

Lifetime Income Annuities: The Instant Pension Plan

by James E. McWhinney (Contact Author | Biography)

After decades of hard work and diligent savings, you've amassed a tidy nest egg and are ready to retire. The challenge you now face is the need to make your nest egg last as long as you do. If outliving your money is your greatest financial fear, the lifetime <u>income annuity</u> may be just what you need.

How It Works

Lifetime annuities, also known as <u>immediate annuities</u>, begin with a simple proposition. The investor hands over a lump sum amount of money in exchange for a guaranteed payout for life. At its most basic, that's the story in a nutshell. Investors looking to customize the arrangement have a wide variety of options from which to choose.

Under the base scenario, the investor's initial investment goes to the insurance company upon the investor's death. If the investor is married, payments can be scheduled over the lifetimes of the investor and a spouse instead of just over a single lifetime. Spousal payments can be maintained at the level of joint payments or reduced by an agreed-upon percentage, based on the investor's assumptions about the need for future cash flow. (Decrease the value of your taxable estate and prevent the tax man from getting you one last time; read *Shifting Life Insurance Ownership*.)

If estate planning is a big concern, there are ways to craft the agreement so that a specific percentage of the original investment is passed on to heirs. Choices here include the return of the original investment amount, the return of a percentage of the original investment, the return of the original amount invested minus any amount paid out and other similar variations.

<u>Inflation</u> protection is another option. Structured payments that increase over time, adjustments in the policy's interest rate and the ability to adjust payment size are all strategies that can be used in lieu of fixed income payments. Payments linked to changes in the <u>Consumer Price Index</u>, a common barometer of inflation, are also available.

The list of choices is long and requires some effort in order to craft the perfect scenario. Keep in mind that each of these choices costs money, which is taken out of the investment in the form of a reduced payout. As a result of the costs and basic structure of immediate annuities, they generally offer investors a lower payout than that which might be available had stocks or bonds been selected instead. (Learn more in our complete investment guide; 20 Investments Tutorial.)

This lower payout is often cited as a major criticism, but any bear market largely blunts that argument.

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For example, in the recession that began in 2007, stock market investors saw declines of 40% or more and some <u>bondholders</u> saw their investments reduced to pennies on the dollar. Annuity investors got paid in full, as advertised and as expected. Having that guaranteed payout versus the pie-in-the-sky potential of the stock and bond markets made a significant number of retirees very happy indeed.

The Caveats

The earnings differential between stocks, bonds and annuities aside, lifetime annuity investors do face their own set of challenges. While these annuities do offer an impressive array of choices, these choices can be confusing, as there are a significant number of decisions to be made, and each one has implications for the amount of money the investor and his or her heirs will receive in the future. Since most of the decisions are irrevocable, they must be made with care. That noted, decisions made based on current circumstances and best guesses about the future may not hold up against the test of time. The amount of income needed in the future may be more or less than the amount planned, which can have dramatic lifestyle and income tax implications.

Insurance company health is another concern. Even top-rated insurers aren't always a safe place to put your money, as demonstrated by the collapse of American International Group (AIG), the world's largest insurer, in September of 2008. The firm's failure sent shock waves through the investing community. If the government of the United States hadn't stepped in and used taxpayers money to prop up the firm, AIG's insurance policies would have been worthless. (To learn more about why the U.S. government approved the bailout, read *Falling Giant: A Case Study Of AIG*.)

Lack of liquidity is another concern. Unlike money invested in a stock, bond or mutual fund, getting money back after it has been invested in an immediate annuity is neither simple nor easy. Once that money has been locked up, it may not be possible to get it back if your financial needs change. (Want insight into this challenge? Read <u>Break Out Of Annuity Prison</u>.)

Curious?

If a lifetime supply of income free from the worries about stock market volatility, credit market mayhem or variations in the income stream sound good to you, the internet has made it easy to explore the potential benefits of a lifetime income annuity. Answer a few simple questions, including your age, state of residence, whether or not your spouse will be a joint annuitant and the amount you wish to commit or the payment you wish to receive on a monthly basis, and in seconds you have the answers to your questions. For example, for a 65-year-old man to get \$1,000 a month for life would require an initial investment of about \$155,000. Go to any search engine and type in "lifetime income annuity calculator" for instant access to a wealth of information.

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