Article from

Retirement Section News

June 2019

Issue 98

Guaranteed Lifetime Income—How Much Do You Need?

By R. Evan Inglis

You've saved your whole life to be able to afford a comfortable retirement, hopefully free from significant financial stress. Now the time is approaching, and it may seem pretty stressful already! Do you have enough saved? How much can you spend? Should you have an annuity? Fixed annuity or variable annuity? There are a lot of questions! This article aims to answer the key question: How much guaranteed lifetime income should you have?

To answer that main question, you'll need some information:

1. Your estimated account balance at retirement.
2. Your desired level of spending.

And you'll need a retirement spending strategy. If you don't have one already, use the "Feel Free" retirement spending approach. It's simple and safe, so you can feel confident using it. That makes it perfect for helping you to determine how much guaranteed income you need. Divide your age by 20 and feel free to spend that percentage of your wealth each year. If you are 65, you can feel free to spend 3.25 percent of your wealth. At age 80, you could feel free to spend 4.0 percent of your wealth.

> Guaranteed lifetime income comes in many forms—fixed annuities, variable annuities, deferred income annuities and more.

Guaranteed lifetime income comes in many forms—fixed annuities, variable annuities, deferred income annuities and more. This article won't delve into an explanation of those products, but see the appendix for a glossary with brief descriptions. The key about all these products is that they last for your lifetime. That means that you are able to spend the proceeds without worrying about this source of income running out. With your savings, you need to spend conservatively to make sure you don't run out but not so with a lifetime income source.

Use the following process to determine how much guaranteed income makes sense for you.

1. Estimate your account balance plus other savings at retirement. For most portfolios, using a 5 percent return until retirement should provide a reasonable estimate. (TotalSavings)

2. Determine your desired level of spending, adjusting the amount with estimated inflation by 2.5 percent per year between now and retirement. (TotalSpendAmt)

3. Subtract any anticipated income, including Social Security or pensions, from TotalSpendAmt to determine the spending that you will cover with your savings. If you want to retire before your income starts, reduce the anticipated income amount by 5 percent for each year that your retirement start date precedes the income start date. (DesiredSpendAmt)

4. Determine your safe spending level at retirement as a percentage of your savings using any spending strategy that you feel comfortable with. Using the "Feel Free" strategy, at age 70, your safe spending level is 70/20 or 3.5 percent. (SafeSpend%)

5. Determine your safe spending amount by multiplying your TotalSavings by your SafeSpend%. (SafeSpendAmt)

6. Determine whether you need guaranteed lifetime income.
   a. If your DesiredSpendAmt is less than your SafeSpendAmt, then you're set. You can spend from your savings without too much concern that you will run out of money. You are likely to be able to fund a significant bequest. Stop here and look forward to a wonderful retirement, but keep saving to make sure your account balance at retirement reaches the TotalSavings estimate.
   b. If your SafeSpend% is greater than your retirement age divided by 10, then you should consider working longer or cutting back your planned spending. You won't be able to spend at your desired level without a significant chance of running out of money.
   c. If your DesiredSpendAmt is greater than your SafeSpendAmt but not larger than your age divided by 10, then purchasing a lifetime income product will help you reach your spending goal. Go to step 7.

7. Determine the percentage income that an annuity will provide. If you don't have an actual annuity quote, then use

your retirement age divided by 10 as a rough approximation until you get a more accurate number. Different types of annuities provide different percentages of income. Variable annuities are likely to provide the highest potential spending. (AnnuityIncome%)

8. The amount that you should spend on an annuity to meet your desired spending goal is equal to

   (DesiredSpendAmt – SafeSpendAmt) /
   (AnnuityIncome% – SafeSpend%)

   Buying this amount of annuity income will enable you to spend at a safe level and is likely to preserve your level of savings through retirement.

   Chart 1 illustrates this process.

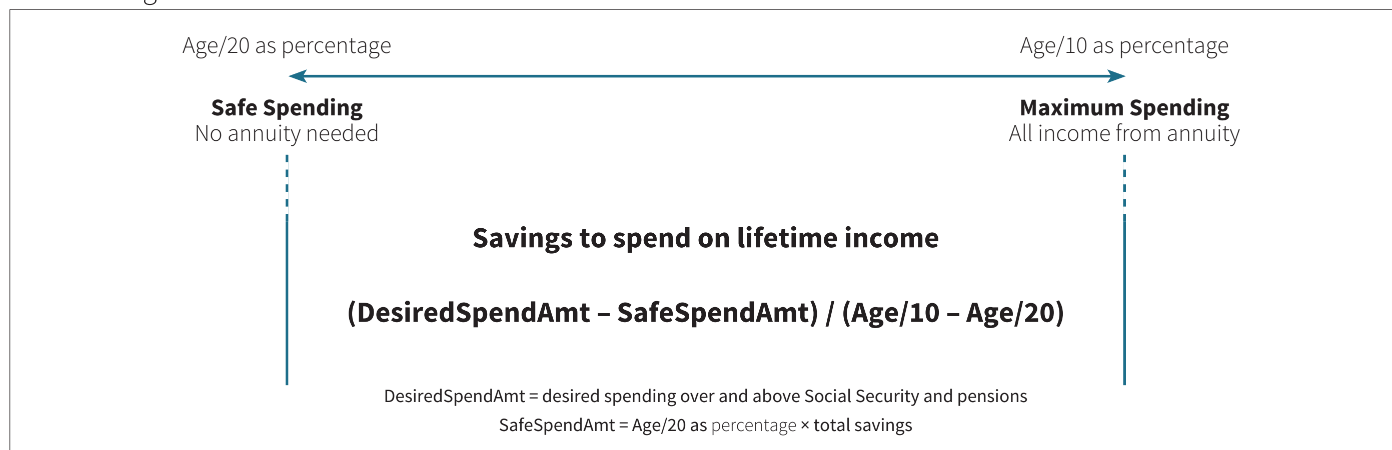
Note that your safe level of savings will change throughout retirement as you get older and as future returns and your actual spending change the value of your portfolio. However, you will need to determine purchase guaranteed lifetime income early in your retirement. Most people spend less as they get older because their level of activity goes down, which is unfortunate because the safe level of spending goes up as individuals grow older. If you feel comfortable with it, you can adjust the process above by increasing the safe spending level just a little to account for this. On the other hand, you may want to be saving for potential long-term care needs.

Note that a variable annuity may provide a significantly higher level of income (in step 7, pg. 12), especially if it is a simple product with no guarantees or return of premium features. It comes with investment risk, but is likely to deliver significantly more income over time than a fixed annuity. In most situations,

a variable annuity will provide the essential lifetime guarantee that enables higher spending in a way that maximizes the safe level of spending in retirement.

Not everyone needs annuity income to provide for the spending they want to do in retirement. However, for those who want to increase their level of spending or need to spend more than is advisable based on a reasonable spending strategy, additional guaranteed lifetime income (i.e., above Social Security) will help. Whatever savings is left over after purchasing some type of annuity is likely to be preserved to a large extent and available as a bequest. Spending down savings in retirement isn't something that most people will want to do and will certainly complicate the objective of being able to spend from retirement savings for your entire lifetime.

Chart 1
Determining Lifetime Income Needs



EXAMPLE

The following example illustrates how you can determine a desirable level of lifetime income. Rather than divide your age by 10 to determine the income from an annuity, whenever possible get an actual quote for the type of annuities that you are considering.

Data

- Age = 65
- Savings = $1,000,000
- Desired Spending = $75,000
- Social Security (at 65) = $25,000

DesiredSpendAmt = $75,000 – $25,000 = $50,000
SafeSpend% = 65/(20 × 100) = 3.25%
AnnuityIncome% (estimate) = 65 / (10 × 100) = 6.5%
SafeSpendAmt = $1,000,000 × 3.25% = $32,500

Savings to Spend on Lifetime Income

($50,000 – $32,500) / (6.5% – 3.25%) = 538,461

Spending Breakdown

- From Annuity = $538,461 × 6.5% = $35,000
- From Savings = $461,539 × 3.25% = $15,000
- From Social Security = $25,000
- Total = $35,000 + $15,000 + $25,000 = $75,000

APPENDIX—ANNUITIES

The options for obtaining guaranteed lifetime income can be identified with one of the categories in the following list. There are numerous variations available within each category.

- Single premium immediate annuity (SPIA): pays a fixed amount for your lifetime or a slightly reduced amount if you choose to have the payments continue to your spouse if he or she lives longer than you.
- Inflation-indexed annuity: the same as an SPIA except that the initial amount is smaller, and it grows with inflation or by a fixed amount such as 2 percent per year.
- Variable annuity or indexed annuity: pays a higher amount than a SPIA initially, and then the amount varies based on investment returns in underlying investment funds or market indexes.
- Deferred income/longevity insurance: payments start at some point in the future, for example at age 85, and then continue for the remainder of your lifetime. ■

Evan Inglis, FSA, EA, FCA, MAAA, is an actuary and thought leader on financial and investment issues for retirement programs and pension plans. He can be contacted at *revaninglis@gmail.com*.