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STRATEGIES

Beyond the Longevity Tables

By MARK HULBERT

WHEN financial markets began to plummet two years ago, many retirees faced the very real prospect of outliving their money.

As a solution, many academic researchers have long advocated “fixed life annuities”: investment vehicles that pay a set amount each year until the investor — or, sometimes, a spouse — dies.

These annuities are not to be confused with a range of other products with “annuity” in their names, including many known loosely as “variable” annuities. Most of these other products don’t directly address retirees’ risk of outliving their money. These vehicles also generally exact higher fees. Only a tiny minority of the products sold as annuities in the United States are of the “fixed life” variety, enjoying that academic seal of approval.

Imagine a 65-year-old single woman who has just retired with $100,000 in her retirement portfolio. According to actuarial tables from the Social Security Administration, she can be expected to live an additional 20 years. If she wanted to lock in a return for that period by investing her $100,000 in Treasury securities of appropriate maturities, she could spend $578 a month ($6,941 a year) for the next 20 years, according to calculations conducted for Sunday Business by Jeffrey R. Brown, a finance professor at the University of Illinois at Urbana-Champaign.

The figures are based on prevailing Treasury yields in early October.

After 20 years, she would have no money left. Yet there is a significant probability that she will live for several additional years. In fact, there is a one-in-three chance that a woman aged 65 today will live until at least 90 — or five or more years longer than the actuarial average.
Fixed life annuities address this so-called longevity risk. If this same woman bought a $100,000 fixed life annuity today, she could not only lock in a higher return ($619 a month, or $7,428 a year) but also have it guaranteed until death — no matter how long she lived, according to calculations by AnnuityShopper.com.

Buying Treasury securities of the requisite maturities is one of many possible alternatives to a fixed life annuity. But in simulations conducted by Professor Brown, fixed life annuities regularly came out ahead of alternative approaches. (He reported on these simulations in 2007 in a National Bureau of Economic Research working paper.)

To achieve higher payouts than those of a fixed life annuity, an investor could try putting a portion of a retirement portfolio into stocks or other riskier assets, according to James Poterba, an economics professor at M.I.T. and president of the National Bureau of Economic Research. But that riskier portion would also not have the guarantee that fixed life annuities provide.

“Although holding riskier assets may offer higher expected returns, the recent bear market amply illustrates that it also brings the risk of substantial losses and their associated unfortunate consequences,” he wrote in an e-mail message.

(Professor Poterba serves on the board of the College Retirement Equities Fund, and Professor Brown on the board of the Teachers Insurance and Annuity Association, both of which sell annuities, among other financial products.)

Benefits of fixed life annuities have long been recognized by a consensus of academic researchers. In fact, this is one of those rare cases in which they take a more sympathetic view of an investment product than do most investors. The late Franco Modigliani, the Nobel winner in economics in 1985, even devoted some of his acceptance speech to wondering why annuities weren’t more popular.

Fixed life annuities have adherents outside of academia as well. Harold Evensky, president of Evensky & Katz Wealth Management in Coral Gables, Fla., a fee-only financial planning firm, said, “There is no other real alternative to dealing with longevity risk.”

It’s important to shop around when considering an annuity, Professor Poterba said, because payout rates can vary widely. Consider the range of rates that companies would currently offer the hypothetical 65-year-old woman with $100,000 to invest. According to AnnuityShopper.com, these vary from $594 to $619 a month — equivalent to $7,128 to $7,428 a year. Mr. Evensky added that because an investor would depend on an annuity for
many years, it is important to buy from highly rated companies and, perhaps, to diversify by buying several smaller annuities from different firms.

Investors may also find it helpful to consult a retirement planner, because the calculations required to determine whether an annuity payout rate is fair can be quite complex.

One feature of fixed life annuities may reduce their attractiveness right now: payouts are linked to bond market yields, particularly those on government bonds — and those yields are now quite low. Low payouts could prove a big disappointment to retirees considering annuities after suffering big losses in the financial downturn.

But Professor Brown said investors who were at least several years away from retirement could hedge against low annuity payout rates by gradually increasing the fixed-income allocations in their portfolios as they get closer to retirement. And if interest rates are abnormally low when they’re ready to buy an annuity, he points out, the bond portion of their portfolios will be worth correspondingly more — enabling them to buy a larger annuity.

This hedge exists only for those who have started, well in advance of retirement, to plan how they will eventually convert at least part of their portfolios into an income stream. As a result, Professor Brown concluded, “perhaps the best lesson investors can draw from the recent bear market — both concerning retirement in general and annuities in particular — is not to wait until it’s too late to begin such planning.”

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