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Longevity Annuities Could Redefine the Retirement Income Planning Landscape

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Risk, like many other four-letter words, describes something unpleasant to be avoided if possible. Unlike most, however, it denotes something that is not well understood.

Finance textbooks speak of many kinds of risk — inflation risk, principal risk, market risk, interest rate risk, currency risk, tax risk, etc. Yet, when the subject is retirement income, none of those things mean much. There's really only "one big risk": What are the chances that my account balance will fall to zero before my blood pressure does?

Because clients fear the prospect of running out of money, we advisors have developed a variety of strategies to eliminate or reduce that outcome. We search for a "sustainable withdrawal rate" and build "optimal" portfolios to support it. We construct models, project future values, and test those projections using Monte Carlo simulation and/or historical "back testing." However we do our modeling of the future, though, we're faced with two imponderables: (1) what future investment returns will be and in what order they will occur, and (2) how long the income that will be derived from the client's portfolio must persist (because we don't know how long the client will live). The second of these is the most troublesome, and becomes even more so as life expectancy increases.

Recently, a financial instrument has been developed that offers great potential to advisors seeking to manage the "one big risk" by providing a known answer to that second imponderable. It's called a "longevity annuity" and it works like this:

Our client, age 60, places a small portion of his retirement portfolio in an annuity that will produce a guaranteed income to him, once he reaches an advanced age (say, age 85). The amount of that income will be greater — probably, far greater — than can be assured by any investment alternative, and it will persist for his entire lifetime. In one insurer's version, as of November 2008, a $50,000 single deposit at age 60 will produce an income of $5,211 per month for life, commencing at age 85. He'll get back his entire principal in less than the first year, and he'll continue to receive that $5,211 per month for as long as he breathes, no matter what happens to interest or mortality rates in the future. How can this product do this?

The longevity annuity can accomplish this because if he dies prior to reaching age 85, the annuity expires without value. Hearing this last point, many advisors may cringe. "Why would anyone buy such a thing? My client buys a policy that won't pay him a penny for 25 years and if he doesn't make it that long, he loses his entire investment?" Sounds like a very bad investment.

And it would be — if it were an investment. But it's not. It's a risk transfer instrument — a pure insurance play. The risk that the purchaser transfers to the issuing insurer is the risk he'll run out of money at an advanced age (when he cannot expect to earn income). That's the covered peril, and if it materializes — if he lives past age 85 — the annuity will provide income in an amount

that will never be reduced, no matter what happens to interest rates, for as long as he is alive.

Transferring the Risk

But what about the risk that he won't live that long? If he doesn't, the insurance company just keeps the money? Well, first of all, the insurance company doesn't "keep the money" in that scenario. It uses it to pay income to those policyholders who did live that long. That's how risk pooling works. But even if the insurer were to "keep the money," it shouldn't matter, in terms of the risk transfer agreement this client made. To put it bluntly, dead people don't need income. The risk transferred is that the policyholder will run out of income in old age. If he never makes it to old age, that risk will never materialize.

Some advisors can't live with this, which is why those few insurers that now offer longevity annuities offer a variant that provides a death benefit if the annuitant does not survive to the payout commencement age. That seems a better deal to some, but it's not. The guaranteed annuity payment in a longevity annuity that offers a death benefit must be far less than that guaranteed by one with no death benefit. That's less leverage, and leverage is what insurance is all about. Moreover, a death benefit in a longevity annuity is like a "return of premium" provision in a term life or disability income policy; it offers protection against an outcome that is the direct opposite of the insured peril, which guarantees that one of the two protections will fail. (One is either disabled or not, alive or not; one cannot be both). Insuring against mutually exclusive outcomes destroys leverage.

In addition, if the dollars constituting the annual premium are so essential to the economic well-being of the insured or his family that he must insure against their "loss," he shouldn't be spending that many dollars on premiums in the first place. (This condition is sometimes known as being "insurance poor"). If our hypothetical client feels the obligation to leave those cumulative premiums to heirs as a legacy, that's an entirely different risk proposition, for which an entirely different type of risk transfer instrument — life insurance — serves well. But one cannot spend the same dollar twice.

Creating a "Back Door" for Retirees

A longevity annuity (without the superfluous death benefit) represents a remarkable opportunity for the financial advisor to redefine the financial planning landscape. It can reduce, or even eliminate, its core uncertainty — the indefinite duration of the retirement income need — by providing a "back door," a point beyond which the retiree's retirement portfolio will not have to provide income because the annuity will do so. For advisors using stochastic modeling to manage the returns and sequence of returns risk, the job will become much easier and the results more credible, because the period of time over which those returns must be reckoned will become certain.

What does this mean, in practical terms? First, it means that having allocated a small portion (perhaps 5-15%) of our client's retirement portfolio to a longevity annuity, we can now manage the remainder differently (because the time horizon for that portfolio has changed). Even more importantly, it means that our client can now afford to engage in activities or behaviors that she

might not normally be willing to consider. The assurance that a known income will be forthcoming, upon reaching a certain advanced age, may allow our client to spend more of her portfolio before reaching that age, and enjoy her wealth while she is able to do so.

Most insurers do not offer longevity annuities at this time. For those that do, sales have been meager. Both conditions are due to a simple, rather sad fact: Most advisors do not understand this new tool, so they do not recommend it. This is not a marketing problem; it's an education problem. The nature of this new device is not well understood, so the value it provides is not understood either.

The nature of the longevity annuity is simple: it is a risk transfer device, an insurance instrument. It is not an investment, and investment logic will not discover its value. I view a longevity annuity as most like a property and casualty insurance product. We insure our homes and automobiles because their loss would cause us hardship, but we don't expect a return on investment for those premium dollars. If our car and home aren't destroyed while we insured them, we've lost nothing, for we had the assurance that they would be restored with insurance proceeds. Similarly, if we "insure" our old age income, using only a small part of our total wealth, and die before reaching old age, that insurance will not have been in vain, for it gave us the confidence to spend the rest of our money while we could. The real value of the longevity annuity is not in the income it provides, but in the choices it makes feasible.

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