Annuity Ladders

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The collapse of financial markets has left people nearing retirement in a state of high anxiety. Many portfolios took a 40% hit over the past year, and despite the stock market's rebound the crisis is far from over. The market could still go down, and for many clients, cashing out means locking in an unfathomable loss. Even the venerable notion that investing in equities will always outperform bank deposits over time is being challenged.

Enter the concept of laddered annuities. Or perhaps we should say welcome back.

In a recent study entitled Variable Payout Annuities and Dynamic Portfolio Choice in Retirement, Olivia Mitchell, a professor of insurance and risk management at the Wharton School of the University of Pennsylvania, argues that by laddering the purchase of annuities-buying annuities gradually over time, while keeping the rest of a portfolio invested in a mix of equities and bonds-people can substantially increase the likelihood of meeting their retirement income goal. They can also "do almost as well as the fully optimized outcome if they hold variable annuities invested 60/40 in stocks/bonds."

"What we've found in this and earlier studies is that people facing retirement want guaranteed income, and they also want liquidity, so purchasing annuities over a period of time, even into retirement, makes sense," says Mitchell, who doubles as executive director of the Pension Research Council at UPenn and coauthored the study with three scholars in the finance department at the Goethe University of Frankfurt in Germany.

BUILDING THE LADDER

Annuity ladders share an advantage with bonds, notes Goethe University's Raimond Maurer, a co-author of the study. You reduce the risk that interest rates—and payouts—will be low at the time of purchase.

"When you ladder the purchases, you can buy in different interest-rate environments over time," Maurer says. When interest rates are particularly low, as they are at this writing, a client might put off a laddered purchase altogether.

Here's how the laddered investment approach works. Say you have a couple, each of whom are 60 years old, who plan to retire at age 66. They have $200,000 in savings. For starters, they buy a $14,000 cost-of-living-adjusted immediate annuity, leaving the rest of their funds invested 65% in equities and 35% in bonds. Every year, until they are 66, they purchase another annuity until the combined payouts reach their income goal. At that point, if the equity and bond markets continue to perform at even close to historical norms, the couple will still have a substantial sum invested in securities in addition to the annuities.

Jerry Golden, president of MassMutual's income management strategies division, suggests this hypothetical scenario. Assume your client is a 64-year-old widower-let's call him "Joe the Retiree." In October 2007, Joe had $1 million in assets, two grown children, six grandchildren and a pressing desire to retire at 65. Joe invested 65% in stocks and 35% in bonds, hoping to withdraw $40,000 a year in retirement. He planned to give himself a 3% annual raise to account for inflation.

By October 2008, of course, Joe's investments were a disaster. His stocks were down 38.1% and his bonds down 9.1%, leaving him with just $719,850. Had Joe left matters alone, he would be facing a 32% chance of exhausting his resources by age 86 (his life expectancy).

But suppose, back in October, Joe had taken a third of his assets, or $237,551, and purchased an inflation-adjusted income annuity that accepted multiple premiums of $17,141. He then could risk shifting the balance of his assets into equities and draw the remainder of his $40,000 target income from that portfolio as required. Each year, for nine years, he would buy more annuities, reaching his required payout of $40,000 per year in nine years. At that point, Golden says Joe could have well over $500,000 for his heirs-even more if inflation stays under 3%.

WORKING THE PORTFOLIO

Conventional wisdom has been to invest client portfolios in a mix of both equities and bonds, with equities providing the long-term growth, while bonds dish up security, predictability and income. According to this model, the portfolio's allocation shifts more weight into bonds as retirement approaches. But many risk-averse retirees are wondering if they can follow conventional wisdom anymore.

"Annuity laddering using payout annuities is particularly effective relative to investment-based strategies," says Chris Rahm, leader of the retirement income practice at Ernst & Young. Rahm notes that with the annuities acting as a client's most conservative investment, "if you were an aggressive advisor, you could argue that the client could move more invested assets into equities."

Golden agrees that advisors can purchase immediate annuities to play the role of bonds, while leaving the remainder of a client's funds heavily invested in equities. Clients who follow this strategy can gradually build guaranteed income while maintaining liquidity and even growing their assets overall.

An added advantage of laddering annuity purchases is that as the buyer ages, the "survival credit" keeps getting higher. Essentially, the older the buyer of an annuity, the higher the payout for a given premium, Mitchell explains.

Golden has back-tested laddering, examining 181 different time periods between 1965 and 2006 and comparing several annuities strategies to a typical stocks-and-bonds investment strategy. In almost every case, he reports, the annuity strategy outperformed stocks and bonds.

While buying even a single immediate annuity at the outset proved better than investing purely in stocks and bonds, Golden says that the laddered approach tripled the original deposit by the end of the test period, on average. Laddering gave superior results regardless of the economic environment or the period selected, he adds.

"Laddering annuities does allow retirees to stay longer in equities," agrees Tom Modestino, a senior analyst at the Boston-based financial research firm Cerulli Associates. "And that's a good idea."

The main downside to annuities is their complexity. "The financial advisor has a lot of explaining to do to the client," Rahm points out, noting that when a client buys an immediate annuity, the payment is a premium, not an investment, and is no longer an asset controlled by the client. "It may not be what they are used to."

But there are positives to the strategy that also need to be explained because they may not be obvious. "People need to know that with this approach you end up with more liquidity, and at the same time you are eliminating two other big retirement investment risks-volatility and timing."

Lisa Plotnick, associate director at Cerulli, cautions that while she likes the idea of laddering annuity purchases, it might not be wise to be locked into one issuer. "With annuities, products are always evolving, and you may find better products or more attractive riders offered by different issuers," she says. "Financial advisors should always shop around to look for the best fit for their clients." FP