https://blogs.wsj.com/experts/2019/09/23/why-most-annuities-arent-inflation-adjusted-and-why-thats-a-problem/

WEALTH MANAGEMENT

Why Most Annuities Aren't Inflation-Adjusted (and Why That's a Problem)

An annuity with payments directly linked to inflation ensures a retiree will always have some constant amount available to spend, in today's dollars, says WSJ Wealth Management Expert David Blanchett. PHOTO: GETTY IMAGES/ISTOCKPHOTO

By

David Blanchett

Sep 23, 2019 9:02 am ET

David Blanchett is the head of retirement research for Morningstar Investment Management.

Retirement for many people could last 30 years or longer, and even a relatively mild 2% annual inflation could have a significant impact on purchasing power over time.

Yet the vast majority of annuities don't include a cost-of-living adjustment (COLA) to help combat inflation. Rather, most have payouts that are constant over time (commonly referred to as nominal)--even though nominal payouts can result in a significant decline in purchasing power for a retiree.

There are two primary ways to consider inflation risk when it comes to annuities: explicitly or implicitly.

MORE IN WEALTH MANAGEMENT

- When Annuities Are a Better Deal for Women Than Men
- The Tax Benefits of a Partial Roth Conversion
- Why I Kicked My College Graduate Out of the House
- The Problem With Bonds in a Retirement Portfolio
- Got a Raise? Here's How Much of It You Need to Save for Retirement

Explicitly considering inflation means to have the payments tied directly to inflation. This how Social Security retirement benefits work today, where benefits are tied to the change in the Consumer Price Index for Urban Wage Earners and Clerical Workers, or CPI-W. An annuity that has payments directly linked to inflation ensures a retiree will always have some constant amount available to spend, in today's dollars, throughout retirement. Annuities linked to inflation are still relatively rare, though, with only about 0.2% of annuities quoted in 2018 including the option.

An annuity that implicitly considers inflation could have what is called a "fixed" COLA, where the benefit would increase by some fixed percentage each year. Two percent is the most common fixed COLA among annuities quoted today. For example, if the initial benefit payment was $1,000, a 2% fixed COLA would result in a payment of $1,020 in the second year, $1,040 in the third, $1,061 in the fourth, etc. Note the 2% increase compounds over time.

Fixed COLAs aren't directly tied to inflation, so it's possible the annuity benefits could differ (materially) from cumulative inflation in retirement. Only about 4% of annuities quoted in 2018 included any kind of fixed COLA.

Taken together, less than 5% of immediate and deferred annuities quoted in 2018 included any type of cost of living adjustment. This is way too low. While it's definitely true that not everyone needs an annuity with a COLA, more retirees should at least be considering them during the purchase process.

Why aren't COLAs included in more annuity quotes? I think they key reason is the impact COLAs have on initial payout rates.

I ran some annuity quotes on Aug. 27 for a 65-year-old female, and the initial payout rate (payout divided by premium) for a nominal immediate annuity was 28% higher than an immediate annuity that included a 2% COLA (with the highest payout rates of 6.03% and 4.70%, respectively) and 58% higher than an immediate annuity with benefits linked to inflation (payout rate = 3.82%).

While the initial payout rate for annuities with COLA is clearly lower than the basic nominal annuity (with constant payments) that doesn't mean COLA is a bad deal for retirees. The true value will depend on things like life expectancy, realized inflation levels, risk tolerance, etc.
The key is to understand the differences in the payouts and place that into the context of what the retiree is trying to accomplish.

Modeling and discussing the implications of inflation is a critical component of a financial plan, since inflation can have a material impact on a retiree's standard of living. For example, even a 2% inflation rate will reduce purchasing by 40% over a 25-year period. The fact that relatively few annuity quotes today provide any type of COLA is a point of concern. At a minimum, retirees need to understand the differences in payouts for different types of benefits for annuities to make the most effective decision.

You can email Mr. Blanchett at **reports@wsj.com**.

Read the latest **Wealth Management report**.

Read More From THE EXPERTS

Share this: https://on.wsj.com/2l17xDk

ANNUITIES   COLA   DAVID BLANCHETT   INFLATION