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Do Income Annuities Increase or Decrease the Liquidity of a Retirement Income Portfolio?

Investors' value liquidity – it is after all their money, they should be able to take it and spend it where ever they want. However, taking it where they want and spending it where they want are two entirely different things. In this article, we will discuss some of the liquidity options that allow clients to take their money from today's income annuities. We will also show how an income annuity can help increase the liquidity of a broader portfolio of assets in a retirement nest egg.

Income annuities are generally thought of as one of the least liquid investments available. After all, insurance companies pool the assets from a large number of investors in order to provide each client with more monthly cash flow (that's guaranteed for life) than what's available from any other investment. This guarantee cannot be provided without a mutual contractual obligation between the annuity owner and the insurance company to retain money in a pool of funds that ultimately increases the lifetime income for everyone who participates in the same arrangement.

To understand how this works, imagine a group of five ninety-year old women that each put $100 into a pooled fund for one year. Each participant agrees that, should she die her money is to be shared by the survivors in the group. The pooled fund (which is called a tontine) would begin the year with $500 (five women depositing $100 each) and because there's about a one-in-five chance of a 90-year-old woman dying in any year, let's assume that one of these women dies before the year ends. To simplify things, let's also assume that the participants forget to invest this money – they are after all, 90 years old. At the end of the year, the women divide the fund, which still has $500 in it, amongst all the survivors. As a result, each surviving participant would receive $125 ($500/4) and each would have experienced a yield of 25% on the money that they forgot to invest. Clearly, had the woman that died changed her mind and chosen to liquidate her $100 asset (i.e. give it to her estate rather than to the survivors of the pool) no one would have experienced any yield from this investment. Income annuities generate more cash flow in a similar way.

Income annuities generally consist of two parts – a guaranteed portion and a life contingent portion – most contracts are structured as guaranteed for a minimum of X-years or the life of the annuitant(s), whichever is longer. The product provides more guaranteed cash flow for life than any other product because insurance companies "pool" the assets of thousands of policy holders. Clearly, if the contract allowed policy holders to withdraw their capital when they found out that they had a terminal illness, many would; and like the tontine where the dying woman was allowed to change her mind about what happens to her capital, a life annuity that allowed a dying policy holder to withdraw their funds wouldn't be able to generate more guaranteed cash flow than a long duration bond fund.

However, liquidity is important to consumers so insurance companies have found ways to provide the ability to at least partially cash out of their income annuity contracts. A recent CANNEX-LIMRA survey found that 22 of the 39 companies surveyed, including nine of the top ten sellers of income annuities, provide some type of liquidity in their income annuity contracts. The most popular liquidity feature (provided by 17 companies) provides clients with access to the guaranteed payments during the guaranteed portion. In other words, the client has the right to withdraw the commuted value of their remaining guaranteed payments. In most cases (15 of the 17 companies), if the annuitant is still alive at the end of the guaranteed period, she would start receiving monthly payments again and these would be guaranteed to continue for the rest of her life. The same survey

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found that two companies also provide their clients with access to a portion of the life contingent portion of their income annuity; others provide access to their life contingent payments only in cases of financial hardship; four companies allow the annuitant to take accelerated (i.e. early) payments and others provide several forms of return off of the premium.

While income annuity contracts allow more access to cash than they ever have in the past, it would still be unwise to buy an income annuity if the client felt that there was a high probability that she'd want to cash it in.

People save for retirement so that they can spend and consume. Other products may allow more flexibility to withdraw your funds, but do they allow you to spend more money? The answer is NO, because if you spend the funds that are set aside for your essential needs in your retirement, chances are very high that you will end up broke and destitute – an outcome which multiple studies have found that most retirees find this more scary than actual death. In other words, when a client says that they want more liquidity, they're often really saying that they'd like the option to spend more money.

There's no one product that maximizes income while minimizing downside market risk – that's why all retirement income advisors worthy of that title advocate product diversification. However, if the client wants to guarantee a certain amount of income for the rest of her life while maximizing liquidity (i.e., improve the ability to spend as much as possible when she want), then the product that helps maximize this type of liquidity in a portfolio is an income annuity.

By using an income annuity to secure the portion of the client's essential expenses that aren't covered by other lifetime sources of income (Social Security and Pensions), the client will have more money left for other liquid investments which can be withdrawn at any time without compromising the income they need to maintain a dignified life.

Why? Well, let's take an example. Let's say that a 70-year old female client tells you that her essential / non-discretionary living expenses are $27,000 per year but only $15,000 of that's covered by Social Security and Pensions. This leaves her with a gap of $12,000 per year. She asks your advice about how to structure her portfolio so she can withdraw the maximum amount of money at any time without impacting her ability to cover her essential expenses for the rest of her life. According to CANNEX, the $1,000 per month in lifetime guaranteed payments that she needs can be secured for a bit less than $180,000 with an income annuity[1]. Alternatively, if the client were to cover that gap from investments alone and systematically withdraw 4% per year from her portfolio (a withdrawal rate that recent studies have found too high to be safe), she would have to set aside $300,000 ($12,000/.04). Comparing the two, not only does the income annuity provide $120,000 more of the kind of liquidity this client is looking for, it also guarantees the $1,000 per month for life. The systematic withdrawal does not.

So, back to the question, 'Do income annuities increase or decrease the liquidity of a retirement income portfolio?' – The answer is 'YES' – an income annuity does both.

Sincerely,

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