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Retirement income planning has traditionally been built around the three-legged stool of Social Security, company pension and private savings. Congress kicked out one of the legs, the company pension, with changes in the tax laws in the mid-1980s. By using a private annuity, retirees can replicate the company pension in their plan.

As life expectancies increase and returns from stock market investment come back to reality, running out of money in retirement is a real fear for retirees. The quandary for many people about to retire (or those recently retired) is whether to work a little longer now and delay drawing on retirement assets, or run the risk of not having enough in later years when working is no longer an option.

Part of the solution may lie in creating an annuity to take the place of the defunct company pension.

An annuity is simply a steady stream of income provided on a regular basis for the lifetime of the beneficiary or for a set number of periods. An annuity can be guaranteed, as in a commercial fixed annuity purchased from an insurance company, or nonguaranteed as in an insurance company variable annuity or an annuity derivative created from equity investments, bonds, rental real estate or similar income producing assets.

The income or cash flow statements of a household and business are very similar. Both identify income sources, as well as fixed and variable costs.

In the case of the household, the fixed costs are those required to cover an acceptable minimum standard of living, such as shelter costs, utilities, food, clothing, insurance and medical expenses.

Variable expenses are the discretionary expenses that are nice to have, but not necessary for basic subsistence, such as travel, recreation and hobbies.

When planning for retirement living, if fixed costs can be met by Social Security and other annuitized income sources, other private savings and investments can be earmarked for the discretionary portions of the budget. And if the risk of the annuitized income sources can be lowered, the remaining portion of investments can be invested more aggressively to take advantage of the long-term, potentially greater, returns offered by the stock market (e.g., using an insurance company immediate annuity).

A few years ago when stock market investments were clipping along at 20 percent or more per year, the

returns offered by an immediate annuity seemed paltry by comparison. A total return approach was feasible by selling off investment assets to provide income. In a down market, selling assets becomes an expensive proposition as more have to be sold for lower prices in order to meet income requirements. In this case, if high cash balances have been maintained, the annuity income stream can be generated by liquidating cash and holding the more risky portion of the portfolio in equities, allowing it to recover over time as the economy and the markets turn to the positive.

Although the insurance company guaranteed approach is appealing, there are both good and bad points to consider. In the latter case, the decision to enter into a contract with an insurance company is irrevocable. Second, since these annuity payments are fixed, it's important to consider inflation. Fortunately, many companies are now offering riders with cost–of–living increases.

On the plus side, income can be guaranteed for life. When nonqualified funds are used to purchase the annuity, only a portion of the payments are taxed, providing significant tax advantages. Finally, the older the annuitant, the greater is the return/payout.

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WALL ON THE STREET

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