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A new take on annuities

With inflation adjustments added, they are now being touted as the modern retiree's pension plan

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When John Slater, 72, of Manhattan, went looking for the best way to allocate a portion of his retirement savings for the remainder of his life, he had a clear goal in mind.

What he found were inflation-adjusted annuities. "I am an inflation-phobe," said Slater, explaining that he wanted to use part of his retirement savings to lock in a monthly payment that would give him a higher yield than Treasury bonds.

"I was interested in them as an alternative to bonds. My conclusion was that with a bond you are sure to lose money, because it is fixed income and every year that money is worth a little bit less than it was the year before."

Slater, who had managed investments for a Quaker meeting in Manhattan before retirement, said, "You sleep well with inflation-adjusted annuities." He added, "You have income for life. That's an important advantage."

At a time when guaranteed pensions are disappearing and people are increasingly worried about inflation eating up retirement savings, the insurance industry is promoting inflation-adjusted annuities as the best answer. They're being touted as a kind of personal pension plan.

An individual invests a lump sum - typically from \$20,000 to \$100,000 - pays an upfront fee (usually from 1.5 to 3 percent), and gets a contract to receive monthly or annual payments that continue as long as the person lives, with a guarantee the payouts will increase enough to cover any rise in inflation.

The industry, and some supporters in the academic community, say inflation-adjusted annuities provide an important insurance element in retirement planning. They note there's some concern about the future of Social Security, and that market investments always carry risk, at least in the short term.

Others are skeptical, however, and see no reason to pay an annuity fee, feeling that a well-

diversified investment portfolio is insurance enough, while also offering growth potential.

To their advocates, immediate annuities are seen as akin to the defined-benefit pensions that were the bedrock of retirement income for the previous generation.

Insurance aspect touted

The overall annuities market is huge: In 2006, Americans spent \$6.1 billion on individual fixed annuities, with the average purchase about \$95,000, according to LIMRA, a life insurance and market research association.

Inflation-adjusted immediate annuity products are now being sold through groups working with insurance companies, such as Income Solutions and the National Association of Personal Financial Advisors. Those in the field say that with these annuities, there is increased possibility for comparison shopping and that more information on various options is available.

"Insurance-based investment products are appealing" because there is more information about choices, so people can shop around, said Paula Hogan, a Milwaukee-based financial planner and member of the National Association of Personal Financial Planners.

Hogan says the annuity market - disdained by some who believe annuities have at times locked people into small returns - has changed dramatically, even in the past few years, with a new range of options and competition.

Some retirement experts believe that the insurance aspect offered by inflation-adjusted annuities is what's been missing from retirement plans that depend heavily on the uncertain performance of the stock market.

"The folks in the investment industry are all pushing equity-based, mutual fund-based products, but they have no insurance features whatsoever," said Zvi Bodie, an economics professor at Boston University who specializes in retirement preparation in the United States. "What people over 50 really need are insurance-type products."

Financial planners traditionally have suggested that retirees can spend 4 or 5 percent of their capital annually, figuring that conservative rates of return on investments should replace much of that. Advocates of the immediate inflation-adjusted fixed annuities say that even such a modest rate of spending down assets forces retirees to gamble at the most vulnerable point in their lives.

"You don't want to run out of money before you run out of life," said Dallas Salisbury, president and chief executive of the Employee Benefit Research Institute, a research institution focused on employee-benefit programs.

Researchers say the increasing possibility of living longer than expected is a financially troublesome trend. Retirees also face the risk that inflation may grow faster than their investments and the possibility that the market may perform more poorly than usual.

Until recently, fixed annuities gave limited protection against these risks and were not adjusted for inflation. They offered a stream of payments that were stable but whose purchasing power declined over time, which could be devastating in a high-inflation era such as the mid-1970s.

In 2004, Vanguard became one of the first financial services companies to offer inflation-adjusted annuities.

"Our expectation is that this marketplace is going to continue to grow," said Patti Colby of Vanguard's annuity and insurance services department. "I think awareness is key. We have had a little more inflation as a result of what was happening in the energy markets, which brought to mind the inflation risk for many of these retirees."

Vanguard's inflation-adjusted annuities are tied to the consumer price index, with adjustments similar to those made each year for Social Security payments. Vanguard guarantees the payment will never fall below the initial benefit amount. In times of inflation, payments will increase. If deflation were to occur, the payment would never drop below the amount you initially received.

Payouts start lower

The extra insurance comes at a price, at least initially.

While Vanguard's standard \$100,000 fixed annuity for a 65-year-old male would provide a monthly payment of \$707.69, a similar inflation-adjusted annuity would pay only \$507.16. Annuities are priced on the basis of age, sex, interest rates at the time of sale and whether a joint-survivor is designated. They also vary depending on the issuer.

In the long run, however, inflation-adjusted annuity payments grow larger and will pay out the same amount as a fixed annuity over time, according to Colby, while offering protection in case inflation is higher than expected.

Inflation-adjusted annuities now account for 13 percent of annuity sales in Vanguard's Lifetime Income program. Bodie and Salisbury both believe these inflation-adjusted annuities will be the foundation for a new approach to retirement planning.

Retirement experts say any annuity purchase should be made when it's time to start allocating retirement funds, instead of just spending down your assets and hoping for the best. The experts are looking to them as an alternative for people who simply burn through their lump-sum payout at retirement.

"A new generation of safe and simple retirement accounts is about to replace the mutual funds of the first generation," Bodie wrote in an opinion article for the Financial Times in October. "These new accounts will have all the desirable features of the defined-benefit plans they are replacing without the limitations."

Bodie emphasizes that fixed, inflation-indexed annuities should be seen as an insurance product rather than an investment tool. They are designed to protect against a potential vulnerability

rather than be wealth-builders, he said.

"Equities on average offer a higher expected rate of return, but that higher expected rate of return comes with higher risk," said Bodie.

Widespread skepticism

Many retirees feel uncomfortable with annuities, having seen family and friends encouraged to buy expensive products that weren't suitable.

"People get locked in [with annuities]; they're lucky if they're at least equal with the money they put in," said 65-year-old retired teacher Janet Taubin of Oceanside, who said she has heard horror stories of people who were pressured into buying variable annuities at retirement seminars.

Others recall investments in fixed annuities whose payments were inevitably outpaced by inflation.

"One of the things that my mother got [in the late 1950s] was a small annuity that paid \$65 a month from that day until she died in 1999," said 65-year-old Lynn Jordan of Mt. Sinai, recalling watching how her mother invested the money after the death of Jordan's father. "But it never grew, it never changed, it was just there. If you have an emergency, that's not going to change with an annuity. I think it's far better to have everything growing."

Retirees list a range of criticisms of annuity-type products, including high fees that are sometimes not visible at first, a lack of control over their money and products that are too complicated to understand.

The potential of annuities to protect against risk of market downturns and unexpected longevity, said Bodie, has been complicated by the public's negative association of the term "annuity" with variable annuities that can include high, and often hidden, fees.

Those who advocate the inflation-adjusted fixed annuities say competitive information about how products are priced now is making its way into the market. Hogan says competition for these annuities will allow them to function as an insurance policy for retirees' income rather than a cash cow for insurance companies.

Because annuities are sold by private insurance companies, the amount paid out in exchange for a lump sum can vary considerably from company to company and even product to product. Comparison shopping has been nearly impossible in the past, and fees on annuities have been hidden inside the product, preventing a meaningful understanding of what is being purchased.

Offering institutional rates

Income Solutions, based in Minneapolis, an organization that offers annuities based on less expensive institutional pricing, has recently begun offering inflation-adjusted annuities to

individual customers at these lower rates.

"Individuals can [now] have the same buying power as large companies have," said Kelli Hueler, president of Income Solutions.

Hueler and others argue the new competition guarantees insurance companies cannot charge the exorbitant fees that have made annuities a bad choice in the past.

Still, some potential investors are uncomfortable placing their money with an insurance company. They worry about being taken advantage of and whether they'll attain a payout equivalent to the amount they paid in. If a company goes bankrupt, it is difficult for an annuity purchaser to recover money, so people should investigate the company thoroughly before placing business.

"I would never buy an annuity, because that seems ridiculous," said Marcia Rosten, 72, of Lynbrook, who still works in a construction office and is passionate about the power of compound interest. "Why should you give someone money and pay for them to give you your money back?"

Those who are wealthy enough - and disciplined enough in their spending habits - to live off the interest and dividends from their investments, or those with defined-benefit pensions, may feel that the inflation protection the new-style annuities promise is not so relevant.

"I retired 22 years ago, but I haven't touched any of my retirement yet, other than things that pay dividends, only because I've done very well and put a lot of eggs in the right baskets," said Donald Boyle of West Islip, a 67-year-old retiree from the pharmaceutical industry.

For those seeking a little extra protection in their golden years, however, the inflation-adjusted annuities may be worth investigating.

Slater is enthusiastic about the annuities, though he cautions that they should not constitute more than half of a retirement strategy.

"I would never suggest that anyone put in more than half," said Slater, adding that he maintains about 20 percent of his retirement savings in the stock market.

Slater also decided to wait to buy his annuities until the amount of the payments offered could compete with the return on a Treasury bond.

As with many things, such patience can be a virtue.

"Every year you wait, the return goes up [because of decreased remaining life expectancy]," said Slater. "It's the only investment I know that as you get older, gets more attractive."

Talking the talk

Here are some definitions:

Annuity: A financial contract that pays a steady stream of income, usually monthly, either for a fixed period or for the lifetime of the annuity owner.

Immediate annuity: Payments begin immediately upon purchase.

Deferred annuity: Annuity payments are deferred until some later date.

Fixed annuity: Amount of monthly payments is fixed at time of purchase.

Inflation-adjusted fixed annuity: Monthly payments are adjusted periodically for inflation, typically on the basis of changes to the consumer price index.

Variable annuity: Monthly payments fluctuate based on the performance of the underlying investments, such as stocks, bonds and money market holdings, selected by the annuity owner.

- Emily Pickrell

Before you decide to lay out the cash, experts say, consider these points

Experts advise that you weigh the following questions before you purchase an inflation-adjusted annuity:

What are the associated fees, which may vary among insurance companies?

How competitive are the payments? Prices can vary among insurance companies and are also related to the prevailing interest rate. It is worthwhile to comparison shop.

What is the financial health of the insurance company offering the annuity? Are they likely to go out of business? Hueler Companies' Income Solutions Web site provides information about specific insurance companies, their credit ratings and the products they offer.

How is the inflation adjustment calculated? A fixed increase does not protect you in the case of unexpectedly high inflation, so be sure to ascertain that any increase is truly inflation adjusted.

How much of your retirement assets do you want to allocate to a secured payment? While recommendations differ, annuities experts encourage a varied portfolio, which may also include stocks, mutual funds or other investments.

- Emily Pickrell

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