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Retirement Income Planning

Trends in the Income Annuity market

One of the oldest and simplest products available, but possibly the least understood

by garyBaker

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Immediate income annuities have long been recognized by academics and financial experts as one of the most efficient vehicles to generate cash flow for an investor in retirement. It is one of the oldest (2,000 years +) and simplest financial products available – but possibly the least understood. With the recent pressures placed on other forms of insured guarantees (e.g., Deferred Variable Annuities with Living Benefits), there is a renewed emphasis on this basic but important product. Development is accelerating across the industry to better align income annuities within an investor's product portfolio. Here are some of the major trends.

Addressing flexibility objections

If the income annuity is an efficient and effective vehicle to complement a retiree's portfolio, why don't financial professionals adopt it more broadly? Generally, there are still many misconceptions about immediate annuities. Too often they are confused with deferred annuities by the financial planning community and financial media alike. Among financial planners who are aware of the product, many contend that income annuities are not flexible enough to integrate within a financial plan and that they will lose control of the assets if a client's plan changes over time. These advisors are saying, in essence, that an income annuity does not fit within their service, business and revenue models.

In addressing the flexibility issue, manufacturers have increased their efforts to provide more liquidity with these types of contracts. Today, a majority of income annuities are sold with some form of cash refund or guaranteed period (i.e., period certain) regardless of what happens to the annuitant. Although this addresses the "if I get hit by a bus and the insurance company keeps my money" issue, these forms of liquidity ultimately go to the beneficiaries. Increasingly, manufacturers are focusing on innovations that will address forms of liquidity for the annuitant while they are still alive. However, similar to the cost of cashing in a CD too early or not holding a bond until maturity, there will always be a cost to cashing in an income annuity in the event a client changes his or her mind. In the case of an income annuity, the intent is to hold it for a lifetime.

There are generally two parts to an income annuity contract – the guaranteed period (if elected) and the lifetime contingent portion (i.e., the part that keeps going until you die). Typically, when investors fully or partially cash in on the guaranteed period part of the contract, the original income stream will restart and continue throughout the lifetime portion. Recently, more options have been introduced that provide easier access to cash, enabling the investor to elect to receive one year's worth of payments in a lump sum to address short term needs. However, investors typically can do this only once during the life of the contract. As far as the lifetime portion of the contract, manufacturers continue to limit the amount that you can partially cash in on certain contracts so they can preserve their ability to give an investor survivor credits, the third form of return, in addition to principal and interest, that is the essence of an income annuity. Future innovations will look to better align the ability to cash in both portions of the income annuity contract.

Managing a retirement income portfolio

These advancements in liquidity alone do not address many financial planners' perception of an income annuity as a "dead asset," one that cannot be managed over time. This stigma is starting to diminish among advisors as new tools and processes emerge to assist them with managing retirement income portfolios. Many advisors contend that converting an accumulation plan and portfolio (one which they have been assisting their client with for many years) into a cash flow plan and portfolio is unnatural to them and presents one of their most difficult professional challenges. Depending upon the type of practice a financial advisor has, he or she will generally use one of three sales or planning tracks in developing a cash flow plan for clients:

- Time Segmentation (or bucketing), by which an advisor sets up a series of investment "buckets" to address retirement and estate needs over time.
- Setting up a guaranteed income stream to cover Essential Expenses (e.g., food and shelter) beyond what a Social Security or pension check can provide.
- Managing a Systematic Withdrawal process from a client's portfolio that uses an income annuity as a bond replacement.

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The common element with each of these approaches is that only a portion of the client's assets is allocated into an income annuity. In other words, it's not an all or nothing proposition. In reality there are still a variety of decisions that can be made with the assets committed to an income annuity contract over time:

- Changing the use or direction of the monthly payout (for reinvestment or other funding)
- Incrementally allocating more assets into the contract as long term needs change (e.g., laddering)
- Triggering certain liquidity options as short term needs arise.

Organizations are developing educational accreditation and designation programs to help advisors learn and understand how to manage the complexities of a cash flow plan. For example, InFRE has a Certified Retirement Counselor (CRC) program that provides a curriculum for advisors who wish to add retirement income planning to their specialty. Also, the Retirement Income Industry Association (RIIA) has recently introduced the Retirement Management Analyst (RMA) program in partnership with Boston University through which an advisor can develop the technical capability to manage a variety of retirement income strategies.

Accounting for assets

Finally, broader adoption comes down to having the income annuity better align with the business and revenue model of the financial professional. One of the most significant gaps today is that income annuity data is not universally available. When advisors place a portion of their clients' assets into income annuities to support cash flow plans, those assets disappear from the clients' consolidated statements and the advisors' AUM reports. Setting aside investors' behavioral finance issues, this omission impacts the scorekeeping and compensation programs for advisors and their firms. It is assumed that if there were a standard process to make income annuity information (including the "value" of the guarantee) universally available on statements and reports, the adoption of this product would significantly improve, leading to a more transparent way to fill the growing guaranteed income gap in the U.S. market. The increase in fee-based programs and practices also would support such a standard. Encouragingly, RIIA is facilitating an initiative, involving manufacturers, distributors and service providers, to determine common definitions and standards for the valuation of income annuities and how to best communicate this data for the benefit of both consumers and financial advisors.❖