You Should Live So Long

Adding longevity insurance to a retirement portfolio could ease old-age money worries.

By Ilana Polyak

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If there were no risk of running out of money, retirement income planning would be a straightforward affair: Save a certain amount and then spend it until you die. There would be no need for Monte Carlo simulations or great debates about the optimal withdrawal rate that both maximizes income and minimizes risk. But as any advisor who has tried to make this calculus work knows, income distribution is anything but simple.

The biggest challenge is getting a grip on just how long a period to plan for. Will retirement last 20 years? Or will it be 30-or even 40 years? Each of these time frames requires a different plan, yet a retirement income strategy calls for keeping all these periods in mind simultaneously-so that retirees have enough money to make it to the final stretch, without having to scrimp unnecessarily during the early years.

One way to bring some certainty to the equation is longevity insurance. Offered only since 2005, the product can protect against living a very, very long time by providing income at the tail end of retirement.

UNDER THE HOOD

Longevity insurance is a combination of an immediate and a deferred annuity, known as a single-payment deferred annuity. As with an immediate annuity, the premiums are generally paid in one lump sum. This is typically done at around age 65. But similar to a deferred annuity, payments don't begin until some point in the future, usually at age 85. Women receive a smaller amount of income from these annuities because of their longer life expectancies.

In its simplest form, longevity insurance offers a retiree something other income distribution schemes don't: the availability of assets late in life. That's the time when nest eggs are close to depletion or seriously drawn down. "It's not as if at age 85 you can tell your client to go get a job because they don't have enough money for retirement," says John Diehl, president of The Hartford's retirement solutions group. "As we age, our options become more limited."

Longevity insurance can also be used to preserve a policyholder's estate later in life. As medical expenses are sure to build up in the late years of retirement, a policyholder can use the income the longevity insurance provides to pay for medical bills and prescriptions while preserving his or her estate.

Many academics have taken to the idea of longevity insurance, as an innovative new option in the ongoing pursuit of retirement income. "If you live long enough, it could turn out to be the best fixed-income investment you've ever made," says Michael Kitces, director of research at Pinnacle Advisory Group in Columbia, Md.

That depends on how long the policyholder lives, though. After all, policyholders who die before the trigger date lose their entire investment. But while these policyholders never receive a return on their investment, they subsidize the income of those still living. Living just two years beyond the annuitization date would allow the annuity holder to recoup his initial investment. Those who live into their nineties do even better.

IT CAN BE CHEAPER, TOO

It takes a substantially smaller amount of money to fund later retirement with longevity insurance than other options, Jason Scott, managing director of Financial Engines' Retirement Research Center, found in a recent report. "You could set aside the money to self-insure against longevity yourself," Scott explains. "But it would only cost you about half as much to buy an immediate annuity at age 85, and just half of that to buy the longevity insurance at age 65 to kick in at age 85."

Here's an example of Scott's calculation using real dollar amounts: Your client could keep an additional $100,000 in reserve for late-life income needs, or he could spend $50,000 on an immediate annuity when he reaches 85. Or, he could commit $25,000 to longevity insurance at age 65 for income needs beyond age 85.

INSURANCE FOR HEALTH NUTS

Clearly, longevity insurance doesn't end up being profitable for people who live only a normal life expectancy. At age 65, only half of an insurance pool is expected to live to 85.

For that reason, consumers and their advisors have been lukewarm toward the product. Even insurance agents aren't pushing it, and longevity insurance sales are said by most industry analysts to be "sluggish" at best. "My clients are really reluctant to take a chunk of money and give it to an insurance company for 20 years," says Steve Podnos, a certified financial planner in Merritt Island, Fla. "If you die, you lose that money."

But health nuts might think about it differently. In general, people who buy annuities are about 10% healthier than the general population-they have an inkling that they'll do well, according to Moshe Milevsky, associate professor of finance at York University in Toronto, who studies annuities as a way to hedge longevity risk. "It's sort of the reverse of life insurance," notes John Olsen, a financial advisor in Kirkwood, Mo., "where the shorter time you live the more you get out of the policy." For that reason, Olsen does not recommend the product for anyone who is in poor health or for whom longevity does not run in the family.

But people tend to underestimate their own longevity. In fact, the over-85 crowd is the fastest-growing segment of the population, according to the National Institute of Aging. That group is expected to grow by 233% by 2040, compared with 33% for the rest of the population.

PREDICTABLE PLANNING

Longevity insurance can also make retirement income planning easier. Many of your clients may have enough money to finance a 20- or 25-year retirement-but a 40-year span? That stretches the saving and planning abilities of even the most prepared.

"Longevity insurance dramatically changes the paradigm of retirement income planning because with retirement you have two imponderables, which is why it is so tough to do," Olsen says. The first is what future investment returns will be. The second is how long a period to plan for. "If you remove the second one, then retirement becomes a period-certain problem."

It also means that retirees can take out more money early on and take on additional investment risk. "Typically clients underspend their retirement income because they worry about how they will fund the tail end of retirement," says Richard Lindsay, senior vice president with Symetra Financial's life and annuity division in Bellevue, Wash., one of the few firms that sells longevity insurance. "They then die with more legacy assets than necessary."

But if a portfolio needs to last for just 20 years, there is no reason not to spend more in the early years, says Christopher Raham, a longevity expert with Ernst & Young in New York City. Retirees would no longer need to hold significant assets in reserve just in case they live a long life. They could confidently spend more in their early retirement years, knowing they will be replenished at a predetermined point in the future.

In fact, Raham says that many retirees would be able to boost their withdrawals by 20% to 30% during those early years if they had longevity insurance in place. "If you assume that 4% to 4.5% is a safe withdrawal rate, with inflation adjustment that will meet income requirements in 95% of cases, now you're talking about a 6% withdrawal rate," he says.

OVERCOMING OBJECTIONS

Introduced less than five years ago, longevity insurance is still in its infancy in terms of development. Only a handful of companies offer the product, including MetLife, The Hartford and New York Life.

Longevity insurance doesn't just compete with other annuity products, either. In fact, it competes with all types of retirement income planning strategies, from bond laddering to the bucket approach to a straightforward withdrawal rate. Financial advisors have spent years honing their knowledge of these methods, so it's no surprise that most haven't rushed to adopt something new.

If Tom Orecchio, president of Modera Wealth Management in Old Tappan, N.J., is any indication, it may be quite some time before longevity insurance makes inroads in retirement income planning. "We don't want to enter any insurance market until it's robust," he says. "It would be like entering the long-term-care insurance market 25 years ago, before all the kinks were worked out."

Financial Engines is currently exploring how it can incorporate longevity insurance into its retirement models. The firm, based in Palo Alto, Calif., hopes to make recommendations for retirement income planning with the products soon, Scott says.

The biggest objection that most advisors have with the product is the risk of losing one's entire premium. The insurance companies have responded with a return-of-premium feature and death benefits, but introducing liquidity erodes the value of the insurance. It can cut the benefit by about half.

"[If you buy the death benefit] you are betting on two contradictory and mutually exclusive outcomes, that you're either going to die early or live a long life," says Olsen. It's like wanting your cake and eating it too.

Milevsky likens longevity insurance to a homeowner's policy. "You get absolutely nothing if your house doesn't burn down," he says. "But if it does burn down, you'll pay 10 times as much to replace it than you paid into the policy."

Still, not everyone can get past the "use it or lose it" aspect. Podnos, the Florida planner, for example, says he prefers deferred annuities because if clients die before annuitizing, their heirs can receive a death benefit. Or they can ask for their investment back without ever annuitizing it.

Then there is the issue of inflation. An income stream you buy today may not be adequate 20 years from now, especially given the bottomed-out interest rates we have these days. Most of the products offer an inflation rider of 2% to 6% to begin once the income stream starts. However, inflation indexing, analagous to the method used for tallying Social Security payments, has not yet caught on here.

"That's a significant problem," Kitces notes. "Even if I can target my payout at 85, it may not be enough money to pay my bills at 95 or 100."

The solution may be to keep additional assets in reserve as an inflation hedge, though that defeats the purpose of longevity insurance planning. Another possible fix is to ladder insurance policies to begin at different points in time. A retiree might purchase the bulk of the payment stream to start at age 85, and then smaller amounts to kick in at later dates.

For longevity insurance fans, however, these objections illustrate the main flaw in most consumers' reasoning: The product must be viewed as insurance first and foremost, they insist, not as an investment.

"It is nothing like an investment," Olsen says. "It is a pure risk-transfer strategy."

Clearly, longevity insurance has a long way to go before it begins cropping up in retirement portfolios. But as the battle for retirement income presses on the boomer generation-and clients scramble to recover the losses they suffered during the downturn-these products could, one day, become a popular tool in advisors' arsenals.