INCOME SAVVY℠
INSIGHTS

# Enhancing Retirement Security with Guaranteed Income

White Paper

## Q&A

with Dr. Wade D. Pfau
and Dr. Michael Finke

As the nature of retirement evolves, once widely-trusted approaches to income generation are now proving to be less effective, leaving even pre-retirees who have diligently planned unsure about how to best create lasting, reliable income that will support them through potentially 30+ years of retirement.

It's a nuanced issue with profound implications—not only for individual retirees but also for the financial services industry at large. AIG recently spoke with two of the foremost experts on the topic—Wade Pfau, PhD, CFA®, professor of retirement income at The American College of Financial Services, and Michael Finke, PhD, CFP®, dean and chief academic officer at The American College of Financial Services—to discuss their insights into the future of retirement security and how guaranteed lifetime income from annuities may fit into—and potentially enhance—that picture.

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# About The Experts

## An interview with Dr. Wade Pfau and Dr. Michael Finke

### Dr. Wade D. Pfau

Dr. Pfau holds BA and BS degrees in Economics, Political Science and History from the University of Iowa. He also holds an MA and a PhD in Economics from Princeton University. Dr. Pfau is a Chartered Financial Analyst® and Co-Editor of the *Journal of Personal Finance*. He serves as a Principal and Director of Retirement Research at McLean Asset Management.

Dr. Pfau received the Montgomery-Warschauer Award from the *Journal of Financial Planning* in 2012 and 2014. He serves as Professor, Retirement Income, PhD in Financial Planning and Retirement at The American College of Financial Services. Dr. Pfau is also the Curriculum Contributor for the Retirement Income Certified Professional® (RICP®) designation program at The American College of Financial Services.

### Dr. Michael Finke

Dr. Finke holds BA and BS degrees in English and Economics from The Ohio State University. He also holds an MS and a PhD in Consumer Sciences from The Ohio State University, along with a PhD in Finance from the University of Missouri. Dr. Finke is a Certified Financial Planner® and Contributing Editor of *Research* Magazine.

Dr. Finke received the Montgomery-Warschauer Award from the *Journal of Financial Planning* in 2013 and 2014. He serves as Dean & Chief Academic Officer at The American College of Financial Services. From 2006 to 2016, he served as Professor and PhD Coordinator, Department of Financial Planning, at Texas Tech University.

**Dr. Pfau and Dr. Finke are published frequently in a wide variety of academic and practitioner research journals. They are also two of the authors of the groundbreaking study, "The 4 Percent Rule is Not Safe in a Low-Yield World."**

# Today's Retirement Income Landscape

**Q: What challenges do Americans face as they transition from saving for retirement to generating that all-important retirement income?**

**PFAU:** One of the main challenges is that retirees have less risk capacity because their lifestyle is more vulnerable to market volatility. Downturns in the market can reduce post-retirement standard of living dramatically—and permanently. Retirement, compared to the "savings" years, is inherently risky: Individuals lose the leverage of working a little longer or saving a little more. When you start taking income from your savings, the whole nature of investment volatility changes—if you get a poor market return early on, it can lead you down a path that becomes very difficult to recover from, even if the overall market recovers.

What's more, retirees also have their unknown longevity, in terms of how long they need to plan for. They have to worry about inflation. They have to worry about new types of spending surprises in relation to health care and long-term care.

**FINKE:** I think the biggest difference from the perspective of the average American is that they go from earning a paycheck and knowing how much they can spend every month to all of a sudden having a nest egg and Social Security—and really not having clarity about how much they can safely spend.

**Q: The 4 percent rule was one retirement savings strategy that worked in the past, but it doesn't seem as successful in meeting the challenges today's retirees face—why?**

**FINKE:** One of the key assumptions of the rule is that asset returns in the future are going to look like asset returns in the past. And we don't believe that's going to be the case. Today, we're in a time period that's a bit of an anomaly in the sense that we have a sustained period of stock prices and bond prices that are very high—so yields on bonds are very low and dividend yields on stocks are also low.

Built into the 4 percent rule—as well as many retirement income planning projections—is the premise that retirement encompasses a 30-year timeline. Our research, based on data from the Society of Actuaries, shows that for high-earning couples, at age 65, there is nearly a 50% chance one of them will live beyond that 30-year time horizon. So judging the reliability of a withdrawal strategy based on whether it will last 30 years ignores the reality that many couples are likely to have at least one member outlive that estimate—and, potentially, that money.

> *Our research shows that, for high-earning couples at age 65, there is nearly a 50% chance one of them will live beyond that 30-year time horizon.*
> – Dr. Michael Finke

**PFAU:** Another flaw of the 4 percent rule is the assumption that the investor earns precisely the underlying market return. The evidence suggests that many older investors actually lag behind average market returns. They tend to exhibit poor decision-making—selling after market declines and buying after the market has gone back up—and, with age, it becomes increasingly difficult for them to rebalance a portfolio, as well as to decide how much to spend and manage through a market downturn. Research has shown that older investors have underperformed in risky investments on average of two percent per year.[1]

**Q: How does all the uncertainty baked into the conditions surrounding retirement affect the state of mind of retirees and pre-retirees?**

**FINKE:** When you no longer have a paycheck and the money could potentially run out, it creates a source of anxiety around spending, making it more difficult to spend down your assets in retirement. It is very apparent from research we've conducted that what most people are concerned about is not just what grabs headlines—the monthly volatility in their investment portfolio. It's lack of clarity as to whether they can make that transition into retirement and still maintain their pre-retirement lifestyle.

**Q: So the experience of spending from an investment portfolio differs from spending from a paycheck or pension?**

**FINKE:** Yes—the amount of happiness we derive from the dollars we spend tends to be higher if those dollars are coming from a paycheck we know is going to be there every month for the rest of our lives than it will be if we're pulling that money out of an investment portfolio where we're not confident in the safety of our withdrawal strategy.

[1] George M. Korniotis and Alok Kumar, "Do Older Investors Make Better Investment Decisions?"

# Guaranteed Lifetime Income From Annuities Offers a Solution

### Q: What strategies can retirees and financial professionals employ to successfully navigate this major shift and create the opportunity for more security around retirement income and spending?

**PFAU:** We've experienced a transition in the U.S. from a pension-driven, defined benefit world to one in which people increasingly have to find a way to manage market risks and longevity risks on their own through defined contribution plans, like 401(k)s. Guaranteed lifetime income in the form of annuities really provides an avenue by which a retiree can create a pension-like model, which helps avoid concentrating all that risk in one investment portfolio.

**FINKE:** Simultaneous to this transition from pensions to 401(k)s, retirees and their advisors are experiencing a situation in which interest rates are very low, as are dividend yields. That means it takes even more capital to generate retirement income from traditional retirement investments such as bonds or dividend-paying stocks. In a recent paper, we estimated the amount of capital needed to generate a specified amount of stable income doubled between the early 1980s and 2015—that means, essentially, when you reach the age of 65, if you want to fund income for the rest of your life with traditional retirement investments, it would require more than twice the capital, compared to years past.

### Q: What are the benefits to including guaranteed income, such as guaranteed income from an annuity, in an investment portfolio to generate income?

**PFAU:** Simulations demonstrate that a strategy that offers a contractual guarantee for income supports spending goals more efficiently—and with less capital—than traditional retirement investments. This, in turn, creates more liquidity for other potential surprises and, in the long run, might support more robust legacy goals.

> *An annuity can help pool key retirement income risks such as longevity risk and market risk.*
> – Dr. Michael Finke

### Q: How can funding essential expenses with guaranteed income help mitigate retirees' fears of running out of money?

**PFAU:** You can give yourself a better quality of life if you have a higher level of confidence that you're not going to run out of money. That's the danger of an investment portfolio only approach—you're keeping that longevity risk and market risk on yourself, and people are too afraid to spend the money on the things that truly make them happy.

You might want to think about not having stock market investments responsible for supporting essential expenses. Instead, look at Social Security benefits, and if there's still a gap and you would like to have additional reliable, guaranteed income to help cover the basics, that's a great opportunity to look into some form of an annuity that offers guaranteed lifetime income—whether that's an immediate annuity or a fixed, index or variable annuity with a guaranteed lifetime withdrawal benefit.

### Q: What is the case for meeting the need for guaranteed income with annuities?

**FINKE:** If you're realistic about the returns you could get on traditional retirement investments today, then you need to look for different strategies to get more dollars of income per dollar of retirement savings. And really, in our view, the only way to do that effectively is through some form of annuity that offers guaranteed lifetime income.

When people are worried about outliving their money, they could easily fall into a situation where they become unwilling to spend an amount equal to what they could reliably receive through an annuity. By pooling longevity risk with other annuity owners, the retiree is able to lessen the worry that they will have to live only on Social Security if they run out of savings.

**PFAU:** With a variable annuity with a guaranteed lifetime withdrawal benefit, for example, you're less exposed to what happens to your own portfolio with respect to income. (Of course, your principal is subject to potential loss.) If your portfolio is decimated by events in the market, that income guarantee becomes very valuable. You're shifting risk onto the insurance company.

**Q: Ultimately, how can financial professionals and clients shift their mindsets from the retirement of yesterday to the retirement of today, keeping the need for income that lasts a lifetime top of mind?**

**FINKE:** This whole defined contribution system is a relatively new thing. And a lot of advisors are having to reframe the way they think about how they're advising clients during both the accumulation stage and the decumulation stage. What we're trying to do is provide an education so that advisors understand how to put together a plan for their clients during the decumulation stage. Annuities are obviously a part of that education.

**PFAU:** In the past, people weren't living as long and were just thinking about getting a little extra income five or ten years out from their investments. Now, people rely on their own investments for increasingly longer retirement timeframes, so they need to think about more than just an investment portfolio. They have to recreate that traditional pension on their own—and annuities can be an effective tool to help achieve that.

**Q: What would you say to a financial professional who traditionally has not been drawn to annuities?**

**PFAU:** If they're truly dedicated to their clients' best interests, they'll have to overcome whatever biases they may have. They have to understand how retirement is different for their clients. Investment volatility at that point can severely disrupt retirees' standard of living. They need to pursue a strategy for their clients designed to manage all those risks that are different from pre-retirement risks. And for some of their clients that will likely include some risk-pooling via some sort of annuities.

**Q: Any final thoughts with respect to helping individuals as they near retirement?**

**FINKE:** I think the most important thing is that you have a strategy. Very often, people will simply spend the amount they are required to withdraw from their IRA after age 70. Or they won't enjoy retirement because they don't feel comfortable spending down assets. That's not a very good plan. Decide at the outset how you want to live in retirement and build the most efficient strategy that can allow you to get the most dollars from your savings and investments in the most reliable fashion possible.

*"We're trying to provide an education so advisors understand how to put together a plan that is best for their clients during the decumulation stage. Annuities are obviously a part of that education."*
– Dr. Michael Finke

**To learn more about designing an income strategy for your retirement and annuities from AIG, please contact your financial professional.**

Additional Information about Bonds and Dividend-Paying Stocks:

- Government bonds are subject to interest rate risk, but they are backed by the U.S. Government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.
- Dividend-paying stocks are subject to risk, including possible loss of principal.

Additional Information about Different Types of Annuities:

- Variable annuities: Variable annuities offer professional money management, along with insurance features (such as a guaranteed death benefit and annuity income options) that are paid for through what is called a separate account fee. Variable annuities are subject to additional fees, including a contract maintenance fee, expenses related to the operation of the variable portfolios, and the costs associated with any optional features, if elected.
- Index annuities: Index annuities are not a direct investment in the stock market. They are long-term insurance products with guarantees backed by the claims-paying ability of the issuing insurance company. They provide the potential for interest to be credited based in part on the performance of the specified index, without the risk of loss of premium due to market downturns or fluctuations. Index annuities may not be suitable for all individuals.
- Fixed annuities: Fixed annuities offer a rate of return guaranteed by the insurance company. Although not all fixed annuities offer income protection benefits, most offer a range of income options through annuitization, including the opportunity for guaranteed lifetime income.
- Immediate annuities and deferred income annuities: These types of annuities offer a range of income options, including the opportunity for guaranteed lifetime income. These types of annuities permanently convert principal into a guaranteed income stream.

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