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A less-risky way to buy annuities for retirement

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By Jonathan Clements, The Wall Street Journal

Retirees are deathly afraid of lifetime-income annuities.

The big fear: They will sink a fistful of money into an annuity and die soon after, losing their entire investment and gaining scant income in return.

Indeed, just $2.6 billion flowed into immediate-fixed annuities in this year's first six months, a pittance compared with the $41.2 billion flooding into mutual funds, according to figures from Limra International and the Investment Company Institute.

That's a shame, because immediate-fixed annuities -- which can provide lifetime income in exchange for a lump-sum investment -- are possibly retirees' best bet for squeezing maximum income out of their retirement savings. What to do? One solution: Buy income annuities -- but buy them on the installment plan.

- Locking up income. Even without the fear factor, income annuities are a tough sell, thanks to the rotten reputation of tax-deferred variable annuities, the often-costly retirement-savings vehicles. This is a tad unfair, because immediate-fixed annuities are really a totally different animal.

In fact, buying an income annuity is more like buying high-quality bonds, but with a few key differences. An income annuity typically doesn't have any principal value, like a bond does. But the payout should be significantly higher -- and you can elect to get that income for life, thus locking up an income stream you can't outlive.

Sound appealing? If you are in poor health, an income annuity would be a lousy investment. But if your health is good, stashing maybe half your nest egg in an annuity could be a smart move.

- Hedging your bets. Even then, it takes a lot of nerve to sink a huge chunk of your wealth into a single annuity. To overcome such fears, annuity sellers often suggest opting for some sort of guarantee, thus ensuring that your heirs will get some money if you suffer an early death.

But William Bernstein, an investment adviser in North Bend, Ore., figures there's a better solution: Buy annuities in annual installments.

To prove his point, he took a 65-year-old man with $1 million in a retirement account and looked at two different strategies. (The numbers would be slightly different for a 65-year-old woman, but the overall conclusion wouldn't change.)

With the first strategy, our 65-year-old man takes the conventional approach and stashes $500,000 in a lifetime-income annuity that guarantees payments for 15 years. Thanks to the guarantee, if he dies at, say, age 71, his heirs would collect another nine years of payments.

The annuity would kick off initial annual income of almost $26,000, according to a recent quote for the inflation-linked annuity offered by Vanguard Group in Malvern, Pa. That payout would climb in subsequent years, in line with the consumer-price index.

Meanwhile, our 65-year-old takes his other $500,000 and invests it in inflation-indexed Treasury bonds, which today yield two percentage points a year above inflation. He can draw on this money as needed. But for simplicity's sake, let's presume he leaves the bonds to grow, so that by age 80 the Treasurys are worth $673,000, figured in today's dollars.

Seem reasonable? I suspect this strategy would strike many retirees as too risky. Sure, our 65-year-old has guaranteed 15 years of payments. But if he dies soon after purchasing, the annuity would be a bum deal. "Nobody's going to be comfortable taking half their money and locking it up all at once," says Vanguard senior investment analyst John Ameriks.

■ Taking it slowly. That brings us to the second strategy. Suppose that, starting at age 65, our retiree plunks $23,300 a year into a life-only inflation-linked annuity, boosting the size of his annual annuity purchases along with inflation. Each investment buys him a small stream of lifetime income. In the meantime, he leaves the rest of his $1 million sitting in inflation-indexed Treasury bonds.

His goal: Match the roughly $26,000 that he could have generated with a one-time $500,000 annuity investment. To that end, our 65-year-old initially has to make hefty withdrawals from his portfolio of inflation-indexed Treasurys. But slowly, his annuity income would grow, as he makes additional $23,300 annuity purchases.

Indeed, by the time he reaches age 80, he would have made 15 annuity investments -- and together they would be yielding almost $26,000, pretty much matching the income generated by a single $500,000 investment at age 65.

What about his inflation-indexed Treasurys? With the second strategy, the bonds would be worth $686,000 at age 80. That's $13,000 more than with the first strategy.

But the real advantage lies elsewhere. With the second strategy, if our retiree's health deteriorates during the first 15 years of retirement, he could knock off his annual annuity purchases, thus preserving money for his heirs.

Moreover, because he's buying at different times, not everything hinges on a single purchase. "This is a solution that gets people through the behavioral hang-ups that prevent them from annuitizing," Mr. Bernstein says.

Still, there is one key drawback. As Mr. Ameriks notes, life expectancies are climbing and we could see stunning medical breakthroughs. Result: When our retiree makes his next $23,300 annuity purchase, he may not get nearly as much income as he hoped, because folks are now living longer -- and annuity sellers will have factored that into their pricing.

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