Motley Fool http://www.fool.com
Rule Your Retirement Newsletter

July 2010 Issue

Perfect Your Portfolio: Can You "Guarantee" Your Retirement?

Retirement can be a risky endeavor -- both planning for it and living in it. While you're working, you hope you're saving enough (and earning enough on those savings) to one day bid the boss *adieu*. Once you retire, you hope the amount you saved will last longer than you do. But after two brutal bear markets in less than a decade, stagnant wage growth, record-low interest rates, and a spike in unemployment, many retirement plans seem to be on shaky ground. Is there any way to add more certainty to the process?

Why, yes there is, says the insurance industry, which has come up with a variety of products referred to as "annuities." However, calling something an "annuity" is about as specific as telling someone at a hardware store that you need a "tool." Several types serve different purposes, and you can add various optional features for an additional cost.

Annuity sales are on the rise, as investors flock to the waiting arms of insurance sales-folks eager to explain the "guarantees" their products offer. While many of these products provide more hype than help, some types of annuities do make sense for some investors. To help you determine whether a given flavor of annuity is right for you, in this article we'll review the major types. In next month's issue of *RYR*, we'll delve deeper into some specific products.

For Retirees: The Single-Premium Immediate-Income Annuity

This is the oldest form of annuity: You hand over a lump sum to an insurance company, and it agrees to send you a check every year (or month, your choice) for the rest of your life. Your involvement ends there; the insurance company makes all the investment decisions. This is also the kind of annuity that we think every retiree should consider, especially those who won't receive a defined-benefit pension. One of its biggest benefits is that the check always shows up in the mail -- regardless of what happens in the markets. Such a secure source of income can provide plenty of peace of mind.

The other benefit is that the income lasts forever, or at least until the investor dies (whichever comes first). Thus, income annuities not only mitigate investment risk, but also longevity risk -- the chance that you'll outlast your nest egg.

Sounds great, right? So what's the catch? Well, after your death, the money's gone. Let's say you give the insurance company $100,000, and it agrees to send you $7,000 a year. You receive one check, but then check out. Well, them's the breaks. The insurance company keeps the other $93,000, most of which will be used to pay the annual income benefits of those who outlive the averages.

That sounds pretty harsh to most people, so they opt for an income annuity that provides a benefit to the spouse if the annuitant (the person who bought the annuity) dies, or a "period certain" feature that continues to pay checks to heirs if the annuitant dies within a certain period (e.g., 10 or 20 years). Such a feature can make income annuities more palatable to retirees, but the flip side is a lower annual benefit.

Finally, most annuities don't adjust for inflation. Thus, the benefit loses purchasing power each year. Many companies do offer annuities with payouts that increase annually -- either by a set percentage or according to the Consumer Price Index -- but that, too, will result in a lower initial amount.

The table below indicates how much annual income an insurance company would pay, based on a $100,000 investment and various features:

65-Year-Old Male	65-Year-Old Female	Married Couple With 75% Benefit to Surviving Spouse	65-Year-Old Male With 10-Year Period Certain	65-Year-Old Male With 20-Year Period Certain	65-Year-Old Male With Inflation Adjustment
$7,092	$6,490	$6,038	$6,790	$6,072	$5,160

Source: Vanguard Lifetime Income Program quotes

For Those Not Yet Retired: The Tax-Deferred Annuity

A tax-deferred annuity is similar to a traditional 401(k) or IRA. You save while you work, making the investment decisions yourself from among the offered options, and then make withdrawals after you retire. Contributions aren't tax-deductible, but you don't pay taxes on the growth of the investment until you make withdrawals, which are taxed as ordinary income. (The portion of each withdrawal that is attributable to the money you invested comes out tax-free.)

With a tax-deferred annuity, you can withdraw as much as you like, whenever you like (the exception is for an annuity with "living benefits" -- more on that later). However, if you run out of money, you're out of luck. You can also decide to "annuitize" the amount you saved, converting the tax-deferred annuity into a single-premium income annuity that will pay income for life.

The investment within the annuity depends on the type you choose. Here are the three major options:

Fixed annuity: The insurance company pays a fixed rate of return. Often, the rate is only fixed for a certain period, after which it's based on prevailing interest rates.

Variable annuity: These are even more like a traditional 401(k), in that the investor can choose from among several "sub-accounts" (essentially mutual funds in an insurance wrapper). And, as with your 401(k), the return depends on the investments you choose and their subsequent performance.

So where's the "guarantee"? Your heirs will receive at least the amount you invested (minus withdrawals), even if the investments are worth less when you die. Certain varieties of the variable annuity have more guarantees (at higher costs); we'll get into those later in this article.

Equity-indexed annuities: With these, the investor's return is based on the performance of an index, such as the S&P 500, with a guaranteed modest minimal return. However, the key word there is "based," since the returns are actually calculated by a formula (say, 80% of the index's return, excluding dividends, with a cap on the maximum return). Then, of course, costs have to be subtracted. These formulas can be very complicated, and they often aren't clearly explained by insurance salespeople. Suffice it to say that anyone who tells you an equity-indexed annuity "provides all the upside of the stock market but none of the downside" is, in Biblical terms, bearing false witness. That's not to say these products are a bad choice in every circumstance, but they do require serious investigation.

The Hybrid: Annuities With "Living Benefits"

As baby boomers move into retirement, the annuity industry has begun to offer products that focus less on accumulation and more on "decumulation" -- the gradual spending of what you've spent decades saving.

Knowing that many retirees are reluctant to commit their savings to an income annuity (an often irreversible decision), the industry has developed products that provide some guaranteed income yet allow investors some (restricted) access to their money. These features, known as "living benefits," are essentially riders (the insurance-industry term for "extra features") added to a variable annuity at additional cost.

Following are general descriptions of the most common living benefits. Keep in mind that insurers add their own twists (and names) to these features, so the actual terms and details of the riders will vary from company to company.

Guaranteed minimum accumulation benefit: Regardless of what happens in the markets, the annuitant receives a guarantee that the annuity will be worth at least the amount invested (in some cases, more) after a certain period of time, such as 10 years. This benefit costs 0.5% to 1% annually.

Guaranteed minimum income benefit: While the money accumulates, the investor is guaranteed a fixed rate of return (such as 5%) or the return earned by the underlying investments (after expenses), whichever is greater. After a period of years, usually 10, the contract must be converted into an income annuity. This feature generally costs 1% a year.

Guaranteed minimum withdrawal benefit: This feature allows investors to withdraw at least the amount they invested, even if the value of the annuity has declined. Let's say a retiree invests $100,000 in a variable annuity with a 7% guaranteed minimum withdrawal benefit rider. She will be able to withdraw at least $7,000 annually for 14.2 years (getting her $100,000 back), more if the underlying investments grow. The cost of this benefit is 0.5% to 1% a year.

Guaranteed lifetime withdrawal benefit: This is similar to the previous benefit, except that it sounds even better: The withdrawals continue for life, regardless of investment performance. However, this feature costs more -- 1% to 1.5% a year -- and withdrawal is usually limited to 5% or so, whereas annuities with the guaranteed minimum withdrawal benefit can allow annual withdrawals as high as 12%.

Guaranteed lifetime hair benefit: Unfortunately, this one doesn't really exist.

Sounds Good, But ...

Before you grab your checkbook and run out to your local insurance agency, keep a few points in mind.

First, the price of these benefits is on top of the usual annual investment expenses (1% to 1.5%) and insurance charges (1% to 1.5%). Add a living benefit rider and you're looking at 2.5% to 4% a year -- meaning the investment will need to earn that much just to break even.

Second, choosing an annuity usually means tying up your money for a long time -- from several years to the rest of your life. If you take the money out early, you could pay "surrender charges." Also, as with traditional tax-deferred retirement accounts, withdrawals from deferred annuities before the annuitant turns 59 ½ can result in a 10% tax penalty.

Still to Come

Now that you have a general idea of what annuities offer, join us next month as we pull back the curtain, reveal what's behind some real-life products, and figure out which (if any) is right for you.

Finally, you may have noticed that we often put quotation marks around the word "guarantee." That's because the promised benefits of an annuity are only good as long as the insurance company is in business. (Each state does have an annuity guaranty fund, which insures at least $100,000 to $500,000 of annuity assets, depending on the state.)

If you decide to purchase an annuity, look for a company rated A or better by ratings agencies, such as Fitch, Weiss, or Standard & Poor's. These agencies aren't perfect (they did rate mortgage-backed securities to be as safe as Treasuries), but their ratings are the best indication available of whether a company will be around to pay your future benefits.