LIFETIME INCOME: OPTIONS, MISPERCEPTIONS AND REALITIES

A guaranteed source of lifetime income can offer a sense of both financial and emotional security for a retirement that could last 30 years or more. Today, there are only three available sources of guaranteed lifetime income: Social Security benefits, defined benefit pension plans and annuities.

Overview

Lifetime income sources generally provide minimum payouts to help cover everyday expenses. In most cases, these benefits are not impacted by fluctuations in the investment markets.

For example, Social Security benefits are based on one's lifetime earnings, so they reflect a proportionate amount of income based on your assumed standard of living. To maximize benefits, it's best to delay drawing them until full retirement age or later. It's also important for married couples to strategize on the best way to maximize spousal benefits. In 2018, the highest Social Security benefit — based on earning the maximum-taxable earnings since age 22 and waiting until age 70 to draw benefits — is $3,698 a month ($44,376/year).[1]

In post-World War II America, many employers began offering defined benefit pensions to workers at age 60 who had given at least 20 years of service. By 1960, approximately half of the private sector workforce had one.[2]

Today, only 23 percent of private-sector, state and local government workers have pension plans. According to the Pension Rights Center, the following are annual median pension benefits (2016) for adults over age 65:[3]

- Federal government: $22,172
- State and local government: $17,576
- Private sector: $9,262

For those seeking a higher level of lifetime income throughout retirement, they may need to use their own savings and investments to create additional streams of income. Those who opt to supplement income from interest and dividends from their portfolio will need to accumulate significant assets to produce a high level of income. Even then, this income may be subject to market and economic factors that could cause those streams to fluctuate. This strategy also poses the risk of outliving assets.

Currently, the only other vehicle available to produce lifetime income during retirement is an annuity, which offers guarantees based on the financial strength of the insurer. Depending on the type of annuity contract purchased, the owner has options as to when and how much of the annuity value to convert into a lifetime income stream.

"A recent academic study — "Putting the Pension Back in 401(k) Plans" — shows how taking a piece of your nest egg and deferring it into a lifetime annuity is a cost-effective way to hedge longevity risk, and that overall it provides people with substantially higher consumption levels, particularly at older ages." [4]

Annuities for Lifetime Income

There are two main categories of annuities: fixed and variable. A fixed annuity earns a guaranteed rate of interest and, once income payments are started, guaranteed income amount for a certain time period or for life, depending on the options selected.

A variable annuity provides income subject to underlying investment performance, so even though the interest credits may not be guaranteed during the accumulation phase, it does offer the potential for higher payouts over time. Once income payments start, they are guaranteed for either the time period or for life, depending on the options selected.

There are also annuities that offer both fixed and indexed interest crediting. For example, depending on the interest crediting options chosen, an indexed annuity provides a guaranteed interest crediting rate with the opportunity to enhance accumulation and therefore income payouts based on the performance of a market index, such as the S&P 500. If the S&P has a good year, the annuity owner will receive higher interest credits, up to a predetermined limit, based on a proportionate calculation of index earnings. If the S&P performs poorly, there will be no additional interest credit, but the annuity owner will continue to receive the guaranteed minimum benefit. Unlike variable annuities, fixed index annuities do not actually participate in the market; they only track the index as a means of determining interest credits.

It is important to note that all annuities offer the option of guaranteed payouts. The type of annuity chosen dictates the type of interest credits the account value will receive, and ultimately, the amount of interest credited combined with the underlying principal determines income payouts once income is elected.

Annuity Misperceptions

Opinions vary regarding annuities. For a long time, they were considered effective vehicles for only a select group of investors. Now, however, many retirement strategists are recommending them more widely to help retirees secure an additional stream of lifetime income.[5]

Annuities have evolved over time to meet the needs of a broader population. As such, there are still some misperceptions about what they offer. Things that used to be true aren't necessarily in force anymore, or only in limited circumstances.

For example, there's the practice of an insurance company keeping your money if you pass away before receiving a full return of premium via income payouts. First of all, this only happens if you "annuitize" your contract, which isn't all that common. These days, many annuities offer a lifetime income rider (in some instances for an additional fee), which allows you to select a lifetime income payout option without giving up control of your account. In many cases, the annuity will offer a guaranteed death benefit to the contract beneficiary (which, in some cases, may be offered for an additional fee).[6]

There is also a perception that the annuity owner may not make withdrawals from his annuity the way he can an investment or savings account. And while annuities do have surrender charges associated with them during an initial period, in most

cases, the annuity merely caps the amount the owner can withdraw, such as no more than 10 percent a year. Bear in mind that withdrawals will impact the amount of benefit the annuity pays out at a later date.

Annuity Realities

One common perception is that annuities are difficult to understand. This, in fact, is true — largely because there are so many options available in today's market. Bear in mind that annuity strategies are not designed to be one-size-fits-all; many offer a plethora of options and features to help individuals and couples tailor a retirement income plan suited for their specific needs. Because of this, it's important to work with an experienced insurance professional to help navigate which type of annuity to choose and which options are most appropriate for your financial situation.

Lifetime Guarantee
Another reality is that despite an annuity's guarantee, it is possible to miss out on lifetime income. This feature is determined by actuarial calculations based on the amount of money initially used to purchase the contract. Therefore, if the owner violates any of the withdrawal limits or other contract rules, it could result in a reduction of benefits or even void the guarantee altogether. This is another reason to work with a qualified advisor and read the policy literature to understand the features, risks, charges and expenses — including the tax status for when you receive distributions.

Also be aware that all annuity guarantees are subject to the claims-paying ability of the issuing company.

Cost
There is also the perception that annuities are expensive. In reality, there are low-cost annuities and others with more expensive bells and whistles. In many cases, an annuity can be tailored so you pay only for features and benefits that match your needs.

Limits
This is one of the areas where annuities shine. Unlike 401(k) plans and IRAs, the IRS does not impose contribution limits on a nonqualified annuity (although some insurers may require pre-approval for extremely high purchase premiums). This means you can maximize post-tax income contributions to grow tax-deferred until you are ready to withdraw income. And although Social Security and pension payouts are capped, an annuity can help you develop a higher stream of guaranteed income using personal assets.

Final Thoughts

Lifetime income is not an easy thing to provide. In recent years, there has been increasing concern about the ability for both underfunded pension plans and Social Security to provide guaranteed lifetime income at their current levels. People looking for more predictability during retirement may need to be proactive about developing their own stream of guaranteed income using a portion of their savings and/or invested assets.

Annuities offer important retirement planning features such as tax-deferred growth opportunity, guaranteed income riders and a death benefit for beneficiaries — but it's important to choose the appropriate type of annuity for your situation. For many people, designing a personally funded plan for guaranteed lifetime income is certainly worth exploring.

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[1] Social Security Administration. "Workers With Maximum-Taxable Earnings." https://www.ssa.gov/oact/COLA/examplemax.html. Accessed July 25, 2018.
[2] Melissa Phipps. The Balance. April 12, 2018. "The History of the Pension Plan." https://www.thebalance.com/the-history-of-the-pension-plan-2894374. Accessed July 25, 2018.
[3] Yoni Blumberg. CNBC. April 16, 2018. "Paul Ryan could get a pension of $84,930 a year – here's how that compares to most Americans." https://www.cnbc.com/2018/04/16/how-paul-ryans-85000-pension-compares-to-the-average-americans.html. Accessed July 25, 2018.
[4] Ashlea Ebeling. Forbes. July 17, 2017. "Make Your Retirement Money Last For Life." https://www.forbes.com/sites/ashleaebeling/2017/07/17/make-your-retirement-money-last-forever/#483fc94f5ce6. Accessed July 25, 2018.
[5] Ibid.
[6] AnnuityGuys.org. July 1, 2016. "Lifetime Annuity Income: Annuitize or Control Your Money with Income Riders." https://annuityguys.org/lifetime-income-annuitize-or-control-your-money-with-income-riders/. Accessed July 25, 2018.

Annuities are insurance contracts designed for retirement or other long-term needs. They provide guarantees of principal and credited interest, subject to restrictions, surrender charges, holding periods, or early withdrawal fees, which vary by carrier. Riders are generally optional and have an additional associated cost. Annuities are not bank- or FDIC-insured.

Investing involves risk, including the potential loss of principal. Any references to guarantees, protection, security or lifetime income refer to fixed insurance products, never securities or investment products.

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