Building Integrated Retirement Income Strategies

With Traditional Investments, Guaranteed Income Annuities, and Whole Life Insurance

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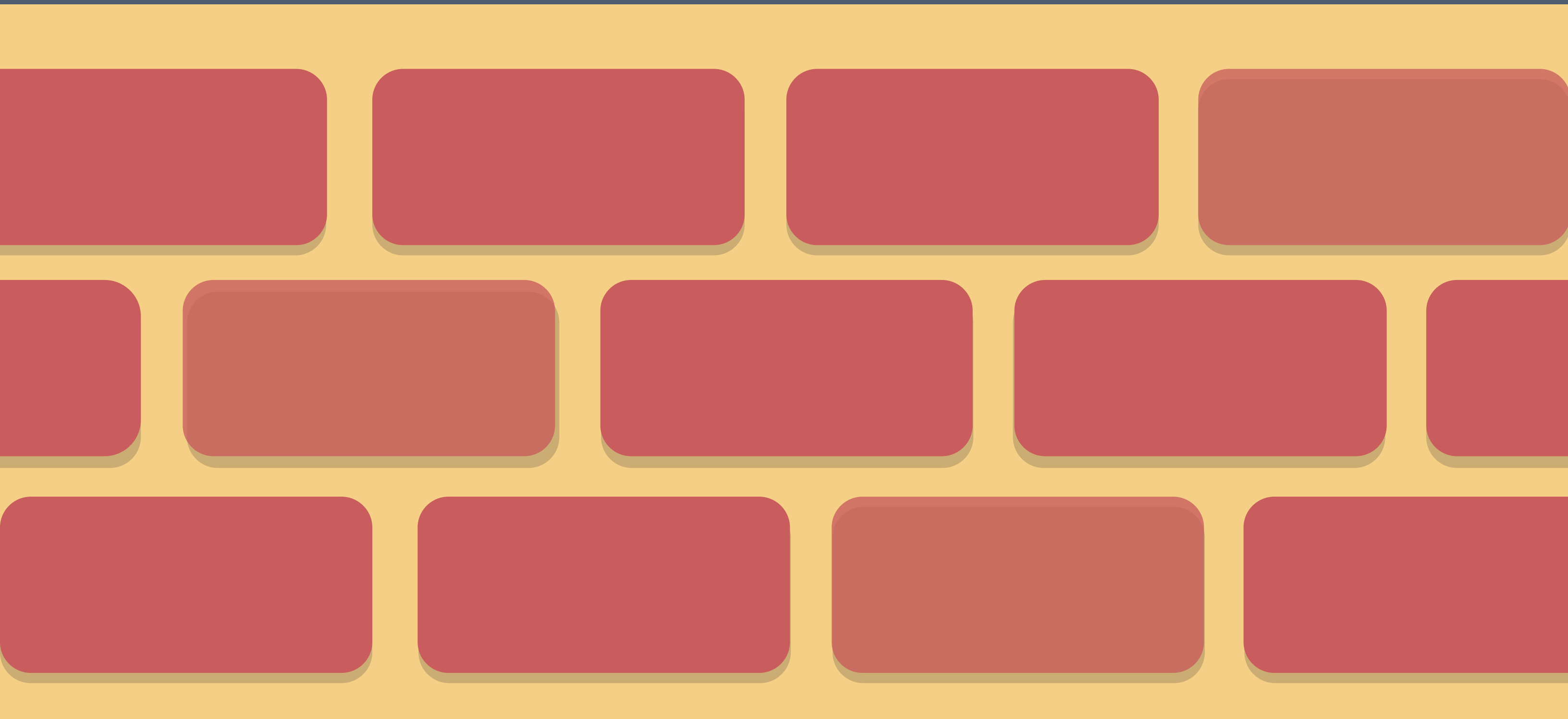

Retirement income planning is a relatively new field in financial services. The field came to exist as it became clear how the needs of creating retirement income are different from the traditional approaches used to accumulate wealth. What makes retirement income distinct from traditional wealth management is that the financial circumstances facing retirees are not the same as pre-retirees. Typically, retirees experience a reduction to their risk capacity, which means that their ability to sustain a desired lifestyle becomes more vulnerable to market volatility. Retirees face a new set of risks post-retirement, and different financial products can play different roles in managing these risks.

Nevertheless, different groups within the financial services profession continue to debate the best approach to building a retirement income plan. A key issue of disagreement focuses on if retirees are best served when placing their focus and trust: in the risk/reward tradeoffs and upside potential of an investment portfolio, or on the contractual guarantee of insurance products (Guaranteed income annuity and/or whole life insurance)[1]. Guaranteed Income annuities and whole life insurance act as guaranteed income and legacy vehicles. They provide benefits based in part on the insured's mortality profile. This is in contrast to equity funds, which not only provide the opportunity for upside growth, but also provide no guarantees.

Integrated strategies including both insurance products and traditional investments may provide a good opportunity for individuals to enjoy retirement success.

As thought leadership develops best practices for retirement income planning, it is becoming increasingly clear that traditional investments like equity and fixed income investments or insurance products alone cannot efficiently manage the range of retirement risks. Each has its own advantages and disadvantages relating to meeting goals and managing risk. Research on "product allocation" has shown how a more efficient set of retirement outcomes might be obtained by combining traditional investments with insurance products. The distribution phase of retirement requires the contemplation of product allocation in addition to risk appropriate asset allocation. Integrated strategies including both insurance products and traditional investments may provide a good opportunity for individuals to enjoy retirement success. The risk pooling features of insurance products combined with the upside potential of investments can make for a more effective combination of retirement income. We explore how traditional investments, guaranteed income annuities, and whole life insurance can jointly contribute to building an efficient retirement income plan.

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[1] *Based on the claims paying ability of the insurance company*

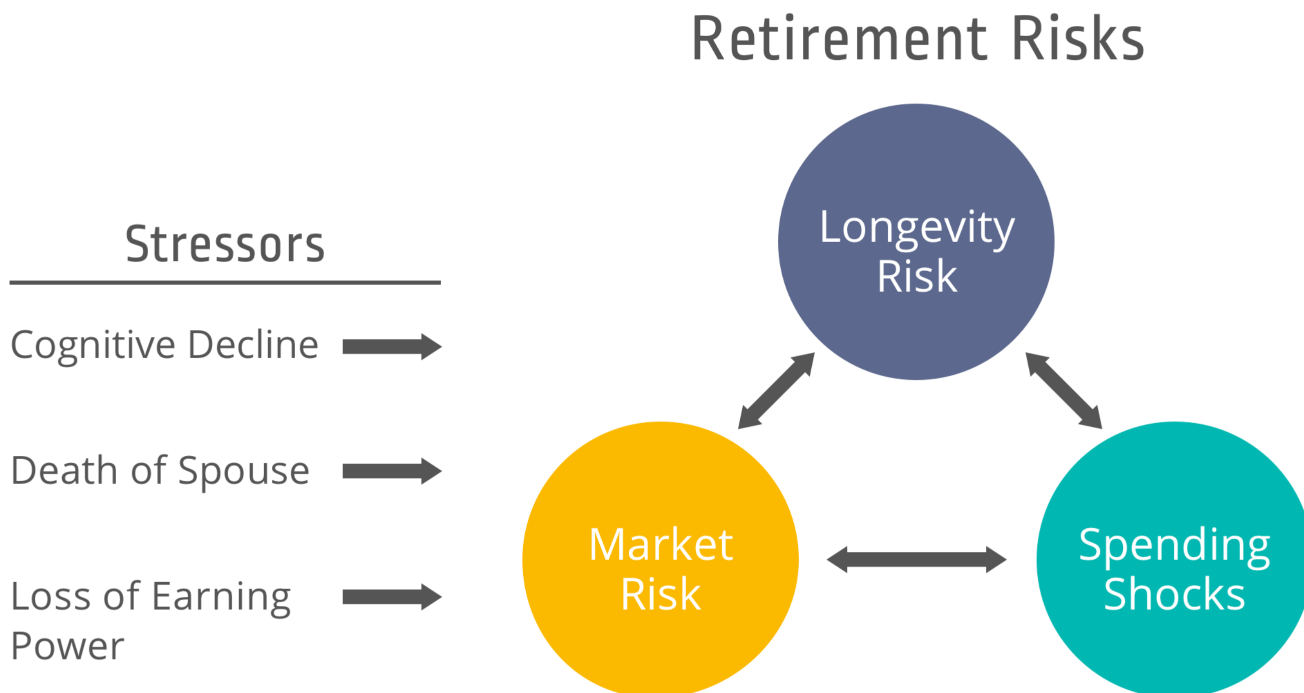
Retirement Goals

Clarifying the goals for a retirement-income plan is an important first step. The primary financial goal for most retirees relates to their spending: maximize spending power [**lifestyle**] in such a way that spending can remain consistent and sustainable without any drastic reductions, for as long as the retiree lives [**longevity**]. Other important goals may include leaving assets for subsequent generations [**legacy**], and maintaining sufficient reserves for unexpected contingencies [**liquidity**]. Using those bracketed terms, financial goals for retirement can be summarized with the four L's:

Traditional Investments and guaranteed insurance products have advantages and disadvantages when it comes to meeting each of these goals. Building a retirement income strategy is a process that requires a determination for how to best combine available tools to both meet retirement goals while effectively mitigating the risks standing in the way of those goals. This requires a further discussion of retirement risks.

Retirement Risks

Retirement risks include longevity risk, market volatility and related macroeconomic risks, and unplanned spending shocks that can derail a budget.



Longevity risk, or the risk of running out of assets before running out of time, is the fundamental risk facing retirees. We know about the distribution of longevity for the overall population, but an individual cannot know in advance precisely where he or she will fall in the distribution. The length of one's retirement could be much shorter or longer than their statistical life expectancy. A long life is wonderful, but it is also costly and a continuous drain on assets. Retirees do not know how long their retirement will last, and so they face a delicate tradeoff between wanting to spend as much as possible without overdoing it and risking old age poverty. A guaranteed income annuity is an option, as otherwise retirees may need to manage this risk by spending less and spreading assets out over a longer period of time. Seeking investment upside growth can provide another way to support more spending than otherwise, if one is willing to accept the risk that market volatility could lead to even worse outcomes.

Market risks relate to the exposure of a retirement plan to macroeconomic forces beyond a retiree's control. These risks include investment volatility, poor market returns and disadvantageous fluctuations in interest rates. Inflation is also a concern. For retirees living on a fixed income, rising prices will slowly erode purchasing power. For example, if inflation averages about 3% per year, the cost-of-living doubles in a mere 23 years. Sequence of returns risk holds a special place within this category. This is a macroeconomic risk with a highly personalized impact, as retirees attempting to fund a constant spending stream from a portfolio of volatile

assets are particularly vulnerable to the specific sequence of market returns experienced in the early part of their retirements. It is not only the average return which matters, but also the order of the returns due to the inherent market volatility. Poor returns early in retirement will lead to an increased spending rate from the remaining assets portfolio, digging a hole for the retiree which will be increasingly difficult to overcome even if markets enjoy a subsequent boom.

As expressed in the following table, options for managing these market risks include spending conservatively, being flexible with spending amounts, reducing portfolio volatility, or drawing from other discretionary assets that do not correlate with the rest of the investment portfolio.

Methods for Managing Market Volatility and Sequence of Returns Risk

Spend Conservatively	Decrease stress on investment portfolio
Spending Flexibility	Limit cash flow needs during poor investment markets
Reduce Volatility	Guarantee income with fixed annuity products
Coordination with Buffer Assets	Use of any available whole life insurance cash value in poor investment market conditions to help reduce the impact of poor market performance on the investment portfolio and Death Benefit for income replacement and legacy[2]

The third category of risk relates to personal spending shocks. The basic budget one has prepared for retirement may not adequately reflect the actual costs of retirement. Issues include an unforeseen need to help family members, divorce, changes in tax laws or other relevant public policies, changing housing needs, home repairs, rising health care and prescription costs, and extended periods of chronic care needs. In addition to using other appropriate insurances to help protect against the spending shocks, retirees may need to preserve flexibility and maintain liquid resources to cover these unexpected expenses.

In retirement, other stressors reduce the capacity for retirees to manage these retirement risks. These stressors include cognitive decline, the death of a spouse, and the loss of earnings capacity.

A retirement income plan must incorporate the unfortunate reality that many retirees will experience declining cognitive abilities, which will hamper portfolio management and other financial decision-making skills. For the afflicted, sound portfolio investments and withdrawal decisions become more difficult in advanced ages. In addition, many households do not equally share the management of personal finances. When the spouse who manages the finances dies first, the surviving spouse can face serious problems if there is not a clear plan in place. The surviving spouse may be left vulnerable to financial predators and other financial mistakes. Survivors can become more exposed to fraud and theft.

[2] Accessing cash value through policy loans accrues interest and reduces cash value and death benefit. In certain instances, there may be tax consequences. Excessive loans can also cause a policy to lapse. As such, one must consider cash value in excess of needed death benefit (legacy) a potential source of retirement income.

Retirees also face reduced flexibility to earn income in the labor markets as a way to cushion their standard of living from the impact of poor market returns. One important distinction in retirement is that people often experience large reductions in their risk capacity as the value of their human capital, or economic value of their skill set, declines. As a result, they are left with fewer options with which to respond to poor portfolio returns. Risk capacity is the ability to endure a decline in portfolio value without experiencing a substantial decline in one's standard of living. Prior to retirement, poor market returns might be counteracted with a small increase in the savings rate, a brief retirement delay or even a slight increase in risk taking. Once retired, however, people can find it difficult to return to the labor force and are more likely to live on fixed budgets.

Each of these risks must be managed by combining different income and legacy tools with different relative strengths and weaknesses for addressing each of the risks. We now consider how traditional investments, guaranteed income annuities and whole life insurance can fit into this picture.

The Advantages and Disadvantages of Investments in Retirement

With traditional investments, the idea is generally to seek upside investment growth to relieve stress for all aspects of the retirement income plan. Those favoring investments rely on the notion that the market will eventually provide favorable returns for most retirees. Though stock markets are volatile, historically, equities have outperformed fixed income over a reasonable amount of time. Those believing strongly in equity investments consider upside potential from a portfolio to be so significant that insurance or annuity products play limited roles. Why needlessly cut off the upside?

With traditional investment solutions, a higher lifestyle may be supported if one is willing to invest aggressively in the hope of subsequently earning higher market returns to support a higher income rate. And should decent market returns materialize and sufficiently outpace inflation, investment solutions can be sustained indefinitely. Portfolio balances are also liquid in the sense that they are accessible to the retiree —not locked away as part of a contractual agreement such as an income annuity. Upside growth could also support a larger legacy than a whole life insurance death benefit and provide liquidity for unexpected expenses.

> Retirees find it difficult to return to the labor force and are more likely to live on fixed budgets.

For those favoring a traditional investments-only approach should consider that investing during retirement is a rather different matter from investing for retirement. Retirees generally worry less about maximizing risk-adjusted returns and worry more about ensuring that their assets can support their spending goals for the remainder of their lives. After retiring, the fundamental objective for investing is to sustain a living standard while spending down assets over a finite but unknown length of time. In this new retirement calculus, views about how to balance the

tradeoffs between upside potential and downside protection can change. Retirees might find that the risks associated with seeking return premiums on risky assets loom larger than before, and should be prepared to sacrifice more potential upside growth to protect against the downside risks of being unable to meet spending objectives.

The dual impact of sequence-of-returns and longevity risk creates a very real possibility that one cannot support their desired lifestyle over the full retirement period. These are risks which a retiree cannot offset easily or cheaply. Investment approaches may seek to reduce sequence and longevity risk by having the retiree spend conservatively. Retirees spend less as a way to avoid depleting their portfolio through a bad sequence of returns in early retirement, and they also spend less because they must plan to live well beyond their life expectancy. The implication being, should the market perform reasonably well in retirement, the individual will significantly under spend relative to their potential. At the same time, longevity protection (the risk of outliving savings) is not guaranteed with investments and sufficient assets may not be available to support a long life or legacy.

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Investment assets may also be less liquid than they appear. Though they are technically liquid, a retiree who spends assets intended to cover spending needs later in life may find that those later needs can no longer be met. A "reverse legacy" could result if the retiree's portfolio is so depleted that they must rely on others (often one's children) for support. This is particularly important in light of the ongoing improvements in mortality, which means that today's retirees will live longer than those from earlier cohorts. For healthy couples in their 60s, we are approaching the point where 40 years must replace 30 years as a conservative planning horizon.

As well, some individuals may experience declining cognitive abilities with advancing age, as well as the potential death of the household member in charge of their finances, which make it increasingly difficult for them to manage the investment and withdrawal decisions required with a systematic withdrawal strategy.

When integrating investments into a retirement plan, many retirees may be best served by using investments with discretionary wealth to provide lifestyle improvements and liquidity, while seeking to use other assets to cover their basic retirement spending goals.

The Advantages and Disadvantages of Income Annuities in Retirement

Income annuities provide reliable contractual guarantees for income that can create peace of mind and may support higher spending and legacy potential as part of an integrated strategy. Income annuities provide a stream of income that can include a return of premium upon death option. They can offer an additional source of "returns" unavailable to a retirement portfolio. With income annuities clients can receive a guaranteed income that takes into account an insurance companies pooling of longevity risks across a large base of retirees. Those who elect life-only payout option and do not live long lives subsidize the income payments to those who do live longer than life expectancy. Insurance companies call this risk pooling feature a "Mortality Credit". Both groups may enjoy higher spending because of the pooling mechanism that the insurance company uses which can be more favorable than income based on a potentially overly conservative individual time horizon. This may support a higher lifestyle than what is feasible for someone self-managing these risks by assuming low returns and a longer time horizon.

Investment-only solutions may not be efficient because the retiree retains all the longevity and market risks. These are risks that an insurance company is in a better position to manage. There are a variety of payout options available that can result in the ability to recoup principal value upon death. Income annuities provide value to their owners by pooling risks across a large base of participants. Longevity risk and investment risk are the key risks that can be managed effectively by an income annuity. In addition, the guaranteed income stream provided can reduce sequence risk by reducing the need for withdrawals in down markets. Income annuities support longevity through providing "mortality credits" rather than through seeking outsized investment returns (define mortality credits). The Mortality Credits offer an enhanced income level that can be difficult for upside investment growth to outpace over a long retirement.

As well, for investments, an overreliance on the assumption that favorable market returns will eventually arrive and be able to support retirement spending needs can be emotionally overwhelming and dangerous for most retirees as their risk capacity and tolerance for risk may decline. Even if there is a low probability of portfolio depletion, each retiree gets only one opportunity for a successful retirement, and this concern leaves many retirees with worry and may push their spending lower as a way to cope. Income guarantees can also provide a peace of mind for one's lifestyle that leads to a less stressful and more enjoyable retirement experience. Overly conservative retirees become so concerned with running out of money that they spend significantly less than they could, and a monthly annuity payment can provide the explicit permission to spend and to enjoy retirement. The receipt of a monthly income annuity check can also simplify life for those with reduced cognitive skills or for surviving spouses who may be less experienced with financial matters.

Liquidity could be a problem with income annuities when unexpected expenses need to be met. While some income annuities offer some liquidity, there is generally a trade off for this flexibility and this is a potential

weakness for income annuities. As well, income annuities usually offer legacy benefits, which reduce the power of mortality credits. However, an important implication from the household balance sheet view is the nature of liquidity in a retirement income plan. In a sense, an investment portfolio is a liquid asset, but some of its liquidity may be only an illusion if those assets are earmarked to meet future lifestyle spending goals. Spending them on something else will have a direct tradeoff on future lifestyle.

True liquidity emerges when excess assets remain after specifically setting aside what is needed to meet all of the household liabilities. This distinction is important because there could be cases when tying up part of one's assets in something illiquid, such as an income annuity, may allow for the household liabilities to be covered more cheaply than when all assets are positioned to provide technical liquidity. Simply put, an income annuity which pools longevity risk may allow lifetime spending to be met at a cost of 20 years of the spending objective, while self-funding for longevity may require setting aside enough from an investment portfolio to cover 30-40 years of expenses. Because risk pooling and mortality credits allow for less to be set aside to cover the spending goal, there is now possibly greater true liquidity and therefore more to cover other unexpected contingencies without jeopardizing core-spending needs. Liquidity, as traditionally defined in securities markets, is of little value as a distinct goal in a long-term retirement income plan. The liability side of the equation must be considered as well.

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An income annuity dedicates assets specifically toward the provision of income, allowing other assets to be earmarked specifically for growth with an integrated strategy. This can allow for a larger legacy potential, especially when the retiree enjoys a long life and more of their income is supported by the annuity's mortality credits.

The Advantages and Disadvantages of Whole Life Insurance in Retirement

Whole life insurance offers owners a guaranteed death benefit and guaranteed cash value growth as long as premiums are paid when due. Additionally, the premiums are guaranteed to stay level. The potential for dividend payments may also increase the death benefit and cash value well above the guaranteed levels.[3] Whole life insurance offers substantial tax advantages as well. The death benefit is generally provided tax free to beneficiaries. Cash value grows on a tax-deferred basis and may generally be accessed tax-free

[3] *Dividends are not guaranteed*

source through policy loans.[4] This tax treatment can be especially valuable for those worried about future tax increases. With these beneficial characteristics, it is worth considering how whole life insurance can fit as part of an integrated retirement income plan.

First, we must consider the role of a permanent death benefit, which provides a tax-free way to distribute wealth to an estate, as part of a retirement income plan. A single life-only income annuity provides the highest payout rate because it allows for the creation of more mortality credits to be introduced to the risk pool. Income annuities can be purchased with cash refunds, period certain payments, or coverage for two lives. The options allow for a retired couple to leave an income stream to the surviving spouse. A whole life insurance policy can provide an alternative form for supporting this later payout option. The availability of a permanent death benefit may encourage an individual to also purchase a single life-only income annuity to obtain a greater income stream during their living years, with the understanding that the death benefit will restore funds to the household to offset the eventual loss in annuity income.

The death benefit provides a guaranteed legacy to heirs, granting peace of mind as the retiree faces the dilemma of choosing between spending in their own retirement vs. leaving additional assets as part of their legacy.

The second aspect of a whole life insurance policy to consider for retirement income is the role of the policy's cash value. Life insurance cash value can be used in a variety of ways. The cash value of a life insurance policy that accumulated over time can provide a source of liquidity to cover contingency expenses, and/or if the insurance needs and legacy desires decrease in retirement, the cash value can provide a generally income tax free source of supplemental retirement spending , through loans and withdrawals, if structured correctly. Cash value is not correlated with investment portfolio volatility and not subject to sequence of returns risk. Though one needs to be underwritten and there are on-going premium obligations for insurance (which can vary significantly based on individual underwriting factor) and interest on policy loans, these can potentially be counteracted on a net-basis by any dividends paid to whole life policies, the tax deferral on cash value growth, and tax-free distributions that can be obtained from cash value life insurance. Care must be taken to structure the policy properly to prevent lapse and to avoid taxable events. Accessing cash value will reduce the death benefit of the whole life insurance policy.

The cash value can also be a source to provide needed funds during inopportune times in the investment markets. As I previously mentioned, market volatility can prevent a traditional investment portfolio's ability to provide the desired retirement income over the long term. Liquidation of these investments during market declines prevents those assets from benefitting from potential market rebounds and future appreciation in

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[4] The cash value in a life insurance policy may be accessed through policy loans, which accrue interest at the current policy rate, and partial surrenders. Loans and surrenders will decrease the total death benefit and total cash value. There may be adverse tax implications for policies classified as a modified endowment contract (MEC) or if the amount of your loans and/or partial surrenders exceeds the cost basis of the policy. In addition, certain partial surrenders from a policy that is not classified as a MEC and that are made within the first 15 years after it is issued may be fully or partially taxable. Distributions, including loans, from a MEC are taxable to the extent of the gain in the policy and may also be subject to 10% additional tax if the owner is under age 59 ½.

value. The cash value of a whole life insurance contract can provide the funds needed to cover income needs at these times, allowing for the traditional investments to weather market fluctuations. This adds additional flexibility to the retiree's overall retirement asset portfolio.

Conclusions

When building an integrated retirement income strategy, retirees may focus on using contractual guarantees of income annuities and whole life insurance as a potentially more affordable means of devoting assets to retirement spending goals. With a portion of their spending covered, an aggressive investment portfolio may be created with remaining assets to provide true liquidity and enhanced legacy goals over the long-term than an investments-only strategy.

Integrating whole life insurance and income annuities into a retirement income plan can create more efficient outcomes in terms of income and legacy. It is very difficult for financial markets to perform well enough for an investments-only retirement income plan to provide better outcomes than an integrated plan that includes risk pooling through life insurance and income annuities.

Young individuals weighing the advantages of term life insurance versus permanent life insurance should also consider the potential role of a whole life insurance policy as part of a retirement income plan. The mantra of 'buy term and invest the difference' is less apt when considering how life insurance can contribute to a retirement income plan as a source of tax-deferred, tax-free distributions, contingency funds, and support for the idea of purchasing a single life-only income annuity.

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It was written by Wade D. Pfau, Ph.D., a Professor of Retirement Income at The American College of Financial Services, an independent third party, and based on his research in this area.

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Please note that although there is no one way to address the current retirement income planning dilemma, this paper attempts to explore the option of looking at an integrated approach through the use of traditional investments, guaranteed income annuities, and whole life insurance products.

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