THE WALL STREET JOURNAL.
WSJ.com

ENCORE

MAY 23, 2010

Inflation's Toll on Annuity Payouts

By TOM LAURICELLA

The guaranteed payouts on immediate annuities offer insurance against the kinds of rocky times investors have been weathering of late. But retirees need to be sure the value of their investment doesn't get slowly whittled away by inflation.

That may mean taking a lower yield on your investment today. But in the long run, it ought to help protect your savings.

Immediate annuities are insurance contracts that convert your cash into a preset stream of income that can last the rest of your life.

Picked Away by Inflation

For many retirees, that sounds especially good against the backdrop of, first, a shaky stock market and, second, concerns that bond yields are so low that whenever interest rates rise—and prices fall—they will be hit with losses.

But low interest rates also are raining on the annuity parade. The reason is that, as the name implies, the payout on an immediate annuity begins shortly after the money is invested. The catch is that payout amounts are highly dependent on the level of interest rates. And right now, interest rates are at all-time lows.

That means what seems a reasonable return today will be worth less and less over time. That's especially the case if there's a meaningful pickup in inflation, something many fear is in the cards for coming years.

The corrosive effect of inflation is hard to see in any given year, but over time its impact can be dramatic. Take a retiree who in 1990 bought an annuity paying out $6,000 per year to help cover essentials in conjunction with his or her Social Security payments. Based on the increase in the consumer price index over the past two decades, that retiree today would be coming up short nearly $4,000 per year.

"You really are locking yourself into a lifetime arrangement," says Scott Witt, a fee-only insurance adviser and actuary in New Berlin, Wis. "Given that we're in a pretty low interest-rate environment, if you lock in your entire amount you might regret it."

There are different ways to tackle this problem, each with its own particular advantages and disadvantages. Deciding which approach makes the most sense will depend on a retiree's overall financial situation and tolerance for risk.

One strategy is to put money into immediate annuities in several lumps over time, rather than all at once. That would allow an investor to get the annuity guarantees on some portion of the money while, hopefully, capturing the better returns whenever interest rates rise in the future. The remaining money can be held in cash or, depending on the time frame, placed in an investment that will hopefully grow at a higher rate of return than can be earned in the annuity.

Insurance firms are well aware of the hesitation to commit to an immediate annuity in a low interest-rate environment. So in recent years more have been offering immediate annuities that adjust for inflation.

Some annuities will raise the payout based on changes in the CPI while others offer contracts where the payout is increased by a fixed amount -- such as 2% or 3% -- every year for life. Some companies offer both options.

There are other variations as well. New York Life, for example, offers an option on its Lifetime Income Annuity that will increase its payout should interest rates rise by more than two percentage points when the policy hits its fifth anniversary.

The trade-off is that insurance companies offer lower initial payouts on annuities with inflation protection. "Every time you transfer a risk to the insurer you have to pay for it," says Kelli Hueler, founder of Hueler Cos., which provides research and quotes on annuities to financial advisers.

This, says Ms. Hueler, is where many annuity investors make a mistake and simply opt for the contract that provides the highest immediate payout.

A couple—68-year-old male and 66-year-old female—could today get an annuity from a highly rated insurer that promises full lifetime payouts of $3,360 per year with a $50,000 investment, according to Hueler. But 20 years from now, if inflation averaged 3% per year, the income stream would be worth about $1,827 in today's dollars.

Look for Flat Payouts

That may not seem like a good deal, but here's how the inflation adjustments can play out: With a rider on the contract to boost the payout by 3% per year, that same annuity pays out only $2,490 the first year, according to Hueler. But in 20 years, the payout from the annuity would be $4,497.

With an annuity that tracks the CPI, the couple would get a payout of roughly $2,280 per year, more than $1,000 per year less than the annuity without any inflation protection. The reason: For the insurer, the unknown of what will happen with the CPI over several decades is a greater risk than knowing that it will pay out an additional 3% per year. That's especially the case if the CPI adjustment isn't capped.

But for the couple—were there to be a huge spike in inflation, especially in the early years of the contract—they could come out ahead of a fixed annual increase.

One caveat: Some policies reduce payouts should the CPI decline. Look for those that will keep the payouts flat.

Write to Tom Lauricella at tom.lauricella@wsj.com