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Managing your financial plan to avoid extreme market risk before and after retirement

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The dilemma facing many individuals nearing or in retirement is that if they stay invested in the stock market, they risk losing money they can't afford to lose in a market downturn; but if they don't, they get an unsatisfactory return and increase the risk of outliving their desired level of retirement income. According to the Society of Actuaries, there is a better than 50% chance that at least one spouse of a healthy couple age 65 will survive to age 92 or better.

Traditional pension plans insulated participants from market risk (borne by the sponsoring employer) and promised a lifetime retirement income to the participant, and often, their spouse. A new generation of variable annuity products has been designed to perform similarly, with the insurer providing performance and payout guarantees, per below:

* Continued market participation, but a minimum guaranteed return (typically 5-7+);

* Guaranteed payments of 5-7% of the GREATER of actual (i.e., market) or guaranteed account value, for as long as you and/or your spouse lives.

Example: Mr. Smith, age 60, invests $20,000 of his retirement funds in such an annuity. An insurer guarantees that at his age 70 his account will be worth NO LESS than $400,000 (a 7.2% compounded return). At age 70, he decides to begin drawing an income. The insurer guarantees, for as long as he (and, if elected, his spouse) lives, minimum annual payments of $20,000 to $24,000 (depending on product and other factors).

* Mr. Smith self-directs the allocation of his annuity among a broad menu of investment choices, much like a typical 401(k) or IRA. His return will be the greater of the actual (i.e., market) performance of his investments or the guaranteed return. If, in the above example, the market value of his account at 70 was greater than the guaranteed value (say, $500,000), his lifetime payments would be $25,000 to $30,000 a year. In fact, because the annuity account is insured against market risk, Mr. Smith might choose to invest it more aggressively.

* It is NOT necessary to wait ten years to begin payments. You could begin them immediately, or begin them later. But until you are ready to begin payments, the insurer guarantees you a very respectable minimum return.

What are the catches?

* The guarantees are only as good as the insurer's ability to honor them. The guarantees are based upon the claims paying ability of the insurance company.

* There is no additional tax-deferral benefit from having a variable annuity within a qualified plan, since the qualified plan is already tax deferred.

* The additional contract riders associated with these guarantees will increase the cost of the variable annuity within the qualified plan, typically by 2.5-3% against the market value return. For example, if in a good year the investment return of your account is 15%, the net return to the account will be 12-12.5%. Note that charges are ONLY against market performance and do not reduce the insurer guarantees. But the value of the rider must be considered based upon your own needs and goals

* During the first 4-10 years, unscheduled withdrawals of more than 10% or so of the account value are penalized (duration and severity vary by product).

* The product is designed to generate lifetime retirement payments. While your account market value can be accessed in lump sum at any time (subject to above-noted possible penalty), if the guaranteed value is greater than the market value, it can ONLY be accessed as a lifetime income stream. This is why we recommend an annuity for no more than about 30% of your retirement funds, so you have drawdown flexibility with the balance.

One final note: although the underlying product is an annuity, you DO NOT annuitize, instead you draw down an income stream against the greater of your account's market or guaranteed value. You can access the remaining market value of your account at any time, and that value is inheritable by your heirs.

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