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Fixed Annuities Complement Investment Planning

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The investment community has historically used fixed annuities as a stable value component of an integrated investment strategy. Now, two recent innovations within the fixed annuity insurance industry are expanding the role of these products to provide more guarantees to diversify risk and may complement the investment-side of an individual's retirement plan.

The innovations 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:

- Sufficient income to cover their expenses;
- Income that increases over time to bridge the gap between Social Security and any other income;
- Certainty that they cannot outlive their income;
- Emergency income for long-term care or assisted living assistance; and
- Life Style income for unexpected trips for vacation, graduations or weddings.

An investment portfolio can create a desired income and provide a prospect of value and income growth over time. However, without an insurance portfolio the investment-only portfolio creates uncertainty and troubling variability for retirees. And when retirees don't prepare in advance, the cost of adding solutions to provide for these contingencies, increases significantly year after year.

Consider the need to guarantee income for life or longevity risk. Ignoring longevity risk, a typical investment-only approach is to build a portfolio that creates a desired income and asset value through the individual's life expectancy and perhaps a few years beyond that. However, there remains the possibility that the individual 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 retiree's assets. Thus, the longevity risk "tail" ends up wagging the investment strategy "dog."

New Annuity Innovation #1: Longevity Insurance

The first solution is a form of longevity insurance called a deferred payout annuity. The basic idea is that the consumer, 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 the individual 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 the individual to age 85. Retirees are free to live their early retirement years with confidence, perhaps traveling more, because they know the later years are covered.

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 an individual'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.

Genworth Life Insurance Company, in their 2010 Cost of Care Survey, indicated that nearly two-thirds of Americans over age 65 will need long-term care at home or through adult day care, an assisted living facility, or nursing home. Median national costs range from $38,220 to $75,190 annually depending on the type of care needed, and these costs are in addition to—not a replacement for—the individual's current living expenses.

Historically, this risk solution has been long-term care insurance (LTCI), but consumers 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 mind set is demonstrated by the fact that LTCI sales have fallen six out of the last seven years.

New Annuity Innovation #2: Long-Term Care Benefits

This solution is 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 Jan. 1, 2010 that provide for such benefit payments to be income-tax free.

Under these annuity designs, policyholders 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 to the consumer 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 wait, 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 from a treasured gift. Many consumers are considering these affordable and powerful benefits. The insurance industry is innovating all the time and these product features are a great balance to an investment portfolio. To ensure suitability, NAFA encourages investment advisors to consider these insurance options to complement investment planning solutions. Visit NAFA at www.nafa.com for more information. ◻