

M O N E Y M A N A G E M E N T

Income Annuities Can Create Stability In A Sea Of Investment Volatility

By Bill LaVanne

Would you advise your clients to swim across a river in which half of the swimmers who made the attempt drowned?

Of course not. Yet many seniors use investment and income-taking strategies that put themselves at a similar level of risk for outliving their retirement savings. This article looks at a better alternative—income annuities.

The stark reality is that four in 10 Americans over age 60 will experience poverty in their later lives, regardless of their current economic circumstances. One in two will experience near-poverty, according to a May 2001 report from AARP ("Beyond 50—A Report to the Nation On Economic Security").

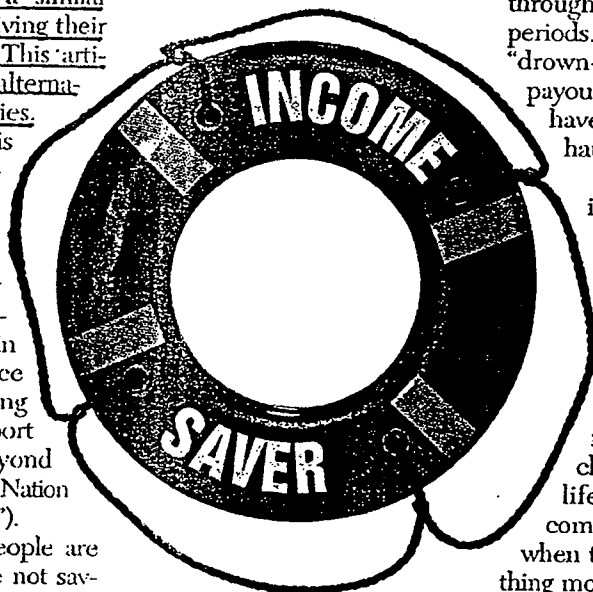
Why so many? People are living longer. They're not saving enough for retirement. Many are entering retirement in debt. Traditional lifetime pensions are disappearing. And many will encounter unplanned expenses and or engage in unchecked spending. These are all troubling trends facing today's retirees.

One of the biggest mistakes retirees make is to believe that the sound investment strategies used for building a retirement nest egg are also the best investment strategies once they begin taking income from their assets. Seniors who plan to rely on their assets, but who lack a long-term strategy, face a risky proposition.

Retirees might be tempted to keep their nest egg in equities. After all, stocks have historically averaged an annual

return of about 10%. Keep in mind, however, this is only an average: the stock market doesn't actually return 10% each and every year.

Although equities are long-term investment tools, too much reliance on them for income can create problems.



Here's why:

While dollar-cost averaging is a time-tested tool for accumulating assets, reversing the process (i.e., withdrawing income) can have a devastating effect on a stock portfolio. During a bear market like today's, retirees are sometimes forced to make up lost income by selling more stocks at the worst possible time: when values are at their lowest. For many retirees, losses incurred during down markets are often more than what can be made up during future bull markets.

Indeed, various studies that have looked at market performance for all 25-year periods between the mid-1940s and today have found

that an all-stock portfolio would have only been able to maintain a 10% income stream about half the time.

In other words, half of retirees operating under this scenario would have been unable to maintain any level of capital greater than zero throughout any of the 25-year periods. Thus, the proverbial "drown-ing." Even at lower payout levels, retirees would have run the risk of exhausting their savings.

Bonds significantly improve the possibility of stabilizing incomes at lower payouts (5% or less) vs. equities, but with a trade-off: Lower risk equates to lower returns. Bond portfolios lack resilience in that the chance of maintaining a lifetime stream of income drops significantly when the retiree draws anything more than 5%.

Investment professionals are forever searching for a magical balance of bonds and equities that will ensure our clients can enjoy a lifetime of income.

What is the solution? Throw retirees an "income saver." Let's take a simple example of a husband and wife, both aged 65, with \$1 million in investable assets. You could put 30% in equities and 70% in bonds. If you take out 5% every year, they would get about \$4,200 per month. The portfolio still holds all the market risk any portfolio faces, as well as an increased inability to handle the stress of additional distributions in the future.

Another alternative is to put \$715,000 into an income



annuity with a 20-year period certain. If the plan were set up in mid-January 2003, this would have guaranteed an income stream of about \$4,200 per month for as long as either spouse lives. (Note: actual payout varies by insurance company and date of quote.)

That would leave the couple with \$285,000 to invest with a longer-term strategy without the worry of market volatility or dollar-price erosion.

If you go back to the original assumption that equities will perform well over time, then, at the end of 20 years, the remaining \$285,000 could reasonably grow to \$1.1 million (assuming a 7% after-tax return). That would more than replace the original \$1 million principal.

The reality is, many retirees do a poor job of managing the large chunks of money they receive through a pension plan or a 401(k) plan. This is so even of wealthy clients.

Income annuities are smart money-management tools. Retirees won't have to worry about market volatility decimating their portfolio or making decisions that can destroy the long-term prospects of their income stream. Most importantly, with an income annuity, they gain income protection that lasts a lifetime. **NE**