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Three reasons to seek annuity income

Blog

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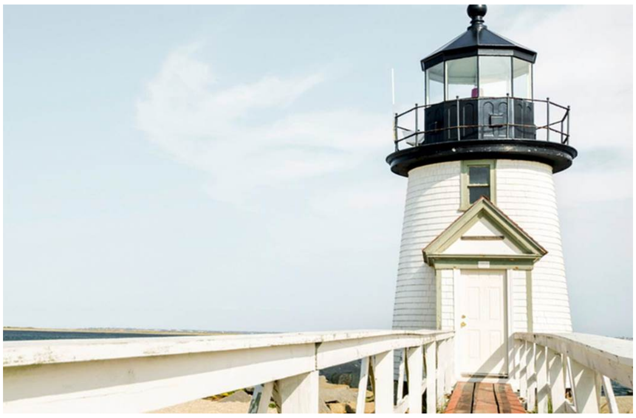
- With longer life expectancies, lower expected returns from stocks, and higher interest rates, we view annuities as an increasingly valuable component of a holistic wealth strategy.
- Adding annuity income to your investment strategy may help reduce the risk of outliving your wealth, increase your ability to safely fund lifetime spending, and give you the ability to earmark more of your investment portfolio for long-term growth.
- A stream of lifetime income may also help you to maintain your lifestyle in retirement, increase your financial security, and give you the confidence to stick with your investment strategy during periods of market volatility.



When approaching retirement, many families struggle with the transition from living off a stream of income to living off a limited pool of retirement savings. That's partially because the act of turning off your “income tap” dramatically increases two key risks:

- **Sequence of returns risk:** This is the risk that your retirement spending—paired with poor market returns—will prematurely deplete your retirement assets.
- **Longevity risk:** This is the risk that you will live longer than you had planned for, potentially requiring you to curtail your spending to reduce the risk of outliving your wealth.

Funding a portion of your retirement spending using a guaranteed lifetime income stream is a direct way to mitigate these risks, creating a series of “synthetic paychecks” that replaces at least a portion of your salary. Pensions, defined benefit plans, and annuities are all solutions that can reduce the pressure that spending will place on your portfolio. Unfortunately, most American families do not have access to a defined benefit plan or pension. In 1975, 88% of private sector workers were covered by a defined benefit plan; today, these plans cover only 15% of non-union private sector workers.[1]

This means that, for most families, Social Security is the primary source of guaranteed income in retirement. In our view, Social Security is particularly potent when used as a longevity hedge, because it offers an annual cost of living adjustment. While delaying your Social Security claiming age to age 70 allows for a 24% increase in annual benefits—and is probably the best strategy for maximizing its value as a longevity hedge—this decision does reduce Social Security's ability to address sequence of returns risk, particularly in early retirement.

Social Security is a valuable resource, but it is a progressive program that is much less effective for higher income families: Social Security benefits will replace about 50% of income for a median income earner (USD 60,024 per year), but only about 30% of income for a worker earning more than the Social Security income limit (USD 147,775 per year).[2] Therefore, it's natural for families—especially higher income families—to consider filling this income gap by investing a portion of their wealth in an annuity, or in a portfolio of annuities.

The case for adding annuity income

Annuity income is one potential solution to these challenges. When you purchase an annuity, you transfer the risk of outliving your savings to the insurance company. In return, they provide you with a guaranteed income stream, often for the rest of your life or until both you and your spouse have passed away. In the case of a lifetime annuity, you can continue to receive regular payments—providing increased financial security for your later retirement years—no matter how long you live.

Allocating a portion of your portfolio to annuities can allow you to lock in higher yields and secure a reliable stream of income that can last for the rest of your life. Similar to a bond, an annuity becomes more valuable if interest rates fall in the future (because it would be more expensive to replace this stream of income when interest rates are lower). By the same token, existing annuities may become less valuable if interest rates rise. Unlike a bond (or any other investment), a lifetime stream of annuity income also appreciates in value if your life expectancy increases due to good health and medical advances that improve longevity.

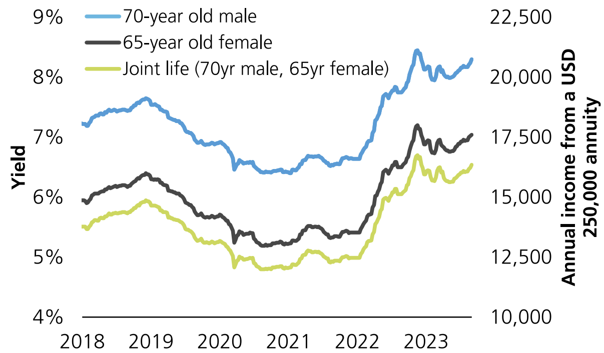
How will annuities affect the growth of my wealth?

No matter who you are, life expectancy is a source of uncertainty that needs to be addressed. Transferring this risk to an insurance company can help you to manage this risk. Annuities help to increase your expected wealth if you outlive your life expectancy. By contrast, life insurance provides its highest return if you die prematurely. Incorporating both solutions in your financial plan can help you increase your lifetime spending and meet your inheritance goals with greater confidence.

Three reasons to consider annuities

1. Annuity yields have significantly improved
Annuity payout yields have historically been highly correlated with investment grade corporate bond yields, as evidenced by the rise in annuity yields over the past few years. Today, families can secure roughly 36% more lifetime income through an annuity than would have been possible three years ago (see Figure 1, which shows terms for single premium immediate annuities). We have seen a similar improvement in terms for other annuity solutions, such as deferred income annuities and income benefit riders available for variable and fixed rate annuities. Just like interest rates, annuity yields are higher than they have been in over a decade.

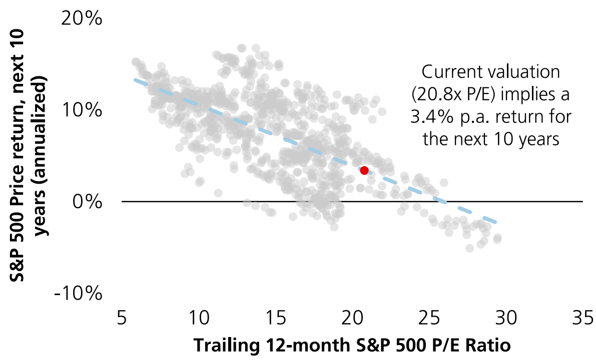
Figure 1 - Annuity yields have risen dramatically along with interest rates
Market pricing for single life or joint life single premium immediate annuity contracts



Source: CANNEX, UBS, as of 31 August 2023.

2. We anticipate lower portfolio returns
Stocks have been incredibly resilient to higher interest rates, and are now trading at some of the highest valuations in modern history. Many investors have learned the hard way that high valuations are a poor timing indicator—and certainly not a reason to exit stock market investments—but they have proven to be a headwind to future returns (see Figure 2).

Figure 2 - Higher valuations suggest lower stock returns going forward
S&P 500 Index starting valuations and subsequent 10-year returns



Source: Bloomberg, UBS, of 31 August 2023.

Although higher interest rates have improved the expected return for bonds—and global diversification and alternative investments can help to offset the dim long-term forecast for the US stock market—we expect that most diversified portfolios will deliver lower returns than they have in the past. Adding annuity income to your portfolio can help you to reduce the risk of lower portfolio returns, and help to improve the effectiveness of a Liquidity strategy that is designed to help you to maintain your lifestyle without being forced to sell during future bear markets.

In addition to offering increased financial security during market downturns, annuity income may also help you to implement more flexibility in the rest of your portfolio. For example, annuity income can reduce the amount of capital that you need to set aside for spending from your core portfolio, allowing you to modestly increase your allocation to stocks—and other higher risk, higher return asset classes—while mitigating the increase in your sequence of returns risk.

By enhancing your portfolio's resilience to market volatility, annuity income can also indirectly contribute to your portfolio's expected return and help you take advantage of future bear markets by increasing your allocation to stocks when valuations are more attractive.

3. It's expensive to manage longevity risk yourself
Especially given that life expectancies are generally rising over time, it's essential to have a plan in place to ensure you don't run out of money in your later years.

You could make sacrifices to try to "self-insure" your financial plan and improve resilience against the risk of poor returns and longevity risk. For example, you could delay retirement; reduce spending; or adopt a more conservative portfolio, prioritizing your lifestyle spending over the secondary goal to grow your wealth for needs that go beyond your own lifetime.

For many families, annuities are an option that can reduce the need to make these adjustments. Figure 3 shows the sustainable annual spending for a married couple with USD 5 million portfolio invested in a 60% stock, 40% bond portfolio. As you can see, adding a modest allocation to an income annuity would increase the "safe spending rate" for this couple, especially if they are focused on targeting a higher probability of success in their financial plan.

Conclusion

Annuities are one effective tool for addressing the risk of outliving your savings, while also helping to provide increased financial security that allows you to enjoy your retirement years. Annuities may be especially valuable for families with a history of longevity, and for families that would like to increase their lifetime spending and the probability of success in their financial plan.

Speak with your financial advisor about annuities during your next conversation; they can help you to assess whether annuities are a good option for you and your family, and help you select the solution that best fits your needs. You should understand how the annuity works, and how each aspect affects the annuity's potential return and contribution to your financial success.

Figure 3 - Annuities can help to increase the spending that is safely supported by a portfolio

Annual spending supported by a 60% US large-cap stocks and 40% US government bonds, based on 1,000 trials using UBS Equilibrium Capital Market Assumptions

Annuity allocation	Annual spending supported by $5,000,000 portfolio (improvement versus portfolio without annuity) 35-year probability of success 85%	90%	95%	99%
No annuity	$170,897	$160,372	$144,951	$118,628
10%	$176,833 (+3%)	$167,044 (+4%)	$153,765 (+6%)	$130,316 (+10%)
20%	$183,523 (+7%)	$174,133 (+9%)	$162,140 (+12%)	$141,229 (+19%)
30%	$189,879 (+11%)	$181,169 (+13%)	$170,247 (+17%)	$151,420 (+28%)

Source: CANNEX, UBS Wealth Management USA Asset Allocation Committee, as of 13 February 2023.

Note: Expected portfolio return 6.0% per year, expected annual portfolio volatility 9.6%. Annuity payout is 6.5% rate, reflecting the terms for a joint life immediate annuity for a 70yr old male and 65yr old female. In this analysis, we assume that the annuity income does not receive a cost of living increase, but spending rises by 2.4% each year to account for inflation.

Further reading

- [Modern retirement monthly: What can Social Security do for you?]
- [Modern retirement monthly: What to know about your 401(k)'s lifetime income illustration]
- [Modern retirement monthly: Will Social Security be there for me?]

[1] Munnell, Alicia H., Kelly Haverstick, and Mauricio Soto. 2007. "Why Have Defined Benefit Plans Survived in the Public Sector?" Issue in Brief 2. Chestnut Hill, MA: Center for Retirement Research at Boston College.

[2] Congressional Budget Office, 2019. "Social Security Replacement Rates and Other Benefit Measures: An In-Depth Analysis," Reports 55038, Congressional Budget Office.

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