

# Episode 217: The Annuity Debate: Smart Strategy or Overpriced Product

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## SUMMARY KEYWORDS

Annuities, retirement income, risk pooling, insurance, longevity credits, fixed annuities, variable annuities, deferred annuities, immediate annuities, living benefits, tax deferral, retirement income styles, total return, income protection, risk wrap.

## SPEAKERS

Wade Pfau, Alex Murguia, Briana Corbin

### **Briana Corbin** 00:00

The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to [retirewithstyle.com/style](https://retirewithstyle.com/style), and sign up to take the industry's first financial personality tool for retirement planning. So

### **Briana Corbin** 00:41

when it comes to annuities, which camp are you misunderstood, overhyped, under explained? Well, Wade and Alex cut through the noise and talk about what they actually do and why they're not nearly as simple as good or bad.

### **Alex Murguia** 00:59

Hey, everybody, welcome to retire with style with our continuing episode on Wade's new release, the third edition of the retirement planning guidebook, we're going through the major questions that this book will answer for you, and in today's episode, we're going to focus on the a word. What's the a word?

### **Wade Pfau** 01:23

Wade probably you mean annuities, but I'd have to double check on that. Yeah, with some of our past in studio episodes, the audio quality was not very good, so we are re recording at this point. That's if you're watching us on YouTube, we're back in the home studio. Got away from that audio quality, so that should not be an issue in any of the subsequent episodes here.

### **Alex Murguia** 01:49

Well, you just brought attention to something that maybe many

### **Wade Pfau** 01:56

hanging in the air there,

### **Alex Murguia** 01:57

but the RE recording, maybe they didn't know that they were like things in the archive.

**Wade Pfau** 02:03

After watching closely, I did wear the same clothes as we had in studio. No, that's not true. I was wearing the Retirement

**Alex Murguia** 02:10

Research Yeah, we were in like, these kind of all right, all right. Well, let's get to it. Thank you for that, that brutal honesty Wade really, appreciate it, and that's the kind of honesty they can come to expect when you break down the financial planning world, right, right?

**Wade Pfau** 02:28

And I don't think we could hide the audio quality issues from those past episodes.

**Alex Murguia** 02:32

Okay, all right, so let's get right down to it. All right, what? What's the scoop on annuities? Are they worthwhile? Give it to us.

**Wade Pfau** 02:42

Wade, yeah. And so this is about chapter five of the retirement planning guidebook, which the topic of annuities, risk pooling, insurance and retirement we talked a lot about the retirement income styles and annuities are tools that fit well, in particular with certain retirement income styles may not be as relevant for other retirement income styles, but if you do have a retirement income style that views annuities as a worthwhile tool, it mainly relates to their the actuarial science idea, the power of risk pooling the insurance that they provide, that you are combining your premiums with a large cohort of individuals. No one in that group knows how long they'll live, but the insurance company can use the law of large numbers, there's 1000s of people, 1000s of customers, in that pool, to know that roughly, say, 90% of their people in that pool will live past a certain age. 10% might live to age 100 they can figure out pretty good and pretty good terms that they don't know who's going to survive to a particular age, but they know what percentage of the customer base will survive to a certain age, and that allows them to pay at a much higher level than individuals might otherwise feel comfortable spending if they have to self manage their own longevity risk. And so that's really the basic idea behind annuities that they can provide that risk pooling potential to help support guaranteed lifetime income in retirement. So in that regard, yeah, they're absolutely worthwhile. It's you've got the investment growth and you have risk pooling and insurance as two alternative means to help fund retirement in the face of longevity and market risk.

**Alex Murguia** 04:20

Well, wait, that all sounds great, but I want you to provide the two perspectives that folks commonly hear from the let's say your you know cocktail party guy who knows everything about personal finance because they watch CNBC 24/7, and the advisor, one way or another, that's always trying to sell you something you know, for annuities where it's the panacea, or against annuities, where it's kryptonite to your financial health. What? What? What? What are. Arguments are they usually making? And what's the remedy for that? Where it's like, well, not so fast.

**Wade Pfau** 05:07

Okay, well, yeah, on the the against annuity side, I think for the most part, people are treating them as an investment, and then rather, and if you do think about them as an investment, it's probably better to compare them to bonds rather than to stocks, but it's always like, well, the stock market will do much better than the annuity, so therefore it's a bad investment, and annuities can be laden with high fees, high charges, so you really just paying a lot for an investment that's going to underperform. That's generally how the argument against annuities is made. And the point there is it's not really thinking about from the context of retirement income planning. It's just thinking about an accumulation based portfolio. Let's build an asset allocation and grow our wealth, and then not really viewing annuities as a good growth and accumulation vehicle, which, fair enough, that's really not the point of them. They are meant to provide those guaranteed payments, which can be over a lifetime in retirement. Now, to the credit of the anti annuity crowd, annuities, for in many ways, have lost that sort of notion that this is what they're for, to provide guaranteed lifetime income. They get used as tax deferral vehicles in the context of accumulating assets. And so I think that can lead to confusion where people end up, well, if they're being treated as investments, let's analyze these investments. And they don't look like good investments. But again, from the retirement income context, that's not really we can talk about with certain retirement income styles. There might be an application as more of an accumulation based tool, but for the most part, we're thinking of them more for that lifetime retirement income planning, and then for the crowd that's perhaps too pro annuity, or is like, you need an annuity for everything, and that's all you need. Well, there are many kinds of annuities out there, but I think those arguments are generally going to be the strong strongest marketing would be for something like a fixed, indexed annuity with a living benefit, where the overly optimistic marketing message is you get, like, the growth of the stock market without any risk of the stock market, and you get a guaranteed lifetime income. And so now they're being compared to stocks, and that's, again, that's not really the right way to think about them either. You do not get the growth of the stock market without the risk of the stock market. You can expect annuities to have returns that are more in line with bonds or other fixed income alternatives then if they do provide that guaranteed lifetime income. That's really the motivation behind it, but it's not a tool that's going to give you stock market growth without any risk. So yeah, that middle balance between those two positions,

**Alex Murguia 07:48**

if someone's looking at annuities that have sort of investment themes in it, you know there, and we'll get to later on in this episode, the different types of annuities right now, we're just speaking more in generalities. But if you get to if you come across someone, and they start hitting up with an annuity that's kind of more investment driven, like something that you said, and they start talking about but these fees are so expensive. Why would I do that when I can get a mutual fund that has a fee of half a percent, or something like that, or an index fund at point 20 of a percent, what? What is going into that fee that's making it so exorbitant? Because I think a lot of times it's the thinking as well. That's what goes to the commission, and things along those lines. And can, can you talk about that a little bit?

**Wade Pfau 08:42**

Well, yeah, I guess here we do need to start to talk about different types of annuities. You've got fixed annuities, and you have variable annuities. And fixed annuities are mostly spread products where you don't actually have any observable fees. It's just internal it's just like if you put money spread product, yeah, that if the bank pays interest on your checking account, the idea is they're paying you less interest than they can earn. They're not paying they may go out and loan your

money at 6% and then pay you a 2% interest rate. The spread is how they're making their money. They're able to earn more on your assets than they're paying to you. And so that's what a spread product would be with an annuity. The idea is, if there are no internal feed drag or no internal like need to support the company that's creating that product, then you might get a higher yield or a higher payout rate, more lifetime income. But the idea is, you're not getting the full actuarially fair value, the insurance company is going to be taking something out internally. It's just that's not an observable fee, other than with optional guaranteed lifetime withdrawal benefits, then fixed annuities might still have an observable fee for that optional benefit. Mostly when people talk about annuities being high fee, it's more on the variable annuity. Side, where you have variable annuity, where you're investing in sub accounts, and then you have fees on those sub accounts that work a lot like mutual fund fees. What does a sub account mean? Just the different investment strategies, they're a lot like mutual funds, except they're technically not called that, because they're inside of annuities. But yeah, you might have a stock market like s, p5, 100 sub account, a bond sub account, different investment options, each with their own fee drag. And then there's annuity fees. On top of that, there's an immortality and expense charge, which is funding the insurance company and funding commissions if they're paid to the advisor and so forth. And then they could be optional living or death benefits that when you add those all up, can get you into that three or 4% range in some cases.

**Alex Murguia** 10:49

And is the mortality charge related to the insurance that you were speaking about earlier, when you were saying these are insurance products, not investment products, hence, comparing them is not an apples to apples comparison, right?

**Wade Pfau** 11:04

And that insurance charge is helping to support the death benefit, which would just be any remaining assets, but also any annuity can be annuitized. This is now getting into some other vocab that we have to kind of break down based on how annuities work today. But if you annuitize the contract, that means you're converting it into a series of payments. These days, a lot of annuity contracts never get annuitized. But yes, part of the insurance expense in the annuity is supporting the idea that you are allowed to annuitize it if you want to. Living benefits can provide an alternative way to get guaranteed lifetime income without having to annuitize the contract. So that's where things can start to get more confusing. But yeah, the the insurance costs are supporting that ability to annuitize the contract.

**Alex Murguia** 11:55

Okay, so before then, you're right, we probably need to get into the nuts and bolts on the different types of annuities. Because I'm sure folks are thinking, What do you mean annuitize? You know, I thought that's what an annuity is. You mean many of them are not annuitized, and why they called an annuity? I can imagine like that. I can also imagine thinking, What do you mean living benefits? What is that about? So before we get into that, in my my understanding what you said, and my understanding in general that you detailed in the book, is that when you're looking at an annuity versus, let's say, a mutual fund, it's not it's not right to just say, hey, an investment is a better product because it has a higher return. So why, in your right mind, would you even consider an annuity? You'd be crazy to do. So your response was, effectively, listen, once an insurance product and its price as an insurance product is providing certain protections. That main protection is you outliving your assets versus the invest, you know, a mutual fund, they're just they don't care if you outlive your assets or not, or if you can't maintain

a sustainable withdrawal rate from that or not. That's your responsibility, that that's on that that liability is on your bet, your own personal balance sheet. We're just going to take care of the investment expense, and that investment expense is naturally lower than the expense of the investment, plus moving potential liabilities to the insurance company's balance sheet. Is that conceptually, the right way to be thinking about this?

**Wade Pfau 13:30**

Yeah, yeah. And I mean to take a little bit further, but like with retirement income styles, if you have that total return style, it means you have that probability based orientation, where you're comfortable relying on market growth. And then that speaks to this idea that you don't really need an annuity, because you're pretty sure the markets are going to outperform anyway. You don't have to worry about it. And then the optionality orientation, you just want as much flexibility as possible. But then the alternative, the opposite retirement income style from total return, is income protection, and that's where you have that safety first, you want protections, backing the assets to meet your essential expenses, and you're comfortable committing to a strategy that will solve for a lifetime need. And that's the role. The traditional idea of an annuity is you provide that guaranteed lifetime income, reliable income, not exposed to market volatility to ensure that your basics are covered no matter how long you live. And for individuals who aren't comfortable relying on the market, this idea that stocks have to do well or I'm not going to be able to meet my retirement expenses if you're safety first, you may be optimistic about the stock market, but you just don't want to have to depend on stock market growth to meet your essential expenses and retirement, and that's where risk pooling steps in as an alternative way to earn if you live a long time or earn a much higher rate of return than you would have gotten out of bonds that can be competitive with any kind of rate of return you might expect from a market portfolio, a diversified total returns investment portfolio.

**Alex Murguia 15:00**

You okay. And then wait, one thing that you said that I think people are going to be thinking about is this idea that if you, if you compare them, compare them to bonds. And I want you to maybe expand upon that a little bit so people know what you're talking about. And and I would bring in the mortality credit component to to the return here, because that sort of throws in the the insurance piece a little bit. Yeah.

**Wade Pfau 15:30**

And in the third edition of retirement planning guidebook, I renamed mortality credits longevity credits, because it's really a credit for living a long time. It's a credit you get from the mortality of others. I think longevity credit just explains the concept a little more clearly. But yeah, another way to think about all this, the kind of the baseline for how you could fund your retirement is you could build a bond ladder. You have bonds maturing each year, and if you want to plan for a 30 year retirement, you could build a 30 year bond ladder, and then the bond yield curve, the interest rates tell you exactly how much you'd be able to spend over that time horizon. If you then live beyond 30 years, you don't have any money left at that point, you would have spent down your bonds entirely. So you've got two options to try to spend more than that, the total return approach, build an aggressive, diversified investment portfolio and rely on the risk premium from the stock market to support a higher level of spending throughout retirement. The safety first, or income protection approach, is use the power of risk pooling and longevity credits or mortality credits, to support a higher level of spending than bonds. And it's well, there's different kinds of annuities. The simple income annuity. You pay a premium to get a guaranteed

income for the rest of your life, and for the most part, the insurance company is taking that premium, investing it in their general account, which is primarily a fixed income portfolio, but that's earmarked more for long term, less liquid bonds with longer maturities, potentially a little more credit risk because of the diversification to get a higher potential fixed income yield than the household could get on their own, but primarily a bond portfolio. And so part of the payout rate reflects the interest that the general account can earn, and then part of the payout rate reflects the mortality credit idea, the idea that the insurance company, like, I may live beyond my life expectancy, I don't know. Like, if I plan for a 30 year retirement, it's like 65 planning to live to 95 for bonds, I'd have to spend a lot less than the annuity can support, because the annuity can pay everyone as though they'll live to their life expectancy. Half of the people don't live that long. Half the people live longer, but just roughly speaking, everyone can spend as though they live to their life expectancy because they know they have that mortality credit or longevity credit back in their retirement. The longer they live, the more spending they can support through the annuity. And that's the alternative way to potentially spend more than just with the bond portfolio. But that's the comparison is more to bonds, not to stocks. Now they can be competitive with stocks for people who live a long time, but really it's a way to outperform bonds, just like stocks are a way to outperform bonds, and you then have options about which of those you feel more comfortable with for meeting essential expenses in retirement. And the idea the annuity is not an all or nothing thing, it's I build a floor of reliable lifetime income, and then I can invest on top of that. And that's where the stock market comes into play for more discretionary types of goals, not for my essential expenses.

**Alex Murguia 18:34**

So effectively, the annuities, you can think of it as, I don't want to say you can think of it as or I don't want people to get proxies or this or that, but effectively, it gives you the return potential of a bond portfolio plus the longevity credits. And that's the that's the wow factor, if you will.

**Wade Pfau 18:55**

Yeah, I wrote an article once called the retirement income showdown, and it was risk pooling versus risk premium or longevity credits versus the stock market, and there are two alternative ways to fund a retirement spending goal.

**Alex Murguia 19:09**

And did they meet at 310, at Yuma?

**Wade Pfau 19:12**

Yes, the showdown. Hi, folks, if you enjoy the conversations we have on retire with style, the retirement planning guidebook takes those ideas and puts them into a structured step by step roadmap. The new third edition brings everything up to date and helps you see how the pieces of your retirement plan fit together before and after you stop working. You can check it out at [books.to.read.com/retirement](http://books.to.read.com/retirement)

**Alex Murguia 19:38**

All right. All right. So you had said something you were you were throwing out terms probability base and all of that. You want to maybe break down the different types of annuities. And maybe perhaps we should use the retirement income style profile as a guide that you can kind of walk folks through.

**Wade Pfau 20:00**

Okay, yeah, in the book I start that discussion by talking about four broad categories. Annuities can either be immediate or deferred, and fixed or variable, and it can start to get confusing though, to try to they don't

**Alex Murguia 20:18**

follow the the guidelines of the English language as as you know that you use in the normal right nomenclature, right?

**Wade Pfau 20:28**

And then another issue is the immediate or deferred aspect can refer to two different things. Well, that's maybe it's we'll start with fixed versus variable, since that's less confusing, probably,

**Alex Murguia 20:41**

and in this please do discuss why a lot of annuities are an annuitized why we do annuitize it like, what's the point? You know, that's

**Wade Pfau 20:50**

an immediate versus deferred. Yeah, part so quick, fixed versus variable. Fixed annuities provide principal protection so that you're not at risk of losing money within the contract, other than if you assuming you haven't annuitized it, we'll get into in a minute, and then variable is there's a risk for loss. So they're treated as securities, and that's traditionally, you could invest in different sub accounts. But that sort of approach is becoming less common, and now the registered index linked annuities are variable annuities, because the buffer annuities that maybe there's some sort of buffer that protects against some downside risk, but you do still have downside risk beyond the buffer, so that would be a type of variable annuity. So fixed principal protection, variable no principal protection, and then immediate versus deferred can mean two different things, but the more like accurate or technical meaning is an immediate annuity means you've annuitized it. You've flipped the switch to convert the value of that annuity into a series of contractual payments, either for a fixed period of time or to be life, contingent to continue on, the contingent on the survival of the annuitant in the contract and the deferred annuity is you have not annuitized it. You still have access to the underlying contract value. You can make decisions now that if you want to get the full money back in the early years of the contract, there may be surrender charges. But if you have a deferred annuity that you hold for long enough so you get past a surrender charge period, it becomes, in a way, fully flexible at that point that you can have all your funds returned. And that's a deferred annuity. So like a simple income annuity, in terms of now going through the different types of annuities out there, that's a fixed immediate annuity. It's an immediate annuity because you're annuitizing the contract, you're taking the premium and converting it into a series of lifetime payments. And it's a fixed annuity, really, because there's no like sub account investments. You're in the case of an immediate annuity, because you've annuitized it, you don't have access to the contract value anymore. But that contract value, the premium that you paid, is just part of the insurance company's general account. The other main kind of fixed annuities would be on the well, my guys the multi year guaranteed annuities, or the fixed index annuities, those are the annuities that have principal protection and link their credited interest to some external market index, such as maybe the S&P 500 would be the most common one, not the total returns of the market, but the price returns with dividends removed, since these are based on financial derivatives that don't pay dividends, but there's a lot of different potential designs. The most common is probably there's

going to be a cap. So I look at the price return on the S&P 500 with dividends removed, if the price return was negative for the year, for if I have a one year term, so to speak, if the price return was negative, the annuity would credit zero for the year. If the price return was between zero and its cap rate, maybe six or 8% I'd get 100% of that up to the cap. And if the price return was higher, I would be credited with the cap rate. What is the cap rate? Just the the number that if the price return was greater than that, you would not get any more so if the if the price, if the market was up 20% and you had a cap of 8% you would be credited with 8% for the year.

**Alex Murguia 24:39**

Now, I realize a lot of folks are hearing this, and you know, we're trying to get through these terms in a podcast, and if many of you are hearing these for the first time, it sounds like learning Latin or something like that, or listening to like your first day in some geometry course, and you're just trying to make make sense of the terms in the. Book, Wade, you give this, it's due treatment. We also have retirement researcher, which is our online membership site, retirement researcher.com and there we have many workshops on many of these different types of annuities. And we break it down, we this and more, but annuities is definitely something that that we pay attention to, just to make sure that folks, first and foremost, just understand

**Wade Pfau 25:24**

it, but right everything we're talking about right now is explained in detail in chapter five of retirement planning guidebook. If you really want to dive in deeper and because this is complicated, it is hard to explain in a podcast setting, but we'll also try the best we can here to to give you that information, yeah.

**Alex Murguia 25:43**

And you had mentioned, well, you finished on the unfixed annuities. Go ahead, do you? Yeah?

**Wade Pfau 25:50**

And so then variable annuities also have immediate types and deferred types. Immediate variable annuities are incredibly rare, and I do explain them in the book, but they're so rare, we probably can skip them for the podcast. Deferred variable annuities are the most common, and that's where you could either treat it as an accumulation tool, where you've got this deferred annuity, you're making investment decisions, or if it's a registered index linked annuity, you're deciding which index to link to, and so forth, but you've got some flexibility there, and it's deferred, and also the same with a fixed index annuity. It's a deferred annuity, but then if I add an optional, guaranteed lifetime withdrawal benefit that provides a structure around how much I'm allowed to distribute each year, and if I don't exceed that amount, should the contract value for the annuity ever deplete, because I've spent down all my assets, then it enters a settlement phase where it will continue to pay a guaranteed income for the rest of my life based on the terms of that living benefit writer. And so that's usually how people are getting lifetime income these days, the income annuities are not as commonly used. They do provide lifetime income. They're annuitized contracts, but the more common approach these days is I would apply an optional, guaranteed lifetime withdrawal benefit to either a deferred fixed annuity, such as a fixed indexed annuity, or a deferred variable annuity, such as a registered index linked annuity, or a traditional variable annuity with sub account investment choices.

**Alex Murguia 27:24**

So what you're saying is that within the annuities, the the investments don't have to go under for you to have to annuitize and get the you know your your a monthly amount for the rest of your life. They have features in which you can get a, right, you can get just income. They just, you know, they price it in, and they'll guarantee you a certain set of income for a certain set of time, for a certain time period, etc, etc. Is that correct?

**Wade Pfau** 27:56

Yeah, it sounds right. It's an optional living benefit. Writer says how much I'm allowed to spend each year, and it has provisions where, if your portfolio, if the sub accounts grow, you might be able to get a step up to even have a higher guaranteed income, but as long as you don't take out more than that, you're spending on your own account. And unlike mutual funds or traditional investments, should that account ever hit zero, that then triggers the annuitization, the annuitization where your content, the insurance company, is now on the hook to continue those payments for the rest of your life,

**Alex Murguia** 28:34

and because they're on the hook, that's why there's an extra level of fee that you don't see in a mutual fund, or Something of those

**Wade Pfau** 28:40

sorts, right, right, to manage that risk. Okay, what

**Alex Murguia** 28:44

about a misconception of and this is embedded in fees, because the more you protect yourself, I would imagine, the less benefit you get, because it's just costlier for the insurance company to have to price that. And so what about somebody who says, Yeah, but if I, if I, I annuitize and I die tomorrow, or I die in a month, it all goes. It was all for naught. So, you know, that kind of argument, What? What? What do you say about that?

**Wade Pfau** 29:14

Yeah, so that would be a life only income annuity. And those are not common, but they tend to have the highest payout rates. Potentially, just because you take, you accept the most risk you're you're offering the most mortality credits to the risk pool that if I die early, all my leftover premiums will go to other people in the risk pool, and so in exchange, you get a higher payout rate for that. But most people aren't comfortable taking that route, so the more common approach would be to have a cash refund provision where you get that guaranteed income for the rest of your life if you pass away before the original premium has been returned as annuity payments, a cash refund of the difference between the premium you paid and what you received thus far would be provided to your beneficiary. And so that takes away some of the risk of like, if I sign the contract with the cash refund get run over by a bus when I leave the office, well, then the cash refund provision would then become the death benefit to my beneficiary, and so I'm taking less of that type of mortality risk, and therefore it's going to have a lower payout rate, because I can't expect to get as much back from the risk pool, since I didn't put as much into the risk pool. Now, for the most part, it's not that hard to outlive the age where you get all your premiums back. Most people will, most annuitants will. So it's not gonna be that big a difference in the payout rate, but the payout rate will be less however. You do need to shop around, because a lot of companies don't even offer life only annuities, and so the best in class annuity with a cash refund might actually have a higher payout rate than the best available life

only income annuity, just because there's a more competitive company offering the cash refund provision. Why would that be? Well, it's because it with it for one company. It would be crazy for that one company to have an annuity with the cash refund, have a high a higher pay rate than a life only annuity, yes, but if there's company and company B, and company B decides not to offer life only annuities, but they're more competitively priced, it's possible that company B's cash refund life annuity with cash refund has a higher pay rate than Company A's life only question,

**Alex Murguia 31:29**

could it simply be because they want the business and they're trying to hustle a little harder than the other one, and with that, what are some potential pitfalls that you know You get what you've paid for? Kind of thing.

**Wade Pfau 31:42**

Yeah, it could be that there's an element of marketing, or some companies they may just not want to. They also they're they're looking at their life insurance portfolios and trying to hedge that as well. So if you're selling both life insurance and annuities, that helps you manage systematic changes in longevity, like if suddenly people live five years longer, well, your annuities will pay out more, but your life insurance will pay out less. So you're kind of hedging that risk for yourself. So some companies may just be able to offer more competitive terms because they're better hedged with the life insurance portfolios and so forth. Now the risks, and this is where it's very rare for insurance companies to not pay the promised benefits. It's happened a few times in history, but that's generally been smaller companies who may have been just pricing to get the sales, not really the best potential company. So you do want to look at credit ratings, credit quality to choose highly rated companies. And then also, when you're looking at fixed annuities, most states offer a state guarantee, where, as long as the premiums are up to a certain threshold, the state guarantee association will support those payments, should the insurance company default.

**Briana Corbin 33:01**

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**Alex Murguia 33:26**

Okay, and so wait. We've spoken about annuities. We talked about resa profile a little bit. Is there a way to match up? Hey, based on your your profile, your resa profile, retirement income style awareness profile. And you know, that's for those of you listening, and that's the whole genesis of this podcast. Was really retire with style. Is a take on retirement income style awareness. How would you you know it? Obviously, these are sort of rules of thumb, if you will. But how do you think about the world in terms of the style and the potential retirement income approach that would fit them. And because we're talking about annuities right now, there's more to the world than just annuities, obviously, but because we're talking about that, you know, going through the matrices of the RESA matrix, how would, how would you size them up? Because you do, you do the term, my guess, earlier, multi year guaranteed income, et cetera, et cetera. How does someone think about this?

**Wade Pfau 34:26**

Yeah, yeah. So there's one more detail we need, and then we can walk through the map, and it's just so annuity, deferred annuities provide tax deferral, just like an IRA does in terms of you're not paying ongoing taxes on the growth you pay the taxes, it comes out as ordinary income when distributed from the annuity. And so if I'm thinking about like, do I have my money in a taxable bond fund or in an annuity, the annuity is also providing tax deferral. So if you're not using the annuity for lifetime income, you're. Probably motivated to use it for tax deferral reasons, and with that, we can now, like tour the Risa matrix.

**Alex Murguia 35:08**

Well, that actually makes me think of because this is a potential thing that you hear a lot of, and so this is kind of a one off question, but I think folks could be thinking about it, since you use the term tax deferral, oh, you never want to buy an annuity in a tax deferred account because it already has tax deferral characteristics. How would you respond to that?

**Wade Pfau 35:30**

Well, if you're using it for lifetime income, there's got to be, right? There's got to be some other reason, because you're not uniquely getting tax deferral. You already had tax deferral inside of a tax deferred retirement plan. So there's got to be some other reason to consider the annuity, and that could be because you're using it for lifetime income, or it could be, if it's like a registered index linked annuity, you like the characteristics of its return potential, but yeah, there's got to be some other reason it's not tax deferral is not a reason to get inside of a tax deferred account, because you already have tax deferral anyway. So it's a fair point. Okay, yeah, yeah. So then, like with the total returns, individual, they're the least likely to be interested in annuities, to be quite franked, on the point, if there is a role for annuities, it's going to be at the margins. Either there are low cost. They're called investment only variable annuities. You have to really focus on having low cost. They're going to be variable annuities, mainly with sub account options, where for your less tax efficient investment choices, they provide you a way to get tax deferral. And you're probably never going to annuitize the contract. You're using it more as a tax deferral vehicle, and the costs have to be low enough so that costs don't eat up any of the benefits of the tax deferral. Then also, just from a purely accumulation based mindset, there can be interesting applications for things like registered index linked annuities as part of a portfolio for total returns individuals, but that's about it. They're not going to be looking at them for lifetime income. They're generally not going to be looking at them for the most part. But if there is an application, that's where it would lie.

**Alex Murguia 37:10**

And why wouldn't they be looking at them? What key components do they have? You know? And I'm drawing from the RESA, and we don't have to give it, it, you know, a full treatment, since we'll do our own arc on the reset itself. But quick and dirty, what are the key components there that you know your total return because you have a preference for you

**Wade Pfau 37:30**

have a preference for just market growth, which you can get through a variable annuity, but also just the optionality idea you prefer the flexibility of a brokerage account. Now, deferred annuities can still have a lot of flexibility, but it's not they're not going to be as flexible as a pure brokerage account investment choice because of surrender charges and so forth. So that's why generally, wouldn't necessarily lean towards an annuity when your total returns now time segmentation,

this is where deferred fixed annuities could play a role in those short term fixed income buckets to meet to meet upcoming expenses because of the tax deferral. You really want to look at when I fill my short term buckets, what's going to give me the best after tax yield. Is it some bond choice, or is it potentially a deferred, fixed annuity, such as a multi year guaranteed annuity, a fixed, indexed annuity? You're not going to be using them for lifetime income. You're using them more to meet upcoming expenses with tax deferral. And then you have to be careful, though, because with the surrender charges, usually, most annuities will offer some sort of free surrender, free free withdrawal, perhaps up to 10% of the premium paid, or maybe 10% of the remaining account value. You can take that out without surrender charges, and so you'd have to make sure that that will cover your expenses so that you don't have to pay surrender charges on the distribution, but then otherwise, you're using those more as a way to meet upcoming expenses in your short term fixed income buckets.

**Alex Murguia** 39:12

Okay, that's time segmentation. And did you touch base on my guess there? Because I think there's a laddering component. And My guys are the equivalent, the insurance equivalent of, let's say, CD ladders. You may want to

**Wade Pfau** 39:24

Yeah, yeah. My guys are deferred fixed annuities. They pay a fixed interest rate. A fixed index annuity is paying anywhere between zero and the cap, or in many designs, but a rate that fluctuates based on the performance of the index, a mica just pays a fixed rate and has the tax deferral, so you're getting a tax deferred fixed rate that you compare to your other fixed income options. Okay?

**Alex Murguia** 39:50

And as we go down the matrix, there's risk wrap, yeah,

**Wade Pfau** 39:54

well, income protection and risk wrap on the bottom half of the RESA matrix, that's where annuities for lifetime. Income will enter the conversation. Income Protection is the classic flooring approach. It's and that's more what annuities offer the highest payout rates. I'm not really going to look at the upside growth potential for the contract. Not necessarily worry too much about the idea that I could get step ups and higher income, I just want what's going to give me the most income if markets don't perform all that well, and that's usually with fixed in fixed annuities, whether it's the income annuities, single premium immediate annuities, deferred income annuities, the Q lacs qualified longevity annuity contracts, those are all types of immediate annuities, which just means they're all contracts that are annuitized right away. So you've got those, and then you have the fixed index annuities with living benefits, which in theory, should have lower payout rates than immediate annuities. But in practice, that's not always the case, and that's just due to sometimes people buy those optional benefits and don't use them. And so they're, they're not getting the full value out of the contract. That makes it easier for the insurance company to raise payout rates within the contracts so they can be competitive with income annuities.

**Alex Murguia** 41:10

So you're taking, like, optically, they're a great deal, but the insurance company is pricing them, knowing that folks won't take advantage of all the all the bells and whistles that they have, so they're fine with it.

**Wade Pfau** 41:23

It's kind of a funny thing. If I buy an income annuity or an immediate annuity, I can't make any mistake because I don't have any flexibility that payment is going to show up in my bank account every month. I don't have a choice to say, No, I don't want to take it this month, whereas with living benefits, I can decide not to turn on the living benefit, or I can decide to not take out the full promise payment. And the less I take out, the less likely the contract is to ever run out, and therefore, the less likely the insurance company will be on the hook to pay out of their own funds, instead of out of my own funds. So if I if I if I'm paying for a living benefit, but I'm not maximizing my distributions, I may not run out of money in the contract, and the insurance company is not on the hook, so through competition, they can offer a higher payout rate that way. And that's the story for why you can find fixed index annuities with living benefits that are competitive with their payout rates, and then on the risk wrap side, so that's now probability based and commitment oriented. That's more a conversation around variable annuities with living benefits, whether it's traditional variable annuities with living benefits or registered index linked annuities with living benefits, where there's more potential the payout rate might be lower, so that if markets don't do all that great, I may get less guaranteed income. But there's growth potential. There's step up opportunities. If markets perform well, I may be able to support a higher average income from that annuity than I could get from a fixed annuity. And that's why variable annuities become more a tool on the risk wrap side of the spectrum

**Alex Murguia** 43:04

and Wade again. We went through the recent matrix. We went through, you know, and how annuities applied. Where can someone, I know the answer, but I guess I'm asking you to give you the you know, the momentum here on retirement researcher or membership site. Is it possible for someone to take the RESA profile and figure out what preferences they may have with regards to not just annuities, but overall retirement income solutions?

**Wade Pfau** 43:34

Yeah, any listener can take our retirement income style awareness. They don't have to become a member of the Academy to do that. They can sign up for the weekly email list at retirement researcher, and one of the first steps after that is they'll have the opportunity to take the RESA, the retirement income style awareness, and that will identify whether your style is more total return, time segmentation, income protection or risk rep. And then right, that translates into what we were just talking about where, based on which of those four styles you are, whether you want to consider an annuity as part of the retirement income plan, and then what type of annuity and whether there's a living benefit, all comes out of understanding better what your retirement income style is,

**Alex Murguia** 44:16

and then bringing it all back home for this Episode, the Reese's discussed in your book as well, correct?

**Wade Pfau** 44:23

Yeah, yeah, that's how we started this series. Chapter One of retirement planning guidebook is on retirement income styles,

**Alex Murguia** 44:32

and anything in the chapters with regards to annuities that we didn't hit that maybe you want to give a little teaser on or we've covered the main points. And if you want to drill down,

**Wade Pfau** 44:45

I think we've covered the main points. I do talk more about like, how to frame the fees on annuities, how to consider, like, do I want just the highest downside guarantee, or will I accept a lower. Downside guarantee for more upside growth potential. I do get into those issues more, but I think we probably covered things pretty well for the basic intro of what chapter five is all about.

**Alex Murguia** 45:12

All right, anyway, well, thank you for this episode, for listening in, ladies and gentlemen, and we'll catch you next week on retire with style. Retire with style. There you go. All right, everyone, thanks a lot.

**Briana Corbin** 45:28

Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you. Consult your financial advisor. All investing comes with the risk, including Risk of Loss past performance does not guarantee future results.