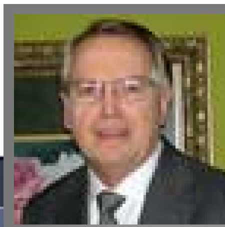


Peter Klein, CFA, has over 25 years of experience as a financial advisor, banking and management consultant. His experience encompasses both life insurance products, along with their appropriate applications. He has been in the forefront of developing unique financial planning tools.

The case for annuities

BY PETER KLEIN

SEPTEMBER 27, 2013 •

Imagine you're driving late at night down a lonely stretch of highway far from any town or gas station and you notice that the gas gauge needle is resting on empty. At moments like this, there is no greater feeling of helplessness and a sense of impending doom. This feeling of helplessness is similar to what can happen to a retiree in their late 70s and 80s, who suddenly find they have spent the last of their savings and all that is left is Social Security, which makes for a very meager existence.

The problem is compounded since most elderly people are left with few remaining options. They may be too frail to work, and it's well known that employers have a bias against hiring older workers (even those in their 50s). Even fewer employers are interested in hiring someone elderly, even on a part-time basis.

The challenges of retirement

Everyone in our society is expected to save, plan and manage their investments for their retirement. On its simplest level, each person is expected to voluntarily self-direct a savings and retirement plan, as well as evaluate retirement age relative to lifespan. Yet very few people have either the skills or temperament to succeed in such an endeavor.

Moreover, most investment management plans are based on the premise that a person will make the proper elections at retirement and know when to liquidate or redeploy their investments. In the most recent recession, we discovered this wasn't the case. People's investment funds were badly damaged in 2008. Consequently, when I meet with prospective clients they all lament their failure to purchase an annuity years ago, instead of relying largely on their investment holdings and the performance of the stock market to fuel their retirement plans.

Alternatively, ING, one of the largest insurance carriers, underwrote a study that shows that the more time a client spends with an advisor, the higher the savings and the more life insurance product protection. Even those who report only a little time with an advisor – one or two consultations – reported proportionately higher levels of savings rates and insurance protection. It stands to reason that a person who develops a retirement plan with clearly defined goals and the support of a financial professional is bound to achieve a better outcome.

What options should clients consider?

They should consider investing in non-correlating investments such as annuities that can generate a guaranteed stream of income for life and special purpose life insurance products with long-term care riders, and thereby off-load some of the risk of outliving retirement funds and capital market risks. Annuities offer considerable benefits over other kinds of retirement products, especially for those who cannot deal with market volatility and the loss of their retirement savings. For example, with an immediate lifetime annuity contract, clients are guaranteed periodic payments for as long as they live. Consequently, the risk of living a long life is borne by the insurance company. Social Security and pensions offer a similar form of retirement income protection — but in limited dollar amounts.

Alternatively, the size of periodic annuity payment is based on the amount of money a client has to purchase an annuity. For many retirees, the older they are, the larger their monthly payments will be for the same price. Unlike a defined benefit plan, annuities can be tailored to provide inflation protection by ensuring that upon annuitization, monthly checks will keep pace with cost of living. For example, the GAO (Government Accounting Office) calculates that income of $1,000 per month in 1980 would have purchasing power closer to $385 a month 30 years later in 2009. Life insurance carriers are regulated by the states, and must maintain reserves to meet future beneficiary obligations. Their capitalization structure gives preference to beneficiaries if there are inadequate assets.

Barriers to making a proper selection

The complexity of annuities, their pro forma performance, perception that they are unreasonably expensive, lockup surrender charges, the lack of knowledgeable advisors and the general bias by some financial advisors against annuities, presents a roadblock to prospective clients in making the proper evaluation of these products and their appropriate application.

Although most advisors say they are familiar with annuities, only 40 percent indicate they are very familiar with annuities, according to the study, entitled *The Evolution of the Annuity Industry*. At the same time, 90 percent of annuity producers say annuities would be easier to sell if people had a deeper understanding of the market. For the first time the GAO has acknowledged this to be a problem for retirees. In its report to the U.S. Senate in 2011 entitled, "Retirement Income, Ensuring Income throughout Retirement Requires Difficult Choices," the report recommends that future retirees without pensions allocate a portion of their savings into annuities. Moreover, the report advocates modification to the tax law on minimum distributions for deeply deferred annuities to provide greater incentives for retirees to invest in a relatively new category of annuities that are designed to act as longevity insurance. Several insurance companies now offer such a product that is purchased before retirement but doesn't annuitize until age 80 or 85. For example, a 65-year-old male could purchase an annuity for $18,500 to provide $1,000 a month guaranteed beginning age 85. The downside is that if the beneficiary dies before 85 the entire investment is lost.

They also agree it takes more time and effort to sell an annuity than a mutual fund and that the purchasing process is more burdensome than for other investments. Due to complexity and the fluid nature of annuity product features, financial professionals have a difficult time keeping track of each carrier's products, but investors want more options and guaranteed incomes and living benefits after retirement. To illustrate the complexities of annuities, see the decision tree developed by us:

Annuity Decision Tree Diagram

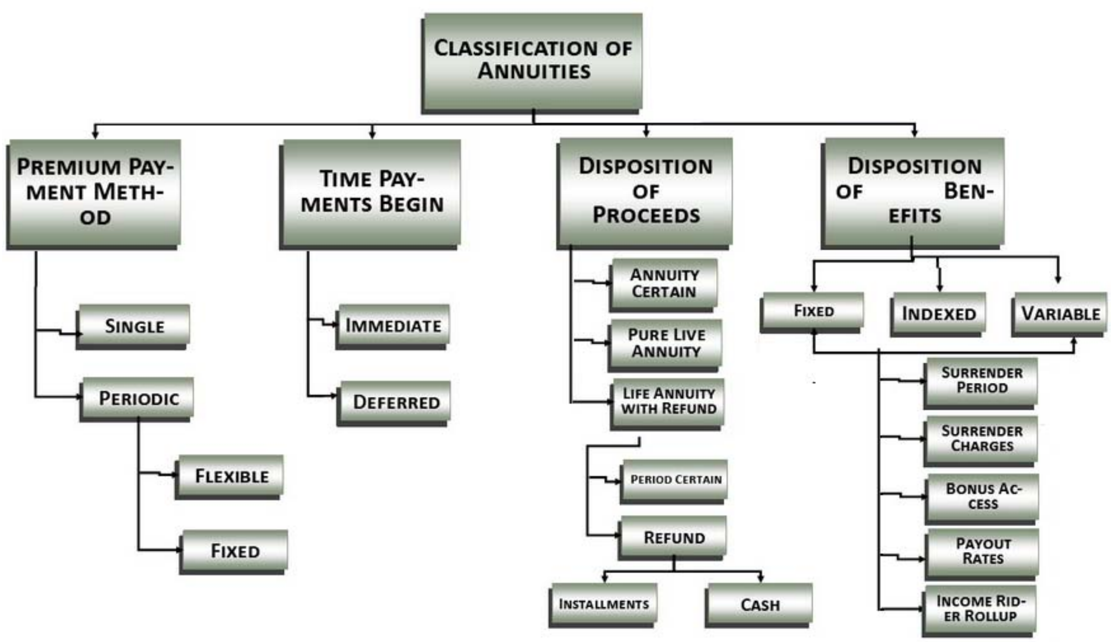
Investment and annuitization options, period-certain payment features and annuity riders offer the opportunity to tailor solutions for clients. Prior to the incorporation of sophisticated riders and enhanced benefits, annuities were positioned as a vehicle for tax deferral and principal protection, but perspectives on annuities have evolved to highlight guaranteed retirement income.

Process of selecting the appropriate annuity

Unlike a life insurance policy, no medical exam or medical underwriting is required for an annuity. However, the payout for immediate annuities can be increased with medical underwriting and a medical exam if the annuitant has impaired health.

Alternatively, we advocate underwriting a client for any annuity. We do this for several reasons. It's important to provide a client with a tool that empowers them to define their needs and understand the trade-offs inherent in the prioritization of their goals. Our process facilitates communication with a client and allows the client to participate in the design and resolution of their financial needs.

In partnership with a life expectancy company, we have developed a customized mortality planning report that is based on the client's unique medical and family history along with lifestyle information to generate a customized mortality curve. The principle feature of this report is a longevity curve that plots the client's survival chances year by year compared against the client's peer group mortality curve. These curves are not meant to be viewed as predictors of an individu-



al's longevity, but rather mortality guidelines that can serve as the basis for defining retirement objectives and facilitate communication between the client and the financial professional in defining their needs.

How does such information assist professionals in advising clients? To begin with, the curve offers probabilities of living for a long time. Suitability of investments should be adapted or tailored to a client's remaining lifespan. The longer the life expectancy, the greater the risk that client will outlive their savings.

There are several factors involved in the selection of an annuity, including longevity, probability of living to certain ages, tolerance to risk, estimation of essential retirement expenses, distributions desired, timing of annuitization, potential for period certain deficits, settlement options and single or joint or survivor options.

If a client can define periods during their retirement when they could experience funding deficits, they can elect a period certain annuitization option, which usually results in a higher monthly annuity payment compared to the life option, which allows the annuitant to receive an income for the rest of his or her life, regardless of how long (or short) their retirement years last.

Client's retirement challenges and solutions

Conventional investments are taxed whenever they pay out earnings and again on profits when you sell. Taxation can reduce the long-term earning power of your investments, but tax-advantaged accounts such as a 401(k), IRA, and annuities are designed for long-term retirement planning, offering deferral of taxes and buildup of pre-tax accruals in exchange for restrictions on early withdrawals. Retirement plans and IRAs have contribution limits, while individual annuities generally are not limited in the amount you can contribute each year, and just like IRAs are protected from court judgment and seizure emanating out of a lawsuit.

One option is to off-load the risk of capital markets and living longer than anticipated. Fixed annuities offer guarantees that their future balances will be at or above the amount invested. Indexed annuities can hedge their long-term value against financial market declines but boost their value if financial markets perform well and provide guaranteed payouts to your beneficiaries should you die before taking full advantage. Effectively, clients have a guarantee that they will receive back at least as much money as they invested in the annuity while annuities offer the added benefit of tax-efficient, tax-deferred returns.

Despite the many advantages of annuities, there are some downsides. Since fixed annuities are considered safe and conservative investments, they don't offer the returns of riskier investments. In addition, annuities are typically less flexible than other retirement options — once you purchase an annuity contract that capital is tied up in that annuity and you no longer have access to that lump sum of money. Alternatively, that lockup feature may also provide spending discipline. Some retirement financial planners recommend that clients reserve at least 40 percent of their retirement assets for unforeseen circumstances. Because most annuities are designed to provide steady income over time, they are not suited to cover large unplanned expenses.

Retirement planning, like many things in life, is harder than it seems. There are many variables such as longevity, interest rates, market volatility, inflation and health-care costs, but with careful planning, the prospect of outliving one's savings can be minimized. ◆