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# Taking a Closer Look at Deferred Income Annuities

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Deferred income annuities (DIAs), which generally are designed as single-premium income annuities with payments beginning after at least one year, have long appealed to the sensibilities of academics. DIAs are also known as longevity insurance for cases such as a when a 65 year old purchases a DIA contract with income to begin at age 80 or 85.

It has only been in the past few years that DIA sales have grown sufficiently for anyone outside of the ivory tower to pay much attention. With a recent ruling from the Treasury Department on qualified longevity annuity contracts (QLACs) regarding the ability to defer taxation triggered by RMDs until age 85, you can expect to start hearing much more about DIAs. I will explain some of the advantages and disadvantages of DIAs as well as how they might fit into a retirement income strategy.

## Advantages of DIAs

DIAs are effective risk management tools for market and longevity risk. A client may really worry about outliving their assets, especially if market returns are poor during retirement and the client lives well beyond life expectancy. The income from a DIA helps alleviate these concerns when they are most likely to materialize in late retirement.

DIAs also provide a form of dementia insurance, which highlights the reality that individuals will face increasing difficulties in managing their portfolios and making withdrawal decisions as they approach their 80s and 90s, without necessarily being aware that they are experiencing cognitive decline. A DIA provides a predetermined plan to help manage household finances automatically when clients are most vulnerable.

> "If DIAs have not been on your radar, they certainly deserve a closer look."

DIAs also offer a way to leverage the mortality credits from an income annuity. That is, annuitants who do not live long will subsidize the payments to those who live longer. The leverage occurs because income payments do not begin until later in the future when survival probabilities are less, and so by skipping over the income payments in the shorter-term horizon, a given lifetime income stream can be supported at a lower cost than with a traditional single-premium immediate annuity (SPIA). If the client ends up not living long, they will have lost their DIA premium, but their retirement will have also cost much less than anticipated. This can still allow for a large unexpected windfall to be available as an inheritance, even after accounting for the loss of the DIA premium. And with a long lifetime, a DIA that alleviates the need for portfolio withdrawals can help a client leave a larger bequest than otherwise.

Finally, rather than having to worry about potentially living for 30 or 40 years into retirement, a DIA can help to effectively cap the planning horizon. If DIA income begins in 20 years, then the adviser and client need to develop a plan for the remaining assets to last 20 years, rather than 30 or 40 years. This can help increase the overall efficiency of a retirement plan in terms of being able to support more spending while also preserving assets for liquidity and bequest.

## Disadvantages of DIAs

DIAs have some problems, though. The first obvious one is that the DIA premium is no longer part of the financial portfolio and cannot be used for other purposes.

Another concern is that if a client adds additional riders, such as a return of premium in the event of early death, or a period certain payment of 10 or 20 years, then they have removed much of the potential to receive mortality credits. The client now has an expensive bond portfolio. The life-only option is the most effective way to use a DIA,

regardless of their performance? Does tenure matter? What is a reasonable percentage for people to receive?

Once we could agree on the larger picture, things fell more in line. We wanted salaries to be high enough so that people felt fairly compensated for the work that they were doing. We wanted to manage better so that people who were not good organizational fits would be able to find better homes.

Handling those two items helped people be more comfortable with profit sharing as a percentage of income rather than performance based.

We understood that firm profits come about due to good work over long periods of time. That enabled us to incorporate tenure in the formula.

We also understood that at times the revenues of the firm can vary due to market performance. The expenses of the firm were primarily driven by staffing. We created a range for the profit-sharing bucket to be funded based on salaries as a percentage of revenues.

What was most interesting to me was that some of those on the task force were arguing against their own self-interests. Why? Because they understood that ultimately they would benefit by others benefiting. They believed in abundance rather than scarcity.

The hardest part about these discussions was understanding from where people were coming with their positions. Our progress was completely impacted by the openness of the group. Arguments would be made for or against a particular way of doing things, but we could not get clarity as to why those arguments were being made. We were not being open with each other. I think the real reason for the lack of candor was distrust—either within the group or within ourselves.

### Align Thoughts and Actions with Values

When I am concerned about being open with someone, it comes from what I am afraid I may lose. Maybe they won't like me, respect me, or trust me. But when I am not open with someone, I am holding on to an illusion.

When people (I am trying to not use the term "prospects" to avoid objectifying them) interviewed the firm, I would write them a note after our meeting and that was it. We began to lose prospective relationships to a firm that had a full-time business development person. I didn't want to reach out to people with whom I met because I didn't want to pester them or because I just wanted them to know that our firm was the right fit for them. That reasoning sounded great, but it was a lie. I wasn't reaching out because I was too fragile to hear no. If I believed that we were the best fit for certain people, then shouldn't I let them know how much I wanted to be in relationship with them? Ultimately, my selfishness in the form of self-protection was causing a surrendering of my beliefs. I became excellent at justification rather than excellent at risking rejection. I have consciously changed my behavior to cohere with my values.

Aligning our thoughts, speech, and actions with our values is an internal job. It means that we don't blame others for our situation, but look directly at ourselves. We don't need to punish ourselves to effect change, but we need to be aware of our behaviors. When I say that I was acting selfishly and protecting myself by not doing follow up, I am describing my behavior, not judging it. I want to be aware of what I am doing that is getting in the way of living the life I want to live. I will make mistakes, but reflecting on them creates possibility; ignoring them stunts it.

Ultimately, I ended up walking into that business meeting less anxious because I was aware of the mental tricks that I had played. I quit looking for a result, and instead chose being in relationship. ■

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but as it is a form of insurance, there is a chance that no income will ever be received from the DIA.

Another concern is that by removing the DIA premium from the financial portfolio, a client wanting to fund the same level of retirement income will have to withdraw an increasing percentage of what is left. This raises sequence of returns risk and leaves open a greater possibility of depleting the financial portfolio in the period before the DIA income begins.

Yet another practical concern is that, currently, there are no DIAs that provide inflation protection for the initial payment level. Inflation-adjusted DIAs only apply after income begins. For the targeted level of initial income, it is necessary to make a guess about future inflation. With a 20-year deferral period, even small differences between the realized inflation and the inflation guess can compound dramatically. If inflation is higher than anticipated, the level of real income provided by the DIA may not be sufficient to cover the client's late-retirement spending needs.

Finally, it is important, though conceptually difficult, to think of the DIA as part of the fixed income portion of a client's asset allocation. As the DIA premium exits the financial portfolio, the client should still attempt to hold the same amount of stocks (or possibly more, given that they now have increased risk capacity with the guaranteed income cushion) from a total household balance sheet perspective. But from the perspective of their portfolio, this would imply holding a higher allocation to stocks. It's not clear whether this logic will always be internalized by clients, or even by regulators. Clients who decrease their overall ownership of stocks when buying a DIA may lose the opportunity to experience the greater efficiencies described earlier.

### Including a DIA in the Retirement Income Strategy

How might one include longevity insurance in a client's retirement strategy? To start, in a 2009 issue of *Financial Services Review*, professor S. Gowri Shankar described a retirement strategy of building a 20-year ladder of maturing individual TIPS along with a DIA to support any spending needs starting 20 years from now.

We can explore the current pricing for this strategy using TIPS yields and DIA prices in late-September 2014. For a 65-year-old couple to buy $10,000 of inflation-adjusted income over the next 20 years with maturing TIPS and TIPS coupons, the total cost of this TIPS ladder is $188,296. For the DIA component, the best available payout rate on a joint and 100 percent survivors DIA for a 65-year-old couple with income beginning at 85, and with a 2 percent growth rate in subsequent payments after 85 (with no return of premium provision in the event of an early death), is 29.3 percent.

We also require an inflation assumption over the next 20 years. The breakeven inflation rate implied by the difference between 20-year Treasury bonds and 20-year TIPS is 2.1 percent. With 2.1 percent inflation, $10,000 today will be equivalent to $15,154 in 20 years. For this income and with a 29.3 percent payout rate, the amount placed into the DIA contract is $51,738. Combing the 20-year TIPS ladder and the DIA contract, the total cost of supporting $10,000 of approximately inflation-adjusted income for life is $240,034. The implied initial payout rate is 4.17 percent.

We can compare this to the current initial withdrawal rate when building a 30-year TIPS ladder, which is 3.79 percent. The TIPS ladder provides full liquidity for assets and 30 years of inflation protection, but if someone lives beyond 30 years, there is nothing left. The payout rate is lower because this strategy lacks any mortality credits.

Another alternative is to use all of the assets to purchase a CPI-adjusted, single-premium immediate annuity (SPIA) at age 65. The payout rate for this strategy is 3.84 percent. At the cost of liquidity, it does provide inflation-adjusted income for life. The TIPS/DIA strategy offers greater liquidity and 9 percent more income than the SPIA, with some accompanying inflation risk related to having to guess about future inflation. Part of the reason for this difference could be related to the high costs of hedging inflation over the long term.

The other main alternative would be to follow the tenets of the 4 percent rule and invest in a broadly diversified investment portfolio with 50 to 75 percent stocks. This approach would offer much more upside potential than the TIPS/DIA strategy, but it does not include any guarantees about success.

David Blanchett, Michael Finke, and I received the *Journal's* Montgomery-Warschauer award for pointing out in the 2013 paper "The 4 Percent Rule Is Not Safe in a Low-Yield World," that the 4 percent rule becomes something closer to the 3 percent rule in our low-interest rate environment. We also have to worry about the increasingly likely possibility that at least one member of a 65-year-old couple will live beyond 30 years. The TIPS/DIA strategy does have an advantage of safely supporting a 4.17 percent withdrawal rate in perpetuity for clients who are particularly worried about downside risks.

If DIAs have not been on your radar as a retirement income tool, they certainly deserve a closer look as the market expands and the latest QLAC provisions introduce new tax planning strategies. ■