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Making More Sense of Annuities

By Kelly Greene

Our recent column about annuities sparked a round of questions from readers who are trying to decide whether the investments are right for them.

To review, we were talking about immediate annuities -- the plain-vanilla investment contracts that guarantee you a lifetime stream of income in exchange for a large, upfront payment. A recent study found that those kinds of annuities bought individually, instead of through pension plans, pay women less -- and cost both sexes more.

Even without that wrinkle, many retirees have steered clear of annuities, partly because they're complicated, and because it's tough to tell whether they're a useful tool. With that in mind, we decided to clear up some of the confusion -- and we asked several financial-planning experts to recommend ways they would use annuities in retirement planning.

Annuities typically come in two shapes: "fixed" or "variable." Immediate fixed annuities are the more conservative choice, generally promising a predictable monthly check for the rest of your life in return for your chunk of cash up front. With variable annuities, you decide how your money is invested (usually, in mutual funds). That often translates into more-volatile swings in variable annuities' returns, though a few products do set minimum payments.

A word of caution: There are very few cases in which variable annuities make sense for retirees seeking to maximize their returns. Most financial-planning specialists advise older adults to steer clear of variable annuities. The reasons: In addition to their volatility, variable annuities can create tax headaches and often carry high fees and surrender charges. Still, brokers routinely pitch them to retirees. For example, reader David Quigley says that at least three investment firms in the Fort Lauderdale, Fla., area this spring have been touting a variable annuity nicknamed "the 7% solution." He considered investing, he writes, but finally decided it was "too confusing and, in my opinion, more of a risk than I care to take."

The marketing is so pervasive that the National Association of Securities Dealers has urged brokers to use restraint in selling variable annuities to older customers for whom they may be "inappropriate." And the Securities and Exchange Commission in 2000 issued an "investor alert" cautioning investors who already own an annuity that they "may be better off" not switching to new ones because of sales charges, commissions and surrender penalties that are incurred.

But with the simpler, immediate fixed annuities, some readers simply rankle at the idea of parting with the nest egg they worked so hard to build, in exchange for a monthly payment that expires as soon as they do. As Mel Langer of Diamond Bar, Calif., puts it: "It sticks in my throat that after the annuitant dies, the insurance company keeps the money. You're betting you'll live, and they're betting you'll die." (There are fixed annuities that continue payments to an owner's beneficiary, although such products typically offer lower monthly payments.)

Several financial planners and economists offer this advice: If you're looking for a steady source of cash to pay your bills each month, particularly if you don't have a pension and you're worried about outliving your money, consider using annuities as an investment tool -- just don't tie up too much of your savings in them.

A recent study by economist John Ameriks of TIAA-CREF, a nonprofit pension and financial-services company in New York, found that a 65-year-old would significantly reduce the likelihood of outliving his money by annuitizing 50% of his assets.

Mr. Ameriks reached that conclusion by running computer simulations, known as "Monte Carlo analysis," to figure out the probability of a 65-year-old's draining his assets prematurely if he were to withdraw 4.5% of his initial assets every year (adjusting for inflation each time) for a set number of years. He used four portfolio types -- conservative, balanced, growth and aggressive -- and time periods in five-year increments ranging from 20 to 40 years. For example, annual withdrawals over 30 years from a "growth" portfolio made up of 60% stock, 30% bonds and 10% cash would deplete the non-annuity part of the portfolio early 12.6% of the time. But if half those assets were annuitized, that likelihood drops to 3.3%.

There's another advantage, too, says Mr. Ameriks: "Once you have that annuity income, something coming in every month that you can count on, you can take a better look at the rest of your assets and how you can make them grow." Although his model didn't take Social Security income into account, he suggests factoring that, along with any private pension payments you receive, into the amount you need to have on hand each month to pay fixed bills.

Even when shopping for a fixed annuity, cautions Christine Fahlund, a senior financial planner at T. Rowe Price Associates in Baltimore, take the time to make some comparisons. Fees and interest rates can vary widely among different companies. A quick look at www.annuity.com, a Web site that offers information about and markets annuities, shows that current rates for fixed annuities range from as low as 4.05% to as high as 9.5%. It's important to ask about the financial strength of the insurer offering the annuities as well, she says, because "once you annuitize those assets, you don't own them anymore. The company does."

Ms. Fahlund recommends investing no more than 60% of your assets in annuities, so you still have money available for emergencies. Some planners recommend investing a smaller portion of your savings, some limiting annuities to as little as 25% of your nest egg.

You also should think about ways to beat inflation, because that $1,000-a-month annuity payment you could get now won't go as far in 15 or 20 years, she says. Depending on your age and health, you might want to buy two to three different annuities and start receiving payments from one annuity now, while allowing the others to grow tax-deferred for several more years before starting to collect payments from them, too.

Still wavering over whether annuities are right for you? "Then try it with a small amount of money and see how it works," says Mr. Ameriks. "There's no need to do it all at once."