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Here's a Retirement Income Idea You've Never Heard of

DELAYED INCOME ANNUITY

BY CURTIS CLOKE AND GARTH BERNARD

The stock market crash of 2008 and the resulting financial devastation of retirement plans have led to an increased appreciation for the guarantees provided by insurance companies. One example is the guaranteed lifetime withdrawal benefit (GLWB) feature on deferred annuities.

At the same time, many advisors are overwhelmed by the extensive variety of GLWB features, the abundance of moving parts and the details that often get lost in the fine print of insurance contracts. While the primary benefit of a GLWB is clear—it provides a guaranteed stream of lifetime income—efforts to describe the additional benefits of a GLWB have often led to some significant misperceptions.

There is a misperception that a GLWB provides a guaranteed rate of return that is equal to the "rollup rate" on the GLWB's "income benefit base." The income benefit base is a shadow account whose sole purpose is to determine the income stream. It is not the cash value, and sometimes the two accumulate independently. Here are three things to keep in mind: The effective rate of return on a GLWB is substantially lower than the rollup rate on the GLWB income benefit base; if a GLWB is used, it is unlikely to leave much of a legacy; and the greatest value can be extracted from a GLWB by waiting as long as possible before making withdrawals from the annuity.

These revelations suggest that advisors would be wise to consider alternative products that could complement a GLWB by addressing these issues. Such alternatives might also provide advisors with a major point of differentiation to compete with other advisors who tell a GLWB-only story.

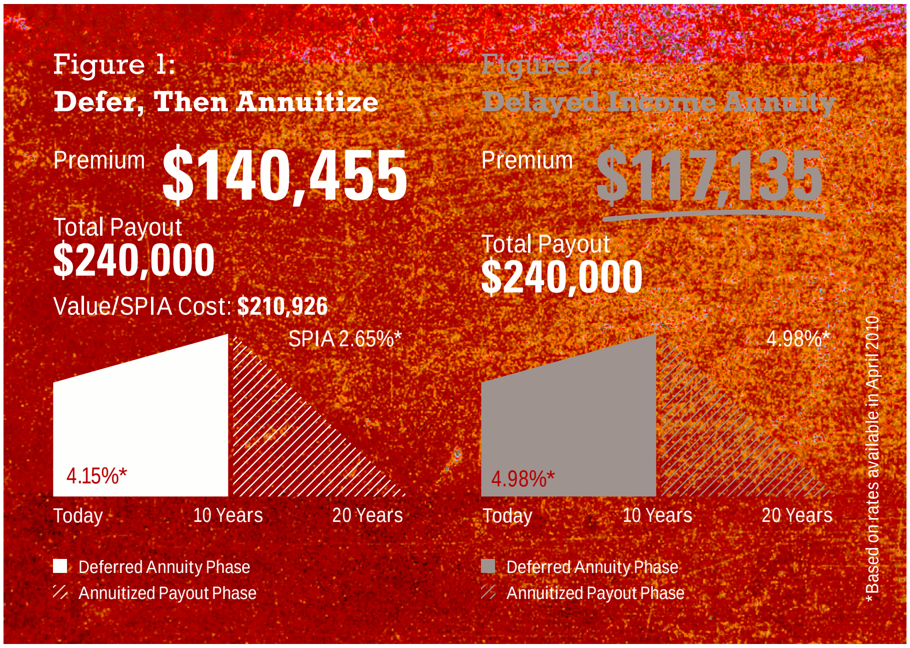
A Retirement Income Product You've Probably Never Heard Of

There is a powerful retirement income product that can be used to maximize the value of a GLWB when used in combination. It is called a delayed income annuity. It's a brand new "I-DIA," pun intended.

What is a DIA, and what makes it so powerful? A DIA is a stream of guaranteed income payments provided in exchange for a single premium. The income payments may be payable for a specified period or for the lifetime of an annuitant or joint annuitants. A DIA's income start date is delayed for 13 months or longer to make it legally different from a SPIA. Because the income payments are deferred, it resembles a deferred annuity with a GLWB rider or a deferred annuity that is annuitized, but there is typically no cash value. In exchange for the forgone liquidity, a DIA typically produces a higher internal rate of return than a GLWB or an annuitized deferred annuity.

To better understand how a DIA works, using the best rates we could find as of April 2010, let's compare a DIA to a deferred annuity that is annuitized. A client is seeking $2,000 per month of guaranteed income for 10 years. The income start date is 10 years from today. Figure 1 shows that $140,455 in a deferred annuity with a 10-year guaranteed credited rate of 4.15 percent would accumulate a sufficient account value to produce $2,000 per month in a guaranteed 10-year period-certain immediate annuity with an internal rate of return of 2.65 percent. We do not really know what annuitization rates will be 10 years from today, so the payout could be higher or lower in the future. Thus, there is no guarantee on the payout (except for the minimum annuitization rates provided by the deferred annuity contract).

Figure 2 uses a DIA. In this case, we need $117,135 to purchase a DIA paying $2,000 per month for a 10-year period, with the first payment starting in 10 years. Besides its being guaranteed, there are a number of interesting observations about a DIA solution:



- With a period-certain DIA, an IRR can be precisely determined, and in this case it is 4.98 percent. This IRR is substantially higher than those in figure 1.

- The same IRR is generated during both the deferral and distribution periods.

- Although there is no liquidity in this DIA example, a period-certain DIA is guaranteed to make the payments to the contract holder or to a beneficiary, so the value of the premium paid is retained by the estate. Also, some insurers provide access to commuted values in a DIA.

- In this example, the DIA costs $23,320 less than the deferred annuitization. If that amount were left to grow tax-deferred at 8 percent over the 20-year horizon, it would accumulate to $108,693. Assets not used for income could be tapped for liquidity needs or for leaving a legacy.

- A nonqualified DIA obtains a tax-exclusion ratio. So DIAs can provide some tax leverage when nonqualified funds are used to purchase them.

- The income payments on a DIA can increase annually at rates of up to 6 percent. They are excellent for offsetting future inflation. In the above example, a DIA with 3 percent guaranteed annual increases could have been purchased with the $140,455.

- Finally, DIAs can be used in combination to form a ladder of fully guaranteed income payments.

DIAs are a flexible, new breed of annuity that may provide tax advantages; use significantly fewer assets to do the job of creating guaranteed income when compared to other alternatives; and help leave more assets for accumulation, for legacy or for purchasing other risk management products. This added value and flexibility will prove indispensable to advisors who take advantage of DIAs.

Using DIAs to Supercharge GLWBs

Here is a simple sales idea for laddering a DIA and a GLWB to create a more powerful story than that of a GLWB alone. A 50-year-old couple with $100,000 will retire at age 60. How much guaranteed income can they expect? Putting the premium into a deferred annuity with a GLWB that has a 10 percent bonus on the benefit base, a 7.50 percent rollup and a 4 percent guaranteed "joint life" withdrawal would create $756 per month for life. Assuming a 5 percent earned rate on the account and a 40 basis point annual fee, there would be no legacy remaining after 14 years of withdrawals.

Here's a better approach. To generate the same $756 of monthly lifetime income, purchase a DIA with a 10-year payout, with the first income payment starting at age 60. The DIA would cost $46,661. Next, purchase the same deferred annuity with the GLWB feature previously described—but now the GLWB feature is exercised at age 70. But because we've allowed the GLWB rollup and payout factors to act for 20 years instead of 10 years, the guaranteed annual withdrawal rate is now 5 percent of a higher benefit base, and we would need to use $38,816 for the GLWB. The total package would cost only $85,477. This leaves $14,523 of the original $100,000. This amount could accumulate at 5 percent per year back to the original $85,477 by age 86, fully replacing what was spent on the solution.

Enhance your clients' retirement with the power of a DIA.

***Curtis Cloke**, a Top of the Table MDRT advisor, is founder and a principal of Thrive Income Distribution System LLC.*
***Garth Bernard** is a principal of Thrive Income Distribution System LLC. You can contact Curtis or Garth at www.thriveincome.com.*