From the Editor

Cracking the Nest Egg

It is ironic that in a nation of chronic shoppers many retirees and near retirees are clueless when it comes to how to spend their life savings. Studies from The Brookings Institution to the US Congressional Budget Office have concluded that workers tend to be "financially illiterate" about the risks they will face in their golden years. Yet as the debate over retirement savings and Social Security reform rages, what is largely ignored is the other half of the retirement equation: how to make that nest egg last a lifetime.

Despite the onslaught of investment advice available to workers, misconceptions abound over life expectancy and post-retirement investment strategies. Retirees who saved diligently during their careers may still find themselves in dire financial straits in their final years while other retirees needlessly pinch pennies only to end up leaving a windfall to their heirs. These problems have been exacerbated as employers increasingly shift from defined benefit plans to 401(k) and other defined contribution plans. Additionally, if President Bush’s push for private Social Security accounts becomes a reality, retirees will be responsible for managing even more of their finances.

One obvious solution, however, is being overlooked by employers and employees alike: the purchase of an immediate annuity upon retirement. An immediate annuity has the potential to address the three major financial uncertainties that confront retirees when their regular paychecks stop: (1) mortality, (2) investment risk, and (3) inflation.

**Mortality** is the most difficult risk to measure, because it is completely unforeseeable on an individual basis. Workers contemplating retirement tend to wildly underestimate their life expectancy. Even having an actuary in the family, however, would not be enough—50 percent of people outlive their life expectancy.

**Investment risk** is easier to calculate, at least over the long haul, as stock and bond returns tend to drift toward the mean. The law of averages, however, is of little solace to someone whose savings have vaporized in a market swoon shortly after retirement. Such a person is unlikely to ever catch up financially as he or she is forced to dip into depleted funds to meet current living expenses. To protect themselves, many retirees opt for an overly conservative investment strategy, trading peace of mind for substantially lower income.

**Inflation** was described by President Ronald Reagan as a thief that takes away people’s savings. Even at the modest 2 percent to 3 percent clip of recent years, a dollar will lose half its value in about 27 years—shorter than many retirements. There also is no guarantee that the US economy will not revert to the double digit inflation of the late 70s and early 80s.
To combat these three risks, many financial advisors recommend that retirees can safely withdraw about 4 percent a year from their retirement accounts. As the account grows with investment income, withdrawals can, in theory, rise in pace with inflation. There are several serious problems with this approach. First, it is expensive, requiring a $1 million account to generate $40,000 a year in retirement income. Second, even at 4 percent annually, most nest eggs will run out for someone living five or ten years past their life expectancy. There is no guaranty that investments will appreciate, yet alone keep up with inflation. Finally, there is the problem of "leakage," which is the polite economic term for dipping into retirement funds to finance luxury vacations and other goodies.

One way to help assure that retirees make the most out of their retirement dollars would be to encourage them to use a significant portion of their account to purchase an immediate annuity at retirement. An annuity, of course, insures that someone will not outlive his or her nest egg. It also allows for larger payments than the individual could safely withdraw on their own. In effect, the retirees would have pooled their mortality risks so that those who die earlier than their life expectancy subsidize the others. This also means, however, that each annuitant receives a larger payment from the annuity than he or she could safely withdraw from the nest egg on his or her own because the individual does not need to hold back to protect against living too long.

Even President Bush's proposal to restructure Social Security into what is, in effect, a funded defined contribution plan, recognizes the value of annuities. Under the President's plan, each worker would be required to use his or her Social Security account to buy an annuity large enough to keep the retiree above the poverty level. The problem with the President's proposal is that the current poverty level for a single person is $9,310 a year ($12,490 for a couple), about enough to feed and house a senior citizen who never visits the doctor, buys a car, or goes to a movie.

Annuities are not without their drawbacks. One major issue is that very few annuities have a cost-of-living escalator. To protect against inflation, most economist and financial planners recommend that retirees devote only a portion of their nest egg to an annuity, dividing the rest between emergencies and a diversified investment portfolio structured to hedge against inflation. That also addresses the most common concern about annuities: that a recipient could die prematurely, leaving a pot of money to an insurance company and nothing to the heirs. (This also can be alleviated with term certain annuities.)

Another issue stems from the fact that the current market for immediate annuities is small and not particularly profitable for insurance companies. The market is too small to generate much price
competition or innovative products, resulting in a scarcity of reasonably priced offerings. Moreover, because most of the people buying annuities are relatively healthy, insurance companies have priced their annuity products on the assumption of a relatively long lifespan. That has made most annuities expensive, particularly for those who expect to fall on the wrong side of the mortality tables.

For all of these reasons, only a tiny percentage of retiring workers today choose an immediate annuity. Employers should step up their education efforts of the mortality, investment, and inflation risks that their workers will face in retirement—well in advance of handing over the gold watch—in order to give each worker the educational tools to handle his or her own finances. Admittedly, offering an annuity payout option in a defined contribution plan is a bother for employers. While well intentioned, the Internal Revenue Code's pre-retirement death benefit and spousal election rules make it far simpler for employers to distribute benefits in a lump sum. A relaxation of these rules would encourage more plans to offer annuity options.

The insurance industry believes the government should encourage annuity sales by providing a tax break. Proposals have been floated that would make the first $20,000 in annuity income tax-free.

Rather than adding yet another tax subsidy, the better solution could be for the federal government to sell basic immediate annuities either directly or through a sponsored agency. Given the huge upcoming market of retiring boomers, a government-sponsored annuity could be reasonably priced (at break-even, so there is no cost to taxpayers) and could include a COLA offering. Employees could be given the flexibility to use their 401(k), 403(b), IRA, and other retirement accounts to purchase the annuity—without employers having to face the hassles that the current system imposes.

With proper financial education and the availability of fairly priced and user friendly annuity products, workers could retire with greater confidence that their nest eggs will last a lifetime.

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