WHY ALLOCATE TO LIFETIME INCOME?

BY DAVID BLANCHETT

There are many uncertainties that should be addressed when building a retirement income plan, such as future market returns, how long retirement lasts, inflation, potential long-term care expenses, etc. While there is not really one single product or strategy that can simultaneously address each risk, one product that can be used to actively address longevity risk, which is the risk of outliving your resources in retirement, is to allocate savings to an annuity that provides income for life.

This piece explores how well a portfolio would potentially do when it comes to matching a given potential income benefit from an annuity and demonstrates why retirees who are especially interested in ensuring they have income for life should consider allocating savings by purchasing a lifetime income annuity.

INCOME ANNUITIES

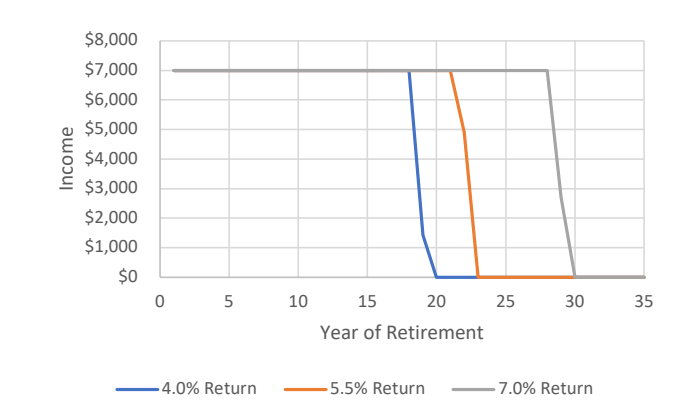
While there are a wide variety of lifetime income annuities today, this analysis assumes the retiree would purchase a single premium immediate annuity as a simplifying assumption. Quotes are obtained for a life annuity with a cash refund provision for a 65-year-old male from CANNEX, which is an online annuity exchange. A life annuity with a cash refund provision ensures that no matter how long the annuitant lives in retirement, he will always at least receive his initial premium back. The best quotes have annual payout rates of approximately 7.0%. In other words, a retiree could covert $100,000 into $7,000 a year of income, that would be paid regardless of how long the retiree survives.

This income level is compared against the potential income matching an annuity payout that could be generated from a portfolio with three different gross return levels: 4.0%, 5.5%, and 7.0%. Note, the 10-year expected geometric return of a portfolio that is 50% stocks, defined as the S&P 500, and 50% bonds, defined as the Bloomberg Aggregate Bond Index, was approximately 5.5% using PGIM Quantitative Solutions Q3 2024 Capital Market Assumptions. The assumed realized return is reduced by 1.0% to reflect advisor and investment fees, so for example, the realized return for the 5.5% scenario is only 4.5%. These are assumed to be geometric returns. Note, the assumed fees for the annuity are embedded in the payout rate, consistent with how payouts work today.

Exhibit 1 includes the income that could be generated from a portfolio. The portfolio with a 4.0% (gross) return only lasts about 19 years, compared to 22 years for the 5.5% return, and 29 years for the 7.0% return. In other words, if the retiree lives more than 30 years in retirement, the portfolio will cease to provide lifetime income.

One notable concern with a lifetime income annuity is that the annuitant would lose the entire premium at death, which could be an issue if the individual passes away earlier in retirement. This “life only” risk is somewhat uncommon, since most annuities include some

Exhibit 1: Matching the Income from an Annuity Using a Portfolio: Constant Returns



Source: Author's Calculations

Exhibit 2: Balances Upon Death for the Various Strategies

Source: Author's Calculations

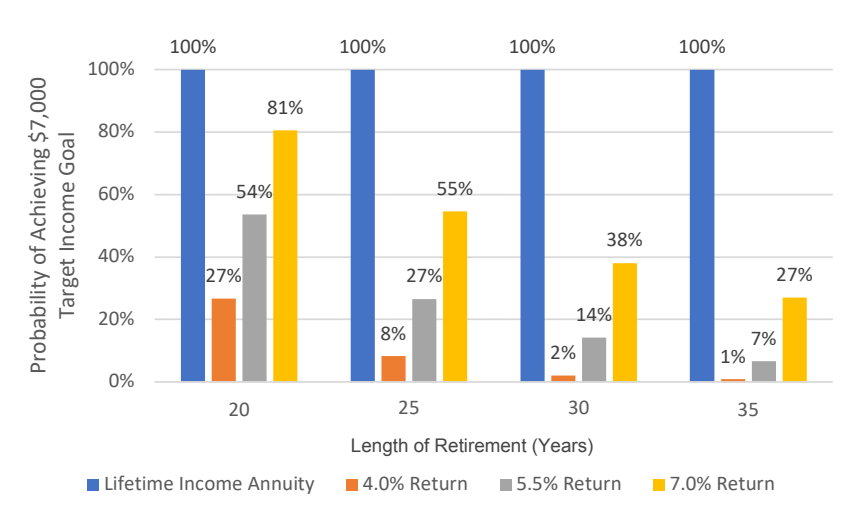
type of return of premium feature, whereby the annuitant, or really their heirs, would be guaranteed to receive some minimum benefit, regardless when the annuitant were to pass away. The annuity modeled for this analysis includes a cash refund feature, which ensures the annuitant at least receives the initial premium back, which is reduced by the annual income benefit received. Exhibit 2 includes information about the balances for the different potential income strategies considered previously.

It is worth pointing out that guarantees aren't free, nor should they be. This is something that Michael Finke and I discussed in an Institute Note for the Alliance for Lifetime appropriately titled "Lifetime Income Guarantees Aren't Free." As such, we can see that while the annuity results in a lower balance than the portfolios, that's effectively the trade for the guarantee for lifetime income, whereby the heirs would (likely) receive less wealth upon the death of annuitant, but the retiree is guaranteed to receive income regardless of how long retirement lasts.

WHAT ARE THE ODDS?

The previous analysis assumes a constant return for a portfolio each year in retirement. In reality, portfolios don't go up by the same amount each year. To demonstrate how volatility could affect the ability of a portfolio

Exhibit 3: Probability of Generating the Target Cash Flow



Source: Author's Calculations

to generate the required level of income, we conduct a Monte Carlo simulation, consisting of 1,000 runs, using the previous returns but assuming an annual volatility level, or standard deviation, of 8.0%. Exhibit 3 includes the probability of the respective portfolios generating the target $7,000 for certain target retirement periods.

We can see that while the lifetime income annuity has a 100% probability of achieving the target cash flow for each of the target periods, the probability of accomplishing the target income amount becomes increasingly unlikely, especially over longer periods for lower portfolio returns.

ACHIEVING THE GOAL

Longevity risk is a very real concern among retirees, whereby many retirees number one concern is outliving their savings. One approach to generate income that is protected or guaranteed for life is to allocate savings to purchase a lifetime income annuity. This piece demonstrates how these products can provide income benefits that are likely to be notably greater than what can be generated from withdrawing from a portfolio, especially with those who are likely to have especially length retirements.

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