Weighing the Merits of Annuities and Managed Payout Funds

The Comfort of a Steady Cash Flow for Retirees

by Danielle Schultz, CFP, CDFA

Would you like to have a steady stream of income in retirement, while having a good chance that your money will last as long as you do? The investment industry is searching for product solutions.

Do you have a pension? You're one of the fortunate few! According to U.S. News & World Report, less than one-third of retirees (30 percent) have income from either a pension or withdrawals from workplace or individual retirement accounts. A pension guarantees some monthly income, but with these individual accounts, withdrawals depend on the strength and return of your investment choices. What ways can you establish a steady stream of cash?

The Right Amount

Virtually no one should hand over their entire investable funds in exchange for a promise of guaranteed lifetime income. There's just too much chance of needing a lump sum for some future emergency. But it makes sense to put a floor under your basic living expenses. Consider what your fixed, necessary expenses are: housing, taxes, utilities, food — anything you must pay to maintain basic needs. Will Social Security cover those costs?

Next, look at your investment portfolio. We all know the rule of thumb that you can withdraw about 4 percent of your portfolio per year and be fairly certain that it will last for your lifespan. Of course, a safe withdrawal rate depends on what you're invested in, the portfolio's overall performance and risk, and your age and expected lifespan when you begin withdrawals. Will the amount generated by that withdrawal rate, combined with Social Security and any pension, be a comfortable amount to cover all your expenses? If so, you're probably fine continuing to invest and generate regular income either by withdrawing dividends, rebalancing periodically and taking out expense money, or some combination.

And if it's close, but not quite enough? Or, if managing a complex portfolio is less appealing as you age? Let's consider some options.

Fixed, Single Premium Immediate Annuities

With this type of investment, you're buying yourself a pension. It's ironic, but most people are thrilled to have a pension from their employer but hate the idea of taking a lump sum from savings to purchase the same thing.

Once you give an insurance company or annuity provider your lump sum payment, annuity payments begin arriving on the schedule you select, usually every month. You're guaranteed a payment as long as you live, so those with a family history of longevity will not need to worry that their money will run out.

Another advantage of an immediate annuity is that it will usually pay you more per year than you could safely withdraw from a portfolio. If you could withdraw 4 percent from a $100,000 portfolio ($333 per month), an annuity might pay you 5 to 6.8 percent ($416.67 to $579 per month) depending on your age at purchase, the strength of the providing company — and you want a strong one — the current market and what options you choose. You can cruise some of the options at:

immediateannuity.com.

SPIAs have all the drawbacks of a pension, however. Although payments for your life are guaranteed, once you're gone, it's gone. Annuity providers depend on some people dying before they withdraw the amount invested. If you invest $100,000 and get hit by a car two years after purchase, the company keeps about $90,000, plus whatever your investment has earned for them in the meantime.

In the most common form, the amount you get per month, as with most company pensions, will be fixed. So as inflation goes up, your monthly payment has less buying power. Some annuities will allow a number of sometimes confusing options: joint life (your spouse gets some portion of the monthly amount if you predecease him or her), cost-of-living increases, period-certain (if you die, someone gets payments for a guaranteed time; e.g., 10 to 15 years total), guaranteed return of some portion of the initial investment and others specific to the annuity. All of these will reduce your monthly payment. As with all investments, the more risk you take, the more reward you should collect.

If you have no heirs or if you do but have sufficient life insurance or investments that will offer a secure inheritance (or you simply don't care), and if this portion of your portfolio will guarantee a better retirement lifestyle, an annuity of this type may be worth considering.

Managed Payout Funds

The mutual fund industry has figured out that most people hate to invest money and never see it again. The lack of access is a deal killer for many people who consider purchasing a SPIA. Yet many retirees love to get a check in the mail each month, and in our low dividend and interest rate environment, most of us cannot live on dividend withdrawals alone.

Finally, the prospect of rebalancing and selling off investments to generate income can be a tough and complex task for many people.

Comparing the Vanguard Managed Payout Fund With 2 Vanguard Mutual Funds

Fund	5-yr standard deviation (risk measure)	Value of $10K at 10 yrs	Yield	5-yr annualized return	15-yr annualized return
Managed Payout (VPGDX)	5.84	$17,031.70	3.76%	8.24%	N.A.%
Wellington (VWELX)	6.38	22,204.75	2.36	10.83	9.08
Balanced (VBINX)	5.84	21,256.71	1.83	9.98	8.02

Source: Morningstar

Most of these funds are relatively new on the scene, five years or less, and offered by only a few companies (Schwab, Vanguard and Fidelity in the no-load arena). They're managed for steady yield rather than growth.

Yields can and do fluctuate with the returns of the underlying investments. This could be an advantage over the steady payment of annuities when the market is booming but a disadvantage when the bond market particularly is low return. Typically, funds invest about 50 percent or less in equities, Vanguard being the exception at 50 to 70 percent.

Not all funds are identical, however. Vanguard has one fund, Vanguard Managed Payout (ticker: VPGDX); Schwab offers three, moderate (SWJRX), enhanced (SWKRX), and maximum (SWLRX) payout; and Fidelity offers self-liquidating income-replacement funds.

Vanguard targets a 4 percent yearly payout rate, which would be consistent with a prudent portfolio withdrawal rate. But it also indicates that the payout depends on the fund's performance and that some of the payout may and can be made up of return of principal.

Morningstar is currently listing the yield of the Managed Payout fund as 3.76 percent, but Vanguard's online calculator indicated the current payout for a $100,000 investment would be $284 per month, a 3.4 percent payout. The fund has a minimum investment of $25,000.

If you investigate the Schwab funds, be prepared for a sales pitch. Schwab states that in a low-interest-rate environment, an investor could expect a 1-3 percent payout, with a 3-6 percent payout in high-interest-rate situations.

But what might you actually receive? Who knows? There's no calculator on Schwab's website and when I tried to get actual amounts, I was told a new-accounts representative would have to call me. The Schwab funds have a low minimum of $100, but payouts on less than six figures would be minuscule.

Fidelity's income-replacement funds are designed to liquidate your investment entirely by a certain date in the future. Your payout is based on the return of the funds — low, since they have little equity exposure — plus return of principal over the funds' designated lifespans.

Be prepared for a payout that could drop significantly in later years: There's less principal to earn investment returns and there will be nothing left for heirs (or for you) if you outlive the entire term. The minimum investment is $2,500.

Tax Considerations

Annuities are taxed differently from managed payout funds. With annuities, some portion of the payout is considered return of principal (not taxed), while the rest is usually considered interest (taxed at your normal income rate). If your income or tax rates have dropped during your retirement, you will be paying less on this interest than you would have by investing in a taxable account while working.

Managed payout funds can pay out some portion of your monthly check as any combination of capital gains, dividends, interest and perhaps return of principal. So they will vary in their tax efficiency.

Weighing the Options

As a financial planner, I find it hard to see the appeal of managed funds, but my experience with clients indicates that simplicity is a very attractive proposition for retirees. The payouts on these managed funds are quite low, with the best payout (Vanguard) also the one most heavily invested in the market (50 to 70 percent equity) and thus the most potentially volatile.

The table above compares the Vanguard Managed Payout (VPGDX) fund with two other common "all-purpose" funds.

Technically, VPGDX has been around for slightly less than 10 years after a merger of several other funds. Although both Wellington and Balanced have lower yields, their total return is so much higher that an investor could be pretty confident in withdrawing 4 percent per year and having a good chance of preserving principal (and growth in that initial investment).

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