Variable Annuities and Guarantees Are Thriving

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Retirees with pension envy increasingly are turning to annuities to restore some financial security to what are supposed to be their golden years. But with payouts near multiyear lows, it's important for them to consider how much to buy and when to pull the trigger—and whether a different strategy might better suit their needs.

Politicians and economists have proposed using so-called immediate fixed annuities to help prevent workers from running out of money during retirement. The gist: You trade a lump sum to an insurance company for a fixed income for life, which is typically an irrevocable move.

Currently, a 65-year-old man paying $100,000 for an immediate fixed annuity can get about $7,600 a year for life, according to ImmediateAnnuities.com, a website that provides free quotes from insurers. That's much more than he would be able to produce from an investment portfolio of the same size, assuming he withdraws no more than 4% a year, the limit financial advisers generally recommend.

From 2005 to 2010, sales of immediate annuities grew by 43% to $7.6 billion. This past week, New York Life Insurance Co., the nation's top seller of these annuities, announced that its first-quarter sales of the product rose 45% compared with the first quarter of 2010. (Immediate annuities are different from variable annuities, whose value fluctuates along with their underlying investments.)

A variety of financial-services companies are getting in on the act. In recent months, Fidelity Investments, Financial Engines Inc. and Allianz SE's Pacific Investment Management Co. have launched products and advisory services that use annuities, in conjunction with other products, to help retirees convert their savings into a reliable stream of lifelong income. Others, including BlackRock Inc. and UBS AG , have added versions of these products to their 401(k) target-date investment options.

There's just one problem: Given current ultra-low interest rates, the payouts on these annuities are only slightly above recent multiyear lows—and buying one today locks in the low interest rate for the buyer's lifetime.

There are strategies to help blunt the impact. Some advisers recommend staggering an annuity purchase over a number of years, borrowing the "laddering" technique that many use when investing in bonds and bank certificates of deposit. With such a strategy, you can lock in some of the income you need right away. But if interest rates rise—as many predict—so will the payments from future purchases.

When David Babbel, 62, retires in three years, the University of Pennsylvania Wharton School professor of insurance plans to put about half of his retirement savings into an immediate annuity. "I'm going to annuitize enough so that, together with Social Security, I will have enough income to maintain the lifestyle I want," he says.

Prof. Babbel says he will divide the rest of his savings into five equal amounts and purchase fixed deferred annuities. These are akin to bank CDs, with three added benefits: Earnings grow tax-deferred, interest rates are often higher, and the money can typically be converted, tax-free, to an immediate annuity.

If inflation erodes the purchasing power of his initial annuity, Mr. Babbel says he will convert one of these five investments into a second immediate annuity. At that point, he figures he will be able to lock in a higher payout because his principal will have grown and immediate-annuity payout rates rise with age. Moreover, inflation tends to result in higher interest rates, which also boost payouts.

Of course, staggered purchases aren't foolproof. Interest rates, although low, could decline further. And those who wait to buy often spend some of the money they otherwise would put into an annuity, potentially resulting in a lower future payout, says Jason Scott, managing director of the Retiree Research Center at Financial Engines Inc., a California firm that manages 401(k) accounts.

Due to the way immediate-annuity payments are structured, "you can delay purchasing annuities in your 60s without too much of a cost," says Mr. Scott. Beyond that, those who spend down their annuity money while waiting to buy are more likely to receive progressively less than earlier buyers did.

For those concerned about today's low interest rates, New York Life offers another option. In exchange for a slightly lower starting annual income, immediate-annuity buyers can obtain a rider that permanently raises the payment on the contract's fifth anniversary, provided interest rates have jumped by two percentage points or more since the contract's inception.

A deferred-income annuity—also known as "longevity insurance"—is also worth considering. As with a conventional immediate annuity, this product produces income for life, but payments don't typically kick in until years later. Most of the small but growing number of insurers that offer this feature permit policyholders to elect to begin receiving payments anywhere from one to 40 years from the time of purchase.

When payments begin, they are more generous than those on a conventional immediate annuity. For $120,000, for example, a 70-year-old man can get $60,000 a year starting at age 85 with a deferred-income annuity. With an immediate annuity, by contrast, he'd have to spend $700,000 to obtain the same income, according to New York Life, which plans to introduce its own version—Guaranteed Future Income Annuity—in July.

Whether you buy now or later, stick with insurers with triple-A or double-A claims-paying ability ratings, such as New York Life, MetLife Inc., Northwestern Mutual Life Insurance Co., TIAA-CREF and USAA, advisers say.

You can also protect your annuity investment by buying from different carriers. In the event of an insurer's insolvency, industry-backed guaranty associations in each state provide at least $100,000 in coverage for such annuities. Go to www.nolhga.com for links to the association and coverage limit in your state.

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