment abilities—or those of a competent adviser—you may be better off taking the annuity.

- 2. Liability risk.** Money that you are investing on your own is usually not protected from liability. These funds have to be used up to pay major medical (or other) expenses, including nursing home costs, if you exhaust other resources. In many cases, though, annuities are not subject to this liability.
- 3. Inflation risk.** While some annuity plans are adjusted (at least partly) to offset the effects of inflation, most are not. The reality of a fixed-payout annuity is a steady loss of purchasing power. If you invest the money on your own, you have a good, but by no means assured, chance of investing it so that it will keep up with inflation.
- 4. Anticipated income.** Generally, annuity payouts give you less income than you could make if you were investing the money on your own. *Reason:* The payout schedules tend to be figured conservatively to minimize the annuity company's future financial risks. In plain English, this means that the company is betting you'll live to two hundred. Find out the exact monthly or quarterly stipend you'd receive from an annuity and compare this figure to your anticipated rate of return if you were investing the money on your own.
- 5. Mortality risk.** Traditionally, annuity payments cease when you do. Consequently, if you die prematurely, your estate is considerably poorer than it would have been if you'd taken a lump sum. Note, though, that many annuity plans—both the corporate type and the kind you buy on your own—offer some sort of provision for this event, although at a price. Typically, it's a continuation of some lesser stream of payments for the benefit of a surviving spouse, or the option of receiving a lump-sum payout of a portion of the money that was originally put into the annuity.

Each payout method has advantages and disadvantages, and no financial decision is "either/or." (See page 124.) Many retirees

will benefit from taking an annuity for part of the money and investing the rest. If you do decide on an annuity, be sure to shop around. Don't assume that the first annuity you come across or your company annuity is the best. Chances are, it isn't.

Annuities Explained

Before delving into a discussion of annuities, let me first explain the various permutations and combinations of annuities. While the subject here is income annuities, the following primer covers both income and deferred annuities. For some information on deferred annuities, see page 155.

Annuity primer. Everyone's heard about annuities, but your eyes may glaze over when trying to figure them out. Here's a quick explanation of four characteristics of annuities:

- ◆ An **income** annuity (synonymous with "immediate" annuity) begins making regular payments to you as soon as you put money into it.
- ◆ With a **deferred** annuity, you invest your money now, let it grow inside the annuity tax-deferred, and later withdraw it in a lump sum, by receiving regular payments until the money runs out, or by rolling the money into an income annuity for lifetime income.
- ◆ A **fixed** annuity grows or makes payments at a fixed rate of return.
- ◆ A **variable** annuity invests the annuity money in a variety of mutual funds of your choosing.

Therefore, there are actually four kinds of annuities based upon these characteristics:

TABLE 6.2
HOW ANNUITIES WORK

	<u>DEFERRED</u>	<u>INCOME</u>
FIXED	Accumulates value based on a predetermined interest rate	Fixed payments received for life or a fixed period
VARIABLE	Increase in value based upon performance of selected mutual funds	Payments vary based upon performance of selected mutual funds

Thanks to the ingenuity of the insurance industry, not to mention its desire to sell more annuities, all manner of variations of the above taxonomy are offered. For example, immediate fixed annuities may include an inflation kicker, and deferred variable annuities may have features that allow you to periodically lock in investment gains. Whether any of these additional bells and whistles are appropriate for you depends on your circumstances. But the best course of action, as with most financial products, is to stick with the basics. There's more competition among the insurance companies for the basic policies, which often helps keep costs down. Also, the newfangled policies are more difficult to evaluate and compare, and many experts in the field fear that there's less than meets the eye with a "new and improved" type of annuity.

Income annuities are hot. Income annuities have been receiving a lot of attention in recent years, primarily because of losses sustained during the three-year bear market from 2000 to 2002. Stories of people nearing or in retirement who lost substantial portions of their nest eggs during that awful period have given new credence to the relative safety of an income annuity. This despite a time of low interest rates. Generally, the higher current prevailing interest rates are, the greater the annuity payout.

Making a Smart Income Annuity Decision

Reasons for choosing an income annuity:

- ◆ You're entering retirement or are already retired.
- ◆ You have retirement resources (pension distributions, retirement accounts, brokerage accounts) that you want to convert into an income stream.
- ◆ You're concerned about outliving your income.
- ◆ You want a guaranteed source of income in retirement.
- ◆ You have other retirement investments that can be invested for growth to offset the loss in purchasing power of a fixed annuity later in your retirement.

Despite their increasing popularity, these annuity arrangements have some nagging drawbacks. Nevertheless, with careful planning, the drawbacks can be ameliorated.

- ◆ **Income annuity drawback #1: your early demise.** This is the income annuity horror story. Some poor sap signs up for an annuity, receives a couple of monthly payments, and then has the audacity to die. And the winner is—the insurance company.

Solution. Consider an annuity that guarantees payments for at least a set number of years. Then, if you die before that set number of years, there will be something left for your survivors. Of course, payments will be reduced somewhat to account for a guaranteed number of payments.

- ◆ **Income annuity drawback #2: the annuitant predeceases some other needful soul.** If you have someone who would suffer financially (as well as, we hope, emotionally) if you're first in line for the grim reaper, a single-life annuity is probably a bad idea.

Solution. The obvious solution is a joint and survivor annuity that will continue payments to a survivor. Of course, this will reduce the initial payments, but this may be a small price to pay in exchange for both of you receiving payments for life.

- ◆ **Income annuity drawback #3: inflation ravages the annuity's purchasing power.** Inflation can wreak havoc on a fixed annuity. In short, while \$1,500 per month in annuity income, in addition to your Social Security and other stuff, could look mighty appealing now, when you retire, you're quite likely to see the purchasing power of that \$1,500 chopped by half or more, even if inflation stays relatively low. At a 3 percent annual rate of inflation, the buying power of that \$1,500 will shrink to just \$817 in twenty years.

Solution. Fear of loss in purchasing power has not been overlooked by our beloved insurance industry. They're more than happy to sell you an annuity with an inflation kicker. However, compared with a fixed annuity without the inflation kicker, you'll receive a considerably reduced initial payment. For example, if a sixty-five-year-old male buys a \$100,000 annuity, his annual emolument goes down from \$7,851 for a fixed annuity to \$5,865 if he adds an inflation kicker. However, if you've got longevity in the family, you may find comfort in either an annuity that increases payments in accordance with the actual rate of inflation (as measured by the Consumer Price Index) or one that rises by a fixed percentage each year (choose *at least* 2 percent; 3 percent would be better). Finally, you might consider taking a fixed annuity, but reinvesting enough of each payment to allow you to keep up with inflation later on. This is further explained on page 150 and illustrated in Table 6.3.

- ◆ **Annuity drawback #4: the insurance company dies before you do.** The likelihood of an insurance company bellying up is

low. But the last thing you want to do during your retirement is lose sleep over some insurance company's financial travails.


Solution. The strategy here is to make sure the insurance company with whom you are contracting for your annuity is in tip-top financial shape, as evidenced by its readings from the various insurance company ratings agencies. Even if you can get a better deal from a lower-rated company (i.e., one whose ratings grades look like my grammar-school report cards), don't be penny-wise and pound-foolish.

◆ **Annuity drawback #5: it's an irreversible financial commitment.** After considering all of the above-described drawbacks, you may still be uneasy with what is, after all, a major financial commitment that can't be undone.

Solution. Annuities are by no means an essential retirement-income tool. If you simply are turned off by any annuity at all, fine. There are many ways to generate needed retirement income. For example, you can create your own income annuity by investing in dividend-paying stocks, bonds, and other interest-earning securities. Alternatively, you could give an income annuity a test run by initially investing only a portion of the money you might ultimately put into annuities and then deciding later on if you want to purchase more.

Income annuity rule #1—gradual is the byword. Such a “staged” approach to income annuities has other advantages in addition to reducing an initial investment in an annuity. By waiting to commit additional money to an annuity, you can increase your income considerably. A male purchaser of a \$100,000 fixed-payment annuity would receive \$7,851 if he bought it at age sixty-five, \$8,942 at age seventy, and \$10,448 at age seventy-five. Also, purchasing more than one annuity allows you to spread your money out among different insurance companies in the unlikely, but not inconceivable, case that

one of the companies goes under. Delaying an annuity purchase can also be advantageous if current interest rates are low. Since fixed annuity payouts are partially tied to the interest rates prevailing at the time the annuity is taken out, waiting until interest rates have risen can make good sense.

Shop till you drop. If and when you're ever in the market for an income annuity, shop for the best return so long as you entrust your money to a financially strong insurance company. Shopping for the best return is particularly important because, once you sign up, there's usually no turning back. You're in it for life, so you'd hate to end up with an annuity that pays quite a bit less than others that were available. Check out the special reader Web site for additional annuity examples and illustrations. 

Loss of purchasing power. This is a major concern of fixed-income annuities. Rather than settling for a much lower payment from an inflation-adjusted income annuity, you might consider:

1. Opting for a higher fixed annuity benefit.
2. Saving a portion of each payment.
3. Using those savings to keep up with inflation later on.

Here is an example of a fixed annuity with lifetime payments of \$18,000 per annum. By saving \$3,000 per year, the annuitant can add 3 percent per year to spending and keep up with that inflation kicker for thirty years.

Forgoing \$3,000 out of an \$18,000 payment is a small price for turning your fixed, eroded-by-inflation annuity into one that rises with inflation. Another advantage of your personal inflation-adjusted annuity is that if you live beyond thirty years, not all is lost. You'll still receive \$18,000 per annum for the rest of your life. Also, if you die

TABLE 6.3
YOUR PERSONAL INFLATION-ADJUSTED ANNUITY

<u>YEAR</u>	<u>ANNUITY INCOME</u>	<u>SAVINGS</u>	<u>SPENDING</u>
1	\$18,000	\$3,000	\$15,000
2	18,000	3,000	15,450
3	18,000	3,000	15,900
4	18,000	3,000	16,400
5	18,000	3,000	16,900
10	18,000	3,000	19,600
15	18,000	3,000	22,700
20	18,000	3,000	26,300
25	18,000	3,000	30,500
30	18,000	3,000	35,300

before thirty years (perish the thought), you'll have something left over from your savings for your kids or other heirs.

Other Ways to Derive Retirement Income

Creating your own annuity with SWPs. If you're leery about committing to a lifetime annuity, you could create your own annuity, albeit with more risk. This strategy is known as a SWP ("swip"), which stands for "systematic withdrawal plan." You simply instruct the financial institutions that are holding your investments to automatically transfer money from your investment account to your checking account by electronic funds transfer. You can even elect to have taxes withheld, which may be particularly useful if the money is coming out of a retirement account whose withdrawals are entirely or mostly taxable. Unless you're Johnny on the Spot with your quarterly estimated tax installments, earmarking a percentage

of your regular SWPs to income taxes could avoid some nasty tax surprises later on.


The appeal of systematic withdrawal plans is that you remain in control of the money rather than ceding it to the insurance company. If the investment gods shine on your money, you might be able to increase your yearly SWP transfers to help you keep up with inflation. So what's the downside? You could still run out of money or run so low that you'd have to reduce your withdrawals later on. A lifetime annuity *guarantees* payments over your lifetime, even if you end up shafting the insurance company by living a lot longer than their actuaries thought you would.

For your own low-cost, inflation-adjusted annuity, delay collecting Social Security. Here's a strategy for creating an inflation-adjusted annuity at much lower cost than buying one from an insurance company. Simply spend your own money from age sixty-two until you become eligible for full retirement benefits. If you want to supercharge your "maximized Social Security benefits" delay benefits until after full retirement age—this can increase your benefits by a third or more. If you work the numbers, you'll probably find that you're financially better off following this strategy compared with purchasing the income annuity. By so doing, you'll enjoy a considerably higher lifetime Social Security benefit that's inflation-adjusted to boot.



NEW DEVELOPMENTS IN ANNUITIES

The insurance industry is introducing a range of products that better meet the demands of the baby boom generation. These new annuity programs replace the old complex and

rigid arrangements with simpler and more flexible ones. If it's at least a few years before you retire, it behooves you to consider the ever-widening range of annuity products. Just keep in mind that "new and improved" doesn't necessarily mean "improved." 

Income Annuity Decision Maker

This Decision Maker will help you decide whether an income annuity should be part of your financial planning.

Yes No

1. Are you uncomfortable investing your retirement savings in the stock market?

Fixed-income annuities and inflation-adjusted income annuities alleviate any concerns about possibly losing money on your investments, although fixed-income annuities will lose ground to inflation. If you are comfortable with the stock market, you could consider a variable-income annuity whose value fluctuates according to the performance of the annuity's underlying mutual funds, or simply invest the money on your own without an annuity.

2. Will your retirement income consist entirely or almost entirely of Social Security and withdrawals from your contemplated annuities?

If resources available to invest for growth are small or nonexistent, inflation-adjusted annuities may be preferable to minimize the risk of losing out to inflation. Where other resources can be invested for growth, a fixed-income annuity might be preferable.

- | Yes | No | |
|-------------------------------------|-------------------------------------|---|
| <input checked="" type="checkbox"/> | <input type="checkbox"/> | 3. Are you and, if applicable, your spouse or partner in good health? The better your health, the more efficacious a lifetime annuity. Those in poorer health should usually opt for annuities with a minimum or fixed guaranteed payment period. |
| <input checked="" type="checkbox"/> | <input type="checkbox"/> | 4. Have your ancestors lived long enough to make the Social Security Administration cringe? Again, long life expectancies bode well for the annuitant and bode ill for the insurance company. What a shame. |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | 5. If you are married, are you concerned that years of nursing home expenses could impoverish the other spouse? If so, an annuity can provide a measure of protection for each spouse since the annuity is not subject to forfeiture to pay nursing home or other care costs. Should other assets have to be spent down, a lifetime annuity will continue to pay for the remainder of the surviving spouse's life. |

Still More Annuity Decisions

Like the knife salesperson on TV infomercials, I'm afraid I have to say, "But wait, there's more." In this case, it's not knives, but it's a couple of other important annuity decisions that you may need to make.

- 1. Selecting an annuity survivor benefit.** If you have a spouse or other dependent family member, you need to decide which survivor option to take on the distributions—100 percent, or 50 percent, for example. You can find an Annuity Distribution Decision Maker on the *You Can Do It!* reader Web site.



2. Considering and evaluating a deferred annuity. In some cases, deferred annuities can play a role for baby boomers who have significant resources outside their retirement plans that they can afford to set aside for many years until they begin making withdrawals in retirement. The special reader Web site offers tips for deciding on both variable and fixed deferred annuities. 