Designing a Monthly Paycheck in Retirement

MANAGING RETIREMENT DECISIONS SERIES

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"WHERE'S MY PAYCHECK GOING TO COME FROM?" That is a common question for new retirees and near-retirees when they start mapping out the retirement journey ahead. During their working years, many had regular paychecks coming in to cover ongoing expenses. But what will take the place of the paycheck in retirement? This Decision Brief points out things to consider when designing monthly income from the available options.

Social Security checks provide a portion of monthly income for most retirees. Some retirees also receive monthly checks from a traditional pension plan. These sources typically form the foundation of a retiree's income plan. But to maintain their desired standard of living, many people also need additional monthly income during retirement. Ensuring that other sources of income last throughout retirement can be a challenge.

For many, the discussion revolves around two questions: "Should I withdraw money from my savings and investment accounts if I need more than my Social Security or pension? Or, should I purchase financial products—like annuities—that will pay me a guaranteed income stream?"

> **Take Note:** The choice between taking withdrawals and purchasing an annuity involves many trade-offs, so it pays to look at the issue from many angles before reaching a decision. There is no one-size-fits-all strategy.

Income Options and Trade-Offs

Understanding the retirement income options and their trade-offs will make it easier to design the best income plan. Here are some key definitions of the major categories of options for generating income:

- *Income annuity.* This is a retirement income plan—an annuity—that insurance companies offer for purchase. It is called an income annuity (or an immediate annuity) because after a retiree pays a lump sum to purchase an annuity, the insurance company starts paying out a guaranteed monthly income for life (or for a set number of years, if preferred). This income is often called an annuity payout. In many ways, the income annuity functions much like a traditional pension plan. Most income annuities do not allow access to the funds in the annuity, so income annuity owners cannot withdraw any additional money later.
- *Other products with lifetime guarantees.* These products (described in more detail later) go by names like variable annuities with lifetime withdrawal benefits and longevity insurance. All these products provide flexible access to the funds during the early retirement years and lifetime income guarantees for the later years.

- *Withdrawal Strategies.* This refers to methods that retirees use to take money from their personal savings and investment accounts to pay for their living costs. They can remove this money as they choose on an as-needed basis or, if they prefer, they can request that the institution holding the money distribute withdrawals on a scheduled basis (called systematic withdrawals). This strategy requires the retiree to manage and invest the funds which can become difficult in older ages if their cognitive ability declines. Withdrawals can continue only while there is still money in the account. There is no guarantee that withdrawals can continue for the life of the account owner.

Here are some advantages and disadvantages of these retirement funding options:

Features	Income Annuity	Other Products with Guarantees	Withdrawals
Guaranteed income for life	Yes	Yes	No
Longevity risk pooling*	Yes	Some	No
Liquidity/access to funds	Not in most products	Yes, within limits	Yes
Remaining account value goes to heirs if early death	Not in most products	Yes, after fees for guarantees	Yes
Owner can control investments in the account while income is being paid out	No	Yes, within limits	Yes

* Longevity risk pooling is a technical term that annuity experts use to describe how annuity companies handle income payments (or payouts) to annuity customers. The company "pools" the funds of annuity owners who have early deaths with those of people who live longer. This produces a type of subsidy between the two groups. The policyholders benefit because the pooling enables them to receive higher payouts than they would typically obtain if taking systematic withdrawals from their funds.

Important: Protection from fraud and loss of income due to poor investment decisions or financial market returns are growing concerns for retirees. *The more a retiree's income is guaranteed through Social Security, pensions and insured annuities, the more protection a retiree will have against fraud and adverse investment returns.*

The good news is that there are choices. The bad news is that it takes time to sort out how to make choices that are best suited to a retiree's needs—needs that may change over time due to changing circumstances.

A good place to start is to evaluate how much flexibility the retiree desires when it comes to accessing savings and investments. Early in retirement, for example, people may have considerable flexibility to spend discretionary funds on hobbies or vacations. In the later years, however, this flexibility may decline or uncertainty may rise because of health care costs or long-term care costs.

Early Steps

An early step is to project future sources of income and estimated expenses. Sources of future income may include Social Security, work-related pensions, or earnings from continuing to work.

Some income items, like Social Security and government pensions, will adjust for inflation. Other income items, like most corporate pensions, are fixed at the original payout level for life. While some corporate pension plans make ad hoc adjustments for inflation, such adjustments have become less common.

For future expenses, experts suggest splitting them into two categories: 1) required living expenses, including taxes; and 2) discretionary expenses. Some even suggest three categories: 1) required living expenses based on a minimum acceptable level of lifestyle; 2) additional expenses based on a more desirable lifestyle; and 3) discretionary expenses. Either way, deciding on an approach to spending needs can help with developing a reasonable plan.

Individuals who have mortgage, credit card or other debt at the time of retirement need to decide whether to pay down all or part of the debt. A key decision factor is the amount of assets and liquidity that will remain after paying down debt.

In addition, those with work-based retirement plans may have decisions to make before considering purchase of any retirement products. For example, Rita has a traditional (defined-benefit) pension plan at work. At retirement, she may be given a choice between: 1) receiving a regular monthly pension payment; or 2) receiving a lump sum equal to the present value of those payments (which she could then use for living expenses).

Once Rita decides and receives the lump sum or the pension payments, she will not be able to change her decision. To help in the decision making, Rita could try comparing the employer's offer to the monthly income she might get from an income annuity that she buys on her own with the lump sum the employer has offered. If Rita is married, she will need to consider the potential impact of her choice on her spouse.

Changes in Discretionary Expenses

A retiree's lifestyle choices and health care needs will change during the retirement years. In addition, many retirees' discretionary expenses will decline over time in retirement.

Factor the Mortgage in Planning

Retirees with sufficient funds might consider this strategy: Use the funds to buy an income annuity and then use the annuity's monthly payouts to pay down the mortgage.

That sounds like a rational approach. However, unless the mortgage interest rate is well below market rates, it is unlikely to make good financial sense.

In general, it rarely makes sense to buy a financial product to pay for another financial product.

Inflation Reminder

Most required expenses, except for fixed-rate mortgages, will increase with inflation.

Products with Lifetime Guarantees

If projected future living expenses exceed future income, retirees may decide to fill the gap by using some of their savings and investments to buy a product containing lifetime income guarantees. The purpose is to increase the amount of guaranteed income available to cover required living expenses. Here are some examples of products with lifetime guarantees:

Income annuities. The most basic choice would be an income annuity. As discussed above, this is essentially an insurance policy. The buyer pays a certain dollar amount up front and the annuity pays a fixed amount per month for life (called the payout or income). Income annuity products come with various features that make them adaptable for individual situations. For example, income annuities:

- Cover either a single life (individual only) or joint lives (individual and survivor).
- Come with various refund options—for example, a guarantee that payments will last at least 10 years even in the event of death of the payee. (The larger the benefit under the refund feature, the lower the initial monthly payment.)
- Pay a flat monthly amount for life, in most cases, or make payments that increase by a set percentage each year.
- May adjust the monthly payments each year for actual inflation. Not all income annuities do this. (Note: The pricing for this type of annuity—which shows up as a reduction in monthly payments otherwise available—may be costly. Some retirees may prefer to purchase an annuity that pays a flat amount or a set percentage increase, and use other investments to provide additional inflation protection.)

Variable annuity with guaranteed lifetime withdrawal benefits. The variable annuity with a guaranteed lifetime withdrawal benefit (GLWB) has become a very popular annuity product in financial income-planning circles.

Variable annuities let annuity owners invest their policy's total value in an assortment of subaccounts including equity, bond, and even fixed interest accounts. People can add a GLWB to the annuity for an annual fee. The GLWB guarantees that the policy owner can make lifetime withdrawals of an amount that varies by the guarantee in the contract. Even if the annuity's subaccount values drop to zero, the guaranteed withdrawal amounts will continue to be paid.

Like an income annuity, a variable annuity with a GLWB rider provides guaranteed income. Unlike an income annuity, if the annuity investments do well, there is the potential to earn returns in addition to the guaranteed income amount. However, there is also the potential that a variable annuity may deliver results worse than an income annuity. Variable annuities may also provide a death benefit that will pay out upon the death of the purchaser.

Despite their popularity, variable annuities with GLWBs do have some negatives to consider. For example:

- Complexity. The GLWB features on a variable annuity are often misunderstood and many people mistakenly believe their investment returns are guaranteed. The complexity of the guarantees offered can make it difficult to compare these annuity products with other alternatives.
- Expenses. Annual costs of a variable annuity with a GLWB may exceed 3 percent of asset value. (Note: Annual cost refers to the amount the insurance company charges for its expenses and the guarantees in the product. An annual cost of 3 percent means the insurer will reduce the rate of return on the product by 3 percent.)
- High surrender charges if the owner exits the policy in the first 10 years. These can limit the policyowner's ability to switch to other retirement income options.

Longevity insurance. This product is an income annuity with the initial payout delayed for a number of years after annuity purchase, even deep into old age. The delayed payout enables the contract to make larger income payments than income annuities that start making payouts immediately after purchase.

A special type of longevity annuity is the Qualified Longevity Annuity Contract (QLAC). This is available to owners of individual retirement accounts or other qualified retirement accounts. These annuities allow an individual to invest up to 25 percent of the retirement account (or $125,000 if less) into an annuity that defers the start of the income payouts for several years, up to age 85. The policyowner can defer taking required minimum distributions (RMDs) from the QLAC account during the deferral period.

Take the example of Pete, a 65-year-old who buys longevity insurance that begins paying a monthly income at age 85. Pete is able to live until at least age 85 on other income and withdrawals from his regular investments remaining after purchasing the longevity annuity. He can do this because he has the assurance of knowing that he will have a source of extra lifetime income available after age 85 if he lives that long. Note that using a longevity annuity does not guarantee Pete's total income before and after age 85 will remain level.

Delaying Social Security

Every month that a person delays the start of Social Security benefits between ages 62 and 70 results in a higher monthly benefit. This is like "longevity" insurance in the sense that the longer a person lives, the more valuable the decision to delay Social Security becomes.

For that reason, it is worth considering whether to delay the start of Social Security benefits before deciding to purchase income products including risk-free bonds, growth stocks, or insurance annuities.

Research has shown that the decision to delay Social Security is the best hedge against the three things that threaten most retirement plans—high inflation, an unusually long lifetime, and bad market returns.

Some people may also want to purchase longevity insurance to provide them with more income at the later ages to help pay for potential in-home care or long-term care expenses. However, purchasing a longevity annuity is generally not a substitute for purchasing a long-term care insurance product.

Investments with Systematic Withdrawals

Many retirees have money in IRAs, 401(k) plans or other account-based retirement plans. One option is to leave the funds invested and, depending on the plan's provisions, withdraw funds on a fixed schedule.

To make withdrawals, they could use a popular rule of thumb called the "4 percent rule". This suggests that, by investing appropriately, retirees could potentially be able to withdraw about 4 percent of their account balances each year and have the funds last for 30 years. Assuming a retirement account invests about 60 percent in stocks and 40 percent in bonds, a person using the 4 percent rule might expect to withdraw $4,000 per year (or $333.33 per month) for every $100,000 saved.

There are several risks to consider with this approach to taking withdrawals, however.

1. Even if the retiree invests appropriately, using a diversified mix of stock and bond mutual funds, the results can be quite different than expected, depending on economic conditions during the retirement years.
2. The 4 percent rule of thumb does not consider taxes. For example, if a retiree who is subject to a 25 percent income tax rate withdraws $4,000 from an individual retirement account, this person will have $3,000 to spend after deduction of income taxes.
3. If the value of a person's investments go down shortly after retirement, the retiree may need to reduce the withdrawals that he or she had originally planned to take in order to stay on budget.
4. There are no guarantees as to the outcome. Poor investment decisions made by the individual or the financial advisor or unfavorable financial market returns can mean a shift in plans. Retirees may need may need to reduce withdrawals from their retirement funds or run the risk of running out of money.

What about the Costs?

In an ideal world, each product category would have a number of attractively priced products available to retirement-minded consumers. However, some product categories are still new and developing. That means consumers may have difficulty locating providers and distributors in one category or another, or difficulty locating a variety of prices and options.

In general, in today's market, the following trends prevail:

- Variable annuities are widely available.
- Income annuities are widely available.
- Longevity insurance is offered only by a few companies.

Bottom Line

When comparing regular investment products to other investment or insured products with longevity guarantees, retirees and their advisors will find some very attractively priced regular investment products available. These include index funds and exchange-traded funds, both of which have an expense cost of a fraction of 1 percent a year. However, remember these regular investment products do not provide a guaranteed income over a person's lifetime.

Some retirees and near-retirees may prefer to invest in products with guarantees. The market for income annuities is competitive, and low-cost products are available. However, low-cost income products are not always available in certain markets. For instance, variable annuities with lifetime guarantees typically factor significant commission expenses into their pricing. Other products are newer with a smaller market that is currently not priced very competitively.

This disparity in guarantee offerings may impact the decisions that older people make regarding selection of retirement products having guarantees. Retirees will need to think carefully about the trade-offs involved in using or not using these products. If a large sum of money is involved, they may want to consider purchasing annuities from more than one insurance company.

In choosing products, retirees will need to pay attention to the tax effects. Tax treatment varies among the different financial products, so after-tax results may look quite different from before-tax results. It also helps to pay attention to the financial strength of the insurance company selling the product.

Another consideration is to evaluate which products provide the retiree with the most security later in life. Cognitive decline impacts decision making, and this may make it difficult to properly manage an investment portfolio over time.

It is essential to work with advisors who are experts in investments, insurance and retirement planning and who understand the tax effects. Advisors or individuals who use financial projection software in their planning will want to check to be sure the software takes tax considerations properly into account.

Key Questions

Key questions for those considering income products with guarantees include:

1. What type of annuities or other income products with guarantees to consider?
2. How much guaranteed income to buy?
3. How much to spend for a guaranteed income product?
4. When is the best time to purchase an income product?
5. Would buying smaller amounts of guaranteed income periodically or over several years work for my needs?
6. What are the advantages and disadvantages of buying income products from more than one insurance company?
7. How financially secure is the insurance company under consideration?

It's important to make the decision in view of the buyer's specific situation since there is no "one-size-fits-all" solution.

Retirees will also want to understand how the advisor is paid. Some advisors are paid more based on the types of products sold, and others are paid fees for time spent. Some are paid a combination.

Assessing so many considerations may seem overwhelming. But approaching income planning on a step-by-step basis may help make the decision-making process easier. Fortunately, there are resources to consult including those listed in the box, and most communities have qualified experts available as well. Setting up a secure income stream for retirement represents a new beginning on life's journey. It is well worth the time and effort involved.

Additional Resources

For the website entries, please go to the website and enter the name of the article or author into the search box.

- Pechter, Kerry. "Annuities for Dummies"
- Dolan, Farrell. "Applying the 4-Box Strategy to Retirement Income Planning: Generating a Lifetime of Income" LIMRA's *MarketFacts Quarterly.*
- Tomlinson, Joseph A. "Income Choices" Financial Planning.
- Vernon, Steve: "Money for Life: Turn Your IRA and 401(k) into a Lifetime Retirement Paycheck" at www.restoflife.com and "A Retirement Income Strategy for Do-It Yourselfers" and "Near-Retirees, Don't Make this Common Mistake" at www.cbsnews.com.
- Anspach, Dana. "Control Your Retirement Destiny: Achieving Financial Security Before the Big Transition"
- Quinn, Jane Bryant. "How to Make Your Money Last: The Indispensable Retirement Guide"
- Center for Retirement Research of Boston College. "Should You Buy an Annuity from Social Security" at http://crr.bc.edu/briefs/should-you-buy-an-annuity-from-social-security/

The Society of Actuaries Post Retirement Needs and Risks committee has other Decision Briefs providing additional information on the major decisions encountered in retirement. All of the briefs can be located at: https://www.soa.org/research-reports/2012/research-managing-retirement-decisions/

The Society of Actuaries would like to acknowledge the work of its Committee on Post-Retirement Needs and Risks in producing this series.

The committee's mission is to initiate and coordinate the development of educational materials, continuing education programs and research related to risks and needs during the post retirement period. Individuals interested in learning more about the committee's activities are encouraged to contact the Society of Actuaries at 847-706-3500 for more information. Additional information and research reports may be found at http:// www.soa.org.

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