

Annuitize And Invest The Difference

BY MATHEW GREENWALD

A new rule of thumb seems in order for this time of financial stress for many retirees: “Annuitize and invest the difference.”

This is not to suggest that retirees should put all, or even most, of their money into a life annuity. But for most retirees, putting 10% to 25% of their funds into life annuities, at one time, or over time, will not only give them more financial security, it will enable them to invest more effectively for the long term.

The strong advantages of this approach can be easily demonstrated. Take the example of a retired 70-year-old man who needs \$1,000 a month on which he can rely, a situation seen by most advisors. (I picked age 70 because it is in the 70th year of age that people must start taking required minimum distributions from their qualified plan accounts. However, the rule of thumb is applicable at somewhat younger and older ages, too.)

A common strategy for producing reliable income is the use of bonds, so this example will use bonds as an alternative. At the time of this writing, in early January 2010, a 10-year AAA-rated corporate bond was paying 3.44%. Thus, an investment of \$349,000 is needed to produce \$1,000 a month for 10 years. However, a 70-year-old man can get \$1,000 a month, guaranteed for life, through payout from a lifetime income annuity for only \$140,000.

Obviously, the “difference” in the cost of producing \$1,000 a month for the two strategies is \$209,000. This means that the person who annuitizes can invest this \$209,000 “difference.”

The key point: Annuitizing (or using

a lifetime immediate annuity) produces income for a lower expenditure than does using other products. This frees up other money—the “difference”—to be invested effectively and for the long term. For retirees, this is crucial.

DEBUNKED

Annuitization Myths

- ▶ If you annuitize, you will leave a smaller estate
- ▶ If you annuitize, you will lose liquidity

WHAT'S TRUE

- ▶ Annuitizing and investing the difference can lead to more financial security for a major segment of the retired population

Critics of annuitization might oppose this strategy by citing one of two common myths.

Myth 1: This says that people who annuitize (or take lifetime annuities) leave smaller estates.

The example above can be used to debunk this myth. The Social Security

mortality tables indicate that a 70-year-old man has a life expectancy of 13.3 years. If the invest the difference strategy only achieves an annual return of 5%, the \$209,000 invested at age 70 would grow to \$396,623 in that 13.3-year period. (Of course, people in average or above average health at age 70—the only people to whom most advisors would sell an income annuity—are likely to live much longer than that.) Thus, the truth is that those who annuitize and invest the difference are most likely to have a bigger, not smaller, estate.

Myth 2: This says that those who annuitize (or take lifetime annuities) lose liquidity.

The above discussion has already demonstrated that, by the 13th year, the “annuitize and invest the difference” approach is very likely to result in more money, and thus liquidity. But even before that, it can be argued that those who annuitize and invest the difference have more real liquidity, even at the beginning.

If the bond holder needs money (and why else is liquidity important?), he would have to sell the bond. But if interest rates rise, as most expect they will, the holder will have to take a loss on the bond sale. Even if the holder does not take a loss, the money withdrawn to meet the liquidity need will reduce the person’s ability to continue to draw the



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income needed for the rest of life.

By comparison, the person who annuitizes and invests the difference has the entire "difference" to liquidate without at all threatening his lifetime guarantee of \$1,000 a month. In the above example, this man could liquidate \$209,000 immediately without disturbing his guaranteed lifetime income.

Granted, the bond holder can get ac-

cess to the total value of the bond, which will be higher in the early years than the value of the side fund in the approach suggested here. But most people will not need to liquidate everything right away. For most, the side fund will be higher in their older years, when the need for liquidity is more likely to emerge.

Let's leave it this way: Those who annuitize and invest the difference have

a lot more liquidity without disturbing their income and are likely to have more overall liquidity later in life. Those who do not annuitize may have somewhat more liquidity in the short term, when they are less likely to need it.

Overall, it appears clear that annuitizing and investing the difference can lead to more financial security for a major segment of the retired population. ■

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