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Protect Retirees' Income With New Step-Up Resets

By Jim Otar, CMT, CFP
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Some variable annuity carriers are beginning to offer "annual-high" resets. Crunching the numbers shows that this new method of calculating step-ups improves clients' chances of fighting off inflation over the course of their retirement.

As baby boomers face the fear of outliving their savings, sales of variable annuities with guaranteed minimum withdrawal benefits (VA-GMWBs) are going through the roof. While some people consider them expensive, they do help reduce the fear of running out of income while preserving the hope of retaining assets for emergencies or for the next generation.

There are three broad categories of financial risk factors during retirement: the longevity risk (living too long), the market risk (premature portfolio depletion), and the purchasing power risk (inflation). Most VA-GMWB products, when properly selected, eliminate the first two risk factors. They provide a guaranteed lifelong income regardless of what happens to the investment side of the contract.

It is the third risk factor—inflation—where there is a shortfall. This is where there is plenty of room for improvement. Yes, if you look at the sales material, they all talk about how automatic step-up resets can create pay increases. But when you look at the market history, step-up resets hardly make a significant difference.

However, there is some good news. As with any financial product, the devil is in the details. There are some significant enhancements on how the step-up reset is calculated.
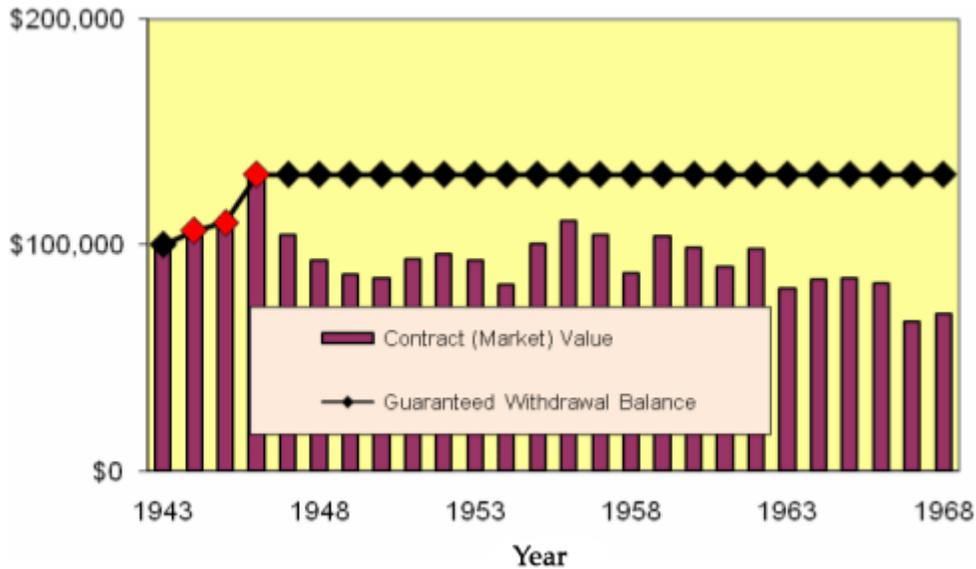
The mechanics of resets

A VA-GMWB has two balances to keep track of. The first one is the market value, which fluctuates just like any mutual fund. This is called the contract value (CV). The second balance is the guaranteed withdrawal base (GWB). It is used to calculate the income payments. The day you buy the VA-GMWB, both the CV and the GWB are the same. Subsequently, even if the CV goes down to zero in adverse markets, annual payments continue for the life of the contract based on a percentage (generally 5%) the GWB.

How is the step-up reset calculated? In the current convention, if markets do well and the contract value—net of all withdrawals—exceeds the value of the guaranteed withdrawal base, the GWB is set higher, equal to the market value. From that point on, the payments to the retiree are proportionately higher for the rest of her life. This is called lifetime-high reset. Generally, resets are activated at each contract anniversary.

Let's work thorough an example: Bob, 65, is just retiring. He buys a VA-GMWB for $100,000 that guarantees 5% withdrawal, or $5,000, for life. His contract allows him annual resets until age 90. The asset mix is 80% S&P 500 index and 20% fixed income. Assume total costs of this contract—including management costs, portfolio costs, guarantee riders, and other fees—is 3% of the contract value. Let's assume Bob retired at the beginning of 1943.

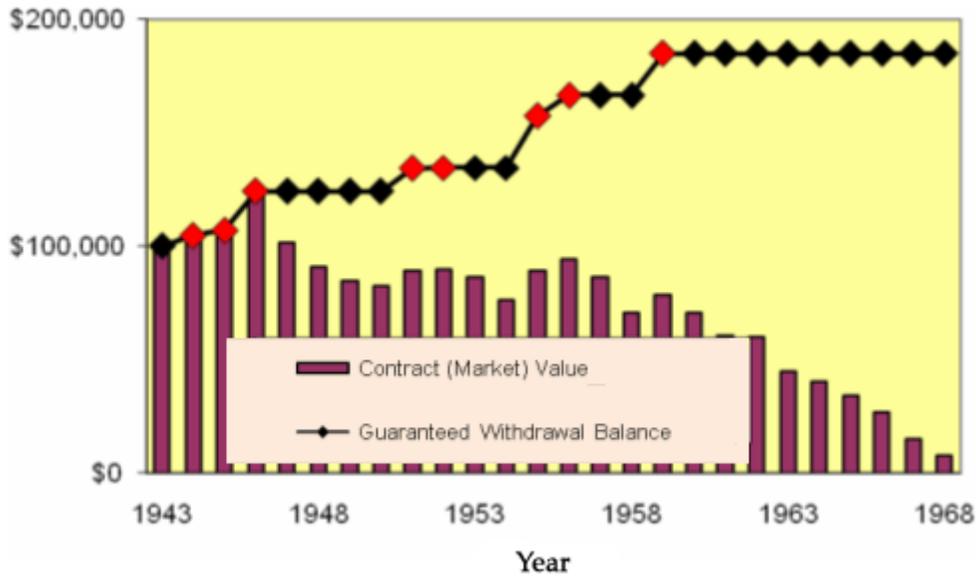## Figure 1: The Effect of Lifetime-High Resets

Source: Otar & Associates

The portfolio made new highs from 1943 through 1946, reaching $131,044. These resets are indicated as red dots on the chart. After age 69, Bob's income is $6,552—5% of $131,044. This sounds great, except after 1946, it never exceeded the guaranteed minimum base ever again. At age 90, Bob receives the same $6,552 as he did at age 70. Based on market history, he actually would have needed $9,735 at age 90 just to keep his original purchasing power. This is not so good, is it?

Enter the new method of calculating the step-up resets. In this innovative method, the market value does not need to exceed the guaranteed withdrawal base to trigger a reset. A step-up reset is triggered if the market value at the current anniversary date is higher than its value at the previous anniversary. This is called the annual-high reset. With this method, even if the portfolio is in the dumps, as long as it is higher than the previous anniversary, you get a pay raise!

Going back to Bob's example, Figure 2 shows the effect of annual-high resets. The maximum allowed equity allocation is 70%; therefore, we used a 70/30 asset mix. Each time the market value is higher over the previous year, there is a step-up reset for the same percentage growth. The final reset occurred at age 81, in the year 1959, and the guaranteed withdrawal base was set to $184,886. Therefore, his income after age 81 would be $9,244. This is 41% higher than the payments using the conventional lifetime-high reset method of calculation. In a distribution portfolio, fluctuations are normally the foe. In this

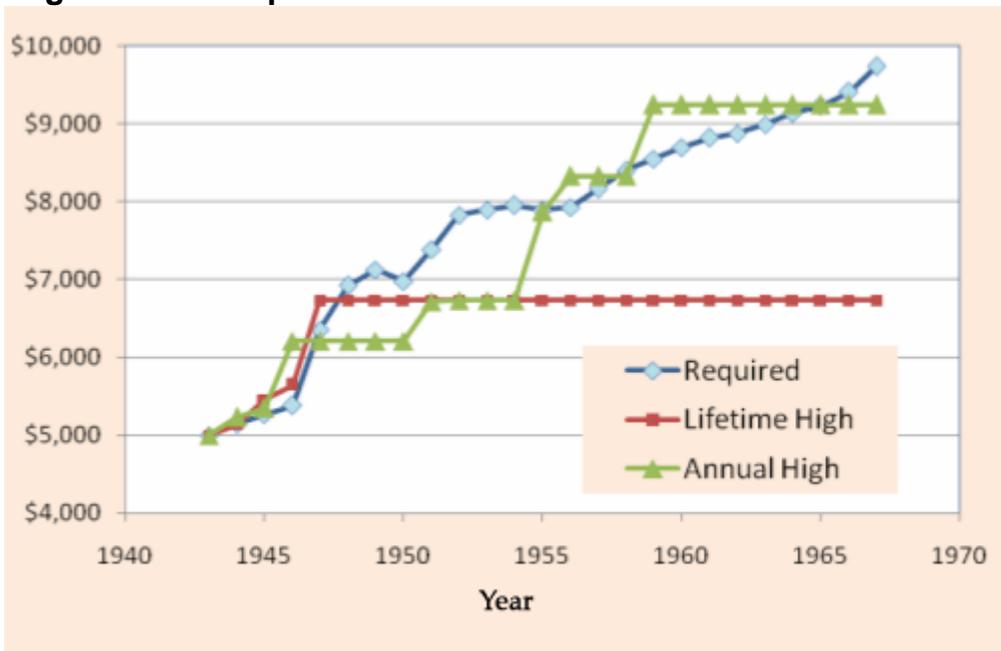case, they are your friend. Not a bad deal.

Figure 2: The Effect of Annual-High Resets

Source: Otar & Associates

Figure 3 depicts the annual dollar amounts over time for these two methods. The blue line indicates the initial $5,000 payment indexed to actual inflation. The red line indicates the payments using the conventional lifetime-high method. And the green line depicts the new annual-high method. Notice the difference.

Figure 3: The Impact of Reset Method on Real Income

Source: Otar & Associates

I expanded this example and calculated for all years of retirement starting in 1900. Here are some interesting statistics based on market history:

Table 1: Comparison of Resets Since 1930

	Lifetime-high reset method	Annual-high reset method
Probability of having no step-up resets at all	30%	0%
Median number of step-up resets	1.0	5.0
Total number of step-up resets for all portfolios since 1900	180	434
Probability of maintaining at least 85% of the original purchasing power at age 90	17%	37%
Median annual pay at age 90	$5,596	$7,039
Bottom quartile annual pay at age 90	$5,000	$6,152
Top quartile annual pay at age 90	$6,686	$8,624

Source: Otar & Associates

Another interesting twist offers a simple, but much-needed benefit. Some carriers will double the periodic payments if you move to a nursing home. Considering the cost of nursing homes, the additional money can come in very handy. The rider cost is reasonable at around 16 basis points for a single person and would cover you even if you do not qualify for long-term care insurance.

As the competition for the retirement dollar heats up, it is not hard to imagine that more insurers will jump on the bandwagon and offer similar products. That is good for the consumer. Quietly, I will keep my fingers crossed and hope that promises offered are promises kept during my lifetime.

Jim Otar is a financial planner, a professional engineer, a market technician, a financial writer, and the founder of retirementoptimizer.com. His past articles on retirement planning won the CFP Board Article Awards in 2001 and 2002. He lives and works in Thornhill, Canada, and can be reached at (905) 889-7170, or by e-mail at jimotar@rogers.com.