# SOCIAL SECURITY WON'T BE ENOUGH:

## 6 REASONS TO CONSIDER AN INCOME ANNUITY

How long before you retire? For some of us it's 20 to 30 years away, and for others it's closer to 5 or 10 years. The key here is that many people have a rough idea of when they want to retire, and as they get older, their date becomes more definite. And the thought of retirement often brings excitement. You may be dreaming about traveling, volunteering or just spending time with grandkids.

And that's why, for a growing number of Americans, saving enough money to meet their retirement goals is one of the largest financial challenges they face, according to Dr. Michael Finke and Dr. Wade Pfau, two well-known experts in the field of retirement planning. Similar to the question about how long until you retire, now think about how long you will live and how long your retirement savings need to last. Not as easy to answer, right?


Northwestern Mutual®

Social Security and pension plans covered the bulk of the retirement income needs for previous generations. With the declining confidence in Social Security, lack of pensions and the fact that people are living longer, your retirement income will need to come largely from the savings you built during your working years. And that's when uncertainty sets in. If you are thinking, "Could I be doing something differently/better in planning for retirement?"—quite possibly, the answer is "yes."

Financial experts Finke and Pfau believe that there are options available to help address these concerns. In a recent research white paper sponsored by Northwestern Mutual, "The Retirement Income Challenge," Finke and Pfau discuss their research on retirement income strategies and their findings.

Based on over 50,000 simulations, they determined that by diversifying retirement assets and including a deferred income annuity (DIA) in the retirement income plan, on average, a person would need to save less to meet the same level of income than if he or she had invested solely in stocks and bonds.

The following pages discuss their research and additional benefits of DIAs in more detail:

1. How deferred income annuities can mitigate a portion of market risk
2. Why your allocation to equities (stocks) can be greater with a deferred income annuity
3. How the more time you have, the more income you can create
4. Why people with DIAs in their retirement plan are happier
5. How DIAs protect you against potentially poor financial decisions later in life
6. How participating deferred income annuities can help overcome low interest rate environments

Social Security replaces only about 40 percent of an average wage earner's income after retiring.[1]


## ABOUT THE EXPERTS

### About Michael Finke,
PhD, CFP®

Michael Finke, PhD, CFP®, is a professor of personal financial planning at Texas Tech University. He was among the 2013 **Investment Advisor** IA25 and the 2012 **InvestmentNews** Power 20, and he was a recipient of the Academic Thought Leadership Award from the **Retirement Management Journal**.

### About Wade Pfau,
PhD, CFA

Wade D. Pfau, PhD, CFA, is a professor of retirement income at The American College. His research article on safe savings rates won the **Journal of Financial Planning** Montgomery-Warschauer Editor's Award, and he also received an Academic Thought Leadership Award from the **Retirement Management Journal**.

[1] Social Security Administration, http://www.ssa.gov/pubs/EN-05-10024.pdf

# ABOUT THE RESEARCH

In their recent research white paper, "The Retirement Income Challenge," Finke and Pfau discuss their research on retirement income strategies and their findings. They compared two approaches to securing income for retirement to determine the best way to address two of the biggest retirement questions: 1. How will the market perform leading into and continuing through retirement? 2. How many years will you live in retirement?

Based on over 50,000 simulations that accounted for bull and bear market returns, longer and shorter lifespans, and periods of high and low inflation, they determined that you will generally need to save less to generate the same amount of retirement income ($100,000 per year, inflation adjusted) by incorporating a deferred income annuity (DIA)[1] into your retirement portfolio.

| APPROACH 1: INVESTMENT PORTFOLIO ONLY | APPROACH 2: INVESTMENT PORTFOLIO WITH A DIA |
|---|---|
| Includes a combination of:<br>STOCKS BONDS | Includes a mix of:<br>STOCKS BONDS DIA |
| • Asset allocation is based on years to retirement and risk tolerance.[2] | • A portion of funds typically allocated to bonds (in approach 1) are used to purchase DIA.<br>• Remaining equity assets are kept invested in the market, resulting in a larger portion of the investment portfolio allocated to stocks. |

# WHAT IS AN ANNUITY, AND HOW DOES A DEFERRED INCOME ANNUITY WORK?

To better understand the research and findings, it's important to understand what an annuity is and how it works. An annuity is a contract with an insurance company in which you make a single payment or series of payments in exchange for income in the future. Income can come in a lump sum or series of payments. Annuities are a powerful retirement vehicle because they can accumulate value on a tax-deferred basis and can provide guaranteed[3] income during retirement. You can decide when that income stream starts—now or in the future—and you have options that will provide for your loved ones after your death.

Annuities can be purchased with either tax-qualified savings (IRA or 401(K) rollover funds) or with non-tax-qualified dollars (personal savings). There are many types of annuities in the marketplace, and it's easiest to group them by the goals they address. Accumulation annuities, such as the variable and fixed annuity, are meant to be accumulation tools to help you save for retirement. The other type of annuity is an income annuity.

[1] For assumptions made regarding deferred income annuities, See Figure 2 on page 7.

[2] Stocks are assumed to be large capitalization stocks (Standard and Poors Composite Stock Price Index) and bonds are assumed to be long-term U.S. government bonds. Data used for simulations is from Yale University Professor and Nobel laureate Robert Schiller's website: http://www.econ.yale.edu/~shiller/data.htm.

[3] All guarantees associated with annuities are backed solely by the claims-paying ability of the issuer.

Income annuities use a portion of your retirement savings to provide predictable, lifetime income, similar to a pension. Income annuities can be either immediate and deferred (based on when income starts). Participating annuities are also either immediate or deferred.

## INCOME ANNUITY

- Guaranteed, fixed income stream beginning at a certain date
- Insulates a portion of your retirement savings from market volatility
- Income payments guaranteed based on the financial strength of the insurance company
- Locks in income based on today's rates

### Immediate Income Annuity

- Typically a lower payment than deferred annuities because the money is deposited today for income immediately
- Income payments begin within one year of purchase

### Deferred Income Annuity

- Typically a higher payment than immediate annuities because the money is deposited today for a future payment
- Income payments delayed, typically 1 to 10 years
- Allows for guarantees during deferral period

### Participating Deferred Income Annuity

- Lower initial payment, with possible upside potential through the distribution of dividends[1]
- Can be immediate or deferred
- Provides opportunity to benefit from dividends
- Dividends can be distributed as cash or used to buy additional retirement income

Income annuities provide predictable, guaranteed income for as long as you live. They are one of only three major sources of guaranteed income available today, including Social Security and pensions. They are often used to supplement Social Security to create a paycheck in retirement, allowing you to cover your fixed or essential expenses, such as housing and health care, with guaranteed income.

## PRACTICAL RETIREMENT BUDGET

| Essential/Fixed | Guaranteed Income |
| --- | --- |
| • Housing<br>• Food<br>• Transportation<br>• Health Care Costs<br>• Taxes | • Social Security<br>• Pensions<br>• Income Annuities |

[1] Dividends are not guaranteed.

# KEY RESEARCH FINDINGS

Finke and Pfau found that the addition of a deferred income annuity to a retirement portfolio of stocks and bonds can reduce the cost of funding retirement.

In Figure 1, you'll see the cost of retirement with an investment-only portfolio (Approach 1). The stock allocation column indicates the percentage of the portfolio that is invested in stocks (with the remaining percentage invested in bonds) along with the median and 90th percentile costs of funding retirement. The second part of the chart shows the same costs of funding retirement but with a DIA added to the portfolio of stocks and bonds.

The last column shows the difference in cost between the two approaches for both the median and 90th percentile.

As Figure 1 demonstrates, by adding a deferred income annuity to an asset portfolio of stocks and bonds, you may be able to lower the cost of retirement relative to an investment-only portfolio in nearly all cases (except for the 100 percent stock-allocated portfolio).

## INVESTMENT TERMS

MEDIAN COST:

The more typical/average cost of retirement, with half of simulations costing more and half costing less to fund retirement.

90TH PERCENTILE:

The downside of risk, or a more costly retirement due to combinations of long life or poor market returns.

Figure 1

| COST OF INCOME COMPARISON: INVESTMENT-ONLY PORTFOLIO VS DIA-INCLUDED PORTFOLIO | | | | | | |
|---|---|---|---|---|---|---|
| Approach 1: Investments Only - No DIA Allocation | | | Approach 2: Outcomes with an Allocation to DIA at Age 55 | | Difference in Retirement Funding Cost Positive = DIA lowers cost Negative = DIA raises cost | |
| Stock Allocation | Retirement Cost (Median) | Retirement Cost (90th Percentile) | Retirement Cost (Median) | Retirement Cost (90th Percentile) | Retirement Cost (Median) | Retirement Cost (90th Percentile) |
| 0% | $2,070 | $3,374 | $2,060 | $3,202 | $10 | $172 |
| 10% | $1,865 | $3,027 | $1,830 | $2,809 | $34 | $218 |
| 20% | $1,685 | $2,781 | $1,651 | $2,562 | $35 | $219 |
| 30% | $1,535 | $2,559 | $1,470 | $2,415 | $65 | $184 |
| 40% | $1,407 | $2,476 | $1,355 | $2,364 | $52 | $112 |
| 50% | $1,297 | $2,400 | $1,251 | $2,336 | $47 | $64 |
| **60%** | **$1,208** | **$2,352** | **$1,157** | **$2,326** | **$50** | **$27** |
| 70% | $1,130 | $2,330 | $1,114 | $2,329 | $16 | $1 |
| 80% | $1,066 | $2,333 | $1,035 | $2,360 | $31 | -$27 |
| 90% | $1,010 | $2,361 | $999 | $2,378 | $11 | -$17 |
| 100% | $965 | $2,412 | $965 | $2,412 | $0 | $0 |

Note: Retirement goal is to spend an inflation-adjusted $100,000 per year from age 65 through the death of the second spouse. All retirement costs are expressed in thousands of dollars. The amount allocated to the DIA is half of the fixed income allocation, assuming the investor has saved the median cost of retirement for that allocation, with a maximum DIA allocation of $500,000. For the purposes of their calculations, Finke and Pfau assumed that at least one member of the couple survives to retirement age and that the couple makes no additional contributions to their savings in the future.

Referring to Figure 1. chart shows the amount of savings required to generate $100,000 (inflation-adjusted) of income each year for the duration of a couple's retirement. For the 60/40 allocation, a typical allocation for average risk tolerance at age 55, the median cost for funding retirement was approximately $1.208M of portfolio assets. However, when a DIA was added to the portfolio of assets, Finke and Pfau found the median cost dropped by $50,000, to $1.157M.

You may be asking, "Why wouldn't I just allocate 100 percent of my portfolio to stocks and have to save only $965K for retirement?" The answer is, you could; but then the entire portfolio is invested in stocks, which increases the potential for large swings in your portfolio's value and is typically not recommended. There is no guarantee the market will perform well. We've all seen the impact of a market downturn and how long it takes to recover; in fact, some of you reading this may still be recovering from the Great Recession (2007-2009). Also, with a higher allocation into equities, the remaining funds wouldn't be enough to get the full benefit because the allocation to the DIA would be nominal.

Below you will find Finke and Pfau's findings in more detail and the additional benefits of a DIA that were discussed as part of their white paper.

## HEAR FROM THE EXPERT


Dr. Finke discusses the impact of longevity and market risk on retirement in this interview with the CFA (Chartered Financial Analyst®) Institute.

Go to video ▸

**1** **DIAs allow you to mitigate a portion of market risk.** Asset returns, leading into and in the first few years of retirement, are your most critical years in the sustainability of your retirement savings. A downturn could dramatically impact/devastate your savings. According to Finke and Pfau, "Rather than worrying about the real risk that poor portfolio returns near retirement will decrease assets available to fund a retirement lifestyle, a DIA enables a client to take money off the table right now in order to fund an income that begins at a later date."

By locking in a portion of guaranteed income before retirement, Finke and Pfau suggest that a DIA "provides a solution for a client who worries that a bear market will put [him or her] at risk of eventually running out of money or that spending will have to be reduced to preserve assets," especially later in life.

**2** **Your investment portfolio can have a higher allocation to securities than before the DIA.** A DIA provides guaranteed income in a portfolio, similarly to how bonds are utilized for their relative stability in an investment-only approach. When you buy an income stream through a DIA, it can be viewed as using a portion of the of the assets that would have been used to buy bonds[1]. The remaining investment portfolio is not rebalanced for the change in the overall value. Therefore, the percentage of the portfolio invested in equities is larger than if the DIA was not utilized.

[1] Deferred income annuities are different than bonds because they have no liquidity once purchased. Deferred income annuities cannot be terminated (surrendered) and the money (premium) paid for the annuities is not refundable and cannot be withdrawn.

3 **The more time you have, the more income you can generate.** The amount of future income a DIA will provide depends on the amount of money (premium) you have and the age at which you purchase the annuity. For the same premium, a longer deferral period allows you to secure a larger income payment than if you bought your DIA closer to retirement.

Figure 2 (below) shows the amount of monthly and yearly income that can be purchased based on varying deferral periods, assuming the same $500,000 premium amount when the DIA is purchased. The quotes show that, on average, a couple would receive more than twice the amount of income for the same premium at age 45 than they would if they waited until age 62.

Figure 2

| Deferred Income Annuity Quotes from Cannex[1] | Monthly Income | Annual Income |
|---|---|---|
| 45-year old couple planning to retire at age 65 (20-year deferral period) | $5,480.78 | $65,769.36 |
| 55-year old couple planning to retire at age 65 (10-year deferral period) | $3,578.53 | $42,942.36 |
| 62-year old couple planning to retire at age 65 (3-year deferral period) | $2,578.39 | $30,940.68 |

Assumptions include Wisconsin as the state of residence, a same-age opposite-gender married couple, joint and 100% survivor's income, a $500,000 premium from qualified funds, a 10-year certain period for income, and return of premium before the income start date in the event of early death. The annuity quotes are averages of the top-5 quotes provided on August 19, 2014.

4 **People with guaranteed income are happier in retirement.** Finke and Pfau cited a study by University of Wisconsin researcher Keith Bender (2012) who found that "older households who receive a higher guaranteed regular income from sources such as a pension or income annuities are happier than retirees who create income from pulling money out of an investment account."

More recent research by Towers Watson found that among people with similar wealth and health characteristics, those with annuitized incomes are happiest. The belief is that "the financial crisis and recession put a new emphasis on the value of financial security and the risks of market dependence." By putting a portion of your money into a DIA, you have guaranteed income regardless of what happens with the market.

[1] CANNEX compiles comparative information and calculations about products and services offered by financial institutions. In the U.S., this includes comparative pricing, illustration, and evaluation tools for Guaranteed Lifetime Income products such as Income Annuities and Deferred Annuities with Income Benefits.

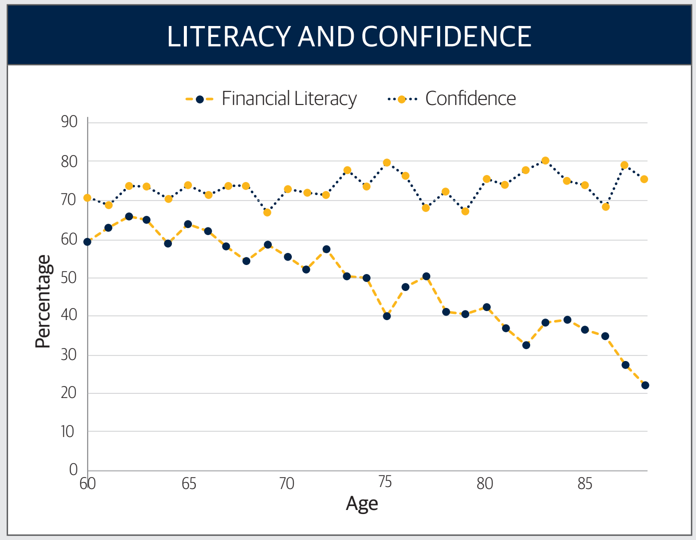
## 5 DIAs can help protect you from your later self.

Finke and Pfau suggest that DIAs may be able to help protect you against making poor financial decisions as a result of old age: "Many retirees experience cognitive decline in old age either as a result of natural aging or because of disease like Alzheimer's." (Refer to Figure 3)

Research shows that financial literacy peaks in your 50s and starts to decline by 2 percent per year at age 60. Even more concerning, the research found that while financial literacy goes down each year, confidence in making financial decisions goes up.

This could put seniors who are at risk of making poor financial decisions in the position of having to draw income from an investment portfolio and possibly running out of money later in retirement, say Pfau and Finke. DIAs offer a way for you to create an automatic stream of guaranteed income you can't outlive, regardless of other financial investment decisions made.

Figure 3




Research results found by Finke, Howe and Hudson (2011).

## 6 Participating deferred income annuities can overcome low-interest rate environments.

To test the benefits of a participating DIA, Finke and Pfau compared a DIA, which features fixed payments against a participating DIA which has the potential to receive dividends. Finke and Pfau found that, assuming higher returns from dividends, "a participating DIA provides more efficient outcomes for retirees with an overall reduction of retirement costs."

Figure 4 (at right) shows the annual income retirees would receive at age 65 (constant income for a DIA) and how the income might increase for a participating DIA over time with non-guaranteed dividends.

Figure 4

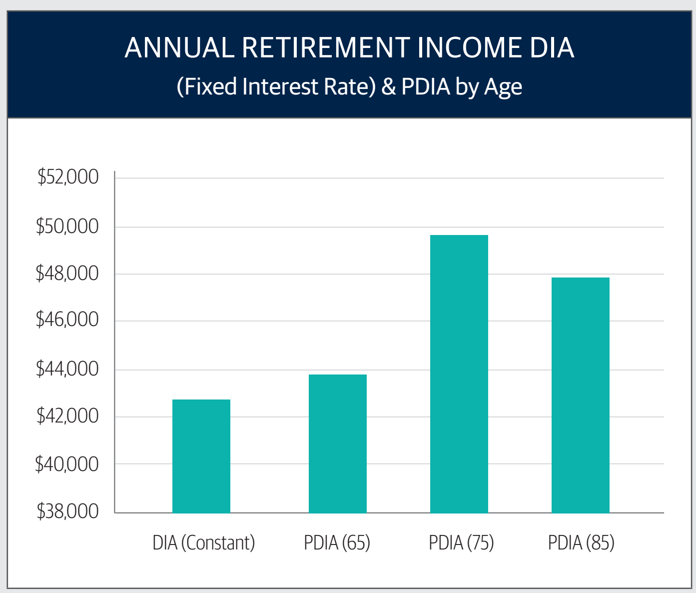



Figure 4 depicts a participating DIA with a hypothetical first-year dividend scale interest rate assumed to be 5.5%. Please see Important Disclosures on page 10 for additional information regarding Figure 4.

# CONSIDERATIONS WHEN PURCHASING A DIA

With any financial product, you need to be certain that your purchase decisions are based on a comprehensive financial plan. Consider these questions before purchasing a DIA.

## 1. Are you comfortable setting aside money today for income tomorrow?

Deferred income annuities let you lock in a stream of guaranteed income years before retirement; no other financial tool can do this. However, this means you are giving up liquidity, or access to your money. Once issued, accessing your money used to pay the premium is limited and subject to fees.

Like a 401(k) or other retirement tool, your strategy should be "contribute and don't touch"; an annuity is the same. If you're considering a DIA, you should first be comfortable with committing a portion of your assets to future income generation.

You should not purchase a DIA if your other savings do not provide the funds needed for day-to-day living or unexpected expenses.

## 2. Is leaving money to loved ones important?

Life insurance often serves as the financial solution to leave a legacy for your loved ones.

However, if you do not have life insurance in place and want to ensure a portion of your annuity premium is passed to beneficiaries should you die early, DIAs can be designed to include certain features:

- Provide a death benefit to your beneficiary should you die during your deferral period
- Allow payments to continue, if already started, to a beneficiary for a certain number of years after your death
- Make payments for the length of two lifetimes (joint annuity) versus one (single)

## 3. Is ensuring lifetime income payments important to you?

Most people think about diversification of stocks within an investment portfolio to mitigate risk, but with DIA, you are mitigating risk by diversifying among assets (not just investment).

You are insuring income payments for a lifetime; therefore, you're not able to compare this income with the income possibilities of investments.

# SUMMARY

Deferred income annuities can be an integral part of retirement plans, and economists and publishers like the Wall Street Journal, Forbes, and Kiplinger's are taking note. Like defined benefit pension plans, DIAs provide guaranteed income for as long as you live. And as Finke and Pfau's research shows, they are effective as creating retirement income in a diversified portfolio alongside stocks and bonds.

It's important to cover your fixed expenses (such as housing, health care, and transportation) with a reliable stream of fixed income, which can be achieved by only three major sources: Social Security, pension benefits, and income annuities. A growing number of investors are finding that a DIA can help bridge the gap between their income needs and what Social Security and their pension benefits (if any) may provide.

DIAs aren't an all-or-nothing solution. Rather, it's best to think of them as one part of a larger retirement income strategy. To evaluate whether a DIA is right for your needs, make sure your financial professional evaluates various scenarios showing you the level of income you can secure for the premium paid and time purchased. More specifically, your advisor should show you how the DIA impacts your retirement strategy when considered in context with other income, how much you have saved, and how much you will need to save to reach your retirement goals.

## ARE YOU READY FOR RETIREMENT?

According to recent LIMRA research, just

**1 in 10**

pre-retirees have a formal, written plan for managing income, assets and expenses during retirement.

Source: LIMRA, April 2013

# DISCLOSURE

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI and its subsidiaries.

NM commissioned the research conducted by Finke and Pfau documented in the white paper, The Retirement Income Challenge.

**Important Disclosures regarding Figure 4 on page 8.**

Figure 4 depicts a participating DIA with a hypothetical first-year dividend scale interest rate assumed to be 5.5%. A dividend scale interest rate, which reflects the insurer's investment experience, is only one component of an overall dividend scale, which is also based on the insurer's experience with mortality and expenses. Figure 4 also assumes any subsequent non-guaranteed dividends paid under the participating DIA are used to purchase additional units of guaranteed income until the date income begins to be paid, at which time 75% would be distributed in cash and 25% used to purchase additional income. Dividends were not assumed to change over time, while market conditions were randomized using Monte Carlo simulation.

A dividend is a distribution of a life insurance company's surplus that may arise when premiums plus investment income are more than enough to cover the company's operating expenses (including taxes), guaranteed income payments and additions to reserves and surplus. A life insurance company will return dividends to its policy owners based on its experience with mortality, expenses and investment income Neither the existence nor the amount of a dividend is guaranteed on any annuity in any given year.

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