

Managing Money for Life

HOW ANNUITIZATION WORKS

So you've saved regularly and invested wisely to prepare for retirement. When this phase of your life begins, managing savings will be key to your retirement security.

The challenge is to use your savings not just to fund the lifestyle you want, but also sustain it for an uncertain length of time—at age 65, you can expect to live to 85, and about half of 65-year-olds will live longer than that.¹

A proven way to meet this challenge is to annuitize at least a portion of your savings. Annuitizing your savings guarantees that your accumulated assets will last as long as you live. It insures you against the risk of outliving your savings by providing regular, periodic income payments for life.

The financial product that helps you annuitize is called an annuity. It's the only private-sector financial product that will provide a guaranteed lifetime stream of income, no matter how long you live. Annuities are contracts written by life insurance companies and sold by life insurers, as well as banks and brokerage firms.

You could attempt to achieve a lifetime income stream by managing the investment of your assets yourself, as well as withdrawals against those assets over time. However, no other investment-and-withdrawal method can give you better economic results than a life annuity payment.² Moreover, self management does not guarantee a steady income for life—only an annuity does that.

The value of annuitization is clear when you compare various asset management strategies.³

IMMEDIATE ANNUITY

Suppose you have \$100,000 from savings or the sale of your home or some other property. Let's say you put that lump sum into an immediate annuity—one that starts payouts right away—with a lifetime payout option. At age 65, you could expect to receive \$8,808 annually from annuitizing this amount for life (see figure).⁴ Part of the \$8,808 is interest earned and part is a return of principal. You will receive that amount no matter how long you live. If you want your spouse to receive income in the event of your death, the monthly payout can be adjusted.

Why do you never run out of income with an annuity? Annuities have an insurance element to pool and share longevity risks across large groups of individuals to make this possible.

SELF-ANNUITIZING

Now let's say you try to self-annuitize your \$100,000: You reinvest the money in accounts with an expected return equal to that of the annuity (4.25 percent in this example) and you withdraw the same amount as the annuity would provide (\$8,808 in this example). This strategy provides for the same level of consumption as an annuity but for a shorter time—after 15 years, all savings have been used and odds are you are still alive.

You run a serious risk of outliving your savings by self-annuitizing because this method lacks the insurance element of an annuity.

LONG-LIFE STRATEGY

What if you decide to spend down your \$100,000 gradually, so it will last until age 100?

Your money will last a long time but the annual withdrawals will be far less than with an annuity. Assuming the same interest rate (4.25 percent), you will be able to withdraw \$5,250 per year for 35 years starting at age 65—40 percent less than the annual annuity amount of \$8,808

And what if you reach 101? Your savings will be exhausted and your income drops to zero. This cannot happen with a lifetime annuity payout option.

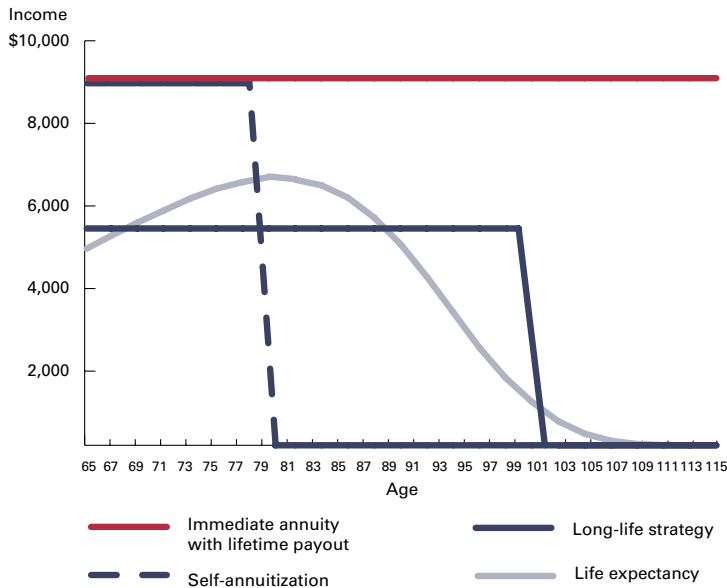
LIFE EXPECTANCY

Now let's suppose you take the \$100,000 and spend a fraction of your money each year in direct proportion to your remaining life expectancy. For instance, at age 65 your life expectancy is 21 years, so you withdraw 1/21 of your assets in the first year. You then re-estimate your withdrawal every subsequent year based on your life expectancy at that age and the interest earned on your remaining assets.

You will never run out of money, but income under this strategy fluctuates: It increases steadily in the first 16 years under this approach, then decreases sharply after that.

As these examples clearly show, an immediate annuity is the only strategy that will guarantee a steady income throughout retirement.

ANNUITIZATION VS. ALTERNATIVE ASSET MANAGEMENT STRATEGIES



Sources: Derived from Jeffrey R. Brown, *Taxing Retirement Income: The Case of Non-Qualified Retirement Annuities*, paper presented at the Stanford Life Insurance Taxation Workshop, Washington, D.C., December 2000; and Ron Gebhardtsbauer, American Academy of Actuaries Senior Pension Fellow, testimony presented to the U.S. Department of Labor, Advisory Council on Employee Welfare and Pension Benefits Plans, Task Force on Leakage, June 9, 1998.

Note: Assumed rate of return on investments is 4.25 percent. Mortality is based on the IRS Single Life Expectancy Table (unisex).

NOTES

1. Based on the IRS Single Life Expectancy Table (unisex).
2. Brown, Jeffrey R. *Taxing Retirement Income: The Case of Non-Qualified Retirement Annuities*. Presented at the 2000 Stanford Life Insurance Taxation Workshop, Washington, D.C., December 2000.
3. Ibid. See also Gebhardtsbauer, Ron, American Academy of Actuaries Senior Pension Fellow. Testimony presented to the U.S. Department of Labor, Advisory Council on Employee Welfare and Pension Benefit Plans, Task Force on Leakage, June 9, 1998.
4. According to annuitization calculations by the federal Thrift Savings Plan (Thrift Savings Plan Web site (November 2, 2004). The assumed rate of return on investments is 4.25 percent and mortality is based on the IRS Single Life Expectancy Table (unisex).

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