# Should You Buy An Annuity For Retirement Income?

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Should you buy an annuity for retirement income? A strong *maybe*. This is the conclusion I've reached after taking a good, hard look at how annuities work and what they offer.

Some definitions are in order. First, an annuity is a risk-management product designed by insurance companies to hedge against the chance you might outlive your retirement assets. In essence, the insurance company converts a lump sum of money into a monthly stream of income that lasts the annuity holder's lifetime. If you die prematurely, the insurance company keeps the excess funds, but if you outlive your expected mortality, you win. Thus, an annuity allows one to transfer the risk of outliving one's life expectancy and savings to a third party. Those who die prematurely are effectively subsidizing those who live a long time. This is called "mortality pooling," and is the essence of how annuities work.

Annuities are actually very common and have a long history of working well. The biggest one is our Social Security system, which is a giant (inflation-indexed) annuity. In this case, you give the government a stream of payments during your working years rather than handing it a lump sum at or near retirement.

It's important to note that I am not referring to variable annuities (whose value move up and down with the market) that often come with a complex menu of guarantees (riders) and high costs.

Although variable annuities can be converted into a stream of income, the payments are not guaranteed because they are dependent on how well the underlying investments perform. In truth, the vast majority of variable annuities are never actually converted into annuities and thus act much like a regular retirement account, except funded with after-tax versus pre-tax dollars.

What I am referring to are single-premium immediate annuities (SPIAs), whereby the stream of income starts immediately, and single-premium deferred income annuities that are geared to start providing the income stream at some future date. In both cases, the insurance company is investing your money and taking the investment risk; the payment stream to the annuitant is fixed and is set based on gender, the age when the payouts begin, and the prevailing level of interest rates at the time the annuity is purchased.

Are annuities a good deal? A recent study by a self-professed "annuity hater" concludes they are.[1] This author obtained a quote on a SPIA for a healthy 65-year-old male. Based on a current projected 23-year life expectancy, the annuity produced a 4.36% annualized return. Living 40 years to age 105 resulted in a 6.47% annualized return. He then compared the annuity returns to those achievable by directly purchasing a combination of corporate and Treasury bonds designed to provide the identical cash flow with similar risk characteristics over the annuitant's expected lifespan. His conclusion was the actual cost of the net premium for the longevity insurance that comes with an annuity was near zero. In other words, the annuity generated the same cash flow as the bond ladder, but it was fully guaranteed.

Another recent study took a different approach but came to a similar conclusion. Here the author compared two different retirement withdrawal strategies from a 60% equity/40% fixed income portfolio to an annuity. The first withdrawal strategy is the well-known Bengen Rule, also known as the "4% Rule." The strategy sets a dollar number as a percentage of the investor's initial portfolio to be withdrawn in the first year (not necessarily 4%), and increases that dollar number for inflation each year thereafter. The second withdrawal strategy, which the author refers to as the high withdrawal strategy, allows for higher annual withdrawals, subject to some guardrails so that annual payments are more variable (and might even be lower than the 4% rule generates in certain years). The conclusions are shown in Figure 1.

So why not annuitize? One reason is that annuity rates are pretty low these days because interest rates are low. But current bond rates are also low, and with bonds you may end up running down the bond ladder before you die.

Another reason is poor health. If you don't think you are going to live to your expected mortality, then annuities are a bad deal. It's also reasonable to pass on the opportunity if you believe you have more than enough resources to last your lifetime – even if you expect to live well beyond your mortality. You wouldn't need the extra protection and may prefer having full control over your assets during your lifetime, and the ability to direct them to who you want after you die.

***Bottom Line:***

There is a large and growing need to translate savings into lifetime income. If you are at risk of outliving your money, are healthy, and don't care about leaving a bequest (or know you have other assets you can leave to your heirs such as your home), then annuities are worth a close look.

On the other hand, if you have a sufficient level of assets, reason to believe you will not reach full life expectancy, or a desire to control your money and earn a potentially higher rate of return, then you may want to pass on annuities as a retirement planning tool.

Figure 1. Average Annual Incomes – Safe Withdrawal Strategies versus Annuitizing

| | **Bengen Strategy*** | | **High Withdrawal Strategy*** | | | **Annuity** |
|---|---|---|---|---|---|---|
| Investor | Safe Withdrawal Rate | Average Annual Income | Initial Withdrawal Rate | Minimum Withdrawal Rate | Average Annual Income | Average Annual Income |
| Male | 3.46% | $46,099 | 3.80% | 3.40% | $60,712 | $67,200 |
| Female | 3.36% | $45,691 | 3.30% | 3.30% | $62,133 | $64,200 |

*5% failure rate assumed
Source: Edesess, Michael. "Are Annuities the Best Strategy to Fund One's Retirement**."** *Advisor Perspectives***.** April 1, 2019

[1] Roth, Allen. "An Annuity Hater Revisits SPIAs." *Advisor Perspectives*. January 14, 2019

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