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PERSONAL FINANCIAL PLANNING

Annuities and the Other Side of the Retirement Savings Coin

Help your clients achieve their financial goals for their golden years.

BY RICHARD E. MARCUS AND GLEN JANKEN
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Like many of their clients, CPAs tend to consider the problem of retirement planning solved once they develop a plan for accumulating savings during the client's working years. But as recent events have shown, panics and bear markets can add another dimension to the equation. Moreover, there is another side to the retirement savings coin, the post-retirement side, when clients must figure out how to make their nest eggs last as long as they do. The planning necessary to solve this problem differs from the planning that creates the nest egg.

Indeed, when retirement begins, people face entirely new financial problems, most of them stemming from the fact that, given better health and ongoing improvements in longevity, they are likely to live longer than retirees in the past and, hence, will need their assets to last longer, too. What's more, the ordinary market corrections that, depending on your client's exposure and risk, might cause relatively minor setbacks during the accumulation stage can wreak havoc in retirement, when the individual is least able to recover.

Consider, for example, what might befall the individual who retires with a \$1 million nest egg at the beginning of a "down" year, as has been the case recently, during which the assets in his or her investment portfolio fall in value by 20%. Take away an additional \$40,000 for living expenses and this individual has \$760,000 left at the end of the first year—that is, a nest egg worth 76% of what it was when retirement day dawned. A gain of 7% in the second year, less \$40,000 in withdrawals, brings the nest egg up to \$773,000. But if values fall by 5% in the third year, assuming the same \$40,000 in living expenses, this individual now has only \$694,000.

It is an axiom of financial planning that systematic investing, compounding and dollar-cost averaging can work wonders during the accumulation phase. But the lesson here is clear. Once retirement begins, the vagaries of the markets, coupled with the retiree's need to withdraw money from an investment portfolio to pay for living expenses, can have an effect exactly the reverse of dollar-cost averaging, with unhappy results. This makes it imperative that financial planners not close their files and exit the scene when clients reach retirement. Instead, they must help their clients figure out how to manage their savings so that they need not fear running out of money before they die.

NEED FOR GROWTH AND LIQUIDITY

For financial planners, the first step is to help their clients understand that even though they have spent years investing for the long haul, tolerant of short-term risk, they cannot suddenly stop trying to appreciate their capital once they retire, in part because inflation could very well persist and in part because their nest eggs must last longer than in the past. This has meant historically that retirees should devote between 40% and 60% of their investment portfolio to equity holdings. They should also maintain higher liquidity levels than people who are still working so they can ride out down markets without having to liquidate holdings at depressed prices to meet their income needs. Depending on circumstances, this can mean cash or equivalent holdings equal to as much as two years of living expenses, to be replenished as necessary with earnings from investment holdings and/or portfolio rebalancing. Clients must also understand that no one nearing retirement ought to expect to rely on wages from a part-time job to make retirement comfortable (see sidebar, "What's at Stake: The Retirement Market," below).

The good news is that in recent years financial institutions have developed a host of new products focusing on retirees concerned about outliving their savings. In particular, insurers market a wide variety of annuities targeting retirees, including immediate annuities that hedge against inflation by guaranteeing that payments will increase to reflect increases in the Consumer Price Index or other percentages specified in the annuity contract.

OPENING UP MORE OPTIONS

For the retiree, such annuities offer three benefits. First, they guarantee an income that the individual cannot outlive. Second, they can generate a higher income relative to the initial investment than any other financial instrument of comparably low risk. This is true because the payments generated by such annuities consist partly of a return on the original investment, partly of a return on earnings on the assets in which the capital is invested, and partly of a “mortality credit,” meaning money not payable to annuitants who die. Last but not least, such annuities open up investment options for the client’s assets that would be off-limits otherwise.

To see how, consider the examples of a 75-year-old man and a 65-year-old man. Each has \$1 million in investable assets; each needs to generate \$50,000 in annual income from these assets in retirement to supplement income from such other sources as Social Security and pensions; and each wisely plans to make his assets last at least to age 95.

Assume a “sustainable withdrawal rate” of 5.3% for the 75-year-old—meaning that, given historical rates of return on a balanced portfolio of invested assets, he could withdraw 5.3% from his initial pool of invested assets, increase that amount by inflation each year, and have a 95% chance of not destroying the corpus before he reaches age 95. Note, however, that since \$50,000 is 5.3% of \$943,000, this man would have to commit virtually the entirety of his investable assets to a balanced portfolio to generate such an income, with very little left over as cash holdings to serve as an emergency cushion or to provide any extra luxuries.

The sustainable withdrawal rate for the 65-year-old is 3.7%, and the same calculation shows that if he needs \$50,000 in retirement income, he must have investable assets totaling \$1.35 million, or more than he actually possesses.

The picture changes dramatically if each of these men commits part of his assets to an immediate annuity offering payments guaranteed to increase in accordance with the CPI.

Under one such contract available in today’s marketplace, the 75-year-old could guarantee himself a lifetime annual income of \$50,000, adjusted upward every year to keep pace with increases in the CPI. Given his younger age, the 65-year-old could accomplish the same goal by spending \$874,000.

The payoff? First, neither man will outlive his income. Second, each has freed himself of the worry that inflation will eat away at his ability to support himself in his declining years. Third, each has freed up part of his capital base to be held as a cash cushion for emergencies or for luxury purchases, or possibly to be invested in assets offering higher returns in exchange for higher risk. The older man has committed nearly 60% of his investable assets to the annuity, leaving him with \$405,000 to invest otherwise or set aside. Given his younger age, the second man must commit nearly 88% of his investable assets to the annuity, leaving him with \$126,000. Fourth, payouts from immediate annuities receive favorable treatment under federal tax law, and the older the annuitant, the more favorable the treatment. This is true because, as noted above, these payouts consist partly of a return of principal and partly of interest, and only the interest is subject to taxation. Given their ages, both of the men in our example would benefit from this fact—the older more so than the younger.

There are, of course, downsides to immediate annuities about which financial planners should educate their clients. Chief among them is the fact that payments under many such annuities continue only during the lifetime of the annuitant. Should our 65-year-old die within one year of purchasing his annuity, for example, the insurer would have made only one payment of \$50,000, with no obligation to return any part of his \$874,000 investment to his heirs or estate. To avoid this, annuitants may structure the payout to last for the joint lifetimes of the annuitant and his or her spouse, or specify that the payments will continue to the annuitant’s beneficiaries for a certain period if the annuitant dies prematurely.

Such considerations can give many individuals reason to hesitate to purchase annuities. It remains true, however, that annuities typically generate higher incomes than are available from other investment vehicles of comparably low risk, in large part because of the “mortality credit” mentioned above. Actuaries calculate how many individuals in any given “annuity pool”—that is, the total number of annuitants receiving payouts from an insurer—will die before their life expectancy, relieving the insurer of the need to make further payments. This mortality credit allows the insurer to make higher payments to all of the annuitants in the pool, including those who will die unexpectedly.

Financial planners should also take care to calculate appropriate sustainable withdrawal rates for their clients. Many planners opt for 4% as a rule of thumb based on real rates of return for balanced portfolios in the 70-plus 30-year periods since 1901 to the present. Others, however, argue for rates of 5% or more. See, for example, “Lifelong Retirement Income: How to Quantify and Eliminate Luck,” by Jim C. Otar in *Retirement Income Redesigned: Master Plans for Distribution: An Adviser’s Guide for Funding Boomers’ Best Years*. Otar’s calculations yield the 5.3% withdrawal rate for the 75-year-old man in our example. For a more conservative view, see “A Sustainable Spending Rate without Simulation,” by Moshe A. Milevsky and Chris Robinson, *Financial Analysts Journal*, November/December 2005. They derive a sustainable withdrawal rate of 4.47% for a 75-year-old man.

A PLETHORA OF PRODUCTS

Other new annuity products on the market address the sustainability problem in different ways. One is longevity insurance—in essence a deferred annuity that guarantees an income to commence at a specified point in the future and continue for the balance of the annuitant’s life, in exchange for a sum of money paid now. Under one current product, a 50-year-old man could place \$50,000 with an insurer in exchange for a guaranteed lifetime annual income of \$68,500 to commence at age 85. On the downside, this particular product does not adjust payments to reflect inflation, but the delay allows for a larger income stream than would be payable under an immediate annuity and simplifies the job of managing the retiree’s other investable assets, given the shorter time over which those assets must provide living expenses.

Insurers offer a number of specialty riders to variable annuity contracts to hedge against other risks as well. Known as “living benefit riders,” these new contracts take several forms. “Principal protection riders” guarantee the value of the original investment, irrespective of the performance of the assets in which that capital has been invested. Early withdrawals from such annuities during the guarantee period—usually the first seven or 10 years—void the guarantee, leaving the annuitant with capital equal to the actual value of the annuity’s underlying investments, which may be more or less than the original investment.

Other living benefit riders seek to address this problem. Various called “guaranteed minimum withdrawal” or “guaranteed minimum income” benefit riders and often accompanied by a dizzying array of extra features and benefits, these riders guarantee a lifetime income, usually determined as a percentage of the actual value of the assets in the underlying portfolio or, if higher, a percentage of the “income base,” a value based on the original investment plus simple interest (not compounded—a potential downside), typically 6%.

For example, assume that an individual deposits \$500,000 into such an annuity at age 55. Ten years later, the value of the income base will be at least \$800,000—that is, \$500,000 plus 10 years of simple interest at \$30,000 per year. Assuming contractually guaranteed withdrawals of 5%, the annuity yields a guaranteed lifetime income of \$40,000 annually.

These new annuities, like many other innovative financial products on the market today, can play a valuable role in hedging the new financial risks that people face in retirement. Indeed, they can form a crucial part of an overall plan designed to permit people to enter their golden years confident that they will not outlive their savings. For CPAs who offer financial planning services, the key is to understand when and how to use these new products to preserve their clients’ nest eggs well into their golden years. ❖

What's at Stake: The Retirement Market

It’s a good bet that CPAs who offer retirement planning services for their clients will find themselves even busier in the future.

Huge sums of money are involved. The total U.S. retirement market—defined as assets held for retirement, including pensions, 401(k) plans, IRAs or other holdings—amounted to \$17.1 trillion in the first quarter of 2008, up from \$11.7 trillion in 2000 (*The U.S. Retirement Market, First Quarter 2008*, Investment Company Institute, www.ici.org/pdf/retmrkt_update.pdf).

Meanwhile, retirement assets have become an ever-greater share of household assets. In the first quarter of 2008, retirement assets represented 38% of household assets, up from approximately 25% in 1990, according to the ICI.

Lifecycle mutual funds, so called because they increasingly shift portfolio holdings to more conservative investments including income-producing assets as the individual nears retirement, also continued to grow, according to the ICI. In the first quarter of 2008, such funds managed \$185 billion in assets, up from \$134 billion in the first quarter of 2007 and \$9 billion in 2000.

More retirees work during their golden years, but their numbers remain relatively small. According to a 2007 study by the Employee Benefit Research Institute, 66% of those surveyed said they planned to work during retirement, but only 37% of individuals in the study who were already retired reported having actually worked for pay in retirement.

Moreover, the number of those expecting to work during retirement has not changed significantly in recent years. In 1998, according to the council, 62% of those surveyed said they expected to do so. Then, the number of those actually working during retirement was lower at 22% (*2007 Retirement Confidence Survey Fact Sheet*, Employee Benefit Research Institute, www.ebri.org/pdf/surveys/rcs/2007/RCS07_FS_5_Risk.pdf).

A recent study by the consulting firm McKinsey & Co. throws a different light on the size of the market. In 2004, according to this study, retirees took distributions totaling about \$507 billion annually from their IRAs and defined benefit and defined contribution pension plans. By 2012, such distributions are projected to total nearly \$1.1 trillion annually (“Taking the Risk Out of Retirement,” *The McKinsey Quarterly*, May 2005).

—by Richard E. Marcus and Glen Janken

EXECUTIVE SUMMARY

■ **CPAs advising clients on planning for retirement** must reckon with greater longevity of today’s retirees and the risk of market swings that could drastically deplete the value of invested assets.

■ **These considerations, coupled with the need to withdraw money** to pay for living expenses, can have the reverse effect of dollar-cost averaging. Consequently, retirees must pay greater heed to rebalancing their portfolios, to provide for continued growth and increased liquidity.

■ **Annuities offer an income for life** that is higher relative to initial investment than other low-risk options. Thus, they can also free retirees to seek higher yields for their remaining investable assets.

■ **Annuities can also feature** a variety of risk-hedging devices tailored to individual needs and circumstances such as “living benefit riders.”

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