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INVESTING FOR RETIREMENT

Making the Case To Buy an Annuity

Retirees may get more financial security by combining insurance products and mutual funds, some analysts say

By Lavonne Kuykendall

Many investors approaching retirement think they have no need for annuities. But the lifetime-income guarantees offered by these insurance-company products can add security to portfolios that are mostly composed of stock and bond mutual funds.

A market downturn that hits right before or early in retirement can leave even conservative investors with far less money to draw from than planned and little time to recoup the losses, increasing the risk they could run out. By putting a portion of their retirement funds in annuities, some investment researchers say, investors can arrange for a more dependable income stream for life.

"The longer we live, the greater stress that puts on our ability to pay for our retirement-income goal — an inflation-adjusted income stream that lasts as long as we do," says Tom Idzorek, chief investment officer at Morningstar Inc.'s Ibbotson Associates unit. "We need to go beyond the universe of mutual funds and exchange-traded funds and consider longevity-risk products."

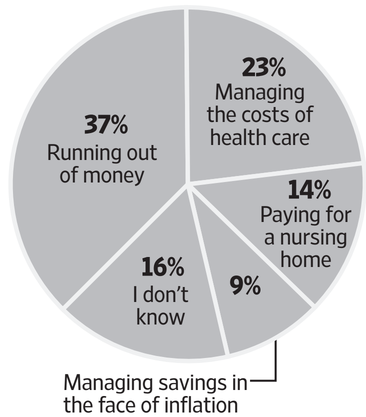
According to Financial Research Corp., a Boston research firm, a 65-year-old retiree who withdraws an inflation-adjusted $45,000 annually from a $1 million portfolio of stock and bond investments has a 25% chance of running out of money before age 92. But if the retiree gets the same annual income by investing $400,000 in an immediate annuity and withdrawing the rest from $600,000 invested in stocks and bonds, the chance of running out of money drops to 6%, the research firm says.

To be sure, Ibbotson and a number of other companies and academics that have cited the benefits of annuities do consulting work or otherwise earn income from insurers that sell annuities. But they make a persuasive case, particularly in light of the two bear markets of the past decade.

SURVEY: What will be the biggest financial challenge if you live to 100?

Here's the breakdown of answers from 1,006 individuals ages 45 to 70

Source: Society of Actuaries



An Annuity Fan

One believer is Bud Hebeler, 77, a retired Boeing executive who runs www.analyzenow.com, a retirement-planning website. He says annuities have made his retirement more secure, helping him avoid the problems that plague many retirees who rely primarily on their savings.

"People didn't think they would live that long, and they spent too much too early," Mr. Hebeler says. Low interest rates over the past few years have hurt, too. "Now, they are trying to ration a limited amount of savings."

According to actuarial mortality tables, a healthy 65-year-old man has a 33% chance and a healthy woman a 44% chance of living beyond 90. For a 65-year-old couple, there's more than a 50% chance that at least one of them will live beyond 90.

Mr. Hebeler has invested in "immediate" annuities in stages over three years — a strategy known as "laddering" — to take advantage of potentially rising interest rates. With an immediate annuity, investors hand a lump sum to an insurer and get a promise of regular payments that will last for as long as they live; when interest rates are low, as they are today, investors lock in payments that are smaller than they might get in other environments.

People in poor health or those with a family history of early death usually are advised to steer clear of annuities. But Mr. Hebeler says he hopes to live into his 90s like his parents did, which would make the annuities a great deal for him and allow him to leave more money to his children. He also says the protection provided by the annuities has enabled him to invest the rest of his portfolio more aggressively, with a larger percentage in stocks than he might have had otherwise.

Two Types of Annuities

Retirees may do best by augmenting their mutual-fund portfolios with both immediate annuities and a second variety — variable annuities that have lifetime-income benefits — according to both Ibbotson and Moshe Milevsky, a finance professor at York University in Toronto who has written extensively about the benefits of annuities.

With a variable annuity, investors typically invest in mutual-fund-like subaccounts — but have the option of buying income benefits that can reduce the risk that a market downturn during retirement will devastate investment values.

For an added fee, typically 0.5% to 1% a year, a rider promises the contract owner a set percentage of the original investment, typically around 5%, annually for life.

If the investments do well, the contract value and annual payout may step up to reflect

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the higher balance. Money not withdrawn in the holder's lifetime can be left to heirs.

On the negative side, variable annuities have long had a reputation as being too expensive and pushed by salespeople for large commissions.

In a paper written for insurer MetLife Inc. Mr. Milevsky explains that immediate annuities and variable annuities with guaranteed living benefits provide different advantages to a portfolio. He gives immediate annuities top marks for protecting investors against the risk of outliving their money, particularly if the investors live longer than expected. Variable annuities with lifetime-income benefits, meanwhile, help protect investments from "sequence of returns risk," or the hazard of a big downturn just before or after retirement.

Ibbotson has developed proprietary guidelines to make personalized recommendations on annuity purchases based on an investor's answers to typical retirement-planning questions. It has licensed the program to some insurers and investment managers, including TIAA-CREF, New York Life and Great-West Retirement Services, a unit of Great-West Life & Annuity Insurance Co.

In general, the guidelines recommend that older investors allocate more of their money to immediate fixed annuities to take advantage of the higher payout that is keyed to age at the time payments begin. A typical 65-year-old should put around 20% of his money in a fixed annuity and about 30% in a variable annuity, according to the guidelines. A 75-year-old should put around 35% in a fixed annuity and a little less than 30% in a variable annuity with a minimum withdrawal benefit for life, Ibbotson says.

Conservative investors should consider investing a little more in each than investors who are comfortable with market risk.

Invest Aggressively

Wealthy investors who face no risk of outliving their money probably don't need annuities at all, many advisers say. But retirees whose pensions and Social Security income fall well short of their needs may want to put a higher percentage of savings into a longevity product. For investors who want to maintain greater control of their assets, a variable annuity with a minimum withdrawal benefit for life should be favored over immediate annuities, some advisers say.

Ibbotson's Mr. Idzorek recommends that investors take advantage of the downside protection in a variable annuity by investing their subaccount funds as aggressively as their contract allows. The fee for the guaranteed-minimum-withdrawal feature is typically the same no matter how the funds are invested.

Most investors buy variable annuities right around retirement. But it may be a good idea to start buying these products five to 10 years before retirement and spread the deposits over several years, rather than try to time the market with one big buy, according to Great-West Retirement Services.

Variable annuities are beginning to make an appearance in some 401(k) plans, and Great-West says it has gotten a lot of interest in its 401(k) annuity offering, launched last year.

Ms. Kuykendall is a former reporter for Dow Jones Newswires.

Annuities are long-term investments designed for retirement purposes. Withdrawals of taxable amounts are subject to income tax and, if taken prior to age 59½, a 10% federal tax penalty may apply. Early withdrawals may be subject to withdrawal charges. Optional riders are available at an additional cost. All guarantees are based on the claims-paying ability of the insurer. An annuity is typically a tax-deferred investment. Holding an annuity in an IRA or other qualified account offers no additional tax benefit. Therefore, an annuity should be used to fund an IRA or qualified plan for annuity features other than tax deferral. Product features and availability vary by state. Restrictions and limitations may apply.

Investors should carefully consider a variable annuity's risks, charges, limitations, and expenses, as well as the risks, charges, expenses, and investment objectives of the underlying investment options. This and other information is provided in the product and underlying fund prospectuses. To obtain a copy of the prospectus or for other information, contact an annuity specialist today at 800-347-7496 or email annuities@tdameritrade.com. If you are a registered investment advisor, contact our Institutional annuities desk at 866-451-1258 or annuities@tdameritradeinstitutional.com. Read the prospectuses carefully before investing.