Episode 243: Why Annuities Aren't Really Investments

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Retirement income, annuities, time segmentation, income protection, bond ladder, deferred annuity, Roth conversion, inherited IRA, tax efficiency, effective marginal tax rate, fixed index annuity, variable annuity, financial planning, retirement income plan, investment vs insurance.

SPEAKERS
Briana Corbin, Alex Murguia, Wade Pfau

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 and sign up to take the industry's first financial personality tool for retirement planning. Quick PSA before we start: An annuity is not a stock, no matter how confidently that guy at the steakhouse dinner tries to tell you otherwise. Wade and Alex spend this episode setting the record straight, plus answering a few listener questions on Roth conversion timing, inherited IRAs, and the hybrid strategy that might finally get your time segmentation and income protection camps to stop arguing at Thanksgiving.

Wade Pfau 01:08
Hey everyone, welcome to Retire with Style. I'm Wade. I'm here with my trusty co-host Alex, and we're continuing our series on Q and A questions that have come from you, the listeners, and many of you listeners as well, the part of our retirement income challenge that we did in July, we got a lot of questions that came through that as well on general retirement income topics, and we're continuing with that. And Alex, we ended the last episode with a cliffhanger because we were we had a bunch of questions about time segmentation, and there was one final question before getting into another set of different random various topics. Time time. Yes.

Alex Murguia 01:52
All right. Let's get here. First one. Can there be a hybrid strategy of time segmentation and income protection where you build a bond ladder for five or 10 years and buy a deferred annuity that starts the year after the bond ladder expires. I think it's a great question,

Wade Pfau 02:11
and the answer is yes. This is definitely an approach that has been considered in in research and things in the past. There was an article, I think it was in 2009, about the idea of you build a 20 year tip ladder, and then you buy a deferred income annuity that would start in year 21, and then it was calibrating out how much could you spend with that type of an approach, what you're assuming about inflation because the The annuity portion wouldn't be inflation adjusted, but but

yeah, absolutely, that would be a way for you to put less into the annuity, more into the bond ladder, and and can also be a way. This is actually a strategy we talk about if you have a couple where one person is time segmentation and the other person is income protection, something like this might be an approach that they'd feel more comfortable with, or it wouldn't necessarily have to match up the dates. But maybe you have the the five or 10 year bond ladder, and then you do have a deferred income annuity or longevity insurance or a qualified longevity annuity contract that might not kick in for 20 or 25 years, and that way you're you're getting the protection at the short end, you're getting the protection at the long end, and that could be a way to build a compromise between those two styles as well. But but yeah, absolutely, you can consider hybrid strategies along those lines that build part of the floor with bonds, bond ladders, part of the floor with more deferred income annuities, or deferred in the context of the income doesn't begin until later into the future. I

Alex Murguia 03:48
think that's excellent. What I like about this strategy is that it shines a light on how the RISA can be used, especially when you have two corresponding profiles, to really come up with solution sets that that kind of hit everyone's buttons, if you will, as opposed to someone sacrificing something or the other, or as opposed to just splitting the baby on an allocation between aggressive and conservative and ending up at moderate. You know, I I think this gets to the heart of financial planning, frankly, which is how do you how can you get to creative solutions that fit that person's profile and appetite a lot better? And you're absolutely right. If someone comes in at time segmentation and someone comes in at income protection, I think a strategy like this really makes a lot of sense. And all things being equal and balanced, should make everyone kind of see this strategy as being quite palatable.

Wade Pfau 04:49
Very good.

Alex Murguia 04:53
Yes. All right. Would it be better to withdraw from? Roth accounts first before withdrawing from IRA accounts.

Wade Pfau 05:06
So, right, this is about like withdrawal order sequencing.

Alex Murguia 05:09
Yeah,

Wade Pfau 05:10
should I spend on my Roths before my my Roth IRAs before my IRAs? There can I'll talk about cases where you might end up doing it this way, but the the general answer is no. The conventional wisdom is you spend on taxable accounts first, then IRAs or other tax deferred accounts, and then Roth IRAs or other tax exempt accounts last. Now the reality, though, is that's not the most tax efficient approach. The most tax efficient approach involves blending, which is you really you spend taxable and and tax deferred or taxable and IRA accounts first, and that could include doing Roth conversions, and then later on you blend between IRAs and and Roth IRAs. Now with blending though, there could be cases where you have so much taxable income already from things outside your investment portfolio. Maybe you're working in

retirement, or maybe you're not yet retired, but you still need more spending power. You're kind of in a situation where you've got a lot of taxable income already, but you still don't have enough to meet your expenses. So you're going to have to take distributions. You might be in a spot where now RMDs always have to come out of the IRA first, but maybe you're still pre-RMD age, or maybe even after RMDs, there's still a gap. If you're at a point where drawing another dollar out of that IRA is causing an effective marginal tax rate that's higher than your target, and we've you're going to ask me to define this, but we've had millions of episodes about it. Like, the the overall tax rate you pay in $1, not just income taxes, but how does that impact social security taxation, Irma, Medicare income monthly income related monthly adjustment amounts? If you're still with the Affordable Care Act earlier in your life, the the loss of subsidies from that, the phase out of some of those below the line tax deductions, the stacking of preferential income on top of ordinary income. If taking another dollar out of your IRA would cause your effective marginal tax rate to be too high, then you don't want to voluntarily do that, and and so you might draw from the Roth IRA, and then if looked at it from like from a cloud above, like the 20,000 foot view of that, it might look like you're spending Roth IRAs before IRAs. That would be a somewhat uncommon case because it's kind of the situation it's caused because you you already have a lot of taxable income, but it's not enough to meet your expenses. You still need more distributions from your investments. So in rare cases, you might not really want to take that from your IRA because you already have too much taxable income. That would speak to spending the Roth IRA before the IRA, so yeah, you could find situations where that's the answer, but I don't think it's going to be the general answer. The general answer would, for most people, they would tend to spend their IRAs more aggressively overall than they before spending their Roth IRAs. But you don't ever want to get to a case where you empty out your IRAs and only have Roth IRAs left, because if you don't have other taxable income to at least fill your standard deduction, that's very tax inefficient. You always want to preserve enough IRA to like at least fill your standard deduction in the future. So it's it's hard to talk about tax planning because there's many different circumstances, so but yeah, sometimes it might make sense to spend Roth IRAs first, but that's not going to be the general answer that would work for most people. You

Alex Murguia 08:51
started with the concept of blending. Could you describe the what what what and how you're using that in this answer?

Wade Pfau 09:00
Now this is something that's really important in that most of the commercial software available to consumers isn't going to even be considering blending. So that's where they can give really misleading misleading guidance around Roth conversions. But the the effective marginal tax rate targets worked both ways. Usually, we talk about Roth conversions, I've met my expenses, and I still have some capacity where I could voluntarily pay some taxes at relatively low tax rates, and therefore I do a Roth conversion to fill up, pay the taxes at those lower rates to help set me up in the future. I won't have to pay taxes at higher rates, especially after RMDs begin, well, the blending idea there is now. I'm already hitting my target. I don't want to generate more ordinary income. I don't even want to just spend from my IRA. So I'm going to blend it. I'm going to not voluntarily spend from my IRA to meet my expenses. I'm not even at the stage where I think about Roth conversions. I'm still trying. Meet my expenses. I don't want to take anything out of the IRA, so maybe I took some out of the IRA, but to meet my overall spending goal, I'm going to blend that with money coming out of the Roth IRA, and that blending is you spend usually earlier on you spend you blend spending from your taxable and IRA accounts, and then

when the taxable accounts are gone later on, you're blending spending from your IRA and your Roth IRA accounts.

Alex Murguia 10:30
Gotcha.

Wade Pfau 10:32
And that commercial planning software that is meant to help consumers do these Roth conversion decisions generally overlays Roth conversions on top of the conventional wisdom of spend taxable, tax deferred, and then tax exempt. It completely skips the notion of blending, and therefore can lead to some pretty bad suggestions.

Alex Murguia 10:54
There you go. Can you use an inherited IRA to pay Quarterly taxes.

Wade Pfau 11:02
Yeah, and I'm not sure the context of the question. That was just a question I said appeared in the chat box. Someone's going to

Alex Murguia 11:09
raise funds to pay a tax bill. Is what that?

Wade Pfau 11:12
Yeah, money is fungible, so yeah, you can use distributions from an inherited IRA to to pay your quarterly tax bill. There's no issue there. Now, you get the whole irony of each dollar you take out of the IRA inherited IRA to pay taxes is going to give you more taxable income and therefore increase your tax bill further. But yeah, you can definitely pay taxes quarter your quarterly taxes through distributions from your inherited IRA.

Alex Murguia 11:45
Okay. Is it true a person should evaluate Roth conversions amounts on an annual basis, being mindful of their tax map effects? I hear lots of noise about doing huge conversions while in the window of age prior to RMDs and Social Security pensions starting,

Wade Pfau 12:08
right? And so we have the tax map calculator at the academy, and in the the third edition of my retirement planning guidebook, I use tax maps to explain how to make these decisions. That's a concept developed by Joel Sasser at Covisum, and absolutely, you want to make those Roth conversion decisions based on their tax map effects. And just as the the question is, I hear lots of noise about doing huge conversions while in the window of age prior to RMDs or Social Security and pensions starting, and that idea of doing the huge Roth conversions, I think that's an idea that came from Larry Kolakov. He wrote some articles about that, and I replicated what he was talking about in his articles and agreed. Yes, while being mindful of tax map effects for the case studies he was talking about, generally over the next three or four years, they were doing Roth conversions of a couple $100,000, got it over with, and then moved on with their lives. Didn't really have Roth conversions after that, and I was getting the same kind of answers as well with with my soft software and algorithms. So, and that's usually the idea when you're. That's what we talk about. When you're in your 60s, if you're retired, you have this window

where you may not have a lot of taxable income before Social Security starts, before RMDs start on your IRAs and so forth. That can be an opportunity to do these huge Roth conversions. You do big Roth conversions for a relatively brief period of time, and then after Social Security starts at 70, you may be done with it. You may not do any more Roth conversions after that point. So that that's the idea, and I agree with it. It's not when he says do huge Roth conversions early on. It's not as though he's saying in year one convert your entire IRA to a Roth. He's still spreading it over a few years, but you might be in a situation where you're targeting the 24% or 32% effective marginal tax rate, and that might call for some pretty big Roth conversions. So, so yeah, yeah.

Alex Murguia 14:14
How much of a how much of a commitment is it to review this on an annual basis?

Wade Pfau 14:23
It's not a huge commitment. Usually, you do the Roth conversions late in the year because you have to know all your like distributions from your investments, and that's not really known until December. So, kind of plan ahead earlier in the year. But just thinking for

Alex Murguia 14:39
the person scoring at home, how should they be like budgeting their time?

Wade Pfau 14:42
Yeah, come December, you're you're trying to plan out what your taxes are going to look like for that year, and like with our tax map calculator, you plug in those numbers. It's kind of like replicating your 1040, and then getting the guidance on what you might want to do with either Roth conversions or or harvest. Capital gains from your taxable brokerage accounts. It's not a huge. I don't know what you mean by like it's not going to take a huge amount of time. Like

Alex Murguia 15:09
some folks hours,

Wade Pfau 15:10
definitely hours, but not days or weeks. Some folks are

Alex Murguia 15:13
do-your-suffers, and you know they're gonna you know they're trying it out. So you know how much of a commitment are they like signing up for

Wade Pfau 15:21
once you know what your 1040 is going to look like, there's that's going to be most of the work. Then there there's not as much work after that for doing the the Roth conversion part, but it's the sky's the limit on how long it would take you to figure out what your 1040 is going to look like for the year.

Briana Corbin 15:39
Are you getting close to, or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement, and now is when they need to earn their keep. To make sure you're on the right

track, download Retirement Researcher's Eight Tips to Becoming a Retirement Income Investor by heading over to retirementresearcher.com/8tips. Again, get your copy of Retirement Researcher's Eight Tips to Becoming a Retirement Income Investor by going to retirementresearcher.com/8tips. That's the number eight tips.

Alex Murguia 16:17
All right. For annuities, there are a lot of poorly designed and overly expensive ones on the market. How can we be sure to get a good one that works well in the plant? How should we shop for

Wade Pfau 16:31
one? So this is like a tough kind of question. No, at McLean Asset Management, Jason Riskalas. We've had him as a guest on the podcast, many times he can be a good resource for our listeners who want to walk through this. But yeah, you do want to be careful in general with annuities. A lot of times, I get the mailings to come to the local, either steakhouse or chicken dinner house, and get a free meal and learn about safe money for your retirement, like with some type of annuity, and that's probably not going to be the most competitive annuity because it's going to be paying a big commission to that advisor, so he can afford your steak dinner that he paid you or provided you. So, yeah, definitely you have to be cautious about things like that, and and you can't really buy annuities direct as consumers. You do have to go through an agent of some kind, and so then just finding somebody who's not just captive to just one company or just selling one particular product, but really looking at you know make sure they're they're kind of doing their homework and looking at several different companies' products and offerings, and finding the one that works best for your plan is really the best approach to take. And you, you and I have met advisors who just have one annuity in their toolkit that they use with every client they meet. That's usually not going to be the the best solution. You really want to make sure you're talking with someone who is looking at annuities from multiple companies and trying to find the best fit for each case? And again, Jason Rizcala here at McLean Asset Management can be a great resource for people that we can definitely mention as part of the the podcast.

Alex Murguia 18:14
No, I I agree with what you said, and I'd like to emphasize a phrase here: poorly designed or overly expensive ones. Can you give us a sense of what what are some look what what are some signals, if you will, for a poorly designed one? In addition, when folks say overly expensive, sometimes I think that's just the thing to say, because it's it's a easy sort of thing to swing at when you're looking at an annuity. Oh, those are expensive, and and you move on from it. You know, you move on from that. And I think people that sort of take that shortcut. I'm not saying this writer did it. I'm just taking advantage of the phrase. I I think people see, you know, are easily to say, "Oh, annuities-that's too expensive. I don't need to do that. And I don't think they're really understanding like a spread product from an annuity standpoint, how you know how that works and the like. So poorly, poorly designed. What are some tells for someone to see a poorly designed one? And then, how do you really? What is the dynamic you look for in an expense? Because you, you know, if you're paying for some sort of protection, you know that you don't need, then it becomes expensive. But that's not an annuity issue. That's just a selection issue.

Wade Pfau 19:36

Yeah. So on the let's start with the expensive side. So that was easiest to start observing in the past with like variable annuities. Usually, when people talked about expensive annuities, they meant variable annuities because there were all kinds of fees associated with them. You had variable annuities where you invest in subaccounts, so you had the underlying investment fees, then you had a mortality and expense chart. And then, if you have the living benefit to support lifetime income, that's that's a charge as well. And you could be finding variable annuities that the expense ratio in all could could be 3% or more. And so that's usually then labeled as expensive. Now that's not the whole story because you're getting a lifetime income through that, so the fee drag would cause the account to hit zero sooner than otherwise. But then the insurance company is on the hook to provide you that income for the rest of your life. But these days we don't even see as many of those variable annuities. And on the fixed annuity side, income annuities, fixed index annuities, well, especially fixed index annuities are often marketed as no fee, and that's not the whole story. But that is where it's not going to be transparent what the fees are. The fees there is no fee drag except for the optional living benefit potentially, but there's no fee drag on the the fixed index annuity itself because it's a spread product. It's just like your checking account. The money you deposit in your checking account, if the bank's paying you point 1% interest, well, maybe they're lending your money out at 5% interest in the spread. Maybe they have a no fee checking account. You don't have to to pay for anything, but they're making money because they're able to earn more on the funds than they pay out to you. Maybe your checking account is even 0% interest. Well, that's how a lot of fixed annuities work as well. The insurance company is keeping part of the returns for themselves and only giving you part of the returns. And that's where maybe if it was a truly fair fixed index annuity, it'd be able to offer an 8% cap from market returns, but then the annuity being offered through the insurance company only offers a 6% cap. Well, that that's where the the idea of the fee it's not a fee and it's not transparent, but it's just you're not getting as good of terms as would be possible if the insurance company was able to put 100% of the money to work for you. So then, when we get into like, what does an expensive annuity mean in the context of like fixed index annuities? Well, it's maybe Company A offers an FIA link to the S and p5 100 with an 8% cap, but then you go to your steak dinner, and that annuity has a 3% cap. That'd be one way to kind of see this differential. Another way is oftentimes those types of marketed annuities, the first year the caps might be really good, but you can be pretty assured that when it comes time to renew the terms, you're not going to be getting a good deal out of that, and so that you want to see what were the renewal rates. And some companies offer the same renewal rates as they offer to new customers. That's probably a company that's going to be more attractive for you to consider versus one that has a teaser rate of a 10% cap. But then next year, if underlying market conditions didn't change, maybe they're only going to renew at a 3% cap. So looking for something like. Well, you say renew

Alex Murguia 23:09
at a 3% cap. What does that mean? Renew.

Wade Pfau 23:12
Well, if it's a one-year term, it's going to offer a 10% cap over the next year, and then if you keep your money in the contract for year two, they have to reset the parameters, and they have to do that because interest rates change, market conditions change, the volatility, the cost of financial derivatives that they use to to provide that upside support change, and so they have to offer a different cap. So maybe there was some market movements. A 10% cap was a good deal this

year. 8% cap might be a good deal next year, based on where the markets are at that point. But they don't give you that good deal anymore. They they drop it down to a 3% cap. So so

Alex Murguia 23:52
the the term term is a specific term here.

Wade Pfau 23:58
Term yeah terms are things like the caps that what percentage of the the market upside do you get? No, but also

Alex Murguia 24:04
you there's a look back. Oh yeah, there's every three years every you know what I mean.

Wade Pfau 24:08
Yeah, there's a term. How like is it a one year term or a three year term or a six year term? But then also the terms of the contractor, like what's the cap rate? What's the participation rate? What's the spread? That sort of thing. So it'll be used in two ways.

Alex Murguia 24:23
So a tell would be like if they have a short time horizon tell, and then you notice that the renewal rates are really poor. That's not a good sign.

Wade Pfau 24:35
Yeah, although you'd want to be able to know that before.

Alex Murguia 24:38
Yeah, yeah, yeah. Enter the contract because then you're

Wade Pfau 24:40
in the surrender charge period where you can't just you can surrender the contract, but then you might have to pay an extra 8% out as a surrender charge if you're surrendering in the early years of the contract. Okay, the

Alex Murguia 24:51
question I got you. So the question: How do we shop for one? It kind of depends on the type of immunity because some you could probably do. Like SPA, you know, you can kind of do a lot of that online, but you know, when it gets to be more complicated, like an FIA, there would be dragons here to some extent.

Wade Pfau 25:10
Yeah, SPAs are easier to compare because it's just what is the payout rate, and there's no external fee that you see. It's just the I talk about in retirement planning guidebook: the idea of money is worth calculations. You could figure out like if it was a fair SPIA using population actuarial data and so forth. How long do people live? What are interest rates that are reasonable for the insurance company to earn and so forth? You could figure out what's the fair price. Like what would be the fair payout rate on the annuity? Maybe it's 6.9% and then you see the commercial annuities offering 6.7% Well, then the difference between 6.7 and 6.9 is is kind

of the estimate of the fees implied. That that point 2% coming out of the payout rate is the underlying quote unquote fee of the Annuity.

Alex Murguia 26:02
Okay, the other the other thing about it, we'll end it with this one. It's not this question, but it's part of it, and I I think it's important because we actually we we even picked up a a client earlier this year, and he was in a bad annuity, and part of it is just the mindset of annuity as an investment. You sold the annuity as an investment when it's in fact that's not what it's intended for. It's like an insurance contract, if you will. And so I think when you're looking at it purely with an investment lens, I I think the word I think I can see why someone thinks it's expensive, but the reality is, it's it's not an investment. It it shouldn't be compared to and like you can't compare an annuity to like an S and P index fund. You know, they they serve two different purposes to to a large extent. Do you want to talk about that, like investment versus insurance, because I think that helps elucidate folks on expensive.

Wade Pfau 27:01
And I remember someone in the YouTube comments got mad at us once because they thought annuities are investments, and when we said annuities are not investments, they they were mad. They thought we're wrong about that. But the the problem is a lot of times these days annuities get treated as investments and like tax deferred investment vehicles, so you could think about them that way, and then it is more like a rate of return argument. But when we're thinking about retirement income, and historically, we're thinking about annuities for lifetime income, and that means they're insurance contracts. They're insuring against the risk that you outlive your ability to spend in retirement. They're insuring against outliving your assets in retirement, so that that's the context of really, if we're thinking about annuities as insurance, then it's not just like maximizing the after expense rate of return on the underlying asset base. It's more what's going to give you the most protection if you end up living a long time in retirement, and that's the context of thinking about them as insurance, and that's always my default way to want to think about annuities. But then these days, you know, sometimes registered index-linked annuities and fixed index-linked annuities are treated more as an asset allocation. And there, it's not that they're especially fixed indexed annuities, even though they link to a stock market index, they're not giving you stock market like returns. It's really more comparing how does their return profile compare against other fixed income or bond options. You get the tax deferral with the annuity, and you might get a competitive yield compared to other bonds that you're looking at, so that's really if you're not even thinking about the lifetime income aspects, that's how to think about it as an investment. I just don't like using. I don't ever want to personally call an annuity an investment because I really want to think about it more as an insurance contract.

Alex Murguia 28:57
Yeah, I think about it as an insurance contract with like lifetime income features, I you know, which is why it's an insurance contract. You know, insuring living a long life. I, I tie. I view it too as my default.

Wade Pfau 29:12
All

Alex Murguia 29:12

right, all right, Wade. That's a good number of questions. What do you think?

Wade Pfau 29:19
Yeah, yeah, we can call it an episode, and we'll we'll have a couple more of these types of episodes. But we are working our way down these list of questions, so we're getting closer to the end of the list right now. But some point, more questions may come in. Who knows? We're getting there. We're working on it. All

Alex Murguia 29:36
right, everyone. Thank you for listening in on Retire with Style, and we'll catch you the next time.

Wade Pfau 29:42
All right, thanks everyone.

Briana Corbin 29:44
Wade and Alex are both principals of McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's 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 a risk, including risk of loss. Past performance does not guarantee future results.