How Immediate Annuities Can Help Meet Retirement Goals

A key concern of many retirees is ensuring that they don’t outlive their wealth. One way to accomplish this is to consider making immediate annuities part of a well-diversified retirement portfolio. Annuities are the only financial instruments available today that, like Social Security and pensions, can provide an income for life. Annuities can thus offer some measure of predictability in an uncertain world.

Of the myriad financial risks related to retirement, top of mind for many is the risk of outliving their wealth. A 2015 Society of Actuaries survey found that 62 percent of pre-retirees expressed concern over the prospect of depleting their savings in retirement (Figure 1). And a 2016 survey found that just 21 percent of workers feel very confident about having enough money for a comfortable retirement. (Figure 2, see next page).

To address such concerns, Merrill Lynch has developed Goals-Based Wealth Management, which enables clients to collaborate with their advisors to invest in a way that best addresses their unique set of concerns and goals. Annuities are an instrument well suited to hedging the risk of outliving one’s wealth. Yet many people are either unfamiliar with annuities or find them confusing.

Figure 1: How Concerned Are You That in Retirement... (Percentage Very or Somewhat Concerned)

- You might not have enough money to pay for a long stay in a nursing home or a long period of nursing care at home: 69% pre-retirees, 58% retirees.
- The value of your savings and investments might not keep up with inflation: 69% pre-retirees, 52% retirees.
- You might not have enough money to pay for adequate health care: 67% pre-retirees, 47% retirees.
- You might not be able to maintain a reasonable standard of living for the rest of your life: 63% pre-retirees, 45% retirees.
- You might deplete all of your savings: 62% pre-retirees, 43% retirees.

Note: Survey sample was 800 pre-retirees and 800 retirees.

KEY IMPLICATIONS

THE CHALLENGE
As the availability of employer pensions decreases and the outlook for Social Security grows less certain, Americans in or nearing retirement need new sources of income for their later years.

A SOLUTION
Purchasing an immediate annuity can provide a retiree a regular income for life.

AN ADVANTAGE
By making a lifetime immediate annuity part of a retirement portfolio, a retiree may substantially reduce the risk of outliving his or her wealth.

THE WHO
Immediate annuities are generally best suited for people over age 60 who are in relatively good health.

THE HOW
Staggering the purchase of immediate annuities over several years can increase the level of payments they generate.

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This note briefly describes what annuities are, the most common types of annuities and how immediate annuities can help clients meet their retirement goals.

**WHAT ARE ANNUITIES?**

Annuities are financial contracts that pay a stream of income either for a set period of time or over the lifetime of an "annuitant." These payments can be monthly, quarterly, semi-annual or annual. What makes annuities significant is that they are the only financial instruments available today that, like Social Security and pensions, can offer a lifetime income regardless of how long a person lives. Retirees who invest their savings in other assets, such as stocks, bonds or funds, can potentially earn higher returns but run the risk of outliving their wealth. This might occur due to a financial market downturn, poor investment choices or living longer than expected. Annuities can offer retirees some predictability as well as a means of boosting their current income.

The range of annuities available is so broad that a comprehensive list can easily make one’s eyes glaze over. To simplify the discussion, we focus on a few basic types.

Annuities are sold as either immediate or deferred. An immediate annuity converts assets into an income stream and usually starts making payments right away. A deferred annuity accumulates value, often tax-deferred, until it pays distributions, usually during retirement.

The investor may withdraw the funds from a deferred annuity at a later date either in a lump sum, in regular payments until the funds are exhausted, or by rolling the balance into an immediate annuity. Deferred annuities offer a means of saving for retirement; immediate annuities can provide retirees a reliable income for life.

Another basic distinction among annuities concerns their certainty of returns. Fixed annuities accumulate savings or distribute income at a fixed rate. Variable annuities accumulate savings or distribute income based on the performance of underlying investment accounts selected by the investor. Many variable annuities offer, for an additional fee, a minimum level of income regardless of how well the underlying annuity investments perform. Based on these two distinctions — immediate vs. deferred and fixed vs. variable — there are four basic types of annuities (Table 1, on the next page).

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3 All annuity guarantees and payout rates are backed by the claims-paying ability of the issuing insurance company. They are not backed by Merrill Lynch or its affiliates, nor do Merrill Lynch or its affiliates make any representations or guarantees regarding the claims-paying ability of the issuing insurance company.

4 A note about optional living benefits: Some variable annuities offer optional living benefits for an additional cost that guarantee a minimum level of income to you regardless of the performance of the underlying investments in the annuity, even if the value of the annuity falls to zero. The living benefit base value is a different value than the annuity contract cash surrender value. The living benefit base that provides income can only be accessed through the income stream and generally is not available for a lump sum withdrawal. If you purchase these benefits there may be some restrictions, such as limitations on your investment options in a variable annuity, age limitations and limits on the amount that can be withdrawn each year.
How Immediate Annuities Can Help Meet Retirement Goals

THE GROWING NEED FOR LIFETIME INCOME

Many retirees receive less guaranteed income from Social Security and other sources than they need to cover essential expenses. Social Security and pensions both provide lifetime income, but their size and availability are uncertain. Retirees face growing uncertainty as to how large their Social Security benefits will be and to what extent they will be taxed. In 2016, 38% of retirees were either not very or not at all confident that Social Security will continue to provide benefits of at least equal value to the benefits retirees receive today — up from 27% in 2001.5

Defined benefit plans (DB), which pay workers a guaranteed income for life, are a vanishing breed. According to the tri-annual Federal Reserve Survey of Consumer Finances, the proportion of workers covered by DB plans has slid from 88% in 1983 to just 29% in 2013 (Figure 3).6

Because of these trends, today’s workers can expect to receive just about a third of their retirement income from Social Security and traditional DB plans, as opposed to nearly 70% for current retirees (Figure 4, on the next page). Moreover, Social Security represents a smaller fraction of retirement income for affluent households than for the overall population. People will increasingly need to rely on their defined contribution (DC) plans, IRAs and other savings to fund retirement. By purchasing an annuity, someone can effectively create lifetime payments that DB plans traditionally provide.

Table 1: Annuities: A Taxonomy

<table>
<thead>
<tr>
<th>Immediate</th>
<th>Variable</th>
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<tr>
<td>Fixed</td>
<td>A fixed immediate annuity makes fixed, regular payments either for a lifetime or for a set period of time.</td>
</tr>
<tr>
<td>Variable</td>
<td>A variable immediate annuity makes regular payments for life or for a set period of time. These payments vary based on the performance of underlying investment accounts.</td>
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| Deferred | Immediate annuities enable retirees to purchase a lifetime stream of income that they cannot outlive. Variable immediate annuities also offer upside participation in financial markets. |
| Deferred | Deferred annuities are tax-efficient retirement savings vehicles that can be well suited to pre-retirees who already save the maximum allowable amount in their other retirement plans. |

LONGEVIDY RISK: KEY THREAT TO RETIREMENT SECURITY

A key threat to retirement security is longevity risk, the risk of living longer than planned and exhausting one’s assets. The retirees who live the longest face a heightened risk of outliving their wealth. Workers’ growing reliance on DC plans and savings to fund retirement means that they must increasingly bear longevity risk. This risk is particularly great when financial markets fare poorly.

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6 A defined benefit plan provides employees a specific level of benefits based on salary history and years of service. A defined contribution plan, such as a 401(k) plan, is one in which employees can elect to defer some percentage of their salaries into the plan. Employers often match some portion of these contributions but provide no guarantee of future benefits.
HOW LIFETIME IMMEDIATE ANNUITIES CAN HELP

Annuities that provide lifetime income are insurance products uniquely suited to helping investors hedge this longevity risk.

In exchange for a lump sum, the buyer receives a stream of income throughout his or her lifetime. Lifetime immediate annuities can be contrasted with life insurance. People buy life insurance to hedge the risk of dying too soon and leaving loved ones in financial need. They buy lifetime immediate annuities to hedge the risk of living so long that they exhaust their assets during their lifetime.

Two of the most common types of annuities that provide lifetime income are immediate annuities and variable annuities with guaranteed income benefits. Each can play a valuable role in building a retirement portfolio. Variable annuities are discussed in our whitepaper “Can Variable Annuities Help You Meet Your Retirement Goals?” We now focus on immediate annuities. Single premium immediate annuities (SPIAs) are particularly relevant to retirement planning because they can assure payments for life.

SPIA annuity payments are generally for a fixed amount. Some SPIAs, however, offer the option for the payout amount to increase annually by a fixed percentage. The issuing insurance company sets the level of annuity payments based on several factors: payment frequency, gender and age of annuitant and current interest rates.

Immediate annuities can help people address longevity risk by providing an income for life that may be higher than they can earn elsewhere. Consider the specific example of a SPIA that pays income for life, but for no less than 20 years, regardless of how long the annuitant lives. At recent prices, a 65-year-old female could purchase a $100,000 SPIA that pays a competitive annual income on the order of 5.6%; a 65-year-old male would receive a competitive annual income of about 5.7%.

The reason is simple: Retirees who purchase a lifetime immediate annuity are exchanging the use of their capital after they die for a higher rate of return during their lifetimes, earning what are known as “mortality credits.” This trade-off may be worthwhile for retirees who need to generate higher retirement income than is generally available from other lower-risk investments.

Age and health should figure into the decision to buy a lifetime immediate annuity. Because such annuities offer higher payouts for older annuitants, they tend to make sense for people in their 60s, and even more sense for those 70 or over. For younger people, other investments are likely more attractive. Moreover, since the cumulative payout of lifetime immediate annuities generally depends on how long the annuitant lives, they are typically suited for people in reasonably good health for their age.
Immediate annuities have some notable shortcomings worth considering. First, the funds used to purchase an immediate annuity usually cannot be accessed after the annuity is purchased except through its periodic payments. Therefore, those funds are unavailable to address immediate needs that might arise, such as unexpected medical expenses. Second, buying an immediate annuity comes at the expense of not being able to leave a bequest from the funds used to make the purchase. Third, the real value of an immediate annuity’s payouts declines over time due to inflation. Merrill Lynch Global Research forecasts U.S. long-term inflation of 2.3%. Even at this moderate rate, today’s dollar will be worth 63 cents in two decades — and of course much less if inflation rises sharply.

**IT’S NOT ALL-OR-NOTHING**

These drawbacks are not as stark as they sound, however, because the decision to purchase an annuity is not all-or-nothing. A retiree might, for example, allocate 30% of his or her wealth to an annuity, while investing the remaining 70% in other assets. By so doing, he or she can gain the longevity protection and regular income that annuities provide while allocating capital for other purposes such as future liquidity needs or bequests. This possibility is one unappreciated by many individual investors, who too often view immediate annuities in isolation.

In recent years, many investors have come to understand that they gain the best risk-return trade-off by viewing their investments in a portfolio context and by diversifying across asset classes, such as stocks and bonds. What is less understood is the benefit of diversifying across financial products as well as asset classes. In particular, allocating some of a retirement portfolio to annuities can help address longevity risk, a benefit not available from diversifying across asset classes. A growing body of research suggests that clients can materially reduce the risk of outliving their income by allocating some of a diversified retirement portfolio to annuities that provide lifetime income.

One other dimension of the decision to buy immediate annuities concerns timing. There are compelling reasons to purchase immediate annuities gradually rather than all at once. As previously noted, the level of annuity payments increases with the age of the annuitant. Thus, waiting a year or two before buying a SPIA can mean higher payments. Moreover, because interest rates are now low by historical standards, annuity payments are lower today than they have been in the past. It might therefore make sense to wait before buying, in the hope of higher interest rates.

Each of these points has a counterargument, however. First, if owning a SPIA provides attractive income, someone who delays buying one forgoes this income in the interim and may, due to inertia, never buy one. Second, although interest rates are low, they could stay low for some time or decline even further, reducing annuity payments. Moreover, while low interest rates mean lower payouts for SPIAs, this does not necessarily make them less attractive vis-à-vis the alternatives retirees have. Indeed, in today’s low interest environment, immediate annuities are an important tool for many retirees.

In view of these considerations, a client for whom an allocation to immediate annuities makes sense should consider purchasing them over time. Someone with $1 million of assets might, for example, buy a $50,000 SPIA today and another in each of the next five years.

For many clients, immediate annuities can be a valuable part of a sensible, well-diversified portfolio that provides income for life. The inclusion of deferred variable annuities (VA) can further strengthen a retirement portfolio. Our recent white paper “Can Variable Annuities Help You Meet Your Retirement Goals?” explains how VAs work and the role they can play in a retirement portfolio.

**SUMMARY**

- Because the prospects for Social Security are uncertain and traditional employer pension plans are a vanishing breed, people will increasingly need other sources of income in retirement.
- Longevity risk, the risk of living longer than expected, heightens the need for lifetime income. This risk is substantial: one in four couples aged 65 will have at least one member live past 97.
- Lifetime immediate annuities, though unfamiliar to many, can help boost lifetime income.
- For many, it makes sense to allocate some savings to lifetime immediate annuities. Including these annuities in a portfolio can substantially reduce retirees’ risk of outliving their wealth.
- Lifetime immediate annuities are generally more suitable for clients older than 60 who are in relatively good health.
- One approach to consider is staggering the purchase of immediate annuities over several years.

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10 Some immediate annuities mitigate this problem, e.g., by paying a joint benefit or by guaranteeing a minimum number of years of payments. These features, however, come at the cost of lower annuity payments.
11 For more on inflation risk, see David Laster, Anil Suri and Nevenka Vrdoljak, “Pitfalls in Retirement,” Journal of Retirement, Summer 2013.
12 Asset allocation does not assure a profit or protect against a loss during declining markets.
13 For a survey of this research, see Moshe A. Milevsky, Life Annuities: An Optimal Product for Retirement Income; CFA Monograph, 2013.

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IMPORTANT INFORMATION ABOUT VARIABLE ANNUITIES: Variable annuities are long-term investments designed to help meet retirement needs. A variable annuity is a contractual agreement where a client makes payments to an insurance company, which, in turn, agrees to pay out an income stream or a lump sum amount at a later date. Variable annuities typically offer (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that can provide guaranteed income for life. The return and principal value of variable annuities are subject to market fluctuations, investment risk and possible loss of principal so that, when redeemed, variable annuities may be worth more or less than the original amount invested. There are contract limitations, fees and charges associated with variable annuities which include, but are not limited to mortality and expense risk charges, sales and surrender charges, administrative fees, charges for optional benefits as well as charges for the underlying investment options. Early withdrawals may be subject to surrender charges, and taxed as ordinary income, and in addition, if taken prior to age 59½ an additional 10% federal income tax may apply. Withdrawals reduce annuity contract benefits, values and optional guarantees in any amount that may be more than the actual withdrawal.

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Variable annuities are sold by prospectus only. Your Financial Advisor can provide you with more information, including a current prospectus. The current contract prospectus and underlying fund prospectuses contain more complete details on the investment objectives, risks, fees, charges and expenses, as well as other information about the contract and the underlying portfolios which should be carefully considered. Please read the prospectuses carefully before investing.

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