Morningstar Research Abstract
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TIAA

Benefits of creating a diversified lifetime income plan in retirement

A new Morningstar research report shows how "income diversification" on average can provide retirees with 20% more certainty-equivalent income in retirement[1]

20%

Variable annuities, when paired with fixed annuities, can provide an additional 20% of certainty-equivalent income in retirement.

Recently, David Blanchett, PhD, CFA, CFP®, Head of Retirement Research for Morningstar Investment Management LLC, an independent investment research firm, found that including lifetime income from both fixed and variable annuities could increase one's retirement certainty-equivalent income by an average of 20%. The paper, ***The Benefit of Diversified Immediate Guaranteed Income for Retirees: Combining Fixed and Variable Immediate Annuities (November, 2019),*** which has been accepted by the *Retirement Management Journal*, indicates that diversification across different asset classes and annuity *product* types is an important part of building an efficient income strategy for a retiree. For many, it is simply prudent to have some sort of income protection given the increased likelihood of 20 or 30 years in retirement, including living past the century mark.

In particular, the paper noted that variable annuities are a unique diversifier from a retirement income perspective. Because variable income payments have the potential to grow over time and are guaranteed for life, they balance out the guaranteed payments provided by Social Security, fixed annuities, or pension income. When only one annuity type is considered, retirees may only realize approximately two-thirds of the benefits of annuitization.

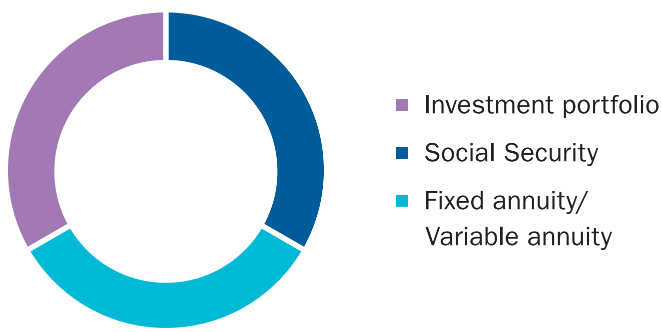
What is a diversified income plan?

Diversification across different asset classes is an important part of building an efficient portfolio. Diversification across different *asset classes and product types* is also an important part of building an efficient income strategy for a retiree. While many financial advisors use traditional investments (funds, EFTs, bonds, etc.) to build out retirement income strategies, there is a significant body of research that supports including guaranteed income products (annuities) as well.

When you leverage multiple sources of income and include lifetime income from fixed and variable annuities, you gain the confidence to power an active retirement.

Just as you spread out your investments while saving, a diversified income plan means you take money from different sources, including fixed and variable annuities.

Components of a diversified income portfolio



Annuities are the only investment products that provide income that's guaranteed for life which can address the risk of outliving your income.

Income from Social Security is guaranteed but, in most cases, it does not provide enough to cover a retiree's expenses. Annuities are the only investment products that provide income that's guaranteed for life, which can address the risk of living longer than the income drawn from your assets.[2] With a diversified strategy, it's the powerful combination of income from Social Security retirement benefits (and pensions if you have one), fixed and variable annuities, as well as your investment portfolio, that can provide the best outcomes for retirement income and increase your financial confidence in retirement.

Essentially, the steady income from Social Security and fixed annuities can be used to cover everyday expenses, creating a guaranteed income floor protected from market volatility. Variable annuity income and withdrawals from an investment portfolio can cover additional expenses, as well as potentially keep pace with inflation and cover rising costs.[3] Together, these varied sources of retirement income can help mitigate different risks that can erode your retirement savings.

Key attributes of a diversified income plan

Adding lifetime income from annuities to your income plan can help mitigate the risks associated with living a long retirement. While many understand the benefits of diversification from a savings perspective, the same strategy can see you through retirement. By combining multiple product types like fixed annuities, variable annuities and a traditional investment portfolio, retirees can address all major retirement risks below, that each product could not individually address alone.

	Fixed annuities	Variable annuities	Investment portfolio
Longevity protection	■	■	—
Market volatility	■	—	—
Inflation	—	■	■
Cognitive decline	■	■	—
Emergency liquidity	—	—	■

With a diversified plan, all risks are addressed.

Diversification is a technique to help reduce risk. It is not guaranteed to protect against loss.

Having a diversified income plan can help hedge against negative outcomes caused by inflation, poor investment returns, declining cognitive abilities, unexpected expenses and the risk of outliving income.

Morningstar research

This paper explores the potential benefits of developing a retirement income strategy using either an immediate fixed annuity (IFA), which provides fixed payments for the life of the annuitant, or an immediate variable annuity (IVA), where payments can vary depending on the performance of the underlying portfolio.

The Morningstar analysis uses a tool for estimating the probability of potential negative outcomes, such as those caused by inflation, poor investment returns and longevity, that potentially decrease income. The tool uses random variable inputs over time to isolate and determine the household attributes that were best suited for annuitization. According to Morningstar research, the households that should consider annuitization are generally those with conservative portfolios, lower levels of existing guaranteed income (e.g., Social Security retirement benefits), higher initial withdrawal rates, higher subjective life expectancies, higher levels of shortfall risk aversion, and lower liquidity preferences.

The percentage of households that should consider annuitizing increases when both IFAs and IVAs are considered during the product allocation process. IVAs tended to result in slightly higher allocations than IFAs, which is because most households already have a base level of fixed guaranteed income (through Social Security); therefore, IVAs are a unique diversifier from a retirement income perspective. Having a diversified income plan can help hedge against negative outcomes caused by inflation, poor investment returns, declining cognitive abilities, unexpected expenses and the risk of outliving income.

Morningstar analysis and results

Morningstar ran 10,000 simulations from the billions of possible simulations using 22 variables that are considered in finding the "best" product allocation. The factors include age, Social Security retirement benefit levels, expected equity and fixed income returns, and risk tolerance. The analysis smooths the income received throughout retirement, and the goal is to achieve the highest "smoothed dollar" income. Each year's income is discounted with interest and mortality. This report also includes any remaining assets in the overall result, although the value of that will vary by the bequest motive of the retiree. A retiree who has no one to leave the money to, should not be interested in how large the estate is upon death. Morningstar subjectively assigned an upper limit of 50% of assets to be annuitized.

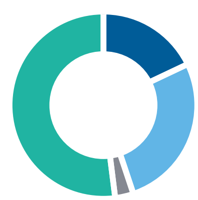
Findings show that retirees should have access to both IFAs and IVAs, since in 87% of the runs the results include an IFA, an IVA or both. ***By including annuities as part of the solution, on average, retirees were able to achieve 20% more certainty-equivalent income in retirement.***

Research suggests approximately 40% of assets should be annuitized with a 50% IFA/50% IVA allocation.

Focusing on the scenarios where both products are available, the average total annuity allocation was 41.96%. The starting point for this conversation is the result of using the “mid” assumption for each of the 22 variables.

Keep in mind, there will be a lower IFA recommendation for those with a high level of Social Security (and other pension) income, more IFA for those who are not confident in future equity returns, and a lower overall annuity recommendation for those with high liquidity preferences. Most importantly, when both products are available, the higher the recommendation to annuities in general and IFAs in particular. The examples below illustrate potential combinations for different situations.

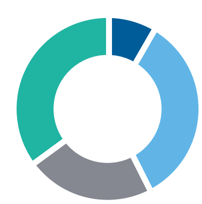
Average Social Security,
Low Equity Allocation



High Social Security,
Average Equity

Low Social Security,
Average Equity

Average Social Security,
High Equity Expectation



Retiree households that are more likely to benefit from purchasing an IFA (versus an IVA) have relatively more aggressive portfolios, lower levels of existing guaranteed income (e.g., Social Security benefits), lower equity return expectations, higher expected equity risk levels, and higher levels of shortfall risk aversion. While in contrast, retiree households that are more likely to benefit from purchasing IVAs have higher levels of Social Security and pension income, less aggressive portfolios and higher equity return expectations.

Every retiree household is different. The greater the range of potential products and solutions a financial advisor has available to recommend to the household, the better the retirement income strategy is likely to be. In this paper we explored the potential benefits associated with using immediate fixed annuities (IFAs) and immediate variable annuities (IVAs), with a particular focus on when each is the best fit. The analysis suggests there is considerable benefit to not only incorporating additional guaranteed income into retirement income strategies (consistent with past research), but also in helping retirees determine which form of guaranteed income is optimal. While many financial advisors often talk about the benefits of diversification from a portfolio perspective, the same concepts also apply to retirement income products.

Overall, this analysis strongly suggests retirees and financial advisors should consider annuities as part of a retirement income strategy and use multiple types of annuities to create the best possible plan.

Next steps and learn more

- Read full Morningstar research report: ***The Benefit of Diversified Immediate Guaranteed Income for Retirees: Combining Fixed and Variable Immediate Annuities***
- Read TIAA white paper: ***Income diversification: A strategy for pursuing better retirement outcomes***
- Get an estimate on the income that can be generated for your clients from variable and fixed annuities from **TIAA's Lifetime Income Calculator**. If your clients are within five years of retirement, visit the **Retirement Profile tool** to see how the combination of lifetime income—such as fixed and variable annuities, Social Security or pensions—and systematic withdrawals have the potential to yield a steady and guaranteed retirement "paycheck"
- Get information about building a diversified income plan at **TIAA.org/replacesalary**

[1] The "certainty equivalent" income calculation incorporates an individual's preference for risk and uncertainty when it comes to funding retirement.

[2] Guarantees are subject to the claims-paying ability of the issuing company.

[3] The income payments from the variable annuity accounts vary with current market conditions and are not guaranteed. They will rise or fall based on investment performance. There are risks associated with investing in securities including possible loss of principal. Past performance does not guarantee future results.

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