What Does $10,000 A Year Cost?

Why Income Annuities offer the best value for retirees

By John Rafferty

A secure retirement has five key components, according to a study published by the Institute on Assets and Social Policy at Brandeis University titled "Living Longer on Less: The New Economic (In) Security of Seniors." One of those is the provision of $10,000 or more in annual income after all essential expenses are covered.

"A cushion of $10,000 annually provides a basis for common but nonessential expenses and savings to meet unexpected expenses. Such unexpected expenses might include home repair, new appliances, car repair and higher out-of-pocket essential expenses such as medical costs in case of illness or large increases in the price of necessities such as heating fuel, gas or medicine."

But how do retirees and those planning for retirement generate $10,000 a year? In reality, there are three basic methods of generating income in retirement, which can best be remembered by the acronym **WIP**:

- **Withdrawals from assets**
- **Interest income from interest-bearing products**
- **Pooling, or mortality pooling, more commonly referred to as an income annuity**

All income has a price tag

Most consumers understand the price of goods they consume regularly. If you asked a 65-year-old what a gallon of milk or a loaf of bread costs, you'll get at least a nearly accurate answer. But ask what retirement income costs and you may get some strange looks. Like any other good or service, income has a price tag. During one's working career, the price of income in the form of salary or commission is long hours, endless meetings, willingness to compromise and the drudgery of a sometimes difficult commute.

During retirement, income also has a price tag, not in terms of human capital but in dollars and cents. And although the choices seem endless with the thousands of different individual financial products — mutual funds, exchange-traded funds, stocks, bonds, annuity contracts — only three core methods generate income. Each of these three methods comes with a distinctly different price tag.

Withdrawals

The most commonly accepted maximum sustainable withdrawal rate cited by academics and practitioners is 4 percent of the portfolio, with an annual inflation adjustment of 3 percent. Backing into the numbers, a 4 percent withdrawal requires an initial sum of $250,000. Increasing that initial $10,000 income by 3 percent per year means in year two, $10,300 is withdrawn and so on. This strategy has been back tested in Monte Carlo simulations and has been declared to offer a 90 percent probability of sustaining the 4 percent inflation-adjusted income stream over a 30-year period.

The advantages of the 4 percent withdrawal strategy are low cost — it

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could be achieved with low-cost exchange-traded funds (ETFs) or index funds — and ultimate flexibility. Low costs can help increase growth potential in strong markets, and flexibility means one can increase, decrease or stop withdrawals at will. The Achilles heel of the withdrawal strategy is the lack of a guarantee — that 90 percent success probability means there is a 10 percent risk of failure.

One key advantage in perception may be a disadvantage in execution — flexibility. How many retirees today are tempted to move more money into cash or bonds, when they'll need equity exposure to fuel their future income over a potentially long retirement?

Interest

Using fixed-interest products like certificates of deposit or bonds can help preserve principal and also pay current, guaranteed income to the owner. However, with interest rates as low as they are today, the yield on interest-bearing products is not very tantalizing, in turn cranking up the cost of income.

According to Bankrate.com, the average yield on a five-year certificate of deposit was 2.76 percent as of Feb. 17. To put this into the context of our $10,000 cost of income, it would require an investment of $362,318 in a five-year certificate of deposit to generate $10,000 of income per year for the next five years. That's almost 50 percent more than the cost of that income using the 4 percent withdrawal strategy described earlier.

The primary advantage of this strategy is the guaranteed return of principal at the end of the five-year term. The disadvantages are the very low yield and thus high cost of income and the unknown interest rates available in five years' time to continue generating income.

Mortality Pooling

Mortality pooling harnesses the power of the law of large numbers to generate attractive outcomes that can't be replicated synthetically and economically. Social Security and defined benefit pension plans utilize this concept, as does the traditional income annuity.

While the guarantee of a lifetime income stream is a well-documented quality of the income annuity, the additional cash flow relative to the withdrawal and interest method of income generation is very attractive but not as highly publicized. In difficult financial markets like our current environment, perhaps it should be.

The cost of generating $10,000 of annual income from an income annuity is about $145,000. This assumes a 65-year-old couple needs that income stream, and a very conservative scenario whereby that income stream has to last 20 years or until the death of the last surviving spouse, whichever is longer.

The $145,000 cost for that $10,000 annual income stream is 60 percent less than the interest method and 42 percent less than the withdrawal method. This financial advantage doesn't come without a trade-off. In exchange for the significantly lower cost of income, the income annuity requires that the principal investment necessary — in this case $145,000 — be irrevocably converted to income. That's a clear departure from most every other popular method of income generation today. If both spouses in our couple scenario die before 20 years pass, the income stream will cease at the end of the 20th year. Regardless, the retirees are guaranteed that the minimum cumulative income stream will be approximately $200,000, mitigating any concerns that they may "lose" the mortality bet and get back less than they invested.

Taking emotion out of the decision

"Academic researchers have repeatedly shown that annuities make sense for most people, except for the very rich and those with minimal retirement assets," said Jodi DiCenzo, partner, Behavioral Research Associates, a research and consulting firm specializing in investor decision- making. "However, advisors need to focus their efforts on overcoming the emotional factors that keep their clients from doing what makes sense for them."

One way of doing that is to carefully frame choices for clients. According to DiCenzo, past research has shown that the way in which choices are framed have a profound impact on the decisions people make.

"There are a number of ways to frame annuities, and we are in the early stages of testing these alternatives. In fact, early results suggest that framing annuities as a way to fund future income needs, rather than as an investment, makes the product more appealing to prospective purchasers," said DiCenzo.

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No reasonable consumer or prudent advisor would put 100 percent of retirement wealth into an income annuity. Yet as retirees look for ways to create or stretch income streams from their finite wealth, income annuities can improve the overall cash flow and ultimately reduce the burden on withdrawal or interest strategies to enhance income outcomes. INN

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