FIXED ANNUITIES Complement Investment Planning

By Kim O'Brien

The investment community has historically used fixed annuities as a stable value component of an integrated investment strategy. Within recent years, innovations within the fixed annuity insurance industry have expanded the role of these products. These innovations provide new opportunities for financial advisors to diversify risk and complement the investment side of an individual's retirement plan with guarantees and insurance. These types of annuities are deferred lifetime annuities and fixed annuities with long-term care benefits.

The Challenge of Retirement Planning

To understand how these annuities are used, it is helpful to examine the core challenge facing retirees and individuals planning for retirement. To retire with confidence, most retirees need:

(a) Sufficient income to cover their expenses,
(b) Income that increases over time to bridge the gap between Social Security and any other income,
(c) Certainty that they cannot outlive their income,
(d) Emergency income for long-term care or assisted living assistance, and
(e) Discretionary income for travel, vacations, weddings, and so forth.

An investment portfolio can create a desired income and provide of the potential for value and income growth over time. However, without an insurance portfolio, the investment-only portfolio can create uncertainty and variability that may be a concern for clients. Plus, when retirees don't prepare in advance, the cost to add solutions to provide for these contingencies can increase significantly year after year.

Dealing with Longevity Risk

Consider the need to guarantee income for life. Ignoring longevity risk, a typical investment-only approach is to build a portfolio that creates a desired income and asset value through the client's life expectancy and perhaps a few years beyond that. However, there remains the possibility that a client could be the outlier, the person who lives 15 years or more beyond the typical life expectancy. How do you deal with that?

Often a solution has been to use immediate annuities and guaranteed lifetime withdrawal and income benefits on variable annuities. Unfortunately, creating a sufficient income with these products often requires committing a large chunk of the client's assets. Thus, the longevity risk "tail" ends up wagging the investment strategy "dog."

Annuity Innovation: Longevity Insurance

A solution that is a form of longevity insurance is called a deferred payout annuity. The basic idea is that your client, who is perhaps age 65, purchases a guaranteed stream of life-contingent income starting at an age well in the future, such as age 85. The payout can be based on a single life or the lives of a married couple. Because the income is delayed until far into the future and because it is only paid if your client is then alive, it is cost efficient.

This annuity solution can be a win-win. Since less money is needed to fund the guaranteed lifetime income stream that can increase over time, more money can be available to create an optimal investment portfolio to take your clients to age 85. Your clients are free to live their early retirement years with confidence, perhaps traveling more, because they know the later years are covered.

Dealing with Long-Term Care Risk

Next, consider the issue of long-term care. Medicare typically does not cover such care beyond a short period following a hospital stay, and Medicaid will typically not pay for long-term care until after your client's assets are depleted. The federal government estimates that half of nursing home residents are paying out of their own pockets. Thus, this is a risk that is clearly the family's to bear, and it can be costly.

Over 70% of 65 year olds may require some form of long-term care in their lifetime. The cost for this care can be expensive; with the average annual cost for a private room in a nursing home being over $94,000.[1] By 2050, the number of individuals using paid long-term care services in any setting will likely double from 13 million using services in 2000, to 27 million people.[2]

Historically, the solution has been long-term care insurance (LTCI), but clients tend to be cool to the idea since they often believe such care will be unnecessary or prefer a home-care solution and either wait until it is too late or too expensive. This mindset is demonstrated by the fact that LTCI sales have fallen 37% over the last year.

Annuity Innovation: Long Term Care Benefits

A beneficial solution can be an annuity that automatically increases the benefits it pays if long-term care is needed. Congress included some helpful provisions in the Pension Protection Act of 2006 that went into effect on January 1, 2010 that provide for such benefit payments to be income-tax free.

1 John Hancock National Study Finds Long-Term Care Costs Continue to Climb Across All Provider Options. July 30, 2013.

2 Source: American Association for Long-Term Care Insurance. http://www.aaltci.org/long-term-care-insurance/learning-center/long-term-care-statistics.php

Under these annuity designs, clients do not pay out-of-pocket for the long-term care coverage. Rather, the carrier deducts charges from the interest that is credited to the annuity. These charges are less than the amount of interest being credited to the annuity, so the annuity balance continues to grow. Moreover, these monthly charges are not included in the owner's income, but instead simply reduce the income-tax cost basis of the annuity.

The benefits for your clients are easy to see. They can do a 1035 exchange of their existing annuities and get something more – sometimes up to triple their money if long-term care is needed. They get long-term care coverage and don't need to invade their savings, and they can receive benefits for care received at home. But notice, it is not use it or lose it – if they never use the long-term care benefits, their annuity balance grows.

Finally, almost all deferred fixed annuities provide many surrender-free liquidity options for unexpected expenses such as trips or to purchase a special gift. So retirees can still enjoy the spontaneity and joy of visiting loved ones or the smile of giving a treasured gift.

These annuities are not for everyone, and it is the financial professional's job to look for all suitable solutions that meet their client's unique needs. However, many clients may want to consider these affordable and powerful benefits. The insurance industry is innovating all the time and these products are a great balance to an investment portfolio. To ensure suitability, it's always important for investment advisors to consider these insurance options to complement investment planning solutions.