Kiplinger's PERSONAL FINANCE

BY ANNE KATES SMITH

TOPIC A

AN INCOME STREAM TO LAST A LIFETIME

NO COMPANY PENSION? YOU CAN CREATE ONE OF YOUR OWN.

IMAGINE A RETIREMENT- savings well that never runs dry, no matter how long you live. If that's the dream of future retirees, why are annuities, which make that very promise, such a minuscule part of our collective nest egg? This so-called annuity puzzle has baffled academics, policymakers and financial advisers for decades. Now, as more retirees shift their focus from accumulating assets to spending them, solutions to the puzzle may finally be emerging.

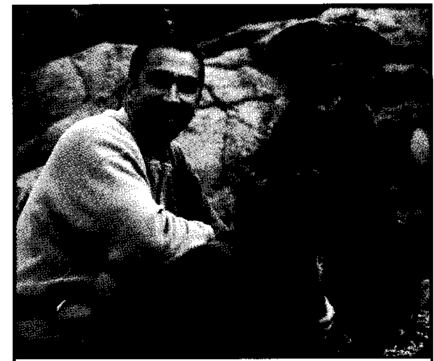
In exchange for a lump sum, annuities guarantee retirees regular payments for the rest of their lives. Sounds attractive, but investors have long shunned annuities, citing high fees, low returns and the inability to bequeath the money to heirs. Worst of all, there's the "bus" risk—that is, the chance of getting hit by one, or meeting some other untimely demise and not getting your money's worth. "I've explored all the perfectly rational reasons people don't like annuities, and I've concluded there's something more fundamental," says Jeffrey Brown, a finance professor at the University of Illinois. Namely, he says, we're trained to think in terms of accumulating wealth, with a focus on rates of return, market risk and the like. As an investment, an annuity just doesn't stack up.

But if your objective is to ensure enough money to live on no matter how long you live—think consumption instead of accumulation—then an annuity is a no-brainer. "I just tell clients that they're buying their own pension," says financial planner Jim Saulnier, in Fort Collins, Colo. "That grabs their attention."

In a world with fewer corporate pensions, longer retirements and substantial 401(k) balances, annuities should loom large in most retirement plans. Borrowing from the playbook of the 401(k) industry is the way to make that happen, says a group of researchers at the Retirement Security Project in Washington, D.C. The group is pitching a plan to employers that would let retirees "test drive" an annuity by automatically channeling a portion of 401(k) assets into one at retirement, similar to the way many workers are automatically enrolled in 401(k) savings plans at the start of their career. After two years, retirees could opt out.

Specifics—such as how much to put into which type of annuity—would vary. In general, Saulnier suggests putting no more than one-fourth to one-third of your portfolio into an immediate annuity, or just enough to cover required expenses. He rarely chooses inflation protection because the monthly payout is so much lower it takes years of inflation adjustments to catch up. He does recommend a "period certain" feature—meaning that if you die before a certain cutoff date, your heirs will receive annuity payouts until the cutoff. Check annuities and their prices at www.immediateannuities.com.

If you designate less for an annuity—say, 10% to 15% of your portfolio—then a longevity annuity may be a better choice, says Jason Scott, of Financial Engines. Because payouts don't start until later in life, perhaps in your eighties, longevity annuities cost less to purchase. Plus, with the worry of outliving your money off the table, these annuities let you spend more freely in retirement. And isn't that what we're all saving for?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