ANNUITIES AND BUCKETS—IT'S A MATCH

Last year, the interest-rate environment hit historic lows. Many investors avoided investing in guaranteed interest investments as they hoped for higher rates. If using "buckets," what other alternatives do investors have?

The time segmentation or "buckets" approach has been used in retirement planning for many decades. Initially developed by Harold Evensky in 1985, "buckets" was a way to reduce sequence-of-returns risk. Originally, there were two buckets: a cash bucket and an investment bucket. The cash bucket was for immediate spending and the other was for growth. The longer-term investments were mainly stocks, but the strategy has since developed into three buckets:

1. **1–5 years: Cash Flow**
   Invest in low-risk vehicles to cover spending needs in the first five years of retirement.
2. **6–15 years: Bonds**
   Medium-risk vehicles provide the opportunity for growth during the middle retirement years.
3. **16+ years: Stocks**
   Equities offer the highest risk with growth as the potential reward.

In these challenging times, can annuities help with this approach?

Bucket One–Money for Current Expenses

For the first bucket, the retiree needs income and cash flow to meet spending needs for the first five years of retirement. Income annuities, such as a single-premium immediate annuity (SPIA), can help meet those essential expenses. A Period Certain option also can provide a guarantee to beneficiaries and simplify planning. Here's a tip: Run an illustration to solve for a monthly amount needed to help determine the initial purchase payment.

A retiree also could use this type of annuity to bridge the gap between retirement and claiming Social Security benefits and ensure the highest Social Security benefit available. Whether delaying claiming Social Security benefits until full retirement age (FRA) or until age 70, this strategy can be a way to manage essential income. This would allow Social Security's delayed retirement credits (DRC) to grow from FRA to age 70.

Bucket Two–Money for the Middle

For the second bucket, the approach has a shorter time horizon but still needs growth. With interest rates and bond yields being low, participation in the market can provide a higher rate of return for the investor. Below are average annual returns from June 30, 2018, through June 30, 2019:

- S&P® index: 14.70%
- Dow Jones Industrial Average: 15.03%
- Russell 2000® Index: 13.45%
- MSCI EAFE Index: 6.90%

The shorter time horizon makes this option riskier than some clients might accept. A guaranteed minimum accumulation benefit with a variable annuity can reduce these concerns. In simple terms, it is a "walk-away" benefit that ensures if the market did not perform during a specified period, the investor will get all or most of the premium back in a variable annuity contract. By investing in equities and bonds, the investor can now participate in market growth while having peace of mind that the "worst-case" scenario is to have all or part of the original investments back.

Bucket Three–Growth for the Future

The third bucket is typically used for long-term investing and is the highest-risk bucket. In nonqualified and qualified accounts, an investment-only variable annuity (IOVA) can be just as simple as that. There are no optional living benefits added, which helps reduce costs. An investor may invest as aggressively as he/she wants using as many (or as few) of the subaccounts offered. In nonqualified accounts, the ability to rebalance investments without recognition of gain, such as tax deferral, can allow assets to grow more quickly.

In addition, some IOVAs offer a death benefit, typically the return of premium (ROP). As a plus, most annuities allow for a 10% annual withdrawal free of sales charges in case the investor unexpectedly needs to move some funds to Bucket One or Bucket Two.

Putting it Together

There are various investment options to use when using the Time-Based Segmentation method, or "Buckets." This strategy can be attractive to retirees because it is easy to understand. The first two buckets use fixed investments to mitigate risk; however, with yields and interest rates so low, it may be worthwhile to look at alternatives. As interest rates start to increase over time, using fixed investments may become popular for this method. Until then, the bucket method could be a distribution strategy used for someone looking to retire sooner rather than later.

Additional Resources and Links

Retirement Income Strategies

The Impact of the Sequence of Returns

Understanding Sequence of Returns

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com (800) 722-2333, ext. 3939. PacificLife.com

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