Is an annuity right for you – four ideal profiles

Retirement bulletin

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AS A FINANCIAL PLANNER WHO HAS BEEN RESEARCHING THE RETIREMENT INCOME[1] PHASE FOR ALMOST 20 YEARS, I AM KNOWN FOR BEING QUITE CRITICAL ABOUT ALMOST EVERY PRODUCT, PLANNING METHODOLOGY AND ACADEMIC PAPER THAT HAS TRIED TO TACKLE THIS COMPLEX LIFE STAGE.

No one solution or approach is right for every situation or at all times, which is why "decumulation" is so much harder than accumulation. While we have yet to agree upon the "modern portfolio theory for decumulation," there are certain products that we can agree should be carefully considered when constructing a sound retirement income strategy. Annuities are one of those products.

With access to periodic income from defined benefit plans in steep decline—40% of today's 60- to 69-year-olds will receive some level of income from a defined benefit pension, which drops by more than half to 18% over the next 20 years—the need for predictable lifetime income is growing.[2] However, households often struggle with whether an annuity makes sense for their retirement income plan due to lack of education, product complexity and potential costs. In my opinion, there are several clear situations in which an annuity may make a lot of sense as one part of a household's overall post-retirement strategy.

LONG LIFERS, INADEQUATE SAVERS

Individuals approaching retirement who have a family history of longevity and who are in excellent health as the result of making good lifestyle decisions are likely to experience above average life expectancy. If they haven't saved enough to achieve their desired retirement spending goal with a high level of confidence, they need to maximize the amount of income their wealth can provide for life—however long that may be. These individuals or households are excellent candidates for an annuity—preferably one that enables them to benefit from mortality credits to maximize their income at an appropriate level of cost.

RETIREMENT "MIS-TIMERS"

Sequence of return risk can be described as "retirement timing risk"—individuals who experience a poor sequence of returns either five years prior to or after they retire. This is typically when household wealth is greatest, and therefore is at greatest risk. The happiest annuity clients are those who purchased their annuities in 2006 or 2007—the annuities provided

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[1] "Retirement income" refers to the process by which investors use current income, capital income and principal to meet retirement spending needs.
[2] LIMRA Secure Retirement Institute analysis of 2013 Survey of Consumer Finances, Federal Reserve Board, 2014.

very valuable protection through the Great Recession—and provided peace of mind to individuals who owned one. No one can predict the future nor time either the market or their planned retirement date to avoid this risk. Protecting a portion of retirement wealth with an annuity should be carefully considered in the context of the desired retirement timing and expectations relative to market volatility and the interest rate environment.

ULTRA-CONSERVATIVE INVESTORS

Individuals have a declining risk appetite as they get older. For more conservative individuals, the transition from work to retirement can magnify their risk aversion, resulting in a desire to have little if any market exposure in retirement. Over a 30- to 40-year retirement, this decision can result in significant erosion of purchasing power and increasing longevity risk. For these types of individuals, including an annuity as a part of their retirement income strategy could help them maintain some level of market exposure through their retirement and increase their likelihood of success. An annuity can be used in two ways: to provide sufficient protected income to cover lifestyle spending needs (typically non-discretionary items), which can help risk-averse individuals make more rational decisions about their remaining investment portfolio. Or, from an asset allocation perspective, shifting existing equity holdings into a variable annuity with principal or income protection that offers a well-diversified investment option can provide them with the protection they are looking for while maintaining access to some upside potential. This can provide a better outcome than shifting the equity allocation to fixed income or cash alternatives.

GOOD SAVERS, BAD SPENDERS

The best savers are very good at allocating monthly income between current spending needs and future savings goals. As those households shift into retirement, the current income from their portfolios replaces their earned income, and may be less or more variable than they are used to. For individuals who are disciplined in their cash flow behaviors, this can be quite an adjustment. A typical approach these households use is to adapt their spending to their current investment income (dividends and interest) combined with required minimum distributions once they turn 70½. Unintended outcomes of this behavior may be to over-reach for yield, to unnecessarily constrain spending and/or to preserve principal through retirement when it could have been used to enhance lifestyle quality. For these households, an annuity can serve as a replacement for earned income as their steady stream of retirement income—and help these households to systematically and efficiently consume a portion of their retirement wealth to augment their lifestyle needs.

IN CONCLUSION

Annuities are an important tool in the toolkit for households approaching and living in retirement to carefully consider allocating a portion of their wealth to when determining their retirement income strategy. These profiles are prime candidates for using annuities to meet a specific retirement need. Annuities are best when they are being used for valuable protection—either in the form of protected income for a lifetime or principal protection through market cycles. Households considering an annuity purchase should carefully review its benefits, trade-offs and fees to make an informed decision about how it supports their overall retirement income strategy.

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NEXT STEPS

For more information, please contact your J.P. Morgan representative.

It is important to consider a number of factors before making an investment in an annuity. Because variable annuities invest in securities they are subject to "stock market risk" meaning that stock prices in general (or in particular, the prices of the types of securities in which a fund invests) may decline over short or extended periods of time. When the value of a fund's securities goes down, an investment in a fund decreases in value. Due to various features, benefits, limitations, early surrender charges, penalties and possible tax implications that may apply to a particular annuity; it is important to read the prospectus, contract, statement of additional information and offering material, and to discuss your particular needs and circumstances with your Financial Advisor to determine the type of annuity that may be best suited for your investment needs. You should consider the risks and objectives of the annuity and match them to your own goals and risk tolerance. In addition, you should fully understand the costs associated with your investment.

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