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Getting Smart About Annuities

These products can be loaded with traps and fees. But there are valuable ways to use them to build a pension -- and salvage your nest egg.

By ANNE TERGESEN and LESLIE SCISM

For years, many retirees were content to act as their own pension managers, a complex task that involves making a nest egg last a lifetime. Now, reeling from the stock-market meltdown, many are calling it quits -- and buying annuities to do the job for them.

In recent months, sales of plain-vanilla immediate annuities -- essentially insurance contracts that convert a lump-sum payment into lifelong payouts -- have hit an all-time high.

That's a big change from a few years ago. Then, the hot products were variable annuities whose value fluctuates with an underlying investment portfolio. Many purchase these products with riders that protect against stock-market losses and guarantee a minimum paycheck for life.

Annuities in general have never been popular with many financial advisers. For the most part, the products don't offer the potential for outsized gains. And once you hand over your money to an insurer, you either can't get it back or can do so only by forfeiting at least some of the guarantee you've paid for. Variable annuities, in particular, can be ridiculously complex and loaded with fees and hidden traps.

But for those grappling with investment losses, annuities today have an undeniable appeal. At first glance, they offer a way to restore some financial security to what are supposed to be your golden years. There is even evidence that retirees with regular paychecks are happier than those who rely exclusively on 401(k)s to supplement their Social Security. The latter "are more prone to depression due to concern about running out of money," says Stan Panis, a director in Sherman Oaks, Calif., for Advanced Analytical Consulting Group of Wayland, Mass., and author of a study about annuities and retirement satisfaction.

The problem: While many investors have a general idea of what an annuity is, few understand the strategies available for making these products a part of their holdings. You have to figure out how much to buy, whether to put your money to work immediately or gradually, and how to invest what remains.

Here are some of the best ways to do that.

Immediate Gratification

The immediate annuity is relatively straightforward: It allows you to convert a payment into monthly, quarterly or annual income for life. Most immediate annuities are fixed, which simply means they pay an amount that's established at the outset.

Typically, immediate annuities provide a significantly higher level of sustainable income than you'd be able to produce from your investment portfolio, assuming you stick to the convention of withdrawing no more than 4% of your nest egg per year. For example, a 65-year-old man who buys an immediate annuity today will receive some 8.4% a year of the amount he invested in the annuity.

The extra income is the result of the requirement that you surrender your principal to the insurer. Each payment consists not just of interest, but also of a portion of your principal, prorated over your remaining life expectancy. The payments are guaranteed to continue for the rest of your life. But when you die, they stop -- regardless of whether you've recouped the amount you paid for the annuity.

If you are willing to settle for a lower income, you can buy features designed to overcome some of the drawbacks of a traditional annuity. With one, for instance, your heirs will receive a set number of years of income if you don't live to collect it. (First, though, check whether buying a life-insurance policy would be cheaper.) Another raises payments by 2% or more annually to keep up with inflation -- a key feature, given the way inflation can erode purchasing power.

How much should you put into an annuity? If Social Security plus any pension you receive won't cover your monthly budget, many economists recommend buying an annuity for an amount that bridges the gap.

But if you're worried about leaving something for your heirs, Jim Otar, a financial planner in Thornhill, Ontario, recommends this approach: Annuitize just enough to meet your income needs -- in conjunction with the 4% annual withdrawals from your investment portfolio that most investment advisers consider prudent.

Consider a 65-year-old man with $1 million of investments who anticipates spending $60,000 a year, in addition to Social Security. That amounts to 6% of his $1 million -- a level that exceeds the recommended 4% withdrawal level. To not risk depleting that nest egg, the man would have to pare spending to $40,000 a year, indexed to inflation. Alternatively, he could put about $720,000 into an immediate annuity that would produce some $60,000 a year for life.

Another option from Mr. Otar: Put $450,000 into an annuity, which would give the man a payout of nearly $38,000 a year for life. To produce the other $22,000 needed to cover his annual expenses, he could withdraw the recommended 4% from the $550,000 that remains of his initial $1 million.

Of course, if the $550,000 nest egg declines in value, the man's income will fall, too. If so, he may have to tighten his belt or purchase an additional annuity, Mr. Otar says. But if he dies tomorrow, such an arrangement ensures his heirs will receive much more -- $550,000 versus the $280,000 he would have with an annuity that produces the entire $60,000 in income.

Longevity Rider

Another way to preserve more for yourself or your heirs is to buy a deferred-income annuity with a longevity feature. Like a conventional immediate annuity, this one produces an income for life. But the payments typically don't kick in until the policyholder turns 80 or 85. For $71,300, a 65-year-old man can get a $60,000-a-year payout starting at age 85; that compares with $714,430 for an immediate annuity, according to insurer MetLife Inc., whose product is called longevity income guarantee.

Knowing that this safety net will be in place, you may be able to withdraw a greater percentage of your savings earlier in retirement than would otherwise be prudent -- some 5% to 6% a year, compared with the typical 4%, says Jason Scott, managing director of the Retiree Research Center at Financial Engines, a Palo Alto, Calif., firm that manages 401(k) accounts. Payments may be timed to kick in when you may need help with rising medical or long-term-care costs.

When should you buy an annuity with a longevity rider? "When you retire," says Mr. Scott. The longer you wait, the more you'll pay for a given level of benefits, simply because your chances of surviving to receive payouts improve as you age.

In contrast, with a conventional immediate annuity, economists are divided over whether it's best to buy at retirement, or after age 70. That's when an unpleasant reality sets in: Your peers start dying in big enough numbers that the financial benefits of joining them in an annuity pool start to outweigh the costs.

Wading In

One way to hedge your bets is to "ladder" your purchases -- by buying immediate annuities in bits and pieces over time.

Proponents say that by doing so you'll reduce the odds of buying at an inopportune time. For instance, when interest rates are low -- as is the case today -- insurers offer skimpier payouts because they stand to earn less on the corporate and government bonds that back their payments.

Another reason to stagger your purchases: It gives you some flexibility to adjust your annuity purchases if your circumstances change, says Benjamin Goodman, director of actuarial consulting services at TIAA-CREF, a New York-based provider of low-cost annuities.

How should you construct your ladder? Mr. Otar uses this rule of thumb: First, decide how many years to spread the purchases over. Those who feel they can afford to take some risk may want to spread purchases over as many as four years, he says.

Then, he says, "the amount of premium you pay in the first year should be twice as much as in the second year, and so on." Someone who wants to annuitize $300,000 over three years should commit roughly $170,000 in year one, $85,000 in year two, and $45,000 in year three. By advising clients to buy more upfront, Mr. Otar seeks to reduce the amount of money that an individual would have at risk in the event of a bear market. (Sample Mr. Otar's calculator, which costs $99.99, free of charge at www.retirementoptimizer.com.)

Of course, these days, trusting your future to an insurer -- even a top-rated one -- requires a leap of faith. But in the event of an insurer's insolvency, industry-funded associations provide at least $100,000 in coverage for the guaranteed portions of annuity contracts held at an insolvent company. Check the site of the National Organization of Life and Health Insurance Guaranty Associations (www.nolhga.com) for links to your state association's Web site, where, generally in the FAQs section, you can find the coverage limit.

So as not to exceed this limit, divide your purchases among highly rated carriers, says David Babbel, a professor of insurance and finance at the University of Pennsylvania's Wharton School.

When shopping, compare quotes from a number of insurers and mutual-fund companies. Web sites such as immediateannuties.com can help.

Upside Potential

While an immediate annuity will generate regular paychecks at once, it does nothing to help rebuild a depleted nest egg. That's where variable annuities with "living benefits" come in.

A variable annuity, in its simplest form, combines tax-deferred savings and, potentially, investment gains -- typically in mutual funds -- with insurance. So when you die, and even if the investments perform poorly, your heirs get a payout. Variable annuities with living benefits have investment-performance guarantees that kick in while the annuity owner is alive -- even if the investments tank.

The most popular form of a living-benefit rider sold in recent years provides a monthly income check from the date you elect benefits to start until you die, with benefits depending on your age at the start date. Some contracts also allow you to buy additional riders that let the income stream continue to a spouse.

These products give you the chance to benefit, after fees, from any market increases, and the insurer protects you on the downside. At a minimum, you get back your initial investment, spread out in monthly checks beginning at some point after you turn 59½, an age set by law. This is called the guaranteed-minimum-benefit base.

Under many living-benefit contracts, the buyer has two, and sometimes three, account balances to monitor. The first tracks the actual value of the stock-fund and bond-fund holdings. The others are different formulations of the guaranteed-minimum-benefit base. When you are ready to tap your income payments, the highest balance is used to calculate the payments.

Many contracts ratchet up the guaranteed base annually to incorporate investment gains in the underlying mutual funds, and many versions sold in recent years promise 5% to 7% compounded annual growth of the initial investment.

The bad news: The best deals are rapidly being pulled from the market. Insurers are trying to bring the guarantees in line with higher hedging costs and to meet stiff capital regulatory requirements showing they can make good on their promises.

income you need as well as whether you use variable or immediate annuities.

For example, a 65-year-old man with a $1 million nest egg can generate $50,000 a year by putting about $600,000 into an immediate fixed annuity. Alternatively, he can get the same $50,000 with a variable annuity that allows for a 5%-a-year withdrawal -- but only if he puts the entire $1 million into the contract.

He also can use a combination of the two. For example, he might put $400,000 into an immediate annuity that produces $33,500 a year and $325,000 into a variable contract that plugs the $16,000 or so gap -- assuming it has a 5%-a-year withdrawal feature.

To figure out how to invest the $275,000 that remains of his $1 million, this individual would first have to figure out which bucket -- conservative or risky -- his annuities belong in.

With immediate fixed annuities, it's straightforward: "These are substitutes for bonds," says Tom Idzorek, chief investment officer at Ibbotson Associates, which designs portfolios of stocks, bonds and annuities. So, if the man above with the $1 million portfolio were to put $400,000 into immediate fixed annuities, he would effectively hold 40% in bonds.

Variable contracts with income guarantees, on the other hand, can be treated as either stocks or bonds -- and their classification may change over time. Such an annuity should be viewed as a bond substitute when the money invested substantially declines in value. That's because the insurer guarantees that, at the very least, you'll receive a bond-like 5% annual return on your initial deposit for the rest your life, says Prof. Milevsky. If, however, the investment fares well, you should treat it as part bond and part stock.

How much should be assigned to each? First, look at the way the money in the variable account is invested. Ideally, those who buy these products should pick the riskiest blend allowed -- say, 70% in stocks and 30% in bonds. (As insurers try to reduce their exposure to risk, many are requiring annuity buyers to put at least 30% into bond funds.)

But due to the guarantee, the variable annuity's actual risk profile is more conservative than it appears. Assuming an investment horizon of 20 or more years, a 70/30 investment mix would behave more like a 50/50 combination, says Mr. Idzorek.

As a result, a 65-year-old man who puts $325,000 into a variable-annuity contract for all practical purposes has 50% of the value, or $162,500, in stocks and 50% in bonds.

As a percentage of his $1 million portfolio, this translates into 16% in stocks and 16% in bonds. Combined with the $400,000, or 40%, he invested in immediate fixed annuities -- in the example above -- the man would have a total of 56% in bonds and 16% in stocks. If his goal is to achieve an overall portfolio mix of 40% in stocks and 60% in bonds, he ought to put the vast majority of the $275,000 that remains in his portfolio into stocks, says Mr. Idzorek.

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