



Capital Ideas

La La Land

"Well she's walking through the clouds, with a circus mind that's running 'round. Butterflies and zebras and moonbeams and fairy tales, that's all she ever thinks about. Riding with the wind...." Jimi Hendrix.

A friend of mine, who is in the insurance business, recently sent me a couple articles on annuities. I always appreciate the articles because annuities have, in the last ten years, become a very important part of American's portfolios.

One article was titled "What is a Guaranteed Rate Really Worth?" and appeared in the August 2009 issue of *Research Magazine* (a magazine for financial advisors). As you may, or may not, know, the hot button in the annuity market has been guaranteed lifetime income benefits. Purchasers of annuities with these benefits are swayed by the income they cannot outlive. Outliving our income is a serious concern of the Boomer generation (those behind the Boomers are not aware that retirement is an issue). By providing this form of annuitization, the insurance industry is providing a valuable benefit—peace of mind in an otherwise turbulent market.

The article provides calculations showing the true investment return equivalent of the guaranteed income benefit. Of course the benefit is not what it appears to be. But that is OK. Any time we are given guarantees, there is a cost. We want the companies providing the guarantees to be in business when we need the

income. If they guarantee a 5% annual withdrawal rate at age 65, that is what we want when we reach 65.

Out of curiosity I decided to do some research on annuity sales. The most recent year for which I could find information was 2007. So the information predates the market collapse last year. Total sales of variable annuities that year were \$182.2 billion (Morningstar, Inc.). Total assets invested in variable annuities were \$1.485 trillion. Those are some impressive figures.

Then I found the average individual contract value. The average variable annuity sold in 2007 had a value of \$67,400. Think about that. Let's also say that the annuity had a guaranteed accrual rate (for benefit purpose) of 7% and the owner was ten years from retirement. That would provide for roughly a doubling in value over the ten year period. So let's take that \$134,800 and apply the 5% withdrawal rate. That will give the owner an extra \$6,740 income per year (\$561.67 per month). Don't forget we have not added in the effect of inflation on the purchasing power.

No wonder these purchasers are worried about getting a guaranteed return! What concerns me is that this is probably all they have to invest. Add in the average retirement plan account of \$50,200 (Fidelity 2008 retirement trends data), double it, and apply the 5% withdrawal rate, and you have a retirement income of \$418.33 per month. Add that to the \$561.67 and you still have less than \$1000 per month income. Then, knock off about a third of that

for lost purchasing power (3% annual inflation) and you have trouble.

I don't see this as a problem for our individual clients. Our individual clients are like the children of Lake Wobegon. But we also work with retirement plans. I know what those participant accounts look like. We do what we can to encourage enrollment, but there is only so much we can do. There is also only so much that the participants can do. They have house payments, car payments, child expenses, and on and on.

What we all need to do is save more. I know that the media tell us that the savings rate has increased in the last year. However, that increase in savings is not what we normally think of as saving. That is just a reduction of credit card debt, and much of that is forced by the lenders.

The big debate in Washington today is health care reform, and rightfully so. It does not matter which side of the debate you are on. We will all be affected whether we get a public option or not. We will be affected whether we get reform or not. Either way, expenses will rise. We will not allow those without insurance to die in the streets. We will let them go to the emergency rooms as they do now. Without reform employer/employee health insurance costs will rise as hospitals

seek to cover increasing costs. With reform, we will see taxes rise. We have an aging population that will become more and more reliant on the current "Public Option"-MediCare. Further, that aging population is living longer. According to the CDC/NCHS, as of 2005, if you attained age 65, you had a life expectancy of 18.7 years. That is a long time on the public option. And, the boomers are just beginning to reach age 65.

The Bush administration tried to tackle Social Security at the beginning of his second term. They did not get very far with that, did they? Social Security is probably a bigger ticket than healthcare. We are working with the same life expectancy. We are still facing the onslaught of Boomers. Add in the average retirement savings and you have a disaster in the making.

The purpose of this discussion is not to create angst. We are not arguing for or against reform. It is not for us to take a political position. However, if we are to be good stewards of your investment dollars, we need to be looking beyond today.

Given the realities of today's economy and where it looks like we are heading, we need to take a hard look at our savings. Take your current savings—all sources—and figure that your assets will double in value every 10 years

(Rule of 72: at a rate of 7.2% compounded, assets will double in value in ten years). Then multiply that number by 5%. That will give you an annual income number to work with (although it does not account for inflation). If that is sufficient to cover your expected needs at retirement (provided no major medical expenses), you are in good shape. If not, save more because I don't know if the government will be able to save you. Put the extra with us, put it in the bank, or buy an annuity. Just put it somewhere.

The alternative is to convince ourselves that everything will work out. Maybe we will get to Hendrix's beautiful world of no cares.

"When I'm sad, she comes to me. With a thousand smiles, she gives to me free. It's alright, she says, it's alright. Take anything you want from me. Anything. Fly on little wing...."



Capital Advisers, Inc., specializes in asset management for individuals, institutions, and qualified plans.

Factual material is obtained from sources believed to be reliable, but the publisher is not responsible for errors or omissions contained herein. Officers of Capital Advisers, Inc., may hold positions in securities mentioned in this publication.

Reprints of this newsletter are available at www.capitaladvisersinc.com or from:

Capital Advisers, Inc.
21 Glenwood Avenue
Suite 107
Raleigh, NC 27603