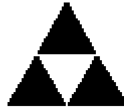

AMERICAN ACADEMY *of* ACTUARIES

National Commission on Retirement Policy
Center for Strategic and International Studies

Policy Hearing on:

Individual Account Reform Options to Social Security: Annuitization

Testimony Presented By:

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Introduction: Good Morning Mr. Chairman, members and staff of the commission, and fellow panelists. My name is Ron Gebhardtsbauer and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the nonpartisan public policy organization for actuaries in the United States and does not endorse legislation. Instead, we analyze legislation for its potential advantages and disadvantages relative to current law.

In the interest of time, I have provided you with copies of my full statement on this subject, so that I can focus on the most important points at this hearing, namely:

- What are the advantages of annuities?
- Why don't people buy annuities?
- What happens if they don't?
- Should we mandate annuities?
- Who should sell them? The government or the private sector?

What are the advantages of annuities?

Payable for life: Life annuities pay benefits for the lifetime of the annuitant or pensioner (and spouse or other beneficiary, if elected), no matter how long they live.

Larger monthly income: They can pay a larger monthly income than you can, because they focus the money on the insurable event. Money saved from someone that dies early does not increase the insurer's profit (unless many more die than expected). It is used to provide benefits for someone who lives a very long life. See discussion in Appendix A and charts.

Spread out evenly for life: A life annuity ensures that income is spread out evenly for the rest of your life. In fact, you can't duplicate this by paying yourself the same amount as an insurance company would pay you. If you live beyond your life expectancy, your money will run out.

Annuities have tax advantages: The investment return on an annuity is not taxed as earned (i.e., larger amounts in the early years, decreasing as the funds decrease). It is assumed to be received in level amounts over one's life expectancy and thus the compounding of interest is more effective. Thus, the taxes on annuities can be less than the taxes on savings accounts (or stocks if churned frequently, although the tax rates have been reduced for stocks sold after 18 months). Stocks that are held and passed onto heirs have the best tax advantages. They never have to pay taxes on the gain at transfer. But then they can't be received as income.

Relieves pressure on government programs: Someone with both a pension from their employer and an annuity from their IRA is much less likely to need public assistance. They also ease the pressure on Congress to increase Social Security benefits.

I have attached some charts which show some of these advantages of annuities. They show that paying benefits over a fixed period equal to one's life expectancy can mean that funds are exhausted (too soon

for half the people). They also show that Minimum Required Distributions start falling after that point in time too. Level life annuities (without inflation adjustments) eventually seem small compared to expenses that go up with inflation. Paying yourself the interest income (and dividends) from your funds produces a smaller benefit than the level life annuity (and thus falls behind inflation even worse) and is not steady (unless you lock in a long duration bond).

Inflation-Indexed Annuities: An inflation-indexed annuity would be best, but you can't buy them yet from insurance companies (possibly due to the lack of buyers and a deep enough market in indexed Treasuries). Only Social Security and some defined benefit plans pay them. TIAA-CREF has a variable annuity using indexed Treasuries which come close.[1] I hope that insurers start using indexed Treasuries to create them. Inflation-indexed annuities are also important to the government since they are especially beneficial to older people, which is where we have the highest poverty rates (see Chart 1). Poverty rates should also improve in the future as (1) the effects of more working women and (2) retirements affected by ERISA[2] reach these older ages.

Why don't people buy annuities?

Experience from most Insurance Companies and Defined Contribution plans, shows that most people (sometimes as high as 90%) do not annuitize, even when the money is already at the Insurance Company. Congress might consider requiring that 401(k) plans offer Joint and Survivor (J&S) annuities and encouraging Defined Benefit (DB) plans. Using the private sector more, could relieve pressure on the annuitization mandates. TIAA-CREF (a DC plan with annuity guarantees) annuitizes a much greater portion of its retirees than other DC plans[3]. Defined Benefit plans mostly pay annuities because people often can't get a lump sum or never really thought of the plan as accumulating a fund of money for them. Social Security, of course, is the most successful DB plan at annuitizing, because people can't take their money out - it is always paid in annuity form.

Some reasons why people take the money out at retirement are:

Fear that they will die early: People worry about the possibility of dying so soon that they will lose a lot of their money and that the Insurance Company will win (i.e. make a profit off them). People don't seem to worry as much about living too long, because that is so far away. As discussed above, those

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[1] They don't exactly increase by the CPI due to a high Assumed Interest Rate of 4%, complete participation even on mortality and expenses, and valuation to market every month or year. It should track inflation closely although it may be ½% or 1% lower, which enables a higher initial benefit. There is not enough history to study it. (Barry Black, FSA)

[2] ERISA is a pension law enacted in 1974 which mandated J&S annuities, unless the spouse waives it.

[3] This is because one could not get a lump sum prior to 1988 , their annual statements focus on annuities like a DB plan (not account balances), and agents don't push the other options. Post-1988, the decision is up to the institution on whether to allow lump sums, minimum required distributions, etc. Still two-thirds or more elect life annuities, and total cash payments are very low.

that die earlier than average enable the Insurance Company to pay benefits to those that live longer than average. They don't increase the Insurance Company's profit (unless more die than expected). If the retiree doesn't think they will live long, they can buy an annuity with a guaranteed return of principle.[4] Some insurers will also take into account your health status (if requested), which would give unhealthy people a better annuity amount.

Liquidity & Extra Ordinary Expenses: Some people don't want to lock up all their money in an annuity. They want the liquidity, in case they need money for unusual health, drug, or long term care expenses, or for an emergency (or to travel).

They have enough income: Some people already have enough retirement income from Social Security and their employment-based pensions. They don't need more income.

They want to pass the money to heirs: Some people may not need more income and may prefer to leave whatever is leftover to their heirs

Financial Advisor: They have a personal relationship with a financial advisor who says they can do better than the Insurance Company. (And so will the advisor.)

They think they can do better: Many people think they can get a better return on their money by investing it themselves, but can they? If they are a risk-averse retiree, they may not do better than if they just bought an immediate annuity[5]. In fact, they may do worse if they live longer than average. However, if they can invest in stocks (because they are less risk averse and have money to risk and a solid foundation of Social Security and Employer Pension benefits) and don't live longer than average, then they may do better.

Life Insurance Agents don't push annuities as much: Life Insurance Company agents sell life insurance, because they can get great commissions. These same commission amounts on annuities would make the annuities totally uncompetitive in the market place (since they compete with partially-similar products, such as mutual funds), so the commissions on most immediate annuities are only around 4%. (New York state won't allow commissions over 7%.) Therefore, with smaller commissions, agents are less likely to push annuities, and thus, less are sold.

Lack of inflation protection: Annuities without CPI increases don't really protect a person fully from longevity risk, because inflation can make the benefit almost worthless by age 95, if inflation is high. Only 2 Insurers sell annuities indexed to the CPI, even though the new CPI-indexed, 30-year

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[4] People don't seem to mind paying insurance premiums for term life insurance, health insurance, flood or earthquake insurance, car or rental insurance, etc, and then not have a claim all year. But maybe that's because they hope not to have a claim. They seem to know that the money will go to those that do have a claim and they get the peace of mind from being covered for a catastrophic event. Maybe it is because those premiums are small compared to the price of an annuity. **If you die early, you can lose a lot of money from an annuity.** If you don't have a car accident for a whole year, you've only lost one year's car insurance premium, which is much less. And each year you get to decide whether you want to pay another premium. Insurers understand this and thus are willing to guarantee benefits for 5 or 10 years (or until you get you get your principle back).

[5] Deferred annuities often aren't good investments, due to their low interest rates & higher commissions.

Treasuries became available in April, 1998. Many insurers think people will not buy indexed annuities due to their larger cost (or lower initial check if you have a fixed amount to spend). In addition, insurers can't offer great returns, since they only get the returns of the indexed Treasuries. Recent Treasury issues offered a good real return of 3 ½ %, but this is still lower than returns on equities, which people don't want to give up. Finally, there is not much experience with these new Treasuries and their market is not very deep yet.

What happens if people don't buy annuities?

As I discussed above, most people don't buy annuities, irrespective of their advantages. Is that a problem?

Live beyond income: Well, it can be if they live much longer than expected. Unless they have an adequate pension (and Social Security benefit), they may not have enough income in their later years, which can be the more expensive years due to higher medical expenses. This is particularly acute after the death of the first spouse. A couple can use up their assets by the first death, and leave the remaining spouse (often the female) with no one to care for her. Thus, the second spouse needs more income to pay for these extra needs. And it is here where poverty rates are higher. Chart I shows the higher poverty levels for the very elderly, especially women.

Withdraw too fast or too slow (leakage): People can also withdraw the money too fast and not have enough when they are old. Or they can withdraw it too slow, have lived like paupers and avoided some important medical care or life enhancing activities. If they have no important heirs, then this was all for naught. Even if they have important, needy heirs, they still maybe should have spent it on themselves instead. A life annuity ensures that income is spread out evenly for the rest of your life. In fact, you can't duplicate this by paying yourself the same amount as an insurance company would pay you. If you live beyond your life expectancy, your money will run out.

Government assistance: Not all of the above points may be important to government. However, it is important to the government if it ends up paying more in public assistance. Thus, for this debate, it may be important to forecast the collateral damage on public assistance programs, when a major change, such as not annuitizing is contemplated for Social Security.

Should we mandate annuities?

Why are we requiring Individual Accounts, if not to ensure adequate retirement incomes? If all the money can be spent at age 65, what have we accomplished? Shouldn't there be some restrictions on early distributions, or should we be happy that *most* people won't waste it quickly? Why do we care? To ensure that government doesn't have to pay more in public assistance? To ensure that poverty levels don't get worse among the very elderly? That is a policy call that the American Academy of

Actuaries does not make. However, here are some issues to consider. (I have assumed that we are not discussing total privatization, which I think would clearly need to require annuitization, at least up to a poverty amount.)

Poverty rates for very elderly could increase if leakage allowed: Social Security currently pays benefits in indexed annuity form (with a survivor benefit). If the Individual Account contributions are carved out of current FICA/SECA taxes, then poverty rates at the very elderly ages will probably increase (especially after the first spouse dies), unless an indexed annuity (with survivor benefit) is mandated.

People don't buy annuities and Defined Benefit plans are decreasing: (DB plans are switching to Defined Contribution and 401(k) plans or just terminating). Therefore poverty levels could get even worse. You might loosen some of the rules on DB plans (to encourage them) and require 401(k) plans to pay J&S annuities.

Minimum Annuity = Poverty: You could require a minimum J&S annuity purchase equal to say the poverty level (or just enough to keep someone off public assistance). Annuities indexed to inflation could be required. Once that requirement is met, one could do anything else with their funds. The National Taxpayers Foundation plan suggests something like this. The survivor benefit could be waived with the consent of the spouse.

Minimum SSA benefit = Poverty: If Social Security pays a minimum benefit equal to the poverty level, then the annuity mandate could be avoided possibly. If not everyone gets the minimum, then annuitization could be automatic for them, unless the retiree wishes to fill out a form that shows their Social Security plus pension income exceeds the poverty level (or whatever threshold is set). If they own a home, the home component of the poverty level could be eliminated (which could be about 1/3 of it).

Encourage good behavior to get waiver: You could encourage good behavior with this form. You could require the annuity from the employer plan be indexed to inflation, in order to satisfy the annuitization waiver. You also might want to require that a certain level of Medigap and Long Term Care insurance be purchased before approving a waiver (just like states require car insurance before getting a car). Since this purchase can be dropped later, there may be difficulties to be worked out here. One option would be to allow the waiver if the employer or insurance company guarantees this insurance for life, but this may be too onerous a requirement.

Aren't liquid assets needed too? On the other hand, requiring everyone to buy annuities with all their Individual Account money might mean they have no funds left over for extra ordinary emergencies and long term care needs, etc. Do you want an annuitization requirement to do this? It could force people onto Medicaid. I guess that can happen today, for people who have nothing but Social Security and Medicare. Allowing a waiver from the annuitization requirement whenever someone has less than say $10,000 or $20,000 would be difficult to enforce, since they could later spend it. How would we guarantee the $20,000 is used for the right items unless the insurance is purchased and not canceled?

Lots of people don't have $20,000. This large group of people then wouldn't need to annuitize and others would say it wasn't fair.

Should sick people be forced to buy an annuity? Sick people may not need an annuity. They could be allowed to choose a Lump Sum distribution or an option providing for a return of principal. On the other hand, insurers could rate them and pay them a larger annuity, based on the probability that they won't live long.

If sick get breaks, what about others? If sick people can choose an option that suits them best, why not accommodate everyone's preferences? However, past experience shows that people don't handle this responsibility very well, since they have no idea how much needs to be saved for lifetime income. That is why we instituted Social Security.

Who should sell the annuities? The government or the private sector?

Social Security and the Federal Thrift Plan have good track records for keeping costs down. Social Security's expenses are less than 1% of their total payments and they don't charge for profits or experience loads. There is very little fraud, waste, and abuse in Social Security. Thus, they could probably do it cheaper than insurance companies, at least initially. If the mandate is for indexed annuities (which I personally think is important), you might want to initially let the federal government pay the annuities, since there are not any Insurance Companies that sell indexed annuities yet.[6] Eventually Insurance Companies could be brought in when they are ready, but there will be problems. At a minimum, Social Security could provide indexed annuities (as an add-on to their DB annuity) and private sector insurers could sell non-indexed ones.

Indexed Annuities may not be easily created: The private sector might not easily create an annuity indexed *exactly* to the CPI.

Capacity: I agree with Mark Warshawsky, that insurers can develop the capacity to provide enough non-indexed annuities. However, if the annuity had to be indexed to the CPI, the private sector might take awhile before it could handle the influx of buyers. This is because indexed Treasury securities (which would back up the indexed annuities) are a new but not very deep market. Currently, only 5-year and 10-year maturities are available. Insurers could use 30-year maturities.

Small account problem: Insurance companies may not like small accounts. Currently many insurers don't charge higher expense loadings for smaller accounts, but they could someday. They could use fixed fees, tiered rating, lower interest rates for smaller amounts, etc.

Unisex problem: Annuities for women will be less than for men with the same amount of funds. If insurers and government are in the business, then men (and smokers and the unhealthy) would buy from insurers and women (and non-smokers) from the government. This would force the government to charge women and non-smokers more or subsidize their annuities. It would be difficult to force insurers to pay unisex annuities. They will resist this very strongly, due to problems with adverse

[6] As mentioned earlier, not even TIAA-CREF has an annuity indexed exactly to the CPI.

selection. The medicine could be worse than the disease.

Insurance companies may charge more: Insurers are required to back up their annuities with bonds, which have lower returns.[7] For CPI-indexed annuities, insurers would back them up with the new indexed Treasuries, which have a lower return. One reason for privatization, is to get better returns, but this won't happen if indexed annuities are required. Stocks can only be used in Variable Annuities, which are confusing to the buyer[8] and are not selling very well. In addition, insurance companies have to pay premium taxes, and they have loads for profits, marketing expenses (including commissions) and experience margins. The loads, margins, and adverse selection will be reduced by mandating everyone buy an annuity. However, Social Security doesn't have these loads, and could therefore be cheaper. Pension plans can also avoid passing these loads on to the individual.

Insurance Companies can go bankrupt: This fear does not exist with Social Security and DB pension plans are generally covered by the PBGC. Congress might want to mandate State Insurance Guarantee Funds at least up to the levels needed to cover these annuities. This could gradually increase the federal government's regulation of insurance companies (in place of the states), which could get into regulating their assets, determining risk based premiums based on their asset quality and their net worth.

Why not use Pension Plans?

In fact, all of these problems are alleviated if DB pension plans are used. They can get better returns in the stock markets, and not load for taxes, profits, or bad experience. Thus, their pensions could be cheaper than what Insurance Companies or Social Security might provide (unless Social Security can invest in the private sector). By law, their annuities are unisex and not a function of size. While companies are not required to have DB plans, they could be encouraged to have them. In my testimony to the Ways and Means Subcommittee on Social Security, I recommended that they consider using private pension plans. If FICA taxes go up or the contribution to the Individual Account increases the contribution, then we must ask where the money will come from. It will come from employee 401(k) contributions and employer contributions to pension plans. If the pension plan is adequate, then they should waive the Individual Account mandate. Instead of 200 million Individual Accounts, there would be only a million pension plans or so and under 50 million Individual Accounts. It would be much easier to initiate this law change and enforce the mandates. The pension plans already exist and already have the distribution rules which they know how to comply with. I think you should strongly consider this option. If you are concerned that a waiver means that no additional savings will occur for these people, then my response is that the mandate will not increase savings either for them, since they will pull their contribution from where they currently save it in their pension plan.

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[7] Even if state laws were liberalized to allow stocks, insurers might not use them right away for fear of the risks to their solvency.

[8] Their benefits are variable (i.e., their monthly annuity amount can go down if returns are low or the Assumed Interest Rate (picked by the buyer to get a higher initial annuity) is high.

The real additional savings comes from low-paid workers at employers that don't have a pension plan. The important question is "Where will they get their additional contribution for the Individual Account?", unless it is just a carve out. Will they get it from borrowing or will employers be required to increase their pay? This is unclear, and should be addressed before the law is passed.

Appendix A

Annuities can be an good investment, because they can provide the most lifetime income, even when they have lower investment returns. As I mentioned earlier, they are better than you think. How can that be? My next paragraph explains this.

Lifetime Pensions/Annuities are Better at Providing Retirement Income: I prepared Chart 5 for my dad to show him a projection of his Minimum Required Distributions (MRD). He doesn't want gifts anymore, so I give him financial advice. Chart 5 shows the payout pattern for his Minimum Required Distributions that the S&L put him into at age 70 ½. He says they never mentioned the possibility of an annuity. As you can see, the money starts running out at age 84. I showed my Dad Chart 6, which shows he could have bought an annuity and ***always*** had a higher income (for the rest of his life). Both of them use a conservative interest rate (6.9% prevailing as of the time my Dad reached age 70 ½). You may ask "how does the Insurance Company beat the MRD, since we all know that annuities have high expense loadings (e.g., 5% or more) for premium taxes, administration, mortality and investment margins, adverse selection costs, profits, etc". The answer is that the MRD pays the money to 2 people: the annuitant and the heirs (or the State if there aren't any heirs), whereas the annuity only pays benefits to one person: the annuitant. The MRD pays large amounts to the heirs if the annuitant dies early (leakage), which the insurance company sets aside for people who live longer. In addition, if we mandate annuities, Insurance Company expenses and loads for adverse selection will decrease. Annuities will become an even better deal.

You may point out that the MRD money could be fully invested in stocks. Chart 7 shows that if returns are 8%, then the MRD benefits will be higher than the level annuity some of the time. However, once (if?) Insurers start using the newly-issued inflation-indexed Treasuries to create inflation-indexed annuities, the annuity payments will be greater [also on Chart 7]. In addition, this chart hides one very important thing. Stocks can have severe fluctuations. Chart 8 shows what happens when you use a 20% standard deviation in the stock investment returns (the average for the past 70 years per Ibbotson). I'd be very nervous if I was depending on stocks for my entire retirement income. However, investing in stocks is a good idea if I wanted the money for my heirs (and then I would hold the stocks until death so that my heirs get the stepped up basis for capital gains tax). Chart 9 shows several other distribution possibilities, and like the earlier charts are based on a single person age 70 ½ .

I added a charts 10 and 11 to show the situation for a married couple. It can be more confusing, since the income may pop up on the first death, if life expectancies are recalculated each year. Another item to note, is that the Joint MRD does better (in about half the years) than a level joint life annuity (because joint MRD's have less leakage than single MRD's), but it's not better than the indexed joint life annuity,

and adding stocks still has the fluctuation problem for MRD's.

WSJ article on Withdrawal Angst: You can see this concern coming thru strongly in the June 2, 1998 WSJ article on "... Withdrawal Angst". [follows Chart 11]. The investment advisors explain the difficult calculations needed for deciding how much one should withdraw each year in retirement. They suggest 6.7%, but note later that the percentage varies by age. The investment advisor then says that if you retired in 1973, you'd run out of money within 13 years. They then recommend you sell half your stocks and buy bonds and bills with it. Now you'd be out of money in 15 years! You got only 2 more years. You might think that 15 years is pretty good because it is approximately one's life expectancy. However, life expectancy is not a cliff age at which point everyone has died. It is the age at which only one-half have died - which means the other half are alive, but with no income. Therefore, the financial advisors then suggest you only withdraw 5.1% each year. That would last you 25 years, but you'd suffer a 25% drop in your income. The final suggestion is to compromise, take out 6% (less than an annuity would pay) and watch out for a bear market, at which point, "slash your withdrawals, curtail spending, and work part-time". These are *not* great ideas for someone who is over 75! Pensions/annuities would solve this problem, but not many hear that advice. That needs to change.

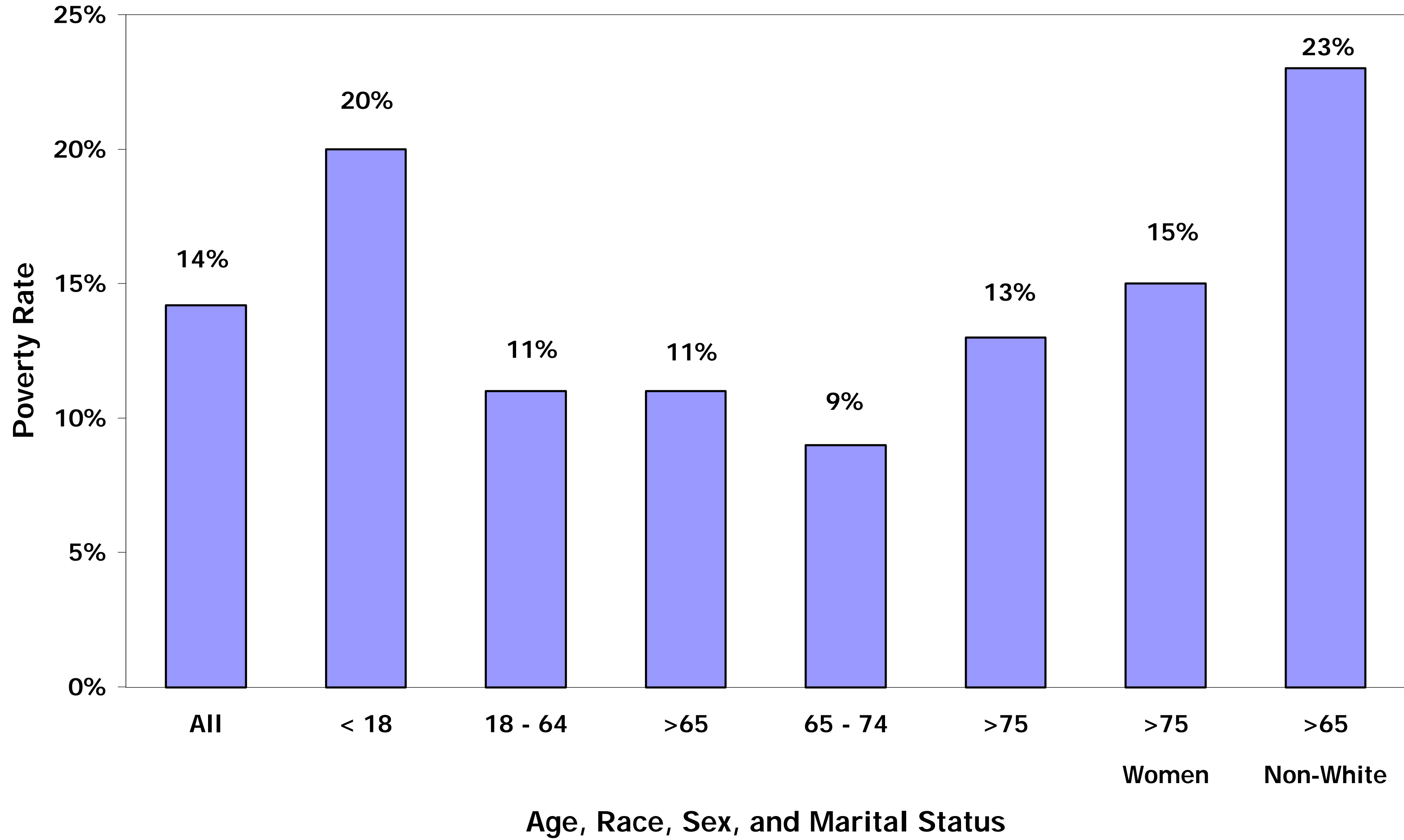

Chart I - Poverty Rates
25%
20%
15%
10%
5%
0%
Poverty Rate
14%
20%
11%
11%
9%
13%
15%
23%
All
< 18
18 - 64
>65
65 - 74
>75
>75
Women
>65
Non-White
Age, Race, Sex, and Marital Status

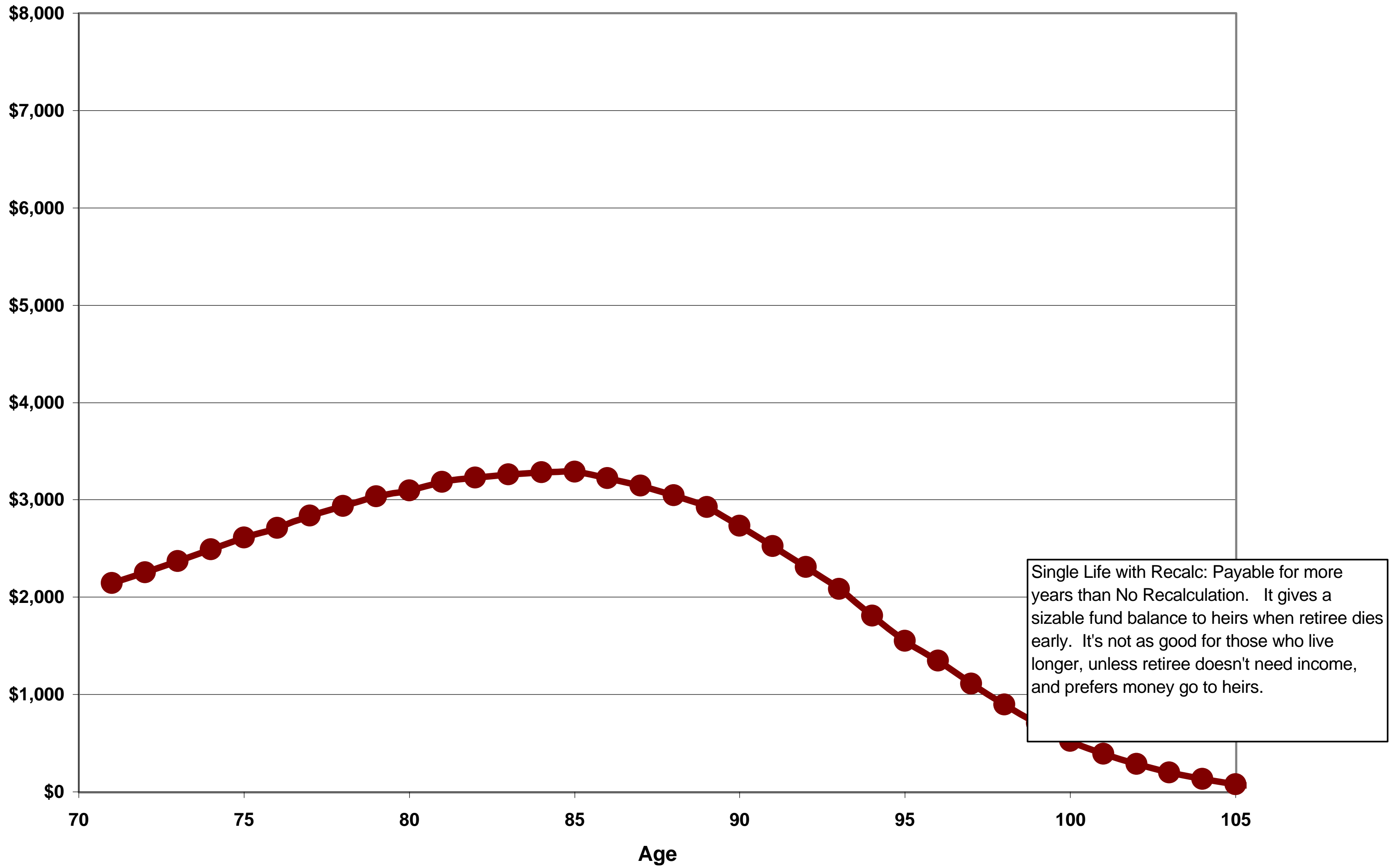
Table 5 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
70
75
80
85
90
95
100
105
Age
Single Life with Recalc: Payable for more years than No Recalculation. It gives a sizable fund balance to heirs when retiree dies early. It's not as good for those who live longer, unless retiree doesn't need income, and prefers money go to heirs.

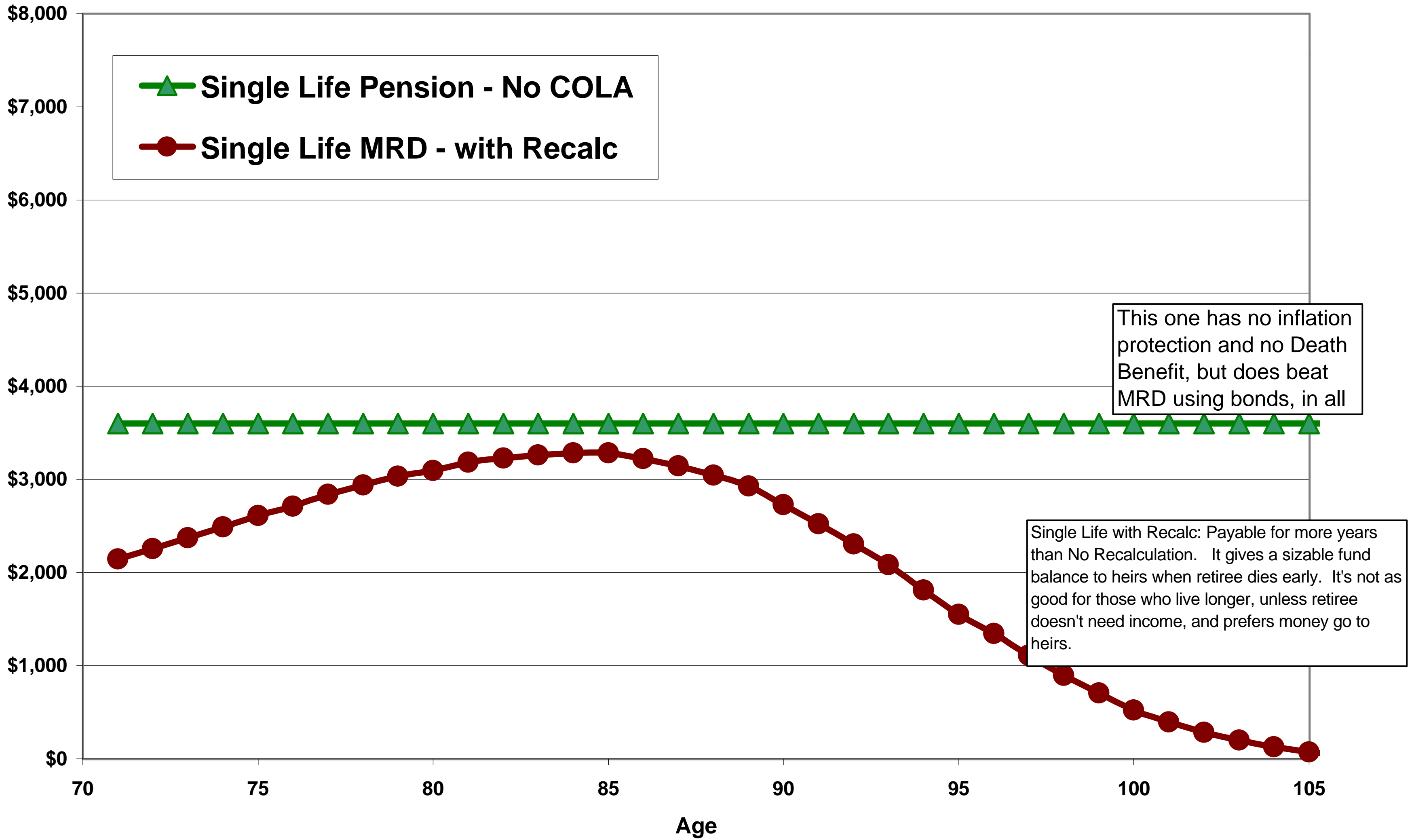

Table 6 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
70
75
80
85
90
95
100
105
Age
Single Life Pension - No COLA
Single Life MRD - with Recalc
This one has no inflation protection and no Death Benefit, but does beat MRD using bonds, in all
Single Life with Recalc: Payable for more years than No Recalculation. It gives a sizable fund balance to heirs when retiree dies early. It's not as good for those who live longer, unless retiree doesn't need income, and prefers money go to heirs.

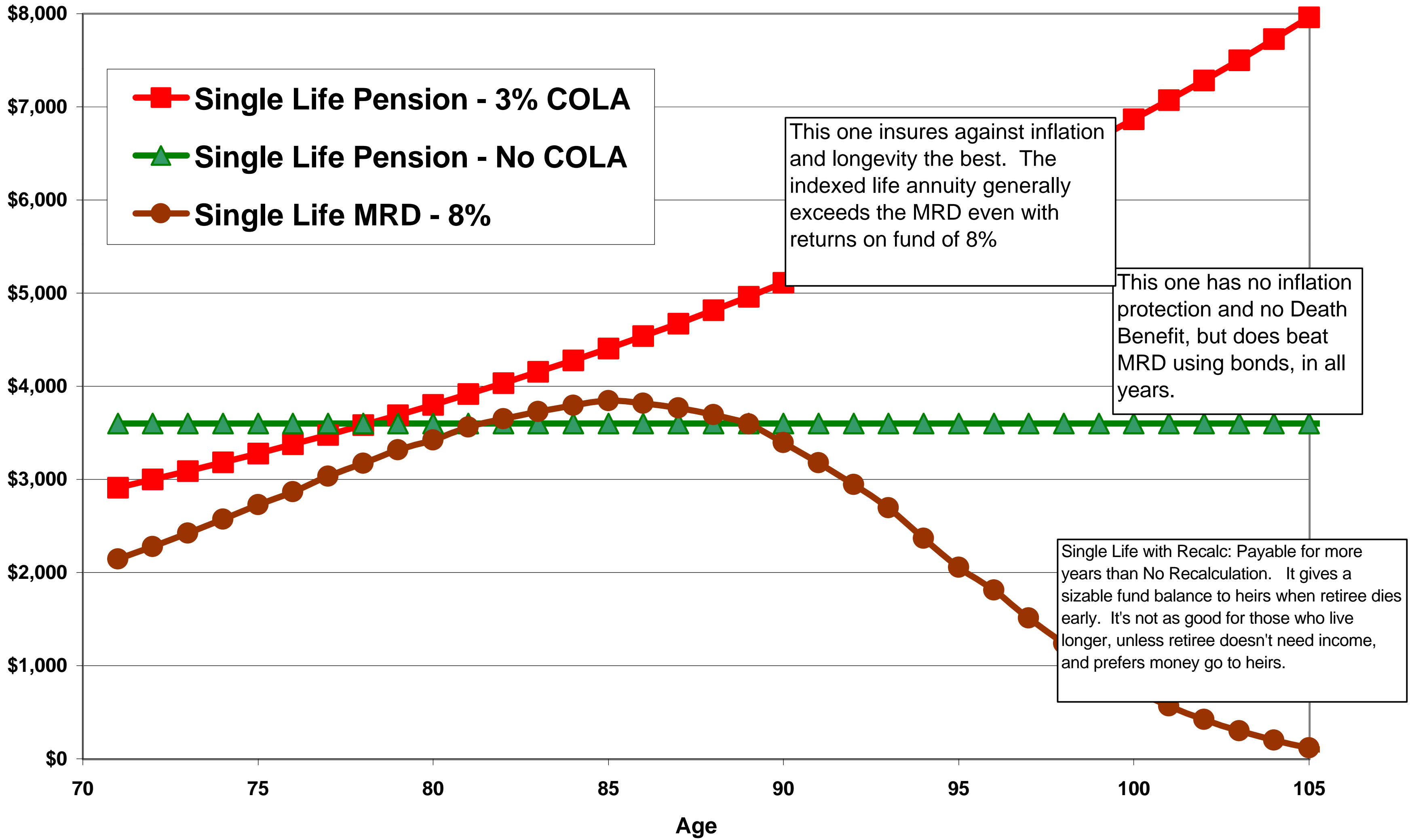
Table 7 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
70
75
80
85
90
95
100
105
Age
Single Life Pension - 3% COLA
Single Life Pension - No COLA
Single Life MRD - 8%
This one insures against inflation and longevity the best. The indexed life annuity generally exceeds the MRD even with returns on fund of 8%
This one has no inflation protection and no Death Benefit, but does beat MRD using bonds, in all years.
Single Life with Recalc: Payable for more years than No Recalculation. It gives a sizable fund balance to heirs when retiree dies early. It's not as good for those who live longer, unless retiree doesn't need income, and prefers money go to heirs.

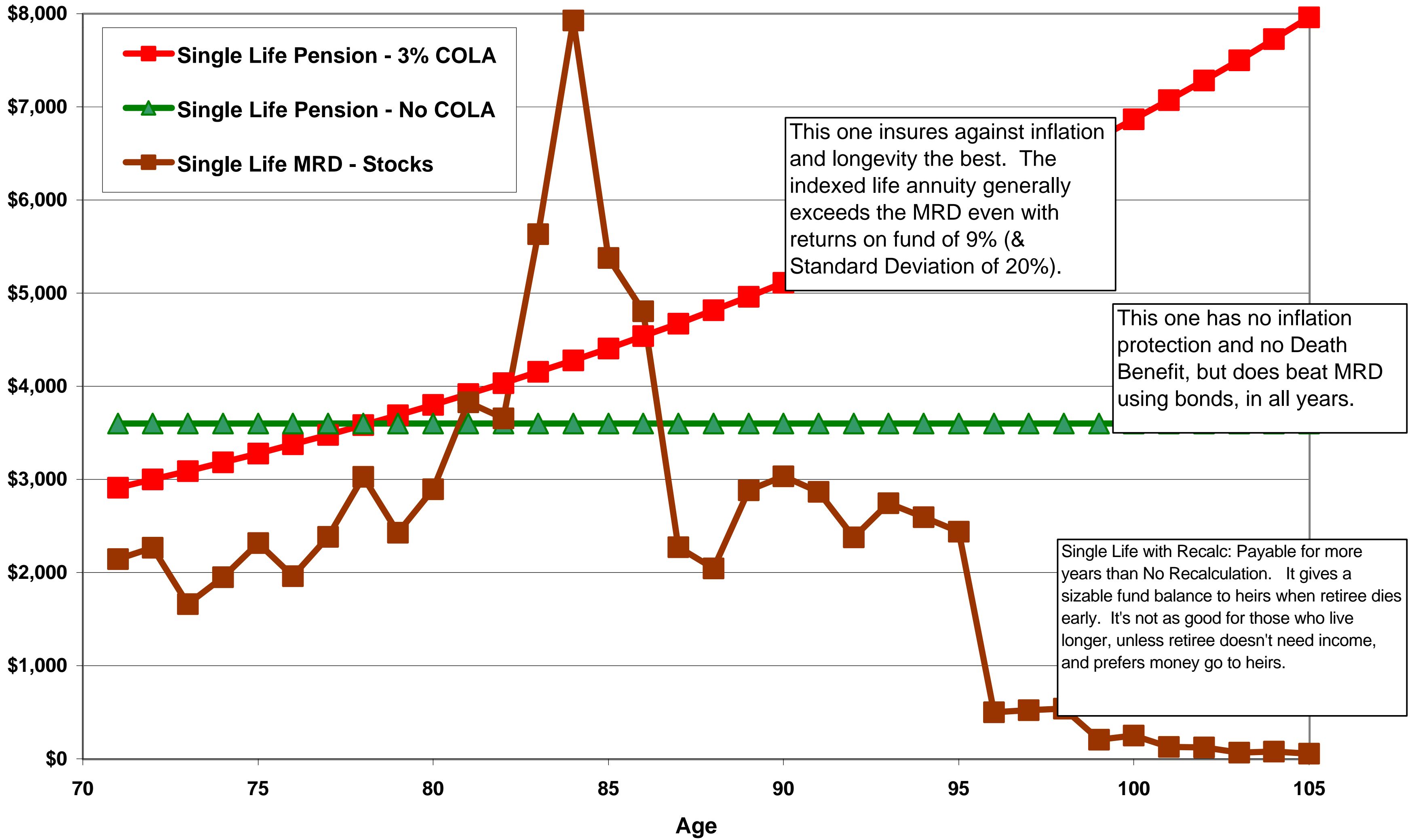
Table 8 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
70
75
80
85
90
95
100
105
Age
Single Life Pension - 3% COLA
Single Life Pension - No COLA
Single Life MRD - Stocks
This one insures against inflation and longevity the best. The indexed life annuity generally exceeds the MRD even with returns on fund of 9% (& Standard Deviation of 20%).
This one has no inflation protection and no Death Benefit, but does beat MRD using bonds, in all years.
Single Life with Recalc: Payable for more years than No Recalculation. It gives a sizable fund balance to heirs when retiree dies early. It's not as good for those who live longer, unless retiree doesn't need income, and prefers money go to heirs.

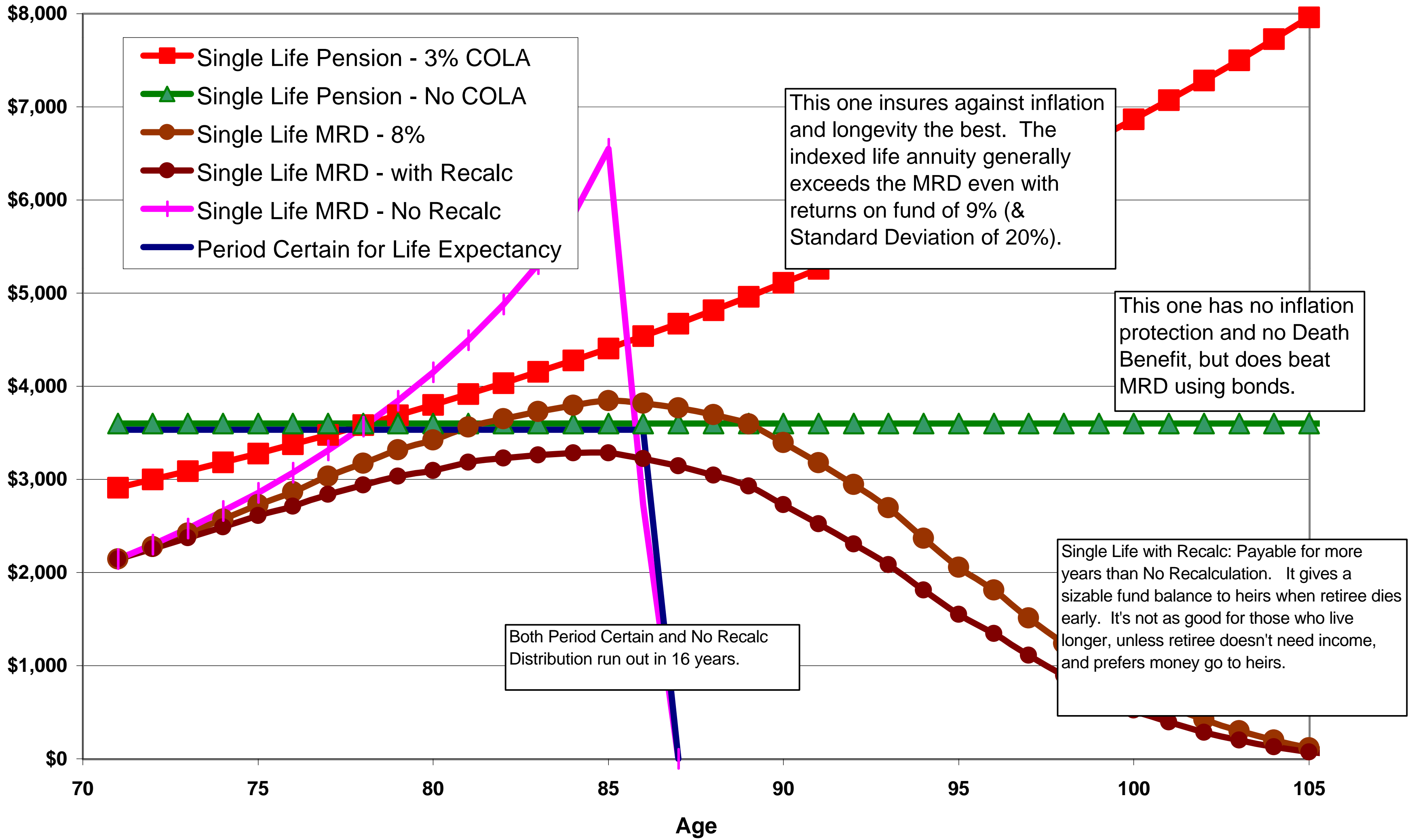

Table 9 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
70
75
80
85
90
95
100
105
Age
Single Life Pension - 3% COLA
Single Life Pension - No COLA
Single Life MRD - 8%
Single Life MRD - with Recalc
Single Life MRD - No Recalc
Period Certain for Life Expectancy
This one insures against inflation and longevity the best. The indexed life annuity generally exceeds the MRD even with returns on fund of 9% (& Standard Deviation of 20%).
This one has no inflation protection and no Death Benefit, but does beat MRD using bonds.
Single Life with Recalc: Payable for more years than No Recalculation. It gives a sizable fund balance to heirs when retiree dies early. It's not as good for those who live longer, unless retiree doesn't need income, and prefers money go to heirs.
Both Period Certain and No Recalc Distribution run out in 16 years.

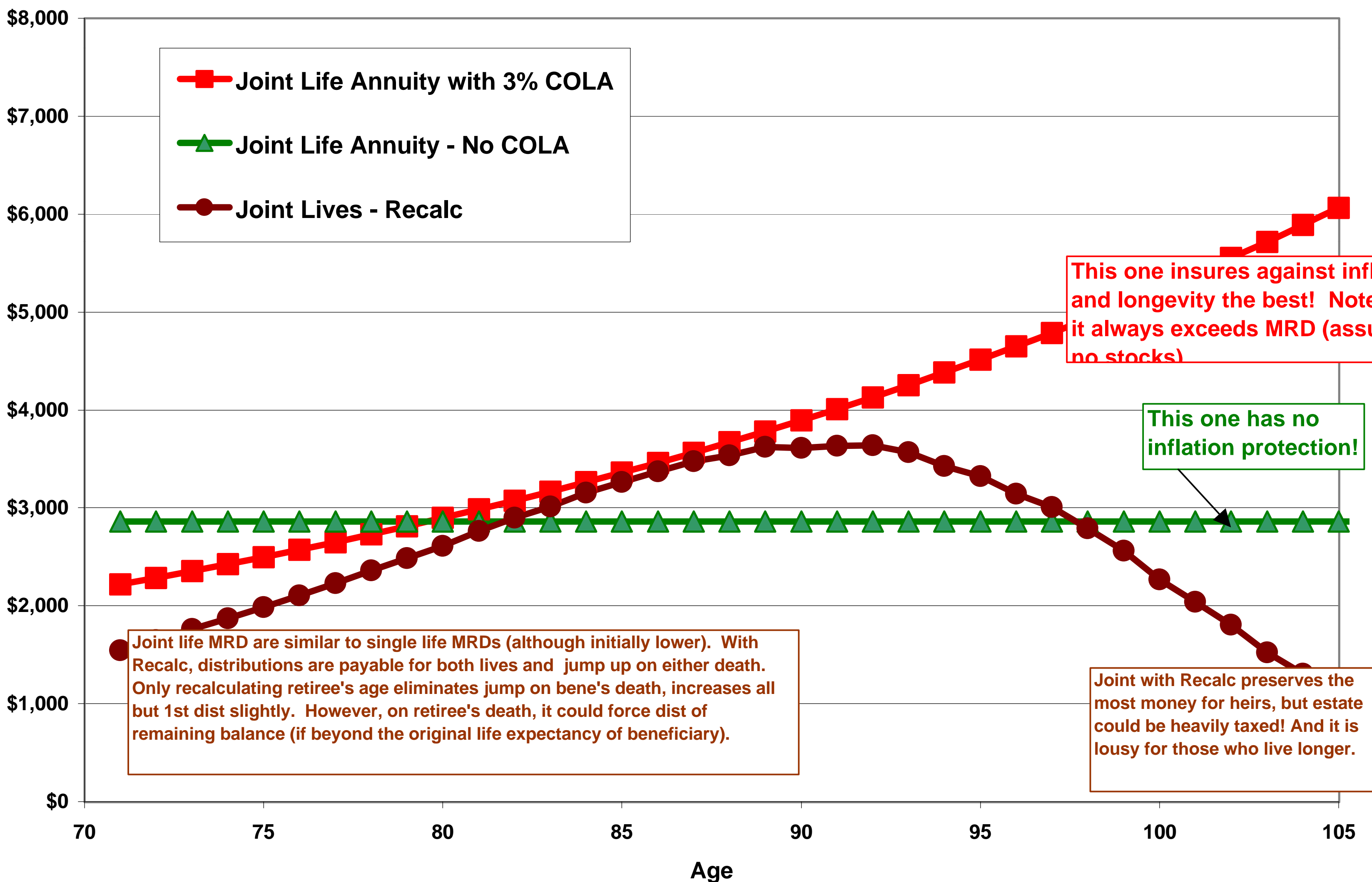
Table 10 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
Joint Life Annuity with 3% COLA
Joint Life Annuity - No COLA
Joint Lives - Recalc
This one insures against inflation and longevity the best! Note that it always exceeds MRD (assuming no stocks)
This one has no inflation protection!
Joint life MRD are similar to single life MRDs (although initially lower). With Recalc, distributions are payable for both lives and jump up on either death. Only recalculating retiree's age eliminates jump on bene's death, increases all but 1st dist slightly. However, on retiree's death, it could force dist of remaining balance (if beyond the original life expectancy of beneficiary).
Joint with Recalc preserves the most money for heirs, but estate could be heavily taxed! And it is lousy for those who live longer.
70
75
80
85
90
95
100
105
Age

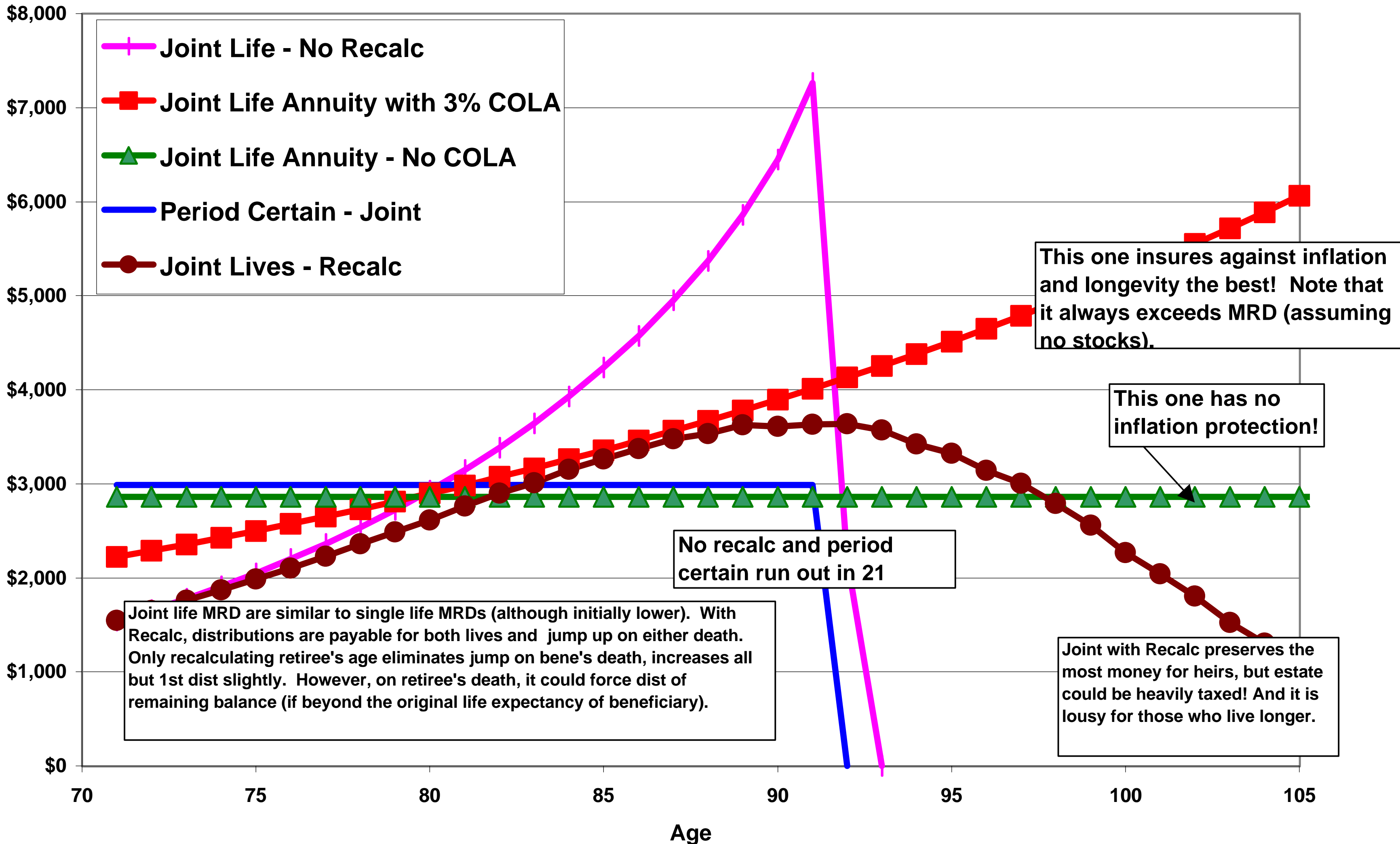

Table 11 : Minimum Required Distributions
vs
Lifetime Pensions / Annuities
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
70
75
80
85
90
95
100
105
Age
Joint Life - No Recalc
Joint Life Annuity with 3% COLA
Joint Life Annuity - No COLA
Period Certain - Joint
Joint Lives - Recalc
This one insures against inflation and longevity the best! Note that it always exceeds MRD (assuming no stocks).
This one has no inflation protection!
No recalc and period certain run out in 21
Joint life MRD are similar to single life MRDs (although initially lower). With Recalc, distributions are payable for both lives and jump up on either death. Only recalculating retiree's age eliminates jump on bene's death, increases all but 1st dist slightly. However, on retiree's death, it could force dist of remaining balance (if beyond the original life expectancy of beneficiary).
Joint with Recalc preserves the most money for heirs, but estate could be heavily taxed! And it is lousy for those who live longer.

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After Scrimping to Build a Nest Egg, Brace Yourself for Withdrawal Angst

How golden will your golden years be?

Figuring out how much to withdraw each year from your retirement portfolio is probably the trickiest financial choice you will ever face. And today's lofty stock market makes the decision doubly difficult.

Sure, the calculation seems straightforward. You start with some assumptions about investment returns and your life expectancy in retirement.

Let's say you expect stocks to gain 10% a year and bonds 6%. Also assume annual inflation of 3% and a 25-year retirement. If you hold 50% stocks and 50% bonds, you ought to be able to withdraw 6.7% of your portfolio's value in the first year of retirement. This withdrawal would come partly from dividends and interest and partly from selling securities.

Thereafter, even if you boost the sum you withdraw each year along with inflation, your money should last through a 25-year retirement.

Easy, right? Unfortunately not. "The vagaries of the market can wreak havoc with the best-laid investment plans," says Steven Norwitz, a vice president with T. Rowe Price Associates, the Baltimore fund company.

What to do? Here are five strategies for coping with Wall Street turbulence.

■ **Don't expect history to repeat itself.**

If you want to see how fickle markets can be, consider the past 25 years. According to Chicago researchers Ibbotson Associates, annual returns were fairly generous, with Standard & Poor's 500-stock index gaining 13.1%, intermediate-term government bonds returning 8.9% and inflation climbing at 5.5%.

But for those who retired at the start of this 25-year stretch, it was a nightmare, because it began with the brutal 1973-74 bear market. If you had begun the period with 50% in the S&P 500 and 50% in intermediate bonds, pulled out 6.7% in the first year and then stepped up your withdrawals with inflation, you would have been penniless within 13 years, T. Rowe Price calculates.

"If you start your retirement with a bear market, you wipe out a lot of capital before you really start withdrawing," says William Bengen, a financial planner in El Cajon, Calif. "The bear market is telling you that you're basing your withdrawals on inflated market values and you really need to reduce them."

■ **Spread your bets.**

Would a more broadly diversified portfolio have fared better? Let us say you still had a 50-50 mix of stocks and conservative investments but it was divvied up as 30% S&P 500, 10% small stocks, 10% foreign stocks, 35% intermediate bonds and 15% Treasury bills.

T. Rowe Price calculates that, with a 6.7% withdrawal rate this better-diversified portfolio would have left you broke within 15 years, a tad longer than the less-diversified portfolio.

"What kills the portfolio is when inflation starts roaring," says Minneapolis financial planner Ross Levin. "You might substitute inflation-indexed bonds for some of the intermediate-government bonds. You might also put a small amount in some sort of hedge, like real-estate investment trusts."

■ **Leave room for error.**

One solution is to spend less right from the start of your retirement. T. Rowe Price figures that the more-diversified stock portfolio would have seen you through the last 25 years if you had used a 5.1% withdrawal rate.

Roman Scott

A good idea? Keep in mind that you pay a steep price for this margin of safety. If you cut your withdrawal rate to 5.1% from 6.7%, that means an almost 24% hit in your standard of living.

■ **Don't feed the bear.**

As a compromise, you might start with a withdrawal rate closer to 6%, but be ready to slash your withdrawals if the market turns sour. Curtailing your spending, or taking on part-time work to earn extra money, is especially important if you get hit with a bear market early in retirement.

"That's the worst-case scenario," Mr. Bengen says. "You want to be conservative and cut back. It's the same thing any business does. If profits drop, they cut back on costs. You should do the same thing."

Mr. Bengen suggests you may want to trim your spending by as much as 20% until the rout is over and you have a better sense of the damage done to your portfolio. What if you don't scale back immediately? You will severely deplete your portfolio and will likely face more drastic cuts later.

■ **Adopt a five-year plan.**

Suppose you expect a 25-year retirement and you own an equal mix of stocks and bonds. To give yourself some margin for error, you opt for a 6% withdrawal rate.

Even if returns are neither surprisingly good nor surprisingly bad over the next five years, go back and review your spending strategy to make sure you're on track. Five years into your retirement, and with 20 years still to go, your withdrawal rate should equal about 7% of your retirement assets at that time; if you are spending more than that, look to cut back.

Another five years have passed? With a 15-year life expectancy, a withdrawal rate of 8.5% should be OK. "You've got to reassess periodically," Mr. Norwitz says, "or you risk running out of money."

OR Just stay in DB plan & Social Securi
or Buy an Annuity