Annuities smart move in long run

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How about a nice, secure lifetime income?

In fact, lifetime annuities may be an unexamined solution for the dilemma millions of Americans face today.

The problem is this: Like it or not, you and I have the responsibility of selecting the amount of income we save. We also have to decide where we save it – 401(k), Roth IRA, taxable accounts. Then we have to decide which assets we'll use (equities, bonds, REITs, etc.). Then we have to select the managers for the assets. We have to do that for all the years we are working. When we retire, we have to continue to do it while making sure we don't outlive our money.

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Due to uncertainties in how much our investments will earn, we're in a constant bind. If we withdraw too much, we'll be broke years before we die. If we withdraw too little, we may enrich the IRS.

Consider this example. In 1995, Fidelity Co-Chairman Peter Lynch wrote an article for Worth magazine in which he asserted you could retire with a 100 percent stock portfolio. You could safely withdraw 7 percent a year for the rest of your life. The basic idea was that stocks returned 11 percent a year. A 7 percent withdrawal would leave enough money "in the pot" to compensate for inflation.

Using historic data, I showed that Lynch was wrong. His idea was a good way to go broke. The safest withdrawal rate was under 5 percent.

Stocks have good and bad years. If you make large withdrawals during bad years, you'll permanently impair your portfolio. Who would want to be withdrawing 7 percent from an all-stock portfolio today?

One side effect is that you need a much larger nest egg. To provide the same income as a 7 percent withdrawal rate, a 5 percent withdrawal rate would require 40 percent more money in your nest egg. Since then, the financial planning community has addressed this issue thoroughly. Their conclusion: A safe withdrawal rate is closer to 4 percent. That means you could need 75 percent more money in your nest egg.

Enter the lifetime inflation-adjusted annuity.

In a paper written for the Center for Retirement Research at Boston College, economist Jeffrey R. Brown pointed out that Social Security retirement benefits represent the only inflation-protected annuity income available. The introduction of TIPS (Treasury Inflation-Protected Securities) in 1997, however, means that private insurance companies now have an inflation-linked asset that would allow them to underwrite inflation-indexed life annuities.

Viewing the current market, Brown points out that very few people annuitize their investments. Payment rates from annuities are lower than you would expect because long-lived people tend to buy annuities. Insurance companies price their products accordingly.

One solution Brown suggests is mandatory annuitization for a portion of the assets in our defined-contribution accounts. This, he believes, would do two things. First, it would reduce the number of elderly people who exhaust their resources. Second, it would create a broad market for annuities based on a cross section of people with average life expectancies rather than above-average expectancies. This would increase the payout rates the annuities could offer.

Research shows that using a portion of your portfolio to buy an annuity income will increase the odds of portfolio survival through your lifetime.

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