IMPROVING THE INCOME OUTCOME

By Lowell Aronoff, RMA

A generation ago, most retirees didn't worry about a strategy to ensure their money lasted as long as they did. They generally didn't need to because most people didn't live very long after they retired. However, those with means often used a rule of thumb – "Never touch the Principal". In other words, your budget should ensure that interest and dividends are sufficient for your needs.

A retiree that never dips into their principal would clearly never run out of money. However it's difficult to plan a budget when you don't really know the level dividends or interest, and it's likely that these retirees would be scrimping excessively in the last few years of their lives, when they could afford a much more comfortable retirement. Today, if someone ended their days in poverty, while leaving an excessively large estate, it wouldn't be considered effective planning.

This is why retirement income planning has evolved. There are a large variety of methods being used to mitigate the key risks in retirement, which include longevity, inflation, and market volatility. Virtually all of these methods fall into three categories of strategies: **Systematic Withdrawals, Time Segmentation, and Income Floor.**

This article will review these three categories of strategies, review when each is most appropriate and discuss how including an income annuity (also called a Single Premium Immediate Annuity, SPIA, of Fixed Immediate Annuity) can improve the outcome.

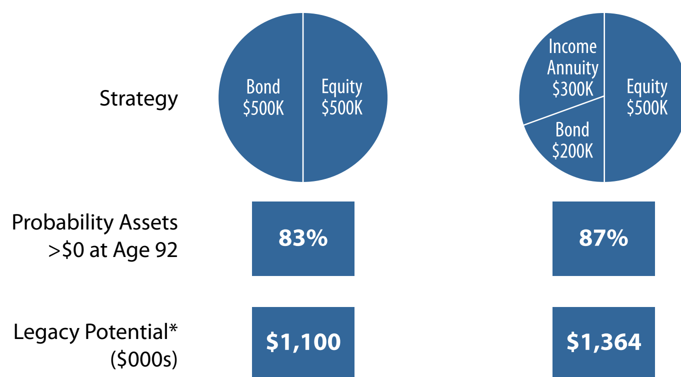
The oldest and still most popular strategy is the Systematic Withdrawal Plan.

The most common variations have the consumer calculating their budget based on their wealth at retirement. Every year, the retiree withdraws a fixed percentage of their initial wealth, adjusted for the previous year's inflation. But what's a safe withdrawal rate?

In 1995, Peter Lynch, an exceptionally successful fund manager, wrote that a 7% withdrawal rate would be prudent for an all stock portfolio. He withdrew this analysis very quickly when shown how overly optimistic it was. In 1997, William Bengen calculated that a withdrawal rate of 4.1% from a portfolio of 50% S&P 500 and 50% government bonds would have survived any 30-year period since 1925. More recently, Wade Pfau found that this rate would likely fail retirements started shortly

Improving Systematic Withdrawals with SPIA

Incorporating SPIA into portfolios takes the pressure off withdrawals, leading to greater certainty that retirees won't outlast their portfolios, and potentially legacies

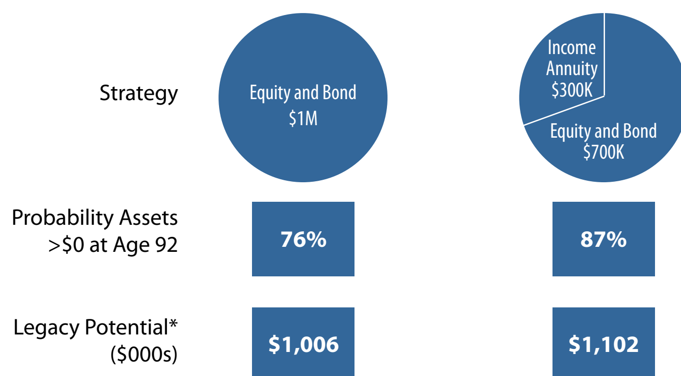


Scenario: Male age 65, 4% withdrawal rate, adjusted annually for 2.5% inflation, Life-Only Income Annuity

* The pre-tax median ending portfolio balance at age 92
Source: New York Life, 2010. Hypothetical value of assets held in an untaxed account of $1,000,000. The illustration is based on a Monte Carlo model of 1000 scenarios. Equity and bond returns were generated using an economic scenario generator, with correlations estimates coming from the historical monthly S&P 500 Index returns from 1982-2009 and Barclay Capital U.S. Aggregate Index returns from 1989-2009. Each withdrawal rate is adjusted annually for 2.5% inflation. The portfolios are rebalanced annually and assume an annual deduction of 150 basis points for management fees on non-annuity assets. Income payments from the income annuity are based upon the average Life-Only payout rates offered by A++ rated (A.M. Best, 01/01/2011) SPIA providers, effective 01/01/2010. This example is for illustrative purposes only and does not represent the performance of an actual investment. Past performance won't guarantee future results. Note: an investor cannot invest directly in an index.

Improving Time Segmentation with SPIA

The benefit of Income Annuities is also evident when added to a bucketing strategy. It reduces the withdrawal strain in all segments, leading to a greater probability that retirees won't outlive their assets, while achieving higher legacy.



Scenario: Male age 65, 4% withdrawal rate, adjusted annually for 3% inflation, Life-Only Income Annuity

*The pre-tax median ending portfolio balance at age 92
Source: New York Life, 2010. Hypothetical value of assets held in an untaxed account of $1,000,000. Details of Strategy 1 and Strategy 2 are described in the previous slide. The above represents a weighted average of the allocations in the 6 buckets that makes up each strategy. Equity and bond returns were generated using an economic scenario generator, with correlations estimates coming from the historical monthly S&P 500 Index returns from 1982-2009 and Barclay Capital U.S. Aggregate Index returns from 1989-2009. Each withdrawal rate is adjusted annually for 3% inflation. The portfolios are rebalanced annually and assume an annual deduction of 150 basis points for management fees. Income payments from the income annuity are based upon the average Life-Only payout rates offered by A++ rated (A.M. Best, 01/01/2011) SPIA providers, effective 01/01/2010. This example is for illustrative purposes only and does not represent the performance of an actual investment. Past performance is no guarantee of future results. Note: an investor cannot invest directly in an index.

before the 2008 meltdown. Pfau discovered when a 60/40 allocation between stocks and bonds is used; the maximum sustainable withdrawal rate is only 1.46%.

Including an income annuity in the portfolio can improve these results because it generates a higher level of income guaranteed for life and thereby takes pressure off the rest of the portfolio. Let's look at how this might play out for a healthy 65-year-old male with a $1 million portfolio who wants a real (inflation adjusted at 2.5%) income of $40,000 per year. There's a one-in-three chance that he will still be alive at age 92[1]. Plugging these assumptions into a Monte Carlo simulation, without an income annuity, the median portfolio balance at age 92 is $1.1 million, but there's a 17% chance of depleting assets. With an income annuity, the median portfolio balance increases to almost $1.4 million and the probability of depleting assets is reduced to 13%[2]. Furthermore, if our 65-year-old man runs out of money after having purchased an income annuity, he would still receive the monthly annuity checks for the rest of his life.

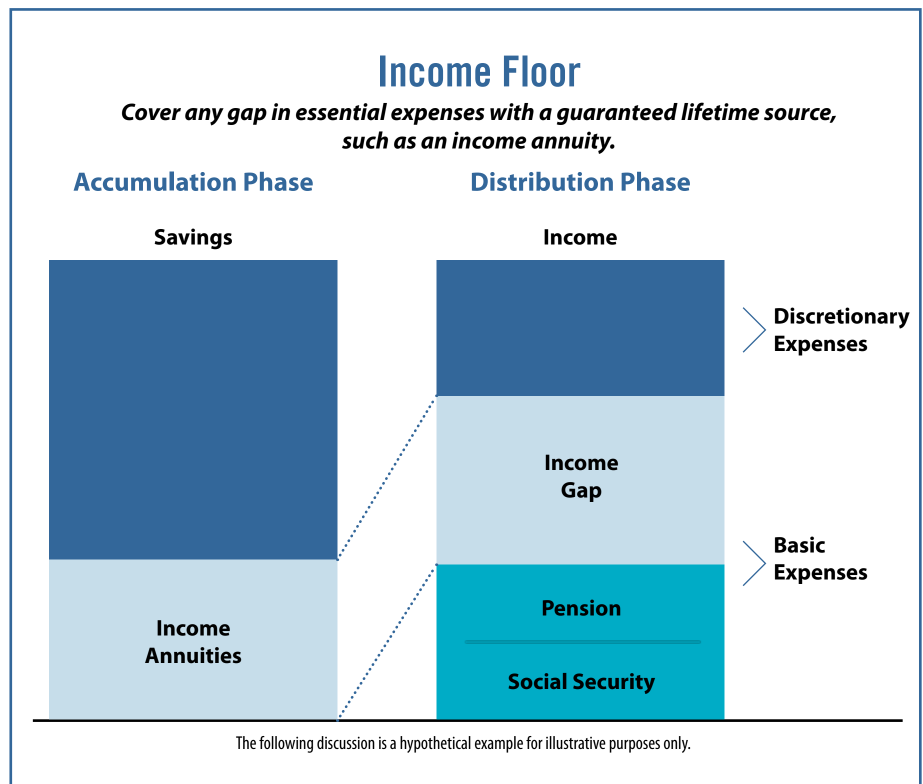
A second strategy uses time segmentation.

Many clients find that money is easier to manage if it's segmented into buckets. During pre-retirement, there might be a food bucket, a mortgage bucket and other buckets to save for university and retirement. These clients may be more comfortable with a strategy that segments their retirement into, for example a number of five-year increments. The immediate five years are invested mostly into cash to mitigate the

[1] SOA Annuity 2000 mortality with 1% improvement
[2] Source: New York Life, 2010

impact of a market downturn, while other buckets have a larger equity balance because there's more time to weather downturns and grow. This strategy requires a fair amount of management – moving money between buckets.

Including an income annuity makes the portfolio easier to manage, because it provides steady cash flow and also improves the result for the same 65-year-old male, using a similar Monte Carlo model, but this time assuming three-percent inflation. Plugging the assumptions into a second simulation, without the income annuity, the median assets remaining are a bit more than $1 million, but there's a 24% probability of depleting assets. With the income annuity, the client is left with $1.1 million at age 92 but only a 13% chance of depleting assets,[3] and once again, if assets are depleted, he can still fall back on the monthly income from the income annuity.



The third common retirement income strategy is called the Income Floor.

Using this strategy, the client determines how much money he needs for the essential living expenses (food, shelter, minimal clothes, etc). This strategy takes the approach that a line needs to be drawn in the sand, because if the client does not have enough income at any stage in life to meet his essential expenses, then at that point he's no longer living a dignified life. As a result, essential expenses should be covered with guaranteed lifetime sources of income like Social Security and pensions. If these sources are insufficient to cover the client's basic needs, then they should be covered by some other guaranteed lifetime source, ideally indexed to inflation. An income annuity is clearly the most efficient vehicle.

Knowing which one of these strategies to use will depend on the client – what resonates and how well funded his retirement is. Generally if a 65-year-old needs to withdraw around two percent or less of his assets per year, he's not in any real danger of depleting his assets and either a systematic withdrawal or bucketing approach would be adequate. If he needs to withdraw around six percent or more of his assets per year, he will need assurances that his essential expenses are covered by an income floor. On the other hand, if he feels he needs eight percent or more of his assets per year, it's important that he consider alternate options, such as going back to work or cutting back his lifestyle.

Whatever strategy turns out to resonate best with the client, it's important to consider an income annuity because it generates more guaranteed income for life than any other investment. ■

Lowell Aronoff is CEO of CANNEX Financial Exchanges Limited, an organization that facilitates the sale of a variety of financial products. CANNEX compiles data and calculations about a variety of financial products and makes that information available to subscribers. Lowell focuses most of his energies on fixed income annuities and how they fit into a client's holistic income plan. For more information, visit www.cannex.com.

[3] Source: New York Life, 2010