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SPECIAL REPORT: RETIREMENT

Investors are realizing what academics have long preached: Fixed-income annuities outshine all retirement income options.

The Best Annuities

By Karen Hube Fixed-income annuities have never paid out so little, and yet had so much appeal. These annuities, which provide a lifetime of guaranteed income, are paying out 12% less, on average, than in 2011, and 25% less than in 2007. And yet sales jumped 17% last year, to their highest level in five years.

The appetite for guaranteed retirement income is reshaping the industry, and drawing investors away from the enormously popular variable-annuity market. Sales of variable annuities usually rise with the stock market, but they have declined steadily for three consecutive years and are 24% below their 2007 highs. Why this new hunger for fixed annuities? As investors get real about how to turn their nest eggs into lifelong income, they're discovering what academics and analysts have been preaching for years: Fixed-income annuities outshine all other income-producing options.

Fixed annuities typically pay between three and four percentage points more than the 10-year Treasury bond, which today yields 2.3%. Competitive contracts now are paying between 5% and 6%; that means a $200,000 investment will kick off about $12,000 in annual income, more than double the $4,600 you'd get from a 10-year Treasury.

Clearly, there's a caveat. With a Treasury bond, you collect the yield while you own the bond, and your initial investment is returned at maturity. With an annuity, your initial investment, or premium, is returned through your annual payouts. If you die young, you could end up collecting less income than you paid upfront. But if you live long, it could far exceed your original investment.

"You know there's a problem with your retirement plan if part of it involves hoping that you'll die before you run out of money."

Small wonder, then, that investors have shunned fixed annuities, instead relying on their 401(k)s, IRAs, and other investments to generate retirement income. This worked well enough when interest rates were much higher, but these days building a retirement-income plan solely around an investment portfolio isn't working for many investors, says Mark Cortazzo, an advisor at Macro Consulting Group in Parsippany, N.J.

High-quality bonds aren't paying enough to live off of, and current market conditions do little to instill a sense of security. After a six-year bull market, stocks may be in for a major correction that could do irreparable damage to retirees' nest eggs – especially those early in their retirement. "You know there's a problem with your retirement plan if part of it involves hoping that you'll die before you run out of money," Cortazzo says.

Make no mistake: Annuities aren't a simple solution. There are hundreds of variations, some that defer income and others that pay right away. Underlying investments may be variable, meaning they swing with the markets, or fixed, meaning investors get a fixed return. And insurers layer on benefits and perks and options – for guaranteed income, death benefits, liquidity, and more – each with their own terms and conditions and expenses.

To help make sense of the vast menu of annuities, Barron's rounded up the most competitive contracts in their categories, based on basic assumptions such as age and size of in-

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vestment. The accompanying charts highlight the 50 best annuity contracts in the industry as of the first week of June; quotes from insurers can change on a daily basis.

Fixed-Income Annuities

There are more options than ever before with fixed-income annuities. All are variations on the most basic immediate-income annuity, which turns a lump sum (your premium) into monthly income for life. Those payouts begin immediately upon purchasing the annuity. In early June, the most competitive of these contracts for a 60-year-old man investing $200,000 offered a $1,006.66 monthly payout, or $12,079.92 yearly. If the investor dies before collecting $200,000 in income, any remainder gets absorbed by the insurer. Some contracts offer guaranteed income over a surviving spouse's lifetime as well, or a return of remaining principal to heirs, albeit at the cost of lower payouts.

Consider an income annuity as part of your overall fixed-income allocation, says Wade Pfau, a professor of retirement income at the American College. "Income annuities are superior to bonds, but not necessarily superior to stocks," he says.

Mathematically speaking, investors would come out ahead if they replaced their entire fixed-income investment portfolio with income annuities, Pfau says. But this is unrealistic: "It doesn't account for needing funds for unexpected spending," he adds.

Devoting half their bond portfolio to an immediate-income annuity did the trick for Jerry Throndset, 73, a retired pharmacist in Lakefield, Minn: "When I created a yearly, monthly, and daily budget, I had a gap between what I could take out of savings and what I needed to live on," Throndset says. "An annuity filled that gap." His advisor, Dean Harder of The Harder Group, estimates that Throndset and his wife have 30% more income than without the annuity.

Deferred-income annuities basically work the same way, but the payment begins at a later date. You can invest, say, at age 50, and turn on your income at 60 or even 80. The longer you wait, the higher the income will be. Another way to use deferred-income annuities is to plan on drawing income from an investment portfolio up to a certain age, at which point you turn on the income from the annuity. This addresses longevity risk, and can help fund late-in-life medical expenses.

Variations on the basic deferred-income annuity are emerging as insurers try to appeal to investors' specific concerns. For example, Northwestern just launched a deferred-income annuity that pays a dividend on top of guaranteed payments.

And a new subset of deferred-income annuities has emerged with a change in tax rules last year. Investors can now sock some of their IRA assets into a deferred-income annuity and shield them from minimum-distribution rules, which require that IRA withdrawals begin after turning 70 1/2. Under the new rule, investors can put 25%, or up to $125,000, into an annuity, and must begin drawing income from it by age 85. A 70-year-old investor who puts $125,000 of a $500,000 IRA in a so-called qualified-life-annuity contract, would, by age 85, have had total required withdrawals of $414,086, instead of $552,112, according to an illustration by Pacific Life Insurance.

Index Annuities

Yet another type of fixed annuity – the index annuity – has also gotten on the income-guarantee bandwagon. Initially, these annuities were intended as "safer" investments. They promise a guaranteed minimum payout, with the opportunity for more, by using some of investors' premiums to buy options on a stock market index. If the options perform well, investors get a portion of the market's return up to a specified cap. These days, caps are about 4%. So if an index returns 10%, investors get 4%.

As investments, index annuities haven't been that popular. Among the issues are that the terms, such as the caps, are subject to change. And if you don't like the changes, you won't get out of the contract for seven to nine years without paying a surrender charge, which starts around 8% in the first year and declines until phasing out.

Starting about five years ago, insurers began selling income riders on these products, and more insurers, such as Symetra and Nationwide, began emphasizing this side of the business, causing sales to jump 53%, to $48 billion, between 2010 and 2014, according to the Insured Retirement Institute.

Despite their complexity, index annuities may appeal to investors who don't like the idea of locking up their money. While some deferred-income contracts allow investors to get part of their money back, that option cuts the amount of guaranteed income. After surrender periods expire on fixed-index annuities, investors have access to assets. "The big difference is flexibility and access to account values," says Matt Gray, vice president of product innovation at Allianz Life Insurance.

Look for more variations on index annuities. Symetra and Nationwide launched "uncapped" products that limit market returns, but use a different calculation that may allow investors to get slightly higher returns than the standard cap. And Genworth designed a contract that doubles payments for up to five years if an investor lands in a nursing home.

Variable Annuities With Income Benefits

Variable annuities also originated as asset accumulators, not income producers. They are baskets of mutual funds in a tax-deferred wrapper. Similar to an IRA or 401(k), the assets can't be tapped without a penalty until age 59 1/2; the value fluctuates over the years depending on the performance of the underlying funds, and withdrawals are subject to income-tax rates.

But the majority of these types of contracts – nearly 80% of the $138 billion variable-annuity business – are sold with benefits such as guaranteed retirement income, payouts to heirs, or liquidity. But since 2008, low interest rates have forced insurers to pare back their guarantees, raise fees, and even require that investors hold a portion of assets in low-volatility investments.

Variable annuities are also costly: The average contract cost is 1.5%, and fees for income riders push the

America's 50 Best Annuities: Index, Variable, and Investment-Oriented Products

These annuities provide guaranteed income, but come with all sorts of bells and whistles that may be appealing to some investors but overly complex for others. Index annuities provide additional income when the market is rising, though that upside is capped and comes at a price. The assets in variable annuities grow tax-deferred in mutual funds, offering the potential for greater returns, but only those with the lowest fees make the most sense.

FIXED-INDEX ANNUITY WITH INCOME GUARANTEE: *Assumes a $200,000 investment at age 55, payout at 65.*

LEVEL INCOME IN RETIREMENT

Company	Rating	Contract Name	10-Year Fixed Interest Rate	First-Year Bonus	Payout Rate	Annual Income Starting at Age 65	Total Income by Age 85	Total Income by Age 95
American Equity	A-	Bonus Gold	7.00%	10%	5.05%	$21,855	$437,100	$655,650
Midland National	A+	Paragon Plus 14	6.75	8	5.15	21,169	423,380	$635,070
American General	A	Power Select Plus	6.50	5	5.00	21,000	420,000	$630,000
North American	A+	Prizm Plus 14	6.75	8	5.00	20,754	415,080	$622,620

RISING INCOME IN RETIREMENT*

Company	Rating	Contract Name	10-Year Fixed Interest Rate	First-Year Bonus	Payout Rate	Annual Income Starting at Age 65	Total Income by Age 85	Total Income by Age 95
Allianz	A	Core Income 7	N.A.	N.A	7%	$17,301	$446,085	733,219

*Annual income increases depend on stock market performance; investors participate partially in the market's upside; this scenario assumes a 2% increase per year.

average costs to 2.5%. Add mutual fund management fees to that, and investors can pay well in excess of 3%. But there's a potential for larger payouts if the underlying investments perform well, says Judson Forner, director of investment marketing at Valmark Securities.

Consider a 55-year-old man investing $200,000 in Jackson National Life's Perspective II Variable Annuity and opting for the Freedom 6 Net income rider. The rider would guarantee a $16,000 minimum annual income at age 65. But a portion of the gains of the underlying investments can be added to the payout. After a 10-year deferral period, the first year's payout may be significantly higher. If you have $100,000 in gains on the $200,000 investment at the end of 10 years, your initial payout will be about $26,600, Forner says. In later years, how much you get above the $16,000 minimum will be based on annual gains above the original investment. In flat or down years, it returns to $16,000.

But the terms of most riders are complicated, and the downsides may not be immediately clear. Consider a 55-year-old man who chooses AIG's Income Plus Choice rider. His $200,000 investment becomes the benefit base, and it grows by a 6% simple interest rate – that is, the interest doesn't compound; each year's 6% is based on the $200,000 initial investment. In the worst case, at age 65, the benefit base will have grown to $320,000, and the rider stipulates a 7% payout rate, for $22,400 a year. That 7% quote is slightly better than the best deferred income annuities, but here's the catch: There's a high likelihood that the payouts could be a whole lot less.

The rider notes that if the value of the investor's contract value goes to zero, then the payout rate drops from 7% to 3%. An investment going to zero may seem like a rare, worst-case scenario, but it may not be: That 7% annual payout rate eats into the value of the investment, as do the annuity's fees and the rider's cost.

The underlying funds, here, would have to return more than 10% a year to avoid depleting the account, Forner says. If the account value does run to zero, the investor's payout drops to a guaranteed minimum of $9,600 a year, 57% less than the original amount.

Because of the complexities and costs, many advisors say that only investors needing an additional tax-deferred vehicle should use a variable annuity, and then the focus is on tax-deferred savings, not guaranteeing income. And keep expenses below the average 1.4% contract fee; otherwise, the fees erode the benefit of the tax deferral. The chart on page 32 highlights 14 variable annuities with ultralow fees ranging from a flat $240 annual charge (which would be a 0.12% fee on $200,000) to 0.6%.

As with all annuities, wise choices and careful placement can increase assets and generate more income, and go a long way toward a more carefree retirement. ■

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