Today's retirees and soon-to-be retirees are facing more challenges than ever. To begin with, the average life expectancy of Americans today is nearly 30 years greater than it was a century ago. A man of age 65 today has a 50-percent chance of living beyond age 83 and a 25-percent chance of living beyond age 92, while a woman of age 65 has a 50-percent chance of living beyond age 85 and a 25-percent chance of living beyond age 94. Adding to the longevity challenge is the rising cost of health care. According to the Centers for Medicare and Medical Services, the out-of-pocket healthcare costs as a percentage of the average Social Security benefit are rising, from 7 percent in the 1980s to an expected 41 percent in 2030.

Just as more retirement income security may be needed to prepare for longevity and healthcare issues, today's Americans actually are not faring as well in terms of retirement income sources compared with previous generations. A 2006 USA Today article reported that the unfunded federal debt obligations for Social Security and Medicare total more than $263,000 per household. There is a genuine worry that Social Security will be depleted in the near future. Meanwhile, defined benefit pension programs are disappearing and are being replaced with defined contribution programs such as 401(k)s and individual retirement accounts (IRAs). In 1983, there were more than 175,000 defined benefit programs and fewer than 17,000 defined contribution programs. In 2008, however, the number of defined benefit programs has stayed almost constant, rising to not quite 25,000, while the number of defined contribution programs has risen to 650,000.

Today’s Americans no longer can rely on Social Security or employer pensions to support their retirements. They have to carefully manage their 401(k)s or IRAs in the hope that they can make regular withdrawals to provide an income stream in retirement without outliving their funds.

### Annuities as a Hedge against Longevity
If we’re living longer, and spending more on health care and other expenses in retirement, it would appear that we don’t have a chance to save enough to live on after we retire. This is precisely why we should look to a different investment vehicle: the annuity. Annuities have become a much more popular retirement-planning tool, and this trend is expected to continue.

We might think of annuities as the flip-side of life insurance. While life insurance can be used as an investment mechanism, its primary purpose is to guard against the possibility that I might die earlier than expected and the income stream that I provide for my family and dependents will dry up too soon. Accordingly, life insurance protects us against such a scenario by providing for those we leave behind in case of such a tragic event.

But what if we die later than expected? While a long life is not a tragic event—quite the opposite—it does place an unexpected strain on retirement savings. If I have saved enough to live at my desired standard of living until I reach age 90, and then I live to age 100, that means 10 years of difficult times. So, the annuity’s primary purpose is to guard against the possibility that I might live longer than expected by guaranteeing me a regular source of income as long as I live.

I will discuss several variations on this theme, as well as several possible concerns with annuities, but here’s a sketch of what makes them so attractive. An annuity can be created by contributing either a lump sum or a regular installment, in exchange for which I am promised a periodic payment, to begin upon retirement and to last as long as I live. The risk that I might outlive my savings thus is eliminated.

### Dollar-Cost Averaging and Reverse Dollar-Cost Averaging
The argument I’ve sketched above is the most obvious argument in favor of annuities as a vehicle for retirement planning. But there is a more-overlooked, and ultimately more compelling, reason to prefer annuities. To see this, let’s think about the decumulation as well as the accumulation of our assets.

The savvy investor recognizes the importance of making our investments work as hard for us as possible, and the guidance we offer as investment advisors is directed to this end. When purchasing equities, this means buying more when prices are low and buying less when prices are high. Dollar-cost averaging is a simple but powerful investment strategy that automates the implementation of this idea. The investor contributes the same dollar amount each month or quarter to the purchase of an equity, regardless of the current selling price. The result is that, when the price of the equity is low, the investor will buy more shares and when
the price is high the investor will buy fewer shares. For instance, if the investment amount were $100 per month, this would buy 10 shares when the price were $10 per share, but would buy 20 shares if the price dropped to $5 per share. Without needing to try to time the market to figure out when prices are relatively high or relatively low, the investor has achieved a high degree of efficiency and intelligence in his investment approach.

Now, let’s consider what happens upon retirement. Suppose an investor has purchased equities expecting to sell them off periodically during retirement to provide an income stream to cover more-or-less fixed recurring expenses. But think about the consequences of reverse dollar-cost averaging as a decumulation strategy. While dollar-cost averaging easily allows one to sell high, reverse dollar-cost averaging doesn’t allow one to sell high; indeed, it forces the investor to sell low. For instance, with a withdrawal amount of $100 per month, the investor would need to sell 10 shares when the price is $10 per share to liquidate $100, but he would need to sell 20 shares when the price drops to $5 per share to liquidate the same $100. In other words, when the price of the equity is low, the investor sells more shares, and when the price of the equity is high, the investor sells fewer shares. As a matter of fact, “Starting with the same portfolio, it is not unusual to lose 35 percent to 40 percent of the portfolio life if one retires at the beginning of a bear market instead of a bull market.”

So, rather than letting the work that our investments have done be wasted upon retirement, we might consider the annuity as an alternative investment vehicle. Whether we live longer or shorter than expected, the benefit of the annuity is that it allows our investments to continue working just as hard in retirement as they did before retirement.

General Features, Types, and Cost of Annuities
All annuities provide tax-deferral benefits. As earnings in the annuity grow, the growth is tax-deferred until withdrawal. When it’s time to withdraw funds, payments can be made in a lump sum, systematic withdrawals, or periodic payments guaranteed for life. Some annuities have surrender periods that impose an early withdrawal penalty. Some insurance companies allow up to 10 percent of annual withdrawal without triggering a surrender charge.

In the event of the annuitant’s death, contract values are passed on to the annuity contract beneficiaries, regardless of whether the annuity is still within the surrender period. Most annuities also have death benefit riders that guarantee the death benefit value at a certain level.

Fixed Annuities
Fixed and variable annuities are the two primary types of annuities. A fixed annuity guarantees a minimum interest rate that sometimes can be adjusted. If the interest earnings are calculated based on market indexes but with a certain cap, this is called a fixed index annuity. The surrender periods for fixed annuities usually range anywhere from five to 10 years. Fixed annuities have no mortality expenses or fund management fees, and they are not considered to be securities.

Variable Annuities
Variable annuities, unlike fixed annuities, provide various investment options within the annuity (subaccounts) and therefore are a type of security. Subaccounts are professionally managed; as such, contract owners are charged annual management expenses, approximately 0.6 percent to 1.3 percent. With certain constraints—namely, surrender period, which will be discussed below—and extra costs (0.4–0.7 percent of contract value annually), variable annuities provide living benefit options that guarantee lifetime income benefits without forsaking the contract value. Some variable annuities also provide account value guarantees. Most variable annuities have a surrender period of between four and 10 years. In recent years, however, annuities with no surrender charges have been gaining popularity among financial advisors.

Guaranteed Minimum Withdrawal Benefit
A commonly used living benefit option is the guaranteed minimum withdrawal benefit, which offers a minimum percentage of lifetime income with step-up opportunities. Usually the minimum income percentage is set at 5–7 percent of the contract value annually, depending on the age at which the annuitant starts withdrawal. The step-up features usually have two components: an annual compounding of 6–7 percent combined with the chance to lock in the highest account value every quarter (or even every day), such that the withdrawal benefits can be based on the highest account value possible.

The following is one of the annuity providers’ examples:* Mr. Client, 55-years-old, purchases an annuity with

“Whether we live longer or shorter than expected, the benefit of the annuity is that it allows our investments to continue working just as hard in retirement as they did before retirement.”
$250,000 and elects the optional lifetime income benefit at an additional cost of 0.6 percent of the contract value per year. His annuity reaches the highest daily value during the fourth annuity year. The value then grows at an annual compounded 7-percent rate, which in turn becomes the basis for his lifetime income on the day he takes his first withdrawal. In the 10th year, he starts to make withdrawals and his guaranteed annual income of $29,006 is based on the highest value growth of 7 percent, which is $580,117 in year 10. This value provides him with a basis for lifetime income that is more than $140,000 greater than his account value of $440,008. Therefore, Mr. Client’s lifetime income benefit essentially grows at a minimum rate of 7 percent without downside potential.

Longevity Annuity
The longevity annuity doesn’t pay out until relatively late in life; for instance, when the annuity’s owner reaches age 85. Because of this late payout, a longevity annuity costs considerably less than a regular (i.e., fixed or variable) annuity. According to an article on longevity annuities by Washington Post columnist Martha M. Hamilton, Hartford is one of very few companies that offers such a product. However, when I contacted Hartford for further information on longevity annuities in December 2008, I was told that Hartford has terminated its service line and no longer provides such a product.

Criticisms and Responses
Just like any other financial product, the annuity is not a cure-all. The most common criticisms of annuities are their high fees, default risk, and surrender period. A variable annuity has mortality and expense charges and subaccount fund management fees. If optional living benefits are elected, a total of 2–2.5 percent in fees can be charged to a contract annually, which seems awfully high compared with other types of investments.

These fees are only associated with variable annuities, and are not charged for fixed annuities. While a fixed annuity does not have fees, it does cap the upside potential of the return the annuity owners would have realized had they instead invested in stocks or equities. Also, fixed annuities are susceptible to inflation risk, should the rate of inflation surpass the fixed rate of return of the annuity.

The primary reason that annuities are so expensive is simple: Annuity owners actually are paying a premium to purchase insurance against living too long. The mortality expense and administrative fees are charged, in part, to pay the reinsurance company and the state to make sure that the contract can be fulfilled if the insurance company becomes insolvent. More importantly, the fees are meant to cover the risk involved in providing the guarantees. So the real decision concerning the cost is whether or not it is worth purchasing such insurance. Obviously, the longer one expects to live, the more incentive there is to purchase insurance against the possibility of outliving one’s retirement savings.

From some academic researchers’ perspectives, current annuity pricing actually is low relative to the risks that insurance companies are taking. As the aging population grows over time, many believe that insurers eventually will have to explore other capital market strategies to sustain the current level of guarantee.

Like all insurance products, annuities are subject to default risk. An annuity is backed only by the insurance company from which it was acquired, and it has no governmental guarantee. Should the insurance company become insolvent, annuities contracts are protected by non-governmental state guaranty associations, usually up to $100,000 per nonqualified contract and $250,000 per qualified contract. Investors should therefore exercise special caution in selecting an insurer from which to buy annuities.

The surrender period is another criticism of annuity products. This criticism is much less worrisome now that some variable annuities do not have surrender periods. For annuities with surrender periods, especially fixed annuities, the first question to ask is whether the prospective annuity buyer has enough cash in reserve to avoid withdrawing from the annuity and thereby incurring surrender charges.

An investor without adequate liquidity (i.e., emergency funds) cannot make an annuity a top priority. A good rule of thumb is to have at least six months of cash reserves available before considering any long-term investment or income vehicle; an annuity, of course, is no exception.

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Endnotes
1 See Table 14a: Life Expectancy, By Age and Sex, Selected Years 1900–2004, available at http://www.agingstats.gov/agingstatsdotnet/Main_Site/Data/2008_Documents/tables/Continued_on_page_44
Truncellito

Continued from page 37


3 Dennis Cauchon, Retiree Benefits Grow into 'Monster,' USA Today (May 24, 2006).


7 Note that the account value that the income benefit is based on is not the same as the actual account value in the annuity contract were the contract owner to decide to take the lump sum. The living benefit options only provide a minimum guarantee of the value that the income benefit is based on, not the actual account value.
