Invest in Stocks? Yes. But Don't Forget About Annuities

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Warren Buffett, in his most recent shareholder letter, defined investing as "the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power–*after taxes have been paid on nominal gains*–in the future." As I read this article it occurred to me that this is the exact reason why, for many seniors, an annuity is a perfect product to help round out a good financial plan.

Annuities are *not* an investment. However, what they do ensure is your clients ability to *have* "power to purchase" in their later years, and to pay taxes on this future income in a way that fits their then current economic situation, based on their tax rate and lifestyle. And while it may be important for your clients to have some of their money in the marketplace, it may be equally as wise for them to take the money they have "left," that they don't want to have at risk, and reposition this money in a way that ensures they have "power to purchase" in later years, allowing them to better determine the risk they are willing to assume with their other funds.

In this same article, Mr. Buffett more succinctly defines the investing philosophy at Berkshire Hathaway as "forgoing consumption now in order to have the ability to consume more at a later date." That, to me, perfectly explains why your client may want to consider an annuity as part of their financial plan. Now in Mr. Buffett's article he, of course, promotes investments in stocks; in fact the article states "...The riskiness of an investment is *not* measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by probability–the *reasoned* probability–of that investment causing its owner a loss of purchasing power over his contemplated holding period." I agree completely (bet he's relieved to hear that!)

Often the argument against senior clients having an annuity is they can do much better by investing and managing their retirement portfolio themselves or by someone else. Often you will hear, from clients, industry related magazines or investment advisors as pundits on talk shows that money invested for a long period of time–say 10, 20 or 30 years–will grow at an average annual rate of 10 percent or 12 percent, based on past history. And while this could be true, this assumption is based on one simple but overlooked fact for seniors: The average growth rate of 10 percent or 12 percent per year is based on the assumption that their money remains 100 fully invested for the entire period.

Here's the problem. For retirement planning, it is anticipated that a certain amount of money will be withdrawn from the retirement fund each year. So for your clients to believe they can invest their retirement money in the stock market, withdraw an income each year, and have their money last their lifetime while it also grows, may not be reasonable. They may be forgetting the essential nature of the market, which is it does not grow at a constant rate; rather it goes up and down. So the concept of "dollar-cost averaging," which theorizes that depositing money into a fund in a periodic manner results in the lowest, average per-share cost in an up and down market. However, pulling money out of a fund has the opposite effect.

Profile client illustration

Doris retired in January 2010 (right when some 10,000 baby boomers a day started entering the senior set), with an investment portfolio valued around $300,000. As a supplement to her Social Security check, she built her retirement plans around pulling out $2,000 a month from her investment portfolio, or $24,000 a year. Considering the past performance of her portfolio, she assumed this 8 percent withdrawal a year would ensure her portfolio could actually grow and provide this needed income.

Then in March of 2011, Doris found her retirement portfolio had suffered about a 25 percent loss (how many of your clients have found themselves in this situation?). And she had drawn down her portfolio by $24,000 the previous year, leaving her an account balance around $200,000. If she continues with her $24,000 annual withdrawal, the $2,000 a month she has been withdrawing to supplement her Social Security, this will be equal to 12 percent of her portfolio. She finds herself in the unfortunate position that her funds will never recover from the setback, and it probably will not last her lifetime.

Could there have been a better way?

What if you had been her advisor and had counseled her to place a portion or most of her funds in an immediate annuity, guaranteeing her required retirement income? According to IRS tables for a married couple, both ages 65, the survivor can be expected to live, on average, another 25 years. Since this is only an average, it's likely one will live only five years while the other lives 30 years.

Because there is a lot of uncertainty in life expectancies, the security of a guaranteed income can be helpful in eliminating some of the risk for our clients. For your clients doing retirement income planning, you might suggest that they calculate their needed income, and provide for any supplement to Social Security and company pension payments by purchasing an immediate annuity.

Any additional funds can be invested in stocks, mutual funds or anything else smart men like Warren Buffett might suggest, without concern for pulling out money during a down market. I agree with Mr. Buffett's definition of investments. As he said in his article, "Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing power over their holding period." Charts of mutual funds, similar to the one in Mr. Buffet's article, can show what $100 invested would be worth five, 10 or 30 years from now.

Even with a 3 percent inflation rate, the illustration shows a good return and makes immediate annuities look puny by comparison. However, as licensed professionals, let's not forget the essential nature of the market, which has been brought home with a vengeance in the past four years. The market doesn't grow at a constant rate, as Mr. Buffett so aptly pointed out in his article; the market goes down as well as up.

Do your clients have the time to make up market losses, or do they need to know they will have the "power to purchase" in the future? I agree with Mr. Buffett that "Investment possibilities are both many and varied." Let's help our clients protect that portion of their funds that they have "left" so they can comfortably and confidently take advantage of the many and varied investment possibilities that lay ahead. And always do the right thing, because that is the right thing to do.

See also:

- Investing, Fast and Slow
- Boomers Seek Less Volatile Portfolios