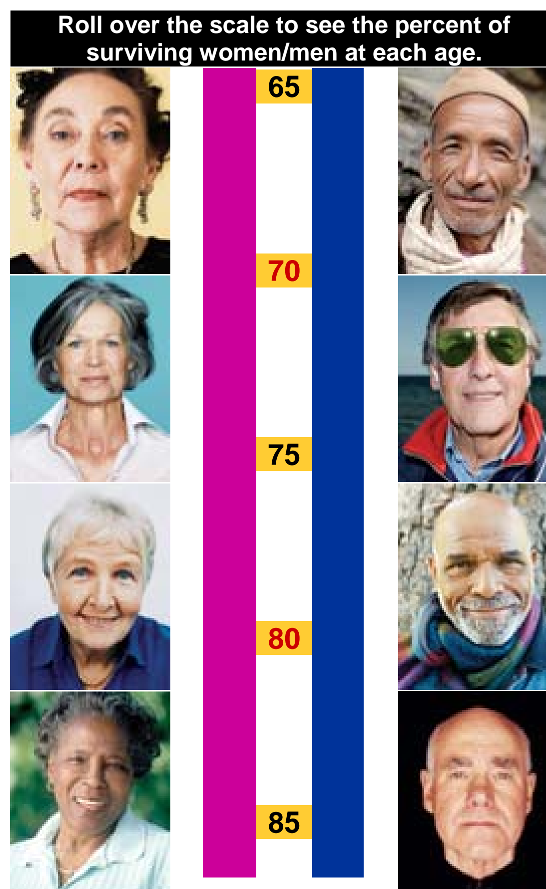
Living Long Is the Best Revenge

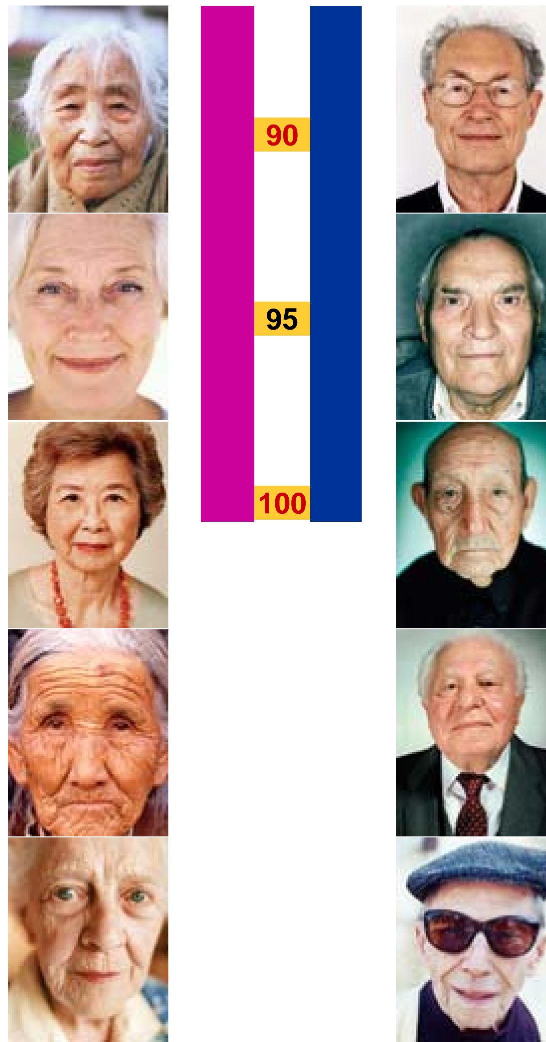
Forbes.com, Scott Woolley, 12.12.05

In the age of do-it-yourself retirement, you're on your own when it's time to convert a 401(k) into an immediate annuity, a stream of payouts that will last a lifetime. One clever tactic: Wait until 70 before buying.

In the old days your employer would take care of you. You'd put in 30 years at IBM or GM and be guaranteed a certain monthly payout for as long as you lived. Such pensions are becoming scarce. Nowadays you retire with a lump sum from a 401(k) or the like, and it's up to you to make it last. For that purpose an immediate annuity, of the sort sold by a life insurance company, is tailor-made. Too bad more retirees don't know about these things.

The annuity market has, unfortunately, been dominated by a different kind of annuity, one that builds up a pile of money rather than running it down. These savings plans come with some (extremely) modest tax advantages and a whole lot of cost and liquidity disadvantages. The build-up annuities, often called variable annuities because they are almost always invested in mutual funds rather than fixed-return obligations, vastly outsell immediate annuities. What a shame. For a lot of people the immediate annuity is a valuable part of a financially healthy retirement. Also, for a lot of people the build-up annuity is a mistake (see Shelter Skelter).





The immediate annuity works like this. Say you're a 65-year-old man who wants a guaranteed $50,000 annual income for life. Pay $622,115 now and State Farm will guarantee you that income stream (called "annuitizing"). By this means you insure yourself against outliving your savings. You don't want to reach 90 only to find yourself penniless and stuck in a Dickensian nursing home. With the State Farm contract, you are betting you can make it past age 77, when you start collecting more than you put in. Immediate annuities' biggest downside is that once you die, even if it's the day after buying the contract, all the upfront money goes to the insurer; heirs get zip. Overall, though, immediate annuities are a square deal. The insurance companies' profit margin is very often in the range of 3% to 5%. That means that for every dollar the average buyer puts in, he will cash checks with a present value of between 95 and 97 cents.

How odd that immediate annuities, for all their many advantages, remain stunningly unpopular. Americans invest at most $10 billion per year in them, estimates Jeffrey Brown, a University of Illinois professor. Build-up annuities dwarf that, with $1.1 trillion in assets. Retirees around the world share that distaste. Rapidly aging populations in Britain, Italy, Mexico and elsewhere have put so little money in annuities that their governments have created special programs that promise to boost annuity sales, lest the public treasury end up supporting millions of broke nonagenarians. "It's a big question," says Olivia Mitchell, a Wharton professor and retirement expert. "Why don't people annuitize more?" Human psychology appears to be the main reason. Most people on the brink of retirement have a hard time imagining themselves reaching 90 and beyond. Nor are they persuaded when life expectancy tables tell them they stand a good chance of doing just that.

The typical 65-year-old woman will live to 86; she has one chance in three of surviving past 90. One in five 65-year-old men will celebrate a 90th birthday. Centenarians, once a rare species, are becoming downright common. Robert Rockwell, a Sandy, Ore. financial planner, says he warns his clients on the verge of retirement that, with advances in medicine, they might well live to see triple digits. He can point to one client who already has. "They still don't believe it will happen to them," he says. Even people who understand actuarial averages can't stand the risk that they might die young and not get their money's worth, says Rockwell. "Most people want to make sure they don't pay $100,000 for an annuity that pays them $2,000 for two months," he says. "It's almost a matter of principle." Rockwell often compromises with clients, directing them into a so-called life-plus-period-certain annuity. He likes a guaranteed ten-year contract, which ensures that a spouse or some other heir gets payments for the balance of that span. Die at year two and your wife gets eight years of payments. Should you live past ten years, the annuity keeps paying you. Drawback: That ten-year guarantee slices a monthly annuity check by 13% (for a 75-year-old male investor).

Yes, there are times when you shouldn't be buying an immediate annuity. Don't buy one if you are in terrible health, since the price presumes that you have at least an average life expectancy. And should your nest egg generate sufficiently high income that you can live on it without dipping into principal, then forget annuitizing.

We examined four high-rated issuers and compiled a list of what you'd have to pay now to get a $50,000 annual annuity income (see table), depending on age and gender. Of course the older you are on the purchase date, the less you have to pay; the older you are, the fewer the $50,000 paychecks the insurer will likely have to write. For those age 65 the payout ranges from 7% to 8%. That beats buying Treasury bonds and living off the coupons (the 10-year bond yields 4.56% and the 30-year 4.7%). Here are some tips on immediate annuities.

Wait until you are at least 70. That's the gist of a study by Wharton's Mitchell and two German professors at the University of Frankfurt, who tinkered with different withdrawal plans and investment strategies. Consider two hypothetical retirees, John and Frank, both 65, who each have $1 million to retire on. They both want to withdraw $58,000 yearly (with increases to compensate for inflation) from their retirement stashes. John simply annuitizes everything. He should, based on an average life expectancy of 83 for a 65-year-old male, be around just long enough to cash checks with a present value of $970,000. (That's $30,000 less than the $1 million he paid, which accounts for the insurance company's gross profit.)

When Frank turns 65, he puts 85% of his money in bonds and 15% in stocks. Each year he withdraws the same amount that John's annuity pays him. Then, at 75, Frank annuitizes what he has left. With that strategy Frank should expect to collect $1,090,000 in total payments by the time he dies (if the returns on his investments match historic averages), or $120,000 more than John. The kicker: Should he die between 65 and 75, before he annuitizes, he'll have something to leave to heirs. John's kids will get bubkes. Frank does take some risk in the stock and bond markets that John does not. But with the very conservative bond-heavy portfolio Mitchell analyzed, that risk is slight. One small caution is that Mitchell's theory ignores the risk that an older person who no longer has all his mental faculties might never get around to buying an annuity.

Roll over tax-sheltered money. If you have both taxable accounts and tax-sheltered ones like 401(k)s and IRAs that could fund your annuity, consider choosing the sheltered accounts for your purchase. Those accounts can be rolled into an immediate annuity, and the payouts can qualify for an IRA's minimum distribution requirements. Then your monthly annuity checks will be taxed as ordinary income. If you buy an annuity with aftertax dollars, you wind up with some messy accounting. You're supposed to amortize the purchase price of the annuity over its expected life span, that being a function of mortality tables. Then you deduct the amortization from the monthly checks to arrive at the taxable amount. (Unused amortization can generally be used by your heirs

to lower your last year's income tax.)

Consider an inflation-protected annuity. Odds are inflation will advance as your retirement winds on. But oddly, that is a threat few are worried about, says Ellen Rinaldi, a retirement expert at Vanguard, which sells one of the few immediate annuities whose payments rise with inflation. Only 1 in 20 people who buy annuities from Vanguard (which are underwritten by insurer American International Group) signs up for an inflation-shielding one. What stops buyers is that the initial payment is some 20% lower than a flat-payment annuity would render. At a 3% yearly Consumer Product Index rise, which is what most savants assume we will have, the inflation-linked annuity would take 7.5 years to reach parity with the regular kind. If we return to double-digit rises, the CPI-tracking annuity would look better. With 10% inflation you'd get parity at 2.5 years.

"People ask me if annuities are a good investment," says professor Mitchell. "I tell them that's the wrong question. Annuities aren't an investment, they're insurance."

Guaranteed for Life

Here's what different companies charge people to provide them with a $50,000 annual income for life.

S&P Rating	State Farm AA	Vanguard[1] AA+	Standard Insurance A+	Genworth AA-
Male, 65	$622,115	$600,847	$612,451	$608,923
Male, 75	452,618	435,112	448,071	437,659
Male, 85	296,126	280,491	306,889	273,927
Female, 65	677,736	644,310	661,259	662,416
Female, 75	498,113	474,588	489,613	499,162
Female, 85	313,955	296,431	323,641	320,200

[1]Vanguard policies backed by AIG.