Explaining the Yield from an Income Annuity

By Lowell Aronoff, RMA

Retired clients are often more concerned about the yield they receive from their investments than they should be. This is because throughout their financial lives, prior to retirement, the primary measurement of how well their portfolio was doing was based on the yield. Yield continues to be important in retirement, but it's an intangible measure of how well the client will live during retirement. A far more tangible measure is how much income the client will receive. Other tangible financial issues that become more important than yield once the client has retired include the risk of depleting assets and the amount of assets available to heirs.

Whether or not yield should be the most important issue for a client to focus on, the fact is that clients use yield to measure their investment. This occurs whether they're accumulating assets for retirement or in decumulation mode. Clients have grown up thinking that all investments are measured by yield and this bias is not going to be changed just because he or she has retired.

There are, of course, many financial products that are not measured by yield – no one calculates the expected yield from their life, home or auto insurance. Sales would likely decline if they did, but insurance is sold as protection – a hedge against a risk that the consumer (or their family) couldn't otherwise afford.

All annuities have an element of protection built into the contract. Whether this is in the form of a death benefit, nursing home waiver or guarantee that payments will continue for life, clients often see these as features and still want to know the yield. Telling your client that their yield cannot be determined because no one knows how long they'll live may be true, but it's a poor response because it sounds evasive.

So, how do you explain the yield from an income annuity? In the last week of September 2012, a healthy 65-year-old woman with $100,000 could purchase a lifetime income annuity with a 10-year certain period that pays about $501.38 per month. While it's certainly true that we need to know how long the client

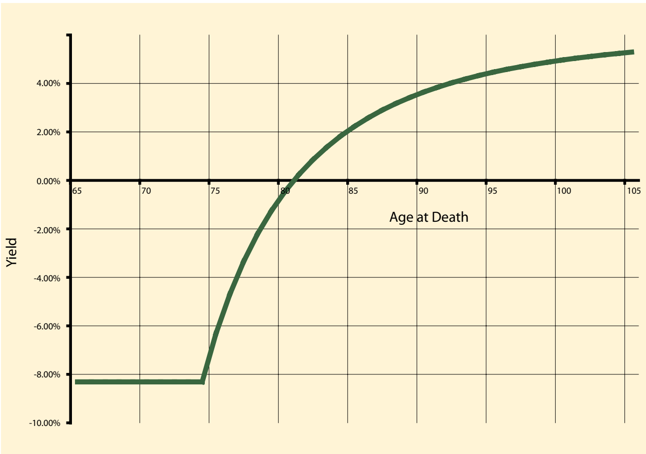
is going to live in order to provide a definitive answer as to what her yield will be, we can graph the client's yield against future ages when they might die. This is shown below.

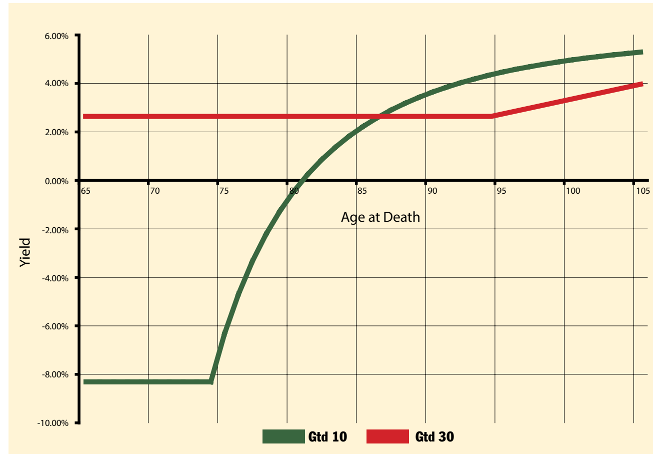
As it's shown, the client's yield increases the longer she lives – this is simply because the client continues to receive payments for as long as she lives.

Upon closer examination, there are several interesting things we can see. If we start with a large group of 65-year-old women, we know that half will live for about 25 years. This is known as their life expectancy. The yield for this 65-year-old female client at life expectancy is 3.6% - a rate that's comparable to what's available from a high quality bond for the same period of time.

If the rate at life expectancy is no better than what's available from the bond market, why buy the annuity? The answer is that the annuity provides protection in the form of an on-going paycheck for life – even if the client has a very long life. 25% of 65-year-old women will see their 96th birthday. If your client is amongst this group, she will get a yield of at least 4.6%. In fact, there is a 10% chance that she'll live to age 102 and get a 5.1% yield, a rate that's well in excess of any fixed interest rate available today for that period of time from as reliable a source. What's important is not really the yield that this client received; it is that the $501.38 per month will continue for the rest of her life.

Every product should be analyzed in both a positive and negative light. Sure, the yield is excellent if the client lives a long time, but no one knows how long they'll live, and in this case, the rate of return is negative if the client dies in 16 years or less. While there is a 77% chance that the client will live 17 years or more, we can mitigate the client's risk of a negative return by increasing the





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guarantee. If the client purchases the annuity with 17 or more years certain, she will be guaranteed to receive a positive yield no matter how long she lives. The cost of this guarantee is the client would have to give up at least $21.07 per month. In fact, the client could guarantee a yield of at least 2.9% by purchasing an income annuity for life, with a 30-year certain period. Generally, the longer the certain period, the higher the yield would be if the annuitant died young, but the lower the yield would be if she lived to an old age. This is seen in the graph below.

The problem with this analysis is that it's focused on an intangible statistic – yield. The purpose of the income annuity - to provide a paycheck that cannot be outlived may make the client feel more secure about her retirement.

When a client asks about yield, she's often concerned about other things – does the income annuity provide a comparable yield to other investments? Or, if she's looking for guaranteed lifetime income, are there better options?

Guaranteed Lifetime Withdrawal Benefit (GLWB) riders are available if the client purchases a Variable Annuity (VA) or Fixed Indexed Annuity (FIA) and these guarantee an income for life. However, the amount guaranteed is less than what's available from an income annuity. There is another option – the client can wait and purchase the income annuity in a few years when she's older. Income annuities are less expensive for older people because they have a lower life expectancy. Instead of purchasing an annual income stream of $501.38 per month for life with a 10-year certain period for $100,000, the client could create an equivalent income stream by purchasing an alternative investment that allows her to withdraw the same $501.38 per month for 10 years and leaves her with enough money to buy an income annuity later when its cheaper because she's older and no longer needs the 10-year certain period. In the last week of September 2012, she could buy this stream of income for $72,789. Should she wait?

To answer this, we can turn to a statistic called the Implied Longevity Yield™ or ILY™, which measures the yield that would be needed from the alternative investment in order to generate the same income on the same schedule as the income annuity - so she's left with enough money to buy an income annuity later. The ILY for the life and 10-year certain income annuity with a 10-year waiting period is 3.9%. In other words, if the client wants income that cannot be outlived and she can find an investment that's as safe as the claims paying ability of a highly rated insurance company, which pays a consistent return of 3.9% or more for the next 10 years (net of commission and expenses), then she should consider waiting to purchase the income annuity. If not, she should consider purchasing it now.

The components of this analysis (an IRR graph and the ILY) will be updated regularly and examples will be available at no cost at the SAFE website (http://annuityed.org/) by the time this article is printed. ■

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