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# The Role of Annuities in an Income-Starved Environment

*By Tamiko Toland*

INVESTMENTS & WEALTH INSTITUTE®

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The annuity is purpose-built to solve for guaranteed income in retirement. In a shrinking world of reliable options to generate income, it is inevitable that more advisors would consider—or reconsider, as the case may be—how best to leverage an annuity to improve retirement-income planning outcomes.

## KEY TAKEAWAYS

- The annuity improves the sustainability of savings through retirement.
- Characterizing the annuity as part of the fixed income portfolio can further benefit outcomes, particularly when the portfolio allocation leans more toward the fixed income side.
  - It can increase retirement sustainability.
  - It increases legacy.
- Equity exposure contributes to both retirement sustainability and legacy.

Generally, the pension, one of the legs of the famous three-legged stool of retirement, has been sawed off and replaced with the 401(k) plan. Few employer-sponsored plans offer guaranteed income as a replacement, yet most retirees need more than Social Security alone. The burden to replace that income then falls to the individual.

For the many financial professionals who support this need, tried and true strategies may fall short in the face of low interest rates. Bond yields make laddering challenging at best. It is irrational to ignore the fact that a genuine income guarantee can provide certainty and improve outcomes. For a majority of clients who put a high value on income protection, this is both quantitatively valuable and qualitatively meaningful.[1]

Naturally, this is where the annuity steps in. Though annuities can serve different functions within a portfolio, this article will focus specifically on its ability to generate a guaranteed lifetime income stream. After all, this is the unique value proposition of the annuity.

An important aspect of the annuity strategy is to consider the income stream as part of the overall asset allocation rather than separate from it by using a portion of the initial investment to purchase future income. To this end, it can both improve the outcome for the client and allow for more aggressive asset allocation of the remaining portfolio. This approach addresses inflation concerns and can even increase legacy.

## SPIAs VS. OTHER ANNUITY SOLUTIONS

A number of annuity solutions are able to appropriately and effectively meet the need for income replacement in retirement. A lot of research, including our own, has focused specifically on the value of the single premium immediate annuity (SPIA) in a portfolio. A SPIA is the simplest form of annuity in which the buyer exchanges a lump sum (single premium) for a guaranteed income stream that starts within a year. The deferred income annuity (DIA) offers payments starting later, and together the SPIA and DIA are called income annuities because there is no accumulation component. The SPIA is famously popular among academics yet commercially it is still just a blip. In 2020, income annuities represented 7.7 percent of fixed annuity sales and less than 4 percent of total annuity sales, according to the Secure Retirement Institute.

The SPIA's appeal comes from its efficient and transparent design: The input of a lump sum of savings turns into a guaranteed income stream. Contracts that do not offer any death benefit also pay the highest income, which is appealing to actuarial types but is less attractive in the commercial market. Consumers have a clear preference that we see in our income annuity quoting statistics: 83 percent of quotes in 2020 included some form of death benefit.

The apparent mismatch between research and reality is an understandable consequence of the perceived advantage of a pure life-only SPIA. In practice, we see that the addition of a death benefit that covers 10 years of payments affects the highest income rate very little—if at all.

On top of this, the income annuity (immediate or, especially, deferred) is not always the most efficient vehicle to provide guaranteed lifetime income.[2]

As we have confirmed through periodic spot-checks that the competitive environment for these products is mercurial, it is critical to check current product rates and specifications due to regular changes. Otherwise, it is impossible to be certain which annuity design will generate the highest guaranteed income, as we saw during and after the flood of product and pricing changes in 2020 that resulted from the onset of the pandemic.

To this point, it is necessary to stress that the general conclusions from the analysis that follows rely on a SPIA but extend to annuities that offer an income benefit. This is especially true during a planning process where there is a delay between the purchase of the annuity and its use for generating income. The point of this exercise is not to identify an ideal product configuration but to demonstrate the value of adding a source of income that will continue for life, whatever form that takes.

Furthermore, integrating annuity income within the fixed income allocation of the overall retirement portfolio helps with the challenge of managing inflation, a planning problem that is difficult to perfectly hedge. One longstanding approach is to expect equity gains to generally keep up with inflation, with the understanding that fixed income investments may have to make up the difference in periods of negative stock performance. A solid income floor can support this strategy, even when it is not itself indexed to real or estimated inflation.

## LIFETIME INCOME IN THE FIXED INCOME ALLOCATION

The analysis that follows explores the validity of integrating the guaranteed income from an annuity into the fixed allocation of a retirement portfolio. To examine the effect that guaranteed income has on the success of a retirement plan, this study uses the methodology and principles of PrARI® (Product Allocation for Retirement Income), a CANNEX tool that calculates a retirement sustainability quotient (RSQ) and financial legacy for a given retirement-income strategy.[3] Both figures are averages based on market simulations presented in present value terms and adjusted based on longevity expectations.

The client purchases a SPIA using 0 percent to 30 percent (in 5-percent increments) of the starting portfolio and assesses the effect of either managing the remaining portfolio separately to the given asset allocation or including the SPIA purchase within the fixed income allocation. This analysis includes three asset allocation models:

- Conservative portfolio: 30-percent equity and 70-percent fixed income
- Balanced portfolio: 60-percent equity and 40-percent fixed income
- Aggressive portfolio: 70-percent equity and 30-percent fixed income

The scenario considers a 65-year-old with $1 million in retirement savings who seeks a starting retirement income of $50,000. Annually, the income increases by 2 percent to account for inflation. The SPIA income amount is based on an average of the top three rates available at the time for a SPIA with a 2-percent cost-of-living adjustment from a company rated at least A++ by AM Best. The rate using a $100,000 premium payment was $410 per month or $4,920 per year (see tables 1 and 2).

## RESULTS

Overall, these findings support the thesis that it makes sense to include guaranteed annuity income as part of the fixed income allocation of a retiree's portfolio. Interestingly, much of the effect of this approach shows up in the legacy component rather than income sustainability. The findings consider the effect of the annuity purchase on both the strategy's ability to provide the target income over a lifetime (RSQ) and the size of the legacy. The results vary by asset allocation, with the most difference related to RSQ in the conservative allocation. This is true both when simply adding the annuity or counting the annuity as part of the fixed income allocation.

Table 3 shows abbreviated results for the three allocations focusing only on the scenarios that allocate 0 percent and 30 percent to the SPIA. The addition of

Table 1

### CAPITAL MARKET ASSUMPTIONS

| Capital Market Assumptions | | |
|---|---|---|
| Fixed Income | Return | 4.5% |
| | Volatility | 6.5% |
| Equity | Return | 8.1% |
| | Volatility | 15.5% |
| Correlation Coefficient | | 26.0% |
| Portfolio Management Fees | | 1.0% |
| Long-term Discount Rate | | 2.5% |

*Note: The equity component is based on the U.S. large-cap equity and the fixed income component is based on the U.S. investment-grade corporate bond returns from J.P. Morgan Asset Management's 2016 Long-Term Capital Market Assumptions.*

Table 2

### PORTFOLIO RETURN ASSUMPTIONS

| Portfolio Return Assumptions | | |
|---|---|---|
| | Annual Return | Volatility of Returns |
| Conservative Portfolio | 4.6% | 7.3% |
| Balanced Portfolio | 5.7% | 10.3% |
| Aggressive Portfolio | 6.0% | 11.5% |

*Note: Returns are net of fees.*

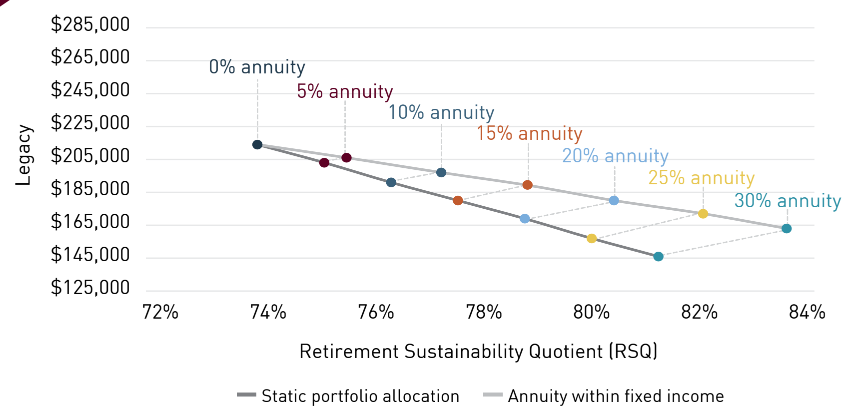
Table 3

## RETIREMENT SUCCESS QUOTIENT AND FINANCIAL LEGACY BY SCENARIO, BASED ON A $1-MILLION PORTFOLIO

| Conservative Portfolio (30% Equity / 70% Fixed Income) | | | | | |
|---|---|---|---|---|---|
| SPIA Allocation | | SPIA + Balanced Portfolio | | SPIA Within Fixed Income | |
| Investment Account | SPIA | RSQ | Financial Legacy | RSQ | Financial Legacy |
| 100 % | 0% | 74.0% | $214,000 | 74.0% | $214,000 |
| 70 % | 30% | 81.2% | $146,000 | 83.5% | $163,000 |
| | Difference (% change) | 7.2% (9.7%) | –$68,000 (–31.8%) | 9.5% (12.8%) | –$51,000 (–23.8%) |
| **Balanced Portfolio (60% Equity / 40% Fixed Income)** | | | | | |
| SPIA Allocation | | SPIA + Balanced Portfolio | | SPIA Within Fixed Income | |
| Investment Account | SPIA | RSQ | Financial Legacy | RSQ | Financial Legacy |
| 100 % | 0% | 79.4% | $260,000 | 79.4% | $260,000 |
| 70 % | 30% | 85.2% | $178,000 | 85.6% | $191,000 |
| | Difference (% change) | 5.8% (7.3%) | –$82,000 (–31.5%) | 6.2% (7.8%) | –$69,000 (–26.5%) |
| **Aggressive Portfolio (70% Equity / 30% Fixed Income)** | | | | | |
| SPIA Allocation | | SPIA + Aggressive Portfolio | | SPIA Within Fixed Income | |
| Investment Account | SPIA | RSQ | Financial Legacy | RSQ | Financial Legacy |
| 100 % | 0% | 80.0% | $269,000 | 80.0% | $269,000 |
| 70 % | 30% | 85.6% | $185,000 | 85.3% | $193,000 |
| | Difference (% change) | 5.6% (7.0%) | –$84,000 (–31.2%) | 5.3% (6.6%) | –$76,000 (–28.3%) |

Figure 1

## CONSERVATIVE PORTFOLIO




the SPIA improves RSQ in all cases regardless of asset allocation or how the annuity is treated. We expect improvement because the SPIA payments do not fluctuate based on any market changes and continue for the retiree's life.

Only for the conservative portfolio, which has a 70-percent allocation to fixed income, does the use of the SPIA as fixed income notably improve the RSQ (81.2 percent to 83.5 percent). This effect is not nearly as large as the improvement to sustainability by using an annuity at all, as the baseline RSQ with no annuity is 74.0 percent. Notably, the baseline is much higher for the balanced and aggressive portfolios (79.4 percent and 80.0 percent, respectively).

Even though the conservative portfolio has the highest allocation to fixed income, it also benefits the most from the addition of the SPIA.

On the other side of the ledger, the SPIA reduces the financial legacy because it dedicates some starting assets to the lifetime income stream with no death benefit. In all instances, the use of the SPIA within the fixed income allocation improves the amount of the legacy, but this effect is greatest for the aggressive portfolio. In this case, the financial legacy with a 30-percent SPIA allocation rises from $185,000 to $193,000 when the SPIA becomes part of the fixed income allocation.

Figures 1, 2, and 3 map out the relationship between RSQ and legacy for both SPIA methodologies. Here it is easy to see how the treatment of the annuity as part of the fixed income allocation improves the outcome noticeably for both the conservative and balanced portfolios but has little effect on the aggressive portfolio. This is despite the fact that the balanced and aggressive portfolios are relatively close in their equity components (60 percent and 70 percent, respectively). By contrast, the balanced portfolio has twice the equity allocation of the conservative portfolio (60 percent versus 30 percent).

Figure 2

## BALANCED PORTFOLIO

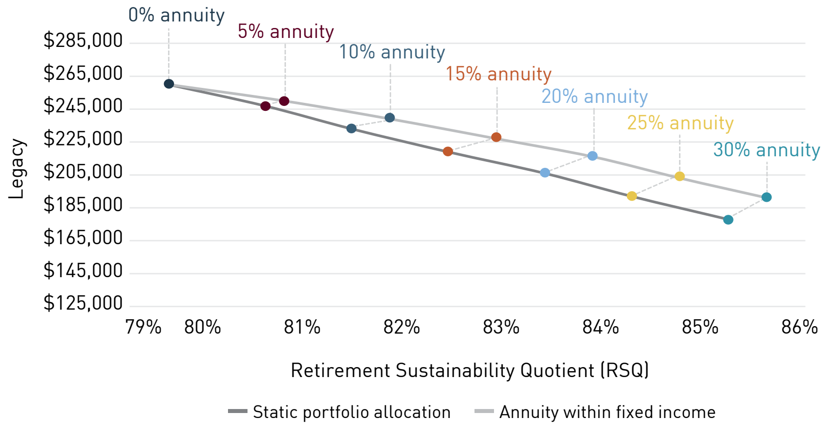
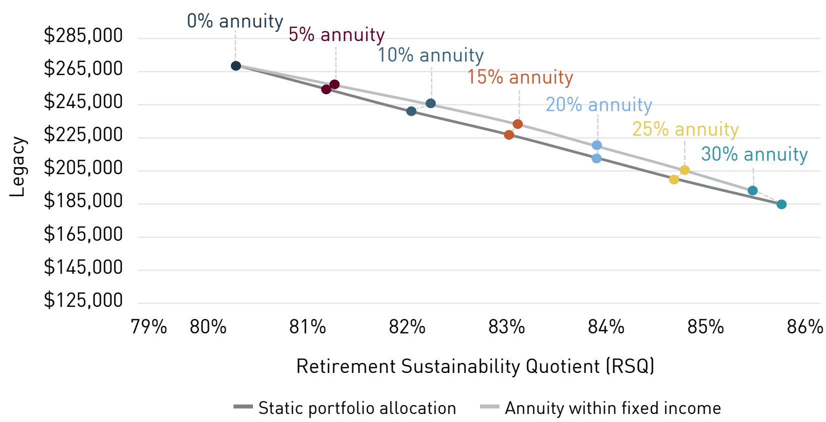



Figure 3

## AGGRESSIVE PORTFOLIO




## EXTENDING THE FINDINGS BEYOND INCOME ANNUITIES

As explained earlier, a deferred annuity (fixed indexed annuity or variable annuity) with an income benefit may provide similar or even better results than a SPIA or DIA. The income benefit provides the option of a future guaranteed income stream whereas the DIA is an irrevocable payment for income to start at a future date. Income benefits particularly outperform when there is a delay, but because of fluctuations in pricing financial professionals should check current rates across the annuities they can access when seeking out guaranteed income.

Though this phenomenon is counter-intuitive at first blush, it makes perfect sense. The management of each of these product types is quite different. Most obviously, every income annuity purchaser will receive the income, but the same is not true of benefits that require an active election to start the income stream; the anticipated use of benefits and contract surrender are components of pricing that make the benefits give higher payout to those who do stick around and use them.

Furthermore, the pricing for income annuities is famously based on very specific client details, including age, gender, and the precise age difference for a couple. The same is not true for fixed indexed annuity (FIA) and variable annuity (VA) income benefits, which rarely distinguish between gender and may use larger age tranches.

## WHY FIAs AND VAs ARE TERRIBLE

It is worth addressing common objections to solutions that use either an FIA or a VA. Namely, the FIA has a shady history and often uses esoteric indexes that are difficult to understand and impossible to compare. The VA is expensive and the guarantee is complicated. For the record, the client ends up paying for the cost of a benefit (even when it is not explicit, as is the case with many FIAs) whether they end up using it for its intended purpose or not. When the objective is to generate income, I assume that the client does in fact use the benefit, so the nominal cost is secondary to the value of the actual income it generates.

### FIA: THE F STANDS FOR FIXED

Many people believe that the FIA is plagued with sales and design problems, largely due to a reputation it earned earlier in its history. In the intervening years, insurers that formerly would not touch an FIA with a 10-foot pole have now enthusiastically engaged this segment of the market and FIAs are now available across a wide range of distribution channels.

One of the misconceptions of the FIA stems from some sellers who have used questionable sales pitches that overemphasize the role of broad market indexes. Even though certain indexes and crediting methods may result in equity-like returns in certain periods, the FIA is fundamentally a fixed annuity. Our guidance on performance is that they may, on average, offer a few percentage points above a multi-year guaranteed fixed annuity, but they also may fall short of that benchmark.

A more recent concern revolves around the plethora of proprietary (mostly low volatility) indexes. They may offer extremely attractive rates that ultimately average out in the same territory, though with different performance characteristics. For example, they may offer more consistent results. Either way, the fact is that many FIA income benefits do not fluctuate much, if at all, based on the index performance. This is particularly the case when the objective is to maximize the income guarantee.

## THE VA AS HYBRID

Many people argue that the VA with income benefit is expensive and that the high fees place an unreasonable drag on the performance of the portfolio. It is certainly true that it is possible to find a less expensive investment vehicle but not one that provides this unique variety of long-dated put option—after all, the guarantee acts as a derivative, because it provides protection against portfolio losses for a longer period of time than any put available on the market. The richest benefits with the highest minimum income guarantees tend to also have the highest expenses; if this is the point of the annuity and the client will use the income stream, then the fate of the account value is irrelevant. It is impossible to simultaneously tap into the liquidity of the account (beyond the limits of the benefit) and preserve the income guarantee.

This leads into the issue of product complexity and the difficulty in comparing among benefits. I cannot argue against this when considering the features of a guarantee structure alone; this is exactly why my company calculates income values based on the specifics of the product design and the individual scenario (age, marital status, and delay until starting income). Otherwise, it is difficult to intuit how well a particular design suits a plan.

The value of the VA is that it offers market-related growth, particularly before starting to take withdrawals. However, it also provides an income floor that protects against sequence-of-returns risk. Through the lens of these two functions, the VA with income benefit is a hybrid that is neither supremely efficient for market-related gains (due to the benefit-related fees) nor generally best at providing the highest income guarantee on day one (due to the cost of insuring against market losses—though we know that there are circumstances where it does actually give the greatest income guarantee). The nature of the income guarantee means that the income stream can be regarded as part of the fixed income allocation within the framework at that point.

*A higher target income amount creates a greater need for the portfolio to generate enough returns to support that income.*

## HOW TO THINK ABOUT THESE RESULTS

The results here reflect the specific scenarios of this analysis and do not dictate a specific course of action or "ideal" asset or annuity allocation strategy. Instead, they suggest how a guaranteed income stream affects retirement outcomes. There are many variables to consider, among them: target income, longevity expectations, and baseline market assumptions and conviction. Surrounding this are client preferences for certainty or flexibility.

A higher target income amount creates a greater need for the portfolio to generate enough returns to support that income. This influences the observation that the baseline RSQ—without any annuity at all—is higher for the higher equity portfolios than for the conservative portfolio.

The desire for sustainable income creates a tension between portfolio stability in the form of fixed income and the need for a growth component to go the distance. Although the annuity performance aligns with the fixed income allocation, it actually serves both of these goals. We see this clearly with the significant improvement to RSQ when we add an annuity to the conservative portfolio.

There are effectively no drawbacks to including the annuity income stream as part of the fixed income allocation. At the higher equity levels in this analysis, this did not momentously shift the RSQ, but it did improve financial legacy except at the highest annuity allocation percentages.

These principles apply equally well to situations where the annuity income will not be used for many years. This approach also addresses sequence-of-returns risk, which can otherwise be devastating to portfolio sustainability.

In an environment where guaranteed income is both desirable and difficult to come by, any financial professional who does not consider using annuities overlooks a potentially valuable tool. I argue that it is useful to contextualize them as part of the fixed income allocation though they do more than other fixed income instruments because of their unique insurance properties.

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## ENDNOTES

1. In 2021, CANNEX and the Alliance for Lifetime Income released results from the Protected Retirement Income Study that found that nine out of 10 investors thought that protection was important for their retirement income. The summary is available online: https://www.cannex.com/wp-content/uploads/2021/06/ALI-CANNEX-PRIP-Research-Summary-6.20.21-FINAL.pdf.
2. We explored this heresy in a 2018 white paper, "Guaranteed Income Across Annuity Products: Withdrawal Guarantees Compete with Income Annuities," https://www.cannex.com/wp-content/uploads/2018/10/Annuity_guarantee_study_2018_FIA_VA_SPIA_DIApdf.pdf.
3. Details on the methodology of PrARI are available here: https://www.cannex.com/wp-content/uploads/2016/09/PrARI_whitepaper_042716.pdf.

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