MAY 5 • 2020 ONLINE EDITION

Forbes

RETIREMENT

Income Annuities: The Guaranteed Stream Of Income In Retirement

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For those seeking to spend more in retirement than the bond yield curve can support, the alternative to seeking risk premium through an aggressive asset allocation is to pool risk through insurance. Income annuities are the simplest type of insurance products which trade a lump-sum payment for protected lifetime income. The ability to convert a portion of assets (as it is not an all-or-nothing decision) into a guaranteed income stream is a fundamental retirement income tool which contrasts with an investment portfolio in terms of the advantages and disadvantages for managing retirement risks.

We start our discussion of annuities with the income annuity because it is the most straightforward and easy-to-understand way to convert a pot of money into a guaranteed stream of spending for life. This chapter focuses specifically on income annuities, also known as immediate annuities, single-premium immediate annuities (SPIAs), deferred income annuities (DIAs), or longevity insurance. The next chapters will expand the discussion to include other types of more complex annuities that are also able to offer lifetime income protections.

Risk pooling and mortality credits are the driver of value from an income annuity. The annuitant accepts the risk of dying early and receiving fewer payments from the annuity in exchange for the ability to continue receiving payments for a very long time in the event of a long life. By pooling longevity risks with a collection of individuals, an income annuity allows its owners to spend assets as though they will earn fixed-income returns and live to their life expectancy. Those who end up living beyond their life expectancy will have their continuing benefits subsidized by those who die before life expectancy.

With an income annuity, one is essentially offering to leave part of the premium on the table for others in the risk pool in the event of an early death, in order to receive the protection of maintaining an ongoing income stream through subsidies from others in the event of a long life. While this clearly benefits the long-lived, we can also conclude that it benefits the short-lived as well by allowing them to enjoy a higher standard of living than they might have otherwise been comfortable supporting from an unguaranteed investment portfolio. This can allow for more spending and a more satisfying retirement experience compared to those self-managing longevity risk by spending less and then leaving too much behind at death.

This risk pooling capability can be an attractive proposition when longevity is unforeseeable. With investing approaches that exclude risk pooling and the mortality credits it can provide, greater spending conservatism is otherwise needed to stretch assets out over a potentially long retirement and in the face of a potentially poor sequence of market returns. Risk pooling can provide a cheaper (in terms of being able to earmark fewer assets for the purpose) and more efficient method for supporting a retirement income goal. This can also leave the remaining assets to be more focused on growth, which can even help to support a greater net legacy over time.

Income annuities also provide peace of mind and other psychological benefits for retirees. Retirement income is no longer dependent upon the vagaries of the stock market and its daily fluctuations. Annuity owners could possibly even live longer because of the reduced stress they face with funding their retirement, and also perhaps because they want to make sure they get their money's worth from the annuity by drawing from rather than contributing to that risk pool.

This is an excerpt from Wade Pfau's book, Safety-First Retirement Planning: An Integrated Approach for a Worry-Free Retirement.

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