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Low Interest Rates *Squeeze* Guaranteed Incomes

(Unless you have an annuity)

When it comes to interest earnings on savings deposits, there hasn't been much difference between your local bank and your mattress. In September 2015, the posted rate online from a national bank for a basic savings account was ***0.1 percent***. Incentives for new accounts, higher balances, and longer holding periods bump the rate a bit, but even the best offers for short-term, FDIC-insured accounts rarely exceed 1.5 percent.

This extended period of low interest rates has severely challenged some long-standing retirement planning conventions. Robert Powell, author of the newsletter *Retirement Weekly*, explained the problem in an April 11, 2011, *New York Times* article:

> (R)ight now, we're in a negative real interest rate period, and many Americans, especially older Americans, who can't afford to lose money in the market and who must also keep pace with inflation, are being penalized for saving.
>
> And that means the era of safe investing is over for that class of investors, at least for the foreseeable future. They either have to take on greater risk with their investments or fail to keep pace with the cost of living.
>
> And the only good news is that this cycle won't last forever. The bad news though is that we don't know how long it will last.

That was 2011, and Powell was right about the bad news; now it's 2015 and historically low interest rates are still with us. But is taking on greater risk the only recourse for retirees who want a secure income? Maybe not.

The lament of low interest rates, & the annuity answer

It's easy to see how low interest rates can hobble retirement strategies predicated on income from safe, interest-bearing accounts. Suppose a retiree projects an average annual rate of return of 4% from low-risk investments; on a million dollar account, that's $40,000 in annual income. Annual interest rates will certainly fluctuate, but as long as they remain around 4%, there is a reasonable expectation of steady future income. If interest rates are a bit higher, the extra can be added to the principal to make up for years when returns might be a bit lower. As long as rates don't drop too low for too long, the numbers work.

But when interest rates run significantly below historical averages for extended periods, these projections fall apart. At 1%, annual income is reduced to $10,000 a year. If a retiree's living expenses are based on receiving $40,000 each year, they face a no-win dilemma: live on less income, or consume significant principal to maintain the current standard of living, leaving less to generate interest in future years.

Since consuming principal creates a downward spiral for future income, many retirees feel compelled to take greater investment risks. But perhaps these risk-averse retirees should consider buying an annuity[1]. Insurance companies can match or exceed historical benchmarks for guaranteed incomes[2] from low-risk investments, even in extended periods of low interest rates, because they pool the resources of many retirees to deliver incomes based not just on today's rates, but on returns from conservative, diversified, long-term portfolios. They not only invest with a longer time horizon, but also have reserves to smooth out interest-rate fluctuations. In true insurance fashion, each retiree becomes part of a larger group of income recipients, thus minimizing or eliminating many of the individual challenges to deriving a steady income.

Consider this: Based on September 2015 quotes from

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several highly-rated insurance companies, a 65-year-old male could secure $40,000 in guaranteed annual income for the rest of his life for about $630,000. And this is for a contract specifying that should the annuitant die before receiving 20 years of income, annual payments of $40,000 will be paid to a designated beneficiary until the end of the 20-year period, a total of $800,000.

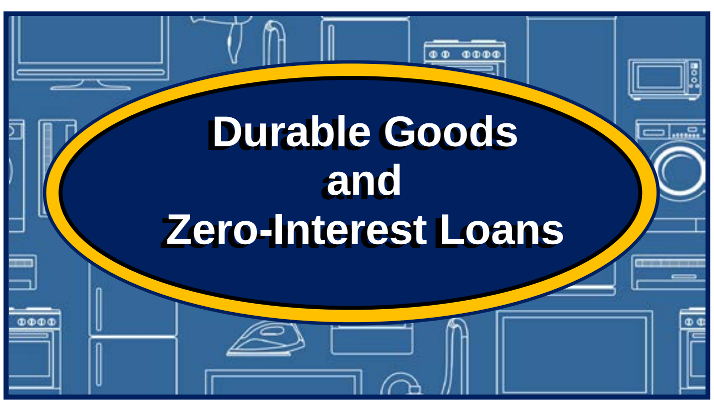
A lifetime annuity is not really an interest-bearing investment, but a guaranteed drawdown of principal and interest, with a promise to continue payments as long as the annuitant lives. So it's hard to say that the above example is an apples-to-apples comparison. Still: on one hand, there's trying to squeeze $40,000 each year from $1 million, knowing the ongoing challenges of fluctuations and potential exhaustion of principal. On the other, there's paying an insurance company $630,000 to provide a guaranteed annual income of $40,000 for life – with $370,000 left for other investments. These numbers don't prove annuities are the better option, but they should prompt retirees to take a closer look at these insurance products, and see if they might benefit from including them in their retirement plans.

As the next generation of American workers approaches retirement, fewer will have employer-sponsored pensions to provide a guaranteed income stream. Instead, they will be personally responsible for devising plans and selecting financial products to deliver a monthly check to their bank accounts. If safe, steady income is a primary retirement objective, it may be desirable to pay an insurance company to do the job.

For those either already retired or on the cusp, a few closing thoughts:

- ***How hard will your money have to work this year to provide an acceptable guaranteed retirement income?***
- ***How comfortable are you with the ongoing decision-making responsibility for selecting the investments to maintain this income?***

If you don't have good answers for those two questions, it might be worthwhile to find out if an annuity can be part of the solution. ❖



A frequently overlooked topic in discussions about personal finance is how to best purchase durable goods. Durable goods are products that don't have to be purchased frequently, usually last for longer periods, and are typically kept for five years or more. This definition encompasses a wide range of items such as automobiles, appliances, home and office furnishings, lawn and garden equipment, consumer electronics, tools, sporting goods, photographic equipment, and jewelry.

Since purchase prices for some durable goods can be pretty steep, most Americans can't simply pay for them out of their monthly discretionary income. So even if they involve economic essentials, like buying a car or replacing a furnace, decisions about how to pay for durable goods are rarely as simple as writing a check or swiping a credit card. Paying for durable goods usually requires some planning.

In some cases, consumers can save up for durable goods, because the item they want is an eventual replacement or upgrade for something they already own, like a car or bedroom furniture. Or it is a non-essential or recreational item – until you can afford it, you can do without it.

But some durable goods are harder to do without, and many consumers either don't have the time or economic resources to accumulate savings to pay for them. Financing is the only practical option.

For larger and popular durable goods, like automobiles, consumers may be able to finance the purchase through a bank loan. But today, banks seldom make unsecured loans for individual durable goods; most purchases are financed either with a personal credit card, or directly by the manufacturer. Because these loans are secured only by the borrower's promise to pay, the interest charges can be substantially higher than loans collateralized by real property (i.e., an automobile). Thus, from an economic perspective, durable goods purchases can be some of the most expensive transactions in personal finance.

Interest-free isn't really free (but you knew that, didn't you?)

An attention-getting finance option offered by some retailers is a zero-interest loan. These loans are advertised with phrases like "one year same as cash," or "0% APR," and sound like they are allowing consumers to "save" after buying, instead of before. But if many consumers are willing to pay high interest rates to obtain a durable good, why would any lender offer zero-interest loans for the same products? The answer: The cost of interest-free financing can be recaptured somewhere else in the transaction.

Consider the factors in a typical zero-interest finance transaction for a car.

- The offer is underwritten by the automaker (or its in-house financing arm), and often applies only to new vehicles – the ones with the highest sticker prices.
- Selecting the zero-interest option often disqualifies the buyer from other discounts, such as rebates, that might lower the car's purchase price.
- The zero-interest payment period is often much shorter than a typical auto loan, sometimes just 24 months. Shorter terms result in higher monthly payments – even if there aren't any interest charges.
- In some zero-interest finance agreements, a single late payment can change the status of the loan, incurring interest charges retroactively on the full amount financed.
- Zero-interest loans are offered only to qualified buyers. According to an August 2014 article by Tara Mello posted on bankrate.com, only 10 percent of shoppers have good enough credit to qualify.

Here's a hypothetical example of zero-interest financing:

A 24-month zero-interest loan for a new car with a list price of $24,000 results in a $1,000/mo. payment. If another buyer applies rebates to buy the same car for $22,700, and finances the purchase at 5 percent interest for 48 months, the monthly payment is also $1,000. The interest "lost" by the auto dealer (who is also the lender) on the interest-free loan is recovered by the higher purchase price. Surprise, surprise, there's no free lunch – or truly free financing.

Since many consumers intend to keep their cars for longer than two years, the option of a longer loan period with a lower monthly payment may also be more desirable than a 24-month loan, regardless the interest costs. A 48-month loan at 5 percent for $22,700 (the discounted price) results in a monthly payment of about $520.

If a $1000/mo. payment is affordable, but you also believe it's likely you will keep the vehicle for four years or longer, the question arises: Is it better to make $1000/mo. car payments for 24 months, then save $1000/mo. for the next 24 months, or save $480 each month for 48 months? Look at the numbers (Fig. 1).

Over four years, Option 1 delivers a $500 accumulation advantage, but requires postponing saving until the loan is repaid. From a big-picture perspective, many households might prefer Option 2, because they build savings immediately, and have a lower monthly obligation.

Better to save? Maybe not

Given the somewhat illusory benefits of zero-interest loans, it might seem desirable to always pay cash for durable goods. But several factors could indicate otherwise.

(Fig. 1)	Option 1	Option 2
Purchase Price	$24,000	$22,700
Term of Loan	24 mo.	48 mo.
Loan Int. Rate	0.00%	5.00%
Monthly Payment	$1,000	$520
Saving Allocation	$1000/mo Mos. 25-48	$480/mo. Mos. 1-48
Accumulation at 48 mos. (@2% interest)	$24,506	$24,006

Even cash purchases have a finance cost: it's the opportunity cost, or what you lose in future earnings when you decide to spend your savings. When the loss of future returns in a savings account is projected to be less than the cost of external financing with a lender (i.e., giving up 1 percent in future returns on $20,000 or paying 5 percent interest to borrow it), cash might be the better option. Conversely, if the current rate of return on savings exceeds the interest rate for borrowing, there's a reasonable argument for outside financing, because paying 5 percent interest could mean not having to liquidate assets earning 8 percent.

Another factor in deciding to pay cash or externally finance is one's cash reserves. If your total cash reserves are less than three to six months of income, how does a $20,000 withdrawal impact your overall financial security? Financing a durable good purchase may not be financially efficient in terms of interest costs, but perhaps prudent.

The opportunity costs of spending cash, and the impact a large out-of-pocket purchase has on reserves prompts other considerations. How much should one set aside for durable goods purchases, and in what type of account? On one hand, an escrow for durable goods should be safe and liquid. On the other hand, since these purchases are infrequent, leaving a sizable sum to languish in a secure, accessible, but low-interest savings account creates another opportunity cost by not allocating it to higher-yielding instruments.

One possibility: Life insurance cash values[1] can provide a unique source of durable goods financing. While the rate of returns on dividends[3] for mature whole life policies can exceed those offered by savings accounts, cash values have similar safety and liquidity characteristics. But a decision to use cash values for this purpose must also assess the impact of loans[4] or withdrawals[4] on the policy's overall performance.

It's understandable that retirement saving and education funding often dominate personal finance discussions; they are big-number, long-term projects. But don't overlook the durable goods purchases that will be made in your lifetime, and their associated finance costs. Savings from better financing strategies could make it easier to achieve those retirement and education objectives. ❖

- **HOW DO YOU PAY FOR DURABLE GOODS?**
- **HAVE YOU CONSIDERED ALL YOUR FINANCING OPTIONS?**

LOAN MANAGEMENT FOR INSURANCE POLICIES

Most whole life insurance policies allow a policyowner to borrow against the contract's cash value. Another resource is a Cash Value Line of Credit (CVLC) through a Bank. You can pledge your policy as collateral with an assignment. The Bank may provide a line up to 95% of your cash value, accessible via a checkbook. The interest rate is often tied to Prime, which is currently lower than most insurance company's loan rates. Much like a home equity loan, this feature maintains the policy's future value (i.e., the death benefit), while also providing immediate cash resources[5]. An August 2012 article in the trade publication *LifeHealthPro* notes how insurance policy loans have played a part in several modern business success stories.

- During the Great Depression, retailer **J. C. Penney** borrowed from his life insurance policies to meet the company payroll, and keep his business afloat.
- When no banker would lend him the money, **Walt Disney** borrowed from his life insurance in 1953 to help fund Disneyland, his first theme park.
- In the early 1960s, **Ray Kroc**, a co-founder and eventual sole owner of McDonald's, took loans from two cash value life insurance policies during the early years of the business to pay key employees.
- With a $3,000 loan from an insurance policy, Doris Christopher started the **Pampered Chef**, a kitchen tool company, in 1995. Seven years later, she sold the business to Warren Buffett for a reported $900 million.

For entrepreneurs and business owners, policy loans may be an attractive source of capital for several reasons. Among them:

- Cash values can be accessed by the owner at any time, for any reason; there is no application or approval process.
- The terms of repayment are determined by the policyowner. Payments can be scheduled (as a monthly automatic payment), irregular (from a bonus or income tax refund), or even suspended for periods.
- Skipped or reduced loan payments will not prompt a call from a collection agency or negatively impact your credit score.
- As long as the policy remains in force, and is not a Modified Endowment Contract, loans are not taxable – even if the amount borrowed exceeds the policy's cost basis.

Life insurance policy loans can prove a valuable source of liquid funds to meet immediate challenges and opportunities. However, if loans are improperly managed, they can severely impact other policy benefits.

Loan interest is calculated every year at the policy's anniversary, and if the owner does not make any repayments during the year, the loan balance will increase. With additional interest, it is possible that a loan balance could eventually grow to exceed a policy's cash value. If it does, the policy will lapse – even if the owner is still paying the regularly scheduled premium.

If you decide to cancel the policy, or if excess loans cause it to lapse, the unpaid loan becomes part of the calculation to determine whether the policyowner has received a taxable gain. Should the insured die with an outstanding loan balance, the loan amount is deducted from the death benefit. (For example: a $10,000 loan against a $500,000 policy would mean beneficiaries would receive a $490,000 benefit if the insured were to die.)

Take care of policy loans, so the policy can take care of you

A whole life insurance policy is a multi-faceted financial instrument that can provide both short- and long-term benefits. But maximizing these benefits requires ongoing review and management. The ease with which policy loans can be initiated, and the liberal terms for repayment, combined with neglect, can result in declining cash values, increasing loan balances, and a policy lapse.

If you have outstanding policy loans, these are good talking points for your next life insurance review:

- Are you making regular loan payments?
- Do loan payments need to begin, or be increased?
- Are the policy's long-term benefits still intact? ❖

Footnotes

[1] NOT A DEPOSIT • NOT FDIC OR NCUA INSURED • NO BANK OR CREDIT UNION GUARANTEE

[2] Annuity guarantees are based on the strength and claims paying ability of the insurance company.

[3] Dividends are not guaranteed. They are declared annually by the company's Board of Directors.

[4] Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59 ½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

[5] All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company.

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