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6 objections to the "myths" of DIAs

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I'd like to start a movement to banish the term "**life expectancy**" from the retirement planning lexicon. It is one of the most abused and dangerously misunderstood concepts in retirement planning. And this misunderstanding is holding us back. It's holding us back from providing the middle-market consumer with real solutions to a serious problem - outliving one's income in retirement. We need to do something to counter these misconceptions.

TREASURY RULING ON LONGEVITY ANNUITIES

As you may have heard, the Treasury has recently issued a ruling allowing longevity annuities, a.k.a. deferred income annuities (DIAs) to be sold as part of a 401K or IRA plan with favorable tax consequences. Simply put, a DIA allows you to purchase a guaranteed lifetime income stream now (say at age 65), that starts sometime in the distant future (say at age 85). Not to be confused with a typical deferred annuity, there is no cash value with a DIA (you can add a death benefit, but that's not its "purest" form). It works exactly like a single premium immediate annuity (SPIA) except payments start further out into the future. This allows the DIA to provide a classic cost-effective insurance solution by deploying a modest percentage of your assets in a vehicle that spreads the risk of living a long time.

BUT "FINANCIAL EXPERTS" THROW COLD WATER

This is an exciting opportunity to apply new solutions to a serious problem. Yet many "financial experts" are trying to throw cold water on the party. Here is just one recent example at *Forbes.com*. Now, if you review this author's body of work, he seems biased against anything with the term "annu-ity" or "insurance company" in it, so we'd likely need to banish a lot more things to satisfy him. But in any case, his concerns are full of misconceptions. I will address each one later in this article, but want to focus first on what I think is the most important and common misconception. That's the one surrounding "life expectancy".

The argument goes something like this. DIAs pay you nothing if you die before the start date (say, age 85). And your life expectancy is around age 85. So you are "likely" to die before receiving any benefits, and so the evil insurance company is "likely" going to keep all of your money. The implication is that your life expectancy is some kind of virtual upper bound on your life, beyond which all but a few fortunate souls survive. That's the misconception. This is not true or even close to what life expectancy means.

SO WHAT DOES LIFE EXPECTANCY MEAN AND HOW IS IT MISUNDERSTOOD?

As an actuary, I take some portion of the collective responsibility for the term life expectancy as it is somewhat of an actuarial concept. So bear with me as I use a little math (details relegated to this linked spreadsheet for those who want to check my work) to demonstrate the misconception.

Let's say you have 100 reasonably healthy age 65 male and female couples for clients. I've used the most recent Society of Actuaries individual annuitant mortality experience table to calculate their life expectancy. (You could justify other assumptions, but the story does not change that much for our purposes.) Life expectancy is the expected average age at death. So the spreadsheet simply calculates that by projecting out how many are expected to die each year and taking an average. For your 100 clients, the male life expectancy is 86 and the female life expectancy is 88.

But those numbers really don't tell you anything useful. What you really want to know is how many of your 100 clients would be expected to live a long life? Under our assumptions, 56 out of the 100 males will live beyond age 85, 34 will live beyond age 90, and 13 beyond age 95. For the females, it's 64 out of the 100 living beyond age 85, 42 living beyond age 90, and 21 living beyond age 95.

But that's not even the whole picture. If you are advising these clients, you would be talking about providing income so long as either are alive. So you would want to use a joint and survivor DIA. Under those same life expectancy assumptions, you could expect that 84 out of 100 couples will have at least one person still alive at age 85. You'd expect that 62 would have one person alive beyond age 90 and 31 beyond age 95. This is all based upon actual industry experience for individual annuitants. It does not even assume any ongoing improvement in longevity, which shows little if

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any signs of slowing down.

As you can see, the life expectancy numbers of 86 and 88 really provide no useful information when considering how long your clients are likely to need income. It is in no way true to imply that the DIA is some kind of insurance company rip-off where you are likely to not receive any benefits. A DIA will provide a very good return for well over half of your clients, and precisely for all of those who will actually need it, because that's what insurance is supposed to do.

SO HOW DOES THIS MISCONCEPTION SHOW UP IN RETIREMENT PLANNING?

You typically see a few different approaches to retirement planning.

(1) Hope For the Best scenario (where "best" means you die young): Some advisors plan income spending to ensure assets last to your life expectancy age. We have shown that this is a disaster for 84 of your 100 client couples. Can you possibly feel like you've done a good job putting together a retirement plan that only works for 16 percent of your clients? And it only worked for them because they died young, and thus your plan did not actually protect anyone from outliving their assets?

To be fair, many advisors do realize that there is an income need beyond life expectancy. But they argue that clients' retirement assets are so inadequate, that it is too overwhelming to discuss how to stretch those assets, so they resign themselves to "at least" provide income to their life expectancy age. But that makes no sense at all, as it just ignores the problem instead of solving it. It reminds me of the old joke about the drunk who lost his wallet in the dark alley. When asked why he is looking for his wallet under the street light, he says the light is better there.

That approach is not helping anybody find the keys to a retirement solution. The sad part is that solving the real problem costs only a little more than the one they are solving.

(2) Live Off the Interest scenario: Finally, many advisors do realize that they need to provide a plan that will last for life. So they recommend a plan where you "live off the interest". They claim it is safe to withdraw 4 percent to 5 percent of your retirement savings each year and that, over the long haul, interest will be sufficient to cover that. This plan has several problems. First, is it just me or does it seem odd that you save all this money for retirement and then are told by your advisor to never actually spend the money you saved for retirement? Second, it is inefficient to leave all your money on the table when you need income. $500K in retirement savings will only generate $20 to $25K in annual income under this approach. That's not much and how many middle-market couples have saved as much as 500K? Third, this plan might not even work. In our current low interest environment, it is pretty hard to generate 4 percent to 5 percent investment income. So presumably, the plan includes the purchase of stocks, mutual funds, etc. Yet, it only takes two years of minus 30 percent returns to possibly make the plan fall apart. It happens. My spreadsheet shows just one such feasible scenario. Finally, a 4 to 5 percent withdrawal scenario likely runs afoul of Required Minimum Distribution (RMD) requirements assuming your money is in a tax qualified vehicle. So it can be inefficient from a tax standpoint, in that you'll need to pay taxes earlier on more money than you are allowed to spend.

Bottom line is that a DIA can be used to develop a plan superior to these common approaches. But to do so, we need to answer all of the objections to DIAs. So let's address the objections in the *Forbes* article one by one.

OBJECTION 1: YOU PROBABLY WON'T COLLECT ANY DIA BENEFITS

We've already shown that 84 percent of your clients would be likely to collect benefits. Yet it is true that 16 percent or so

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might not. Is that bad? Consider that a typical 45 year old male purchasing 20 year term life insurance has about an 8 percent chance of collecting any benefits (assuming he keeps his policy for 20 years). Or a little Googling will show that the probability of ever collecting anything on your auto theft insurance over 40 years is on the order of 20 percent. And the probability of your home ever burning down and collecting on your homeowners insurance is likely about 0.2 percent. Yet those are all essential and valuable insurance benefits because that's what insurance does. Insurance companies pool your money so that you get precisely the benefit you need when you need it and not when you don't.

OBJECTION 2: THE DIA REQUIRES A HAIRCUT ON YOUR INCOME THAT YOU CANNOT AFFORD

The DIA Treasury Ruling allows for up to 25 percent of your 401K/IRA assets to be used to purchase a DIA. The Forbes author thinks this translates into taking a 25 percent haircut on your retirement income. This is entirely false and shows he does not understand how a DIA would work. With the purchase of a DIA that provides income after age 85, the retirees can now safely use portions of their principle to provide income prior to age 85. In fact, a simple calculation (see linked spreadsheet) shows that a couple age 65 with $500K of retirement assets, using a DIA as part of their plan, could reasonably be expected to generate a lifetime retirement income in excess of $29K per year. This assumes the couple purchase a $29K per year joint & survivor DIA that starts at age 85. Then they spend down their remaining retirement assets at $29K per year from ages 65 to 85. A single retiree could generate over $31K of lifetime income. This uses the same 4 percent interest assumption and a very conservative DIA rate (better rates are likely available). $29K compares to the $20K you would generate with a 4 percent "Live Off the Interest" plan. That's about a 45 percent increase in income. At a 5 percent assumption, the couple could generate over $32K of income per year (compared to $25K under a 5 percent "Live Off the Interest" scenario).

And the DIA would use only 13 percent to 20 percent of their assets, not 25 percent. No haircuts for the children of the Age of Aquarius. On the contrary, they can let their hair grow again (if they still have any)!

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OBJECTION 3: THE DIA CAUSES YOU TO LOSE LIQUIDITY AND CONTROL OVER YOUR ASSETS

This was a valid objection to the traditional SPIA, but the DIA was invented, in part, to address this concern.

It is true that the 13 percent to 20 percent of your assets applied to a DIA would not be immediately liquid and available to you. And you are safely spending down your retirement funds over 20 years. Of course, there may be settlement market opportunities out there to turn that DIA back into cash if you really needed to.

But the liquidity of any of the other retirement funding methods is overstated by comparison. If you spend a portion of your $500K, then you'll have less interest to live off of. If you are investing in stocks/mutual funds/long term bonds, then in any given year the value of your funds can fluctuate by a lot more than the 10 percent to 20 percent you invested in your DIA. So how liquid are your funds in any case?

Finally, a DIA contract can provide guarantees and options (changing start dates, guaranteed income, death benefits, etc.) that actually give you more options and flexibility than the "do it yourself" retirement plans do.

OBJECTION 4: THE DIA DOES NOT ADDRESS INFLATIONARY NEEDS

Inflation does indeed present additional risks for retirees. But that is true under any retirement plan. The DIA does not increase those risks. In fact, a DIA can be designed to offer inflation-adjusted income amounts, in a variety of ways, to reduce those risks.

OBJECTION 5: THE DIA ONLY WORKS FOR THE HEALTHY

DIAs can be designed to be underwritten and reflect the health of the retirees. This would result in substantially cheaper rates and perhaps call for scenarios where the DIA income starts at an earlier age for those retirees with health problems. It is important for such retirees to carefully shop for a DIA that does this, but it is not an inherent flaw in the DIA concept.

OBJECTION 6: THE DIA DOES NOT ADDRESS THE PRIMARY PROBLEM - INSUFFICIENT SAVINGS

There is of course no panacea for anyone who has not accumulated adequate retirement savings and this is a major problem for any retirement plan. For some, their only option will be to look to other options, such as depending upon the government, family, charity, or maybe a retirement life of crime or politics (and there is some overlap here). But again, this is true of any retirement income approach, unless you've figured out a fool-proof way to beat the casino or the lottery.

But a DIA actually can help reduce this problem in several ways. We've already shown that a DIA can allow you to safely draw a much larger income than under a "Live Off the Interest" scenario. In addition, the purchase of a DIA can actually help retirees to develop a more concrete delayed retirement plan if needed. Start by immediately purchasing a DIA to generate the retirement income you need at age 85. Now you've reduced your retirement problem to a simple goal. We can precisely determine how much savings you'll need to retire at any given later age and can develop a specific plan to reach your goals. The result can be a safer, more predictable, earlier retirement with higher income compared to the "do it yourself" plans.

The bottom line in this article is that the DIA is an extremely useful tool for the middle-market to develop a safe and secure retirement plan. And the recent Treasury ruling makes it even more so. When you think about it, the DIA actually allows you to turn 401K/IRA balances into better versions of the nostalgic defined benefit pension plans of yesteryear. Yet misconceptions that are reinforced by the nay-sayers stand in the way.

And beyond the damage done to retirees, the sad part for us is that the DIA is a solution that only the insurance business can offer. So we all need to diligently defend and promote its use. I would love to hear your comments and ideas on ways to do that. ■

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