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The Case for 'Income Annuities'

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Strategies outlined in a new study could sharply lengthen the amount of time a nest egg survives in retirement.

The study, soon to be released by the University of Pennsylvania's Wharton Financial Institutions Center, finds that so-called income annuities can assure retirees of an income stream for life at a cost as much as 40% less than a traditional stock, bond and cash mix. The study was co-sponsored by New York Life Insurance Co., which sells annuities.

Income annuities are insurance contracts designed to pay back not only a return on investment, but also a portion of the original principal with each payment. The payout occurs over your life expectancy, but if you live longer, you continue to receive payments. Those who die earlier than their life expectancy effectively subsidize those who live longer.

What it means is that retirees who need a nest egg of, say, $1 million, can live the same lifestyle with as little as $600,000 in an income annuity. Looked at another way, $1 million in an annuity will currently generate about $86,000 a year in income for a healthy 65-year-old male, while the same amount invested in a traditional securities portfolio would currently generate between $40,000 and $50,000 annually, depending on the annual withdrawal rate.

That news could offer hope for the millions of workers about to retire with inadequate retirement savings.

"At 65 years old, you're going to need money, on average, until you're 85," says David F. Babbel, an insurance and risk-management professor at the Wharton School who co-wrote the paper with Craig B. Merrill, an insurance and finance professor at Brigham Young University. "But the problem is that 'on average' means half of the people will need continuing income between the ages of 86 and maybe past 100. That's where [retirement-income planning] breaks down."

To ensure that you have a stream of income that lasts for as long as you breathe generally requires an inordinately large beginning value -- and even then, there is no guarantee your account won't run dry, depending upon your ultimate spending needs in retirement.

An income annuity is the only asset class the two professors found that most effectively addresses the risk of outliving your nest egg, because it generates a permanent stream of income, unlike a typical nest egg of stocks, bonds and cash. Meanwhile, the study notes, investors who place retirement wealth in mutual funds "are subjected to greater risk, typically higher expenses, and returns that are unlikely to keep pace with annuity returns, when investment risk is taken into account."

Yet the study also found that consumers have been tepid buyers of income annuities to this point. Many worry about costs, illiquidity in a financial emergency and the bad reputation the industry as a whole is often saddled with because of well-chronicled and dubious sales tactics with some variable annuities.

Prof. Babbel says the insurance industry is addressing these issues by building new contracts that are inexpensive, allow access to cash and don't have the problems associated with other types of annuities. The best strategy, Prof. Babbel says, is to invest enough in an annuity early in retirement to cover basic fixed costs. That allows you to invest the remainder of your portfolio more aggressively.

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