Life and Health

Top Story: The deferred income annuity is a hybrid worth considering

By WARREN HERSCH

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Might a product that offers a guaranteed future income stream, one that can be bought at a fraction of the cost of a single premium immediate annuity, appeal to some clients? If so, then the deferred income annuity might be an option.

“Two features of the deferred income annuity make it a potentially very attractive alternative to other products,” says Curtis Cloke, a financial advisor at Two Rivers Financial Group and chief executive officer of Thrive Income Distribution System, Burlington, Iowa. “First, there is an accumulation period, which is not typical of an income annuity; and second, there is a distribution period.”

The deferred income annuity (also called a “delayed income” or a “deferred immediate” annuity) is thus a happy cross between the single premium annuity and the conventional deferred annuity. The DIA encompasses so-called “longevity insurance”—products that commonly annuitize at age 85, and sometimes in earlier years.

As with a SPIA, the deferred income annuity secures, in exchange for a single premium, a guaranteed lifetime income stream that starts at a fixed date (within the first 13 months). But like a deferred annuity, the product also provides a cash value component that grows until the income start date. At a minimum, the cash accumulation period is more than 13 months beyond the date of initial deposit.

Why is such a hybrid product advantageous? The product’s contract guarantees, low cost and the control it affords clients are three key attractions, sources say.

As with a SPIA, the income guarantee is unaffected by fluctuations in market interest rates. And like a SPIA, the contractually guaranteed rate of the DIA is based on current mortality tables and rates. The insurer can offer the guarantee because the date of annuitization is known in advance.

Contrast this guarantee with that offered on conventional deferred annuities. These products offer a guaranteed rate for an initial period, after which the client earns interest at the prevailing market rate or the minimum guaranteed crediting rate, which typically is 1.5% or 2%, observers say.

As for costs, the DIA’s future guaranteed income requires a substantially lower outlay than that required of a SPIA.

“Depending on the desired death benefit, clients can insure the tail [income during the final retirement years] with perhaps 15% to 20% of their investment portfolio,” says Rich Lindsay, a senior vice president at Symetra Financial, Belleview, Wash. “By comparison, a SPIA could require 65% or 70% of a portfolio to achieve the same result.”

The difference between these amounts—a liquid portion of the retirement portfolio over which the client retains control—can be invested in stocks, mutual funds, bonds and other growth vehicles. And because future income needs are assured by the DIA, the client needn’t be concerned about withdrawals made against the growth portion. Without a DIA, sources say, such withdrawals could ultimately leave the client’s portfolio depleted because of the effect of reverse dollar-cost averaging (i.e., withdrawing from a fund while it’s experiencing negative investment returns, which can use up the fund a lot sooner than when it’s enjoying positive returns).

“Because the client can separate the retirement portfolio into two parts—one portion to purchase the DIA that will provide a guaranteed future income stream, and a second part to invest for growth, it’s a powerful income planning strategy,” says Garth Bernard, CEO of Sharper Financial Group, Boston, Mass., and president of Thrive Income Distribution System. “That’s because the growth portion is no longer impacted by withdrawals from the portfolio.”

The ideal client is someone within five years of retirement age (before or after), according to industry experts. This is a retirement planning "danger zone,” they say, because, absent a guaranteed income stream, pre- or post-retirees may not be able to meet income planning objectives if their portfolios take a hit due to a market slide.

Depending on their financial situation, clients might also consider incorporating a DIA into an annuity laddering strategy, experts say. Example: Pair the product with a variable annuity that offers a guaranteed minimum withdrawal benefit; then, when the VA account balance runs out after, say, 15 years in retirement, the DIA kicks in--and with potentially high, equity-like returns.

The longer the period of deferral, the higher the guaranteed payout rate will be, sources point out, citing mortality credits as a chief factor.

But sources caution that clients need to bear in mind the potential consequences of deferring annuitization for a long period. Should they die before payouts begin, the investment may be lost.

Clients thus need to factor in their health and the likelihood that they’ll live to an advanced age. If the product is deemed suitable, says Lindsay, they can hedge against the risk of an early demise by purchasing an optional death benefit. While reducing the payout, the rider will assure that unpaid benefits will pass to surviving beneficiaries.

Also to be weighed, say Lindsay, are tax ramifications associated with required minimum distributions.

"Depending on the deferred income annuity, you may be able to use some of proceeds to pay RMDs," says Lindsay. "But that does affect future payment streams. So the advisor needs to consider tax and RMD issues associated with these products."