The Signalert Scoop

Courtesy of Systems & Forecasts

October 1, 2020

What You Need to Know About Fixed Annuities

By Dr. Marvin Appel, President
Signalert Asset Management

According to insurance company surveys the most important financial objective for retirement is a secure income for life, no matter how many more years that may be. Lifetime fixed annuities offer this benefit. The question we will examine here is whether the benefits of fixed annuities are worth the costs.

How fixed annuities work

With a lifetime fixed annuity, you pay a lump sum to an insurance company. In return, they pay you a monthly amount for the rest of your life. For example, immediateannuities.com estimates that in New York State a 65-year-old man would have to pay $207,470 in order to receive $1,000 per month for life.[1] What determines how much you must pay up front for a lifetime income of $1,000/month? Three main factors: your age, gender and prevailing investment-grade interest rates.

The best-case scenario is that you purchase a fixed annuity and live far longer than average. In this case, you have won your bet with the insurance company and will likely benefit more than you would with competing investment options. The nightmare is that you pay a lump sum and die shortly thereafter, forfeiting most of the principal that you laid out.

---

[1] https://www.immediateannuities.com/information/annuity-rates-step-1.html accessed 10/1/2020. There is no guarantee that you can actually obtain an annuity with the same terms quoted on the internet.

Insurance companies offer variations on the basic theme. For example, if you pay a lump sum now but defer taking the monthly income for a number of years, the future monthly payout will be larger. In order to address the fear of throwing away money invested in a lifetime annuity by dying prematurely, some products guarantee a certain number of payments regardless of how soon the annuitant dies. In this case, the estate would get the payments. An annuity with this feature would have to pay a lower monthly benefit than one without.

Social Security – the best fixed annuity

Aside from a government pension, Social Security is the best source of fixed retirement income available today to almost every worker. There is virtually no credit risk and benefits are indexed to inflation. So, if you are considering buying a fixed annuity, your first course of action should be to seriously consider collecting your Social Security benefits beginning at age 70, the latest age possible. Every year beyond your full retirement age that you delay Social Security increases your monthly benefit by 8%. (Conversely, every year earlier than your full retirement age that you begin collecting Social Security decreases your benefits by 8%. Full retirement age is 65-67 years of age, depending on when you were born.)

Payout rates versus interest rates

New York Life provides an example of a fixed annuity online. A 65-year-old man who pays $100,000 will get $5,100/year in lifetime income.[2] In other words, the annual payout rate is 5.1% of the initial principal. In the immediateannuities.com example from earlier, the payout rate is 5.78% ($1,000 per month equals $12,000 per year, which is 5.78% of the $207,470 lump sum payment.)

The New York Life website contains a clear footnote that the payout rate is not the same as an interest rate because the payout includes some return of principal. However, I have heard sales pitches from insurance salespeople who have not been as scrupulous in differentiating the payout rate from the rate of interest income. Let's use the NY Life example to see the difference between investment earnings and payout rates.

The life expectancy of a 65-year-old man is 17.9 years according to the Social Security Administration.[3] (That is, the cohort of men turning 65 years old today can, on average,

[2] https://www.nylinvestments.com/annuities/products/New-York-Life-Guaranteed-Lifetime-Income-Annuity-II, accessed 10/1/2020. There is no guarantee that you can actually obtain an annuity with the same terms quoted on the internet.

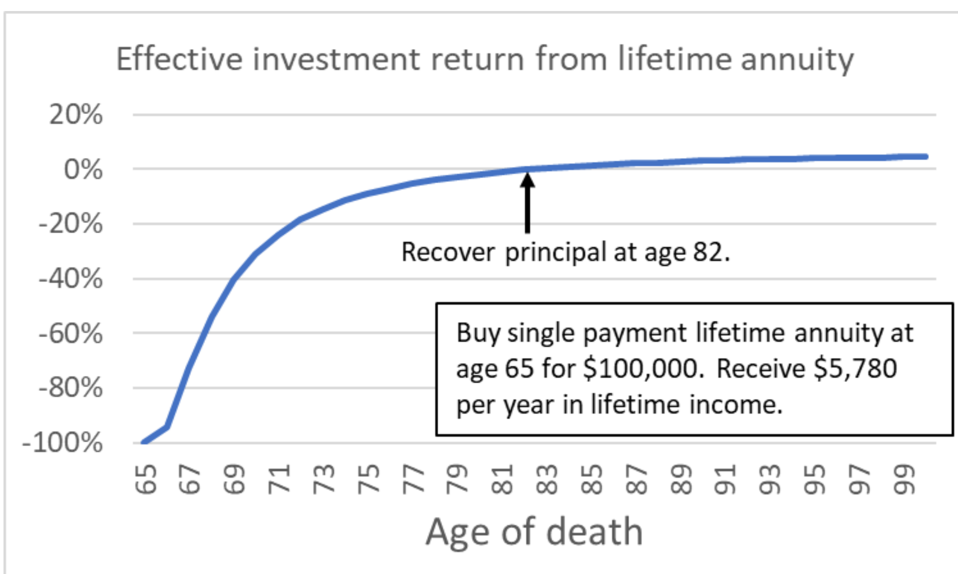
[3] https://www.ssa.gov/oact/STATS/table4c6.html accessed 10/1/2020

expect to live to 82.9 years.) Suppose a 65-year-old man takes $100,000, puts in in no-interest checking and withdraws $5,100 per year. In that case, his money will last him 19.6 years, compared to the expected 17.9 years he would expect to get out of a fixed lifetime annuity. In other words, at today's low interest rates the average 65-year-old man is not earning anything from an immediate annuity that pays out 5.1% of invested principal each year. In fact, he is losing money. The entire 5.1%/year payout is expected to be just a return of principal. He is protected against the financial risk of living longer than average, but will forfeit money if he lives an average lifespan.

Let's turn to the estimate from immediateannuities.com. It suggests the possibility of a payout of $482/month for a $100,000 investment by a 65-year-old man. This is 5.78%/year of cash flow, which is better than the New York Life offering. Based on a life expectancy of 19.3 years, the expected return on invested principal is 0.35%/year.

In comparison, at current interest rates a ladder of Treasury debt ranging from three months to twenty years can earn approximately 0.67% with no credit risk. At these yields, withdrawing $482/month from a laddered portfolio of Treasury debt would last you 18.4 years, compared to the 17.9 years you expect to get from a fixed annuity through immediateannuities.com. Nonetheless, it might be worthwhile to you to accept the slightly lower average return of a fixed annuity in exchange for financial protection if you live longer than average. Conversely, someone with significant health issues (that is, a life expectancy more than one year below average) is highly likely to be better off with a Treasury ladder.

It bears repeating that the longer you are destined to live, the more attractive a fixed annuity becomes. But for every annuitant who benefits by living longer than average there is another who dies sooner than average and realizes less than the expected investment return. In fact, if someone happens to die immediately after purchasing a lifetime annuity, they effectively lose 100% of their investment.



The chart to the right shows how the length of time you hold a fixed annuity affects the lifetime annual earnings. The scenario in the chart is an annuity purchased at age 65 that pays out 5.78% of principal each year.

Notice that you will recover your principal by age 82. If you purchased this annuity and lived to 100, your annual return would be 4.6%/year.

Potentially better lifetime annuities than New York Life's

Barron's wrote an article about annuities in July 2020[4]. The offerings listed in that article assume purchase at age 70 rather than age 65 that I use in this article. That means that the payout rates quoted in Barron's are higher than those in this article and are not an apples-to-apples comparison.

I recommend that you consult this article. Nonetheless, immediateannuities.com appears to me to be the resource with the most attractive fixed annuity payouts.

You lose financial flexibility with lifetime annuities

Once you commit an amount of principal to an annuity, that money is lost to you. If you later decide you need access to that principal, you are stuck. On the other hand, if you attempt to replace a lifetime annuity with a Treasury ladder, you have access to your principal at any time (subject to changes in the price of the bonds due to changes in interest rates). The trade-off is between financial flexibility (which argues against lifetime annuities) and insurance against outliving your income (which argues in favor of lifetime annuities).

Another risk to lifetime annuities is inflation. If inflation heats up after you make the commitment, your fixed income will buy you less. Other investment strategies such as trading equities or high yield bond funds have the potential to keep ahead of an increase in inflation. Of course, unlike a lifetime annuity, these strategies expose you to the risk of market fluctuations which even a successful market timing program can only partially mitigate. The table below lists several different investment options for retirement income, along with some advantages and disadvantages of each.

[4] https://www.barrons.com/articles/the-best-annuities-51595028594 accessed 10/1/2020

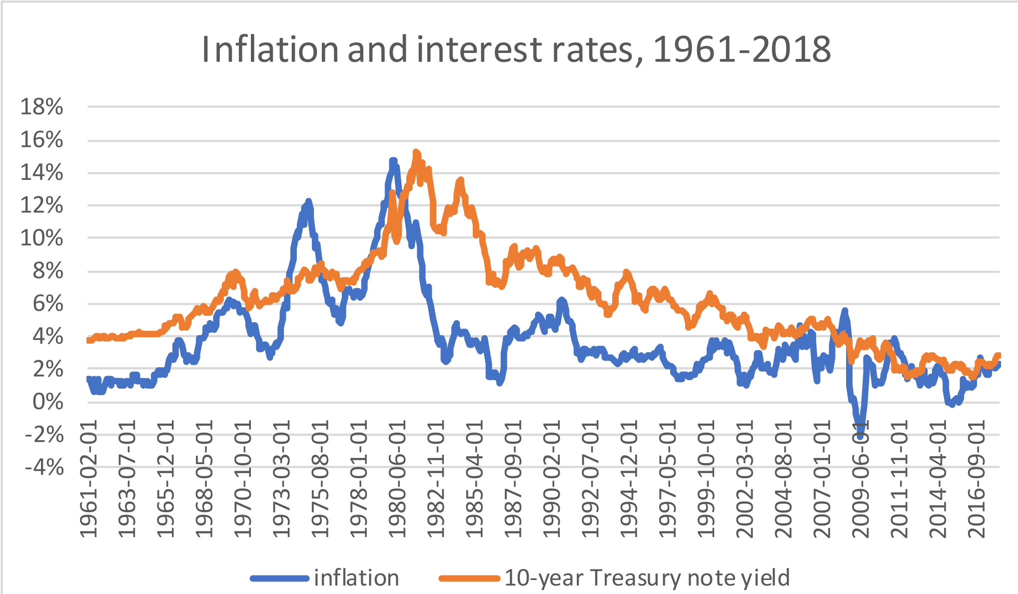
Vehicle	Pros—Risks addressed	Cons—Risk exposure
Fixed lifetime annuity	Good for as long as you live, minimal risk to principal	Risk of loss if you die sooner than expected, exposure to inflation risk, no access to principal if needed sooner than expected
Investment-grade bonds	Low risk to principal, access to principal if needed sooner, principal remains in estate in the event of early death	Risk of outliving your investment income, risk of inflation, risk of principal loss if interest rates rise
High yield or floating rate bond fund trading	Higher potential returns, flexibility in case interest rates or inflation rise, access to principal if needed early, principal remains in estate in the event of early death	Higher investment risk, level of income is not fixed, risk of outliving your investment returns
Equities	Higher potential returns, best potential to keep ahead of inflation over the long term, access to principal if needed early, principal remains in estate in the event of early death	Highest investment risk, level of investment returns is uncertain, risk of outliving your investment returns

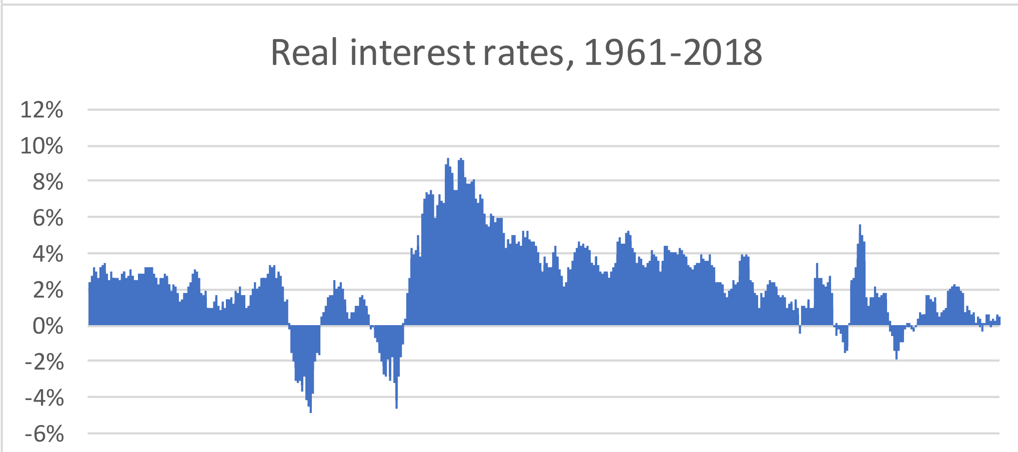
Lifetime annuities are a bet on long-term interest rates

As with any other investment, the odds of success are greater when valuations are attractive. In the case of lifetime annuities, the ideal times to buy would be when real long-term interest rates are above average. The real interest rate is the stated interest rate (currently 0.7% for 10-year Treasury notes) minus the inflation rate (1.3% over the past twelve months), giving a real interest rate of -0.6%. The historical average real interest rate has been 2.4%, so you can see that as of this writing in October 2020, fixed annuities pay far less than they used to.

The chart below shows the history of 10-year Treasury note yields (a benchmark for long term interest rates), inflation and real interest rates from 1961-2018. Inflation, interest rates and real interest rates are all near the low end of their historical ranges. Real yields are unlikely to get back to 2.4% any time soon. (That would imply 10-year Treasury note yields of 4.4% if the Federal Reserve achieves its inflation target of 2%.)

Although I cannot guarantee any future level of interest rates, it seems prudent to me to defer buying a fixed annuity for as long as the Federal Reserve and European Central Bank engage in quantitative easing. I believe this is artificially depressing long-term interest rates around the world. Ideally, I would want to see a level of real 10-year Treasury yields of 2% or nominal yields of 4%. At a minimum, I would want to see real 10-year yields at 1% or higher before recommending lifetime annuities.





Charitable lifetime annuities

Some charities offer you the opportunity to make a contribution through the purchase of a lifetime annuity. You pay the charity a lump sum up front and in return receive lifetime income. These charitable annuities have below-market payouts, which are based on the assumption that half of the principal you invest will be retained by the charity after you receive your lifetime payouts.[5] The difference between the lower payout of a charitable annuity and the rate authorized by the Internal Revenue Service represents the amount of your contribution. For example, the American Council on Gift Annuities recommends a payout rate of 4.2% for 65-year-old annuitants, which is lower than the 5.1% offered by NY Life.

[5] https://www.acga-web.org/public-resources/news/460-suggested-maximum-rate-schedules-effective-july-1-2020#SingleLife accessed 10/1/2020

Conclusion

Fixed annuities can be a valuable component of your retirement planning. However, you must be aware of the costs as well as the benefits before you commit your capital. First, you generally have no access to the principal you use to buy a lifetime annuity, so make sure that you will have ample reserves to meet unexpected emergencies. Second, fixed annuities do not account for inflation. Third, and most important, current interest rates are so low that annuity payouts effectively lock you in to a very low rate of return, approximately 0.35%/year based on a payout of 5.78% for a 65-year-old man (immediateannuities.com). I do not recommend fixed annuities until interest rates get higher, for example a 10-year Treasury yield above 3% and at least 1% above inflation.

Social Security is the best lifetime annuity and does keep up with inflation. You should work with an advisor to maximize your benefits.

Note that the payouts in this article were current at the time I wrote it, but are subject to change at any time. If you are considering a fixed annuity I recommend that you visit the websites I cited for up-to-date data to help you make a decision.

Please also check out our review of variable annuities.

Signalert
Asset Management

Registered Investment Advisors

525 Northern Boulevard, Suite 210
Great Neck, New York 11021
516-829-6444

Since 1973, Signalert, a registered investment advisor, has specialized in risk management and preservation of capital while providing long-term growth.

For personalized investment management or financial planning, please contact us at:

Signalert Asset Management LLC

Email: clientservices@signalert.com
Web: www.signalert.com