Annuities Provide Retirement Alpha Without Beta

The public has yet to be convinced about the value of an annuity-based strategy on retirement income planning. Here is how you can convert the skeptics.

By Curtis Cloke

"More money for less risk." If I had to express in a single statement the one thing all clients want when they entrust their hard-earned money to us, I would choose that statement.

My ability to navigate that trade-off as a retirement income advisor is my No. 1 measure of success. It defines the most important value I can return to my clients in exchange for their business, so whenever I consider various strategies for helping my clients structure their retirement income plan, that tenet is constantly on the top of my mind.

The use of annuities in retirement planning is in a strange state today. Experts and academics in the field consider the use of annuities in retirement income plans to be of absolutely vital importance. However, the current data on how extensively annuities are used in retirement plans tell us that the public has yet to be convinced.

Why is there a disconnect? I can tell you from my experience that annuities have a lot of negative stigmas attached to them. The most pervasive of those stigmas is that annuities are loaded with fees and therefore cannot provide competitive financial returns on investments. I can also tell you from my experience that this stigma is generally unsubstantiated by the evidence. In fact, an annuity can provide significant freedom from fee drag on financial performance, in addition to tax advantages. Annuities can blow the competition out of the water when all of the facts are laid bare. I call the powerful combination of benefits that annuities can deliver "retirement alpha without beta."

Retirement Alpha Without Beta

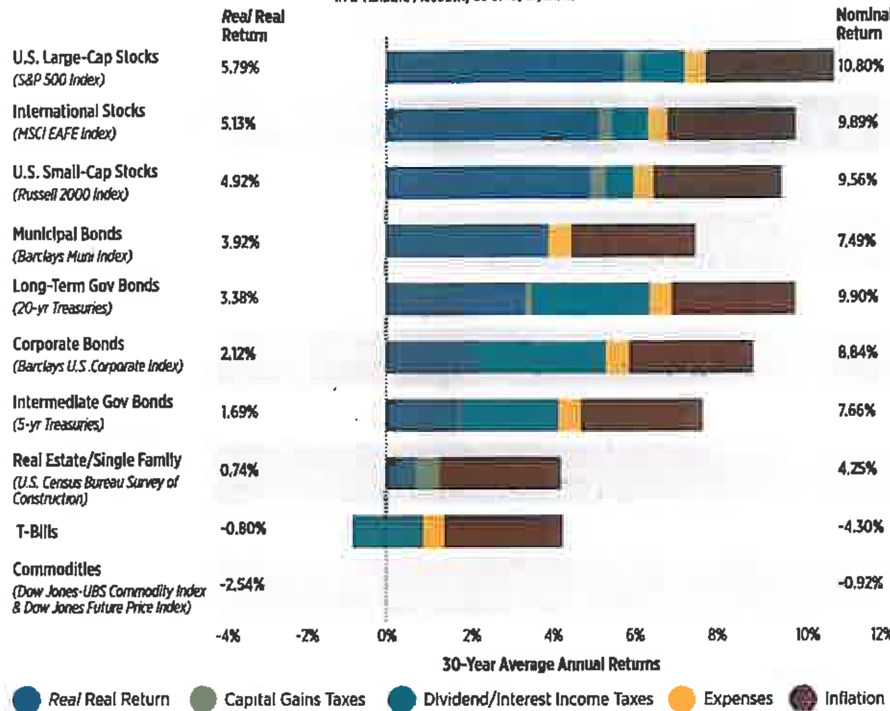
This is a term I use to describe the cocktail of benefits that clients receive when they invest in annuities. The "without beta" part is the easiest to explain: When we talk about annuities, we are talking about life insurance products. These products provide, to varying degrees, contractually guaranteed income.

Alpha can generally be described as the amount of return a person receives in excess of what they reasonably expect from an investment with a given amount of risk.

Unlike a traditional investment, a major contribution an annuity can make toward alpha comes from its ability to generate mortality credits. Mortality credits are the financial returns that life insurance policyholders receive because of risk pooling. They come from the reallocation of premiums paid to members of the risk pool who live longer than others. There is no market risk, no beta whatsoever, in securing those returns.

However, the discussion about the "retirement alpha" provided by annuities should not be restricted only to the financial performance of the annuity itself. Alpha is contextual; it has to do with client expectations of performance given the amount of risk they take. In my experience, clients do not understand that the returns advertised by investment funds, of whatever risk class they want to invest in, are not the same returns they will actually see. This is known as the difference between nominal returns and real returns.

Most financial professionals understand that there is a world of difference between nominal returns and real returns. One of my favorite resources on this topic is Thornburg Investment Management's "A Study of *Real* Real Returns." This publication summarizes an analysis of the performances of different asset indices (large-cap, small-cap, municipal bonds, etc.) over the past 30 years. It compares their nominal returns and the *real* real returns, which are nominal returns net of fees, taxes and inflation. As you can see, there is a huge difference between the rate advertised by investment funds (the nominal return) and the



Source: Thornburg Investment Management, "A Study of Real Real Returns," July 2013

return investors will actually receive (the *real* real return).

If you are going to convince clients of the legitimacy of an annuity as an investment, you must manage their expectations of the performance of the other investment options available to them. All clients understand the emotional benefits of having a guaranteed source of income for life. Most of them grasp the power of annuities in helping to mitigate their exposure to the most potent financial risks in retirement. However, until you educate them further, few of them are able to see that they are getting a competitive "bang for their buck" from annuities from an investment perspective.

The only way to make an apples-to-apples comparison between annuities and index funds is to compare returns net of the effects of fees, taxes and inflation. After you do that, clients can see that annuities can compete not only against ultraconservative investments such as inflation-protected government bonds, but also investments with higher amounts of risk such as real estate and corporate bonds. These returns are not just *possible* when a client invests in an annuity – they are *guaranteed*. That is retirement alpha without beta.

Client Case Study

I illustrate the kind of economic benefits that annuities can provide with a case study based on a real set of clients I had (the names have been changed).

Jack and Jill were a married couple approaching retirement. Jack was 63 years old and Jill was 62. They planned to retire together in three years.

Their assets and income sources looked like the chart below.

Jack and Jill had a desired monthly income in retirement of $11,285 with a 3 percent cost of living increase (COLA) per year. That left them with a monthly income gap (the difference between desired income and current income) of about $1,844 per month. In order to withdraw that much every month from the beginning of retirement until their respective life expectancies, they would have to draw down a total of $1,038,738 from their assets.

ASSETS	
Joint Non-Qualified	$1,174,963
Jack's IRA/401(k)	$679,496
Jill's IRA	$76,288
INCOME	
Jack's Social Security	$2,099/month
Jill's Social Security	$1,059/month
Jack's Deferred Compensation	$1,425/month (1% COLA/year)
Jill's Pension	$4,858/month (3% COLA/year)

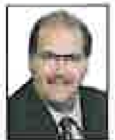
I decided to sketch out a different strategy for them – a strategy based on annuities. I ran an analysis of a scenario where they invested in three tandem buckets of inflation-protected deferred income annuities (DIAs). It turned out that by doing so, they could guarantee themselves their desired level of income by purchasing only $422,299 in annuity contracts. Can you guess which strategy they decided upon?

By using that strategy, I built in inflation protection and a no-fee-drag income investment option, while providing favorable tax-exclusion benefits. In short, I beat a traditional 5 percent assumed-rate systematic withdrawal investment plan (SWIP) strategy in 31 years by $400,000. This is retirement alpha without beta in action.

Clients are smart. They know what they want when they walk into my office: more money for less risk in retirement. But they need my help in knowing how to go about getting it.

My obligation to clients is to consider every strategy with an agnostic mindset. I have to shut out the populist hearsay and take a look "under the hood" at the math and science of those claims. When it comes to the use of annuities in retirement planning, the hearsay is not based in fact. Quite the contrary, it is the traditional investment classes that need to be scrutinized more by the public.

When the problem is framed correctly and fair comparisons are made, annuities are not only competitive, they can destroy the competition when it comes to efficiency in retirement income planning. All thanks to the unique ability of annuities to leverage retirement alpha without beta.



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