



## MCP *Insider* - EIA News & Commentary for Advisors

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### Why You Can Forget About Buckets

by Mitchell Maynard

There is a software sales tool for annuities that seems to have permeated the income planning industry – I get asked about it regularly. I have heard it said by users, "It's all about the math". However, after analyzing the "income bucket" strategy employed within the software I have found that it doesn't add up. In fact, I will hopefully convince you that the income bucket strategy is actually nothing but "Smoke and Mirrors".

As a former investment advisor, I used the split annuity approach for meeting client income needs frequently. The goal of the client usually was to increase their income through investing in the stock market, while at the same time maintaining level income provided through an immediate annuity.

For you who may be unfamiliar with what a split annuity is, let me explain. Clients need stable income and yet they need to increase their income over time to compensate for the loss of buying power due to inflation, for example. A split annuity is just that, splitting an investment into 2 different annuities; an "Immediate Annuity" and a "Deferred Annuity".

The immediate annuity turns the portion invested into a guaranteed income stream that creates level income for a set period of time, during which time the portion invested into the deferred annuity grows to a value greater than the initial value of the total investment. Since the deferred annuity is usually invested in securities (we are talking about a 'variable annuity' here), the immediate annuity should be for a long enough period to reduce the principal risk. For example, if historically the S&P 500 has never had a loss over a 10 year period, then using a "10 period-certain" (immediate annuity payout terminology) would be sensible.

The concept is really very simple: Give your client a stable income while providing for growth. The added value to this strategy is that the immediate annuity provides for a lower taxable income because of the immediate annuity's exclusion ratio. This exclusion ratio is nothing other than a measured amount of each payment that is considered a return of principal; therefore there is no taxation on it. Immediate annuities are good for creating level income with no risk but they have very low Internal Rates of Return; currently around 1.5%.

*Important note: there is an increasing taxability each time the immediate annuity is purchased.*

Now that we understand with the "split annuity" concept, we can begin to understand the "bucket" strategy used within that sales software. The strategy employed is an attempt to leverage the benefits of the split annuity. It increases the frequency of immediate annuity maturities while investing the maturing deferred annuities in principal-safe insurance products.

When I used the split annuity concept, the Equity Indexed Annuity had yet to be invented. If it had, I would not have used the split annuity at all; let me show you why. The only reason I used the immediate annuity to create the income for a client was that I needed to allow ample time for the investments in securities to grow and minimize principal risk. However, this strategy promotes the use of EIAs as the deferred annuity because an EIA carries with it no principal risk.

In a world that includes EIAs I would never need to use the split annuity strategy. I would simply use the EIA and withdraw the amount the clients needed each month. Think about it this way:

- The internal rate of return (IRR) on an immediate annuity is around 1.5%
- The average return a fixed annuity is about 4%
- The average return on an EIA is around 7% (for a No Cap product)

If there is no principal risk to the EIA why wouldn't you have all the client's investable dollars in the EIA?

**Is it because there is a tax benefit with the Immediate Annuity?**

Let's think about it: what interest rate would we need to earn to compensate for "full taxability" in order to be superior to the immediate annuity? If the IRR on the immediate annuity is 1.5% and the client's effective tax rate is 33%, then we would need to earn 2.25% to be equal.

**If the EIA averages 7% then you can see that we would not be just equal, but far superior.**

Additionally, when using this multi-bucket approach and deferring taxation, you run the risk that the beneficiaries will inherit the tax. In the late 1990's, financial advisors were being sued by their client's beneficiaries because of taxes. The claimants proposed that the financial advisor was not instituting good judgment by failing to evaluate the overall tax consequences of tax deferral for both the client and their beneficiaries. If you are an advisor to seniors, you must be conscious of both your client's needs and their beneficiaries. This is simply good estate planning.

The math is simple:

<b>\$100,000 Initial Investment</b>	
<b><i>Bucket Strategy</i></b>	<b><i>No-cap Equity Indexed Annuity</i></b>
\$40,000 @ 1.5% = 0.6%	\$100,000 @ 7%
\$30,000 @ 4.0% = 1.2%	
\$30,000 @ 7.0% = 2.1%	
<b><i>Weighted Return = 3.9%</i></b>	<b><i>Weighted Return = 7%</i></b>

The results speak for themselves: EIA all the way (it's all about the math).

All in all, the tax benefits are moot since the bucket strategy is designed for eventual consumption of the investments by both the client and their beneficiaries. And since many beneficiaries have higher tax rates than the client, the overall taxes could be greater.

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