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The Case for Replacing Some Bonds With Annuities

Unless you die relatively young, income annuities will give you more retirement spending power than bonds, some economists say

By Neal Templin

If you want to maximize how much you can safely spend in retirement, some economists say, sell some of your bonds and buy lifetime income annuities.

While you're still working, a diversified portfolio of stocks and bonds is an efficient way to save for retirement. But once you've retired and are drawing down that nest egg, income annuities can outperform bonds, some economists' research shows.

The most efficient portfolio for retirees consists of stocks and income annuities, says Wade Pfau, a professor of retirement income at the American College of Financial Services. The annuities provide dependable income, while the stocks provide growth, cover unexpected expenses and help leave a legacy for heirs.

Although they are often misunderstood or marketed over-aggressively, annuities are a big part of retirement planning. Retirement experts favor low-fee income annuities where you turn over part of your retirement savings and get a monthly check in return—a predictable stream for life. Annuities are a form of longevity insurance, where the insurer, not the retiree, assumes the financial risks of a long life or poor market performance during retirement.

The current low interest rates make such annuities even more attractive than bonds, experts say. While annuity payouts have dropped because of low rates, alternative strategies such as bond ladders—a portfolio of bonds that mature on different dates—have been hit harder.

Consider a 65-year-old retired woman who has a $1 million nest egg, is risk-averse and wants to finance her retirement entirely through bonds. She is a nonsmoker, in average health. According to actuarial tables, there is a 22% chance she'll live 30 more years. She decides to build a bond ladder that will run out of money when she's 95 years old. At current interest rates, such a portfolio could provide her with around $42,000 a year for 30 years, Dr. Pfau calculates. If she instead used her $1 million for an income annuity, she could currently get around $54,000 a year from a range of insurers. One insurer, American Equity, has been offering a payout of more than $61,500.

No 'upside potential'

To be sure, bonds can outperform annuities in a shorter retirement. The 65-year-old woman could construct a bond ladder giving her more than $58,000 a year to age 85, exceeding the payout on most annuities, though not the $61,500 from American Equity. But using a 20-year bond ladder means she would have no income if she lived past 85 whereas the annuity will keep paying no matter how long she lives.

"You don't have any upside potential with a bond ladder," Dr. Pfau say. "If you live past 85, you're out of money."

The math remains the same for partial annuitization: Unless you die relatively young, income annuities will give you more retirement spending power than bonds.

When you buy an annuity, you are entering into a long-term relationship with an insurer. So buy them only from a strong, well-financed insurer that you believe will be around for decades. (Sites such as immediateannuities.com contain financial-strength ratings for insurers along with quotes.)

How much you should spend on annuities depends on your personal circumstances, says Moshe Milevsky, a finance professor at York University in Toronto. If you already have plenty of income to cover essential expenses through Social Security and employer pensions, there may be no need to purchase a private annuity, he says. Once you buy a basic income annuity, that money is no longer in your portfolio to cover emergency expenses, and that spooks many investors.

People without dependable income, however, could run out of money sooner without having annuities. "You absolutely need to cover your fixed expenses with income that will last for the rest of your life," Dr. Milevsky says. "That's the floor."

Social Security's role

Social Security is itself an inflation-adjusted income annuity, and it's usually smart to max it out by not claiming until age 70 before you buy a private annuity. That's because Social Security is more generous in how it calculates payouts than other annuities. Your Social Security pension rises 8% for each year you delay claiming beyond your full retirement age.

"The very best annuity you can buy is to delay Social Security," says Steve Vernon, an actuary who is a consulting research scholar at the Stanford Center on Longevity. Mr. Vernon, 67 years old, is himself working part time so he can delay claiming Social Security until age 70.

Let's say a 70-year-old couple has $50,000 of combined Social Security income and a $1 million portfolio. The portfolio contains $600,000 in stocks and $400,000 in bonds.

The couple figures they need $70,000 a year in retirement to cover their basic living expenses. If they sold all their bonds, they could currently buy a $400,000 life income annuity paying more than $21,500 a year as long as one of them is alive. This annuity isn't inflation-adjusted, so it will gradually lose some of its spending power over the couple's life. But economists such as Dr. Pfau say that is all right because most people spend less as they get older. Plus, Social Security is inflation-adjusted, and the stocks in their portfolio should provide some inflation protection as well.

Because the couple now has $71,500 a year in guaranteed income, they could safely keep the remaining $600,000 in their portfolio in stocks to create the biggest possible legacy for their heirs.

Dr. Pfau advises people to think of an annuity as replacing the fixed-income portion of their portfolio. "Even though you look at your portfolio and it shows all stocks, that isn't really the case," says Dr. Pfau. "If the stock market goes down, and you have all this annuity income, you're not negatively impacted."

Comfort level

That's how an economist views it. Many retirees would be unnerved by the volatility of an all-equity portfolio. Last year, the market tumbled more than a third during the early days of the pandemic than surged to end up 16% for 2020.

So whereas the most efficient portfolio would be invested 100% in income annuities and stocks, most retirees are still going to keep some bonds or cash to damp portfolio volatility and provide an emergency reserve.

"The goal isn't to be on the efficient frontier," says David Blanchett, Morningstar's head of retirement research. "It's to be as close as you're comfortable being."

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All investments carry some level of risk including the potential loss of principal. There are key differences between bonds and income annuities as they relate to liquidity, guarantee of principal, immediate access to income and underlying risk. There may be fees associated with managing a portfolio of bonds. Bonds have various risks associated with them, such as market risk, reinvestment risk, interest rate risk, inflation risk and default/creditor risks to name a few. Income annuities are created to provide lifetime income and have no cash value. Once issued they can't be surrendered, and any premiums paid into it are not refundable/cannot be withdrawn. Distributions from an income annuity may be subject to ordinary income tax and a 10% federal tax penalty may apply if you take distributions before age 59½. Tax status of bond distributions vary depending on the type of bond purchased