Want to buy an annuity? Don't wait for higher rates

By Walter Updegrave - CNNMoney
November 18, 2011

NEW YORK (CNNMoney) -- *I'm 68 and considering using $100,000 of my $500,000 of retirement savings to buy an immediate annuity. But I'm wondering whether I should wait until interest rates go up so I'll get a better return. What do you think? -- Michael P.*

On the surface, waiting sounds like a great idea. After all, the size of the payment you'll get from an immediate annuity depends mostly on two things: where interest rates are at when you "annuitize" (the higher rates are, the bigger your payment) and your age (the older you are, the more you get).

So, the reasoning goes, if you wait until interest rates rise, you'll get a larger monthly check due to loftier rates and your advanced age.

But there are several problems with this strategy.

First, it assumes that you know what interest rates will do. Sure, like most people I expect interest rates will climb at some point from their recent historic lows. But it's far from certain when the turnaround will come. For all we know, we could be in for a very long wait.

For example, the interest rate on high-quality corporate bonds -- which largely determine annuity rates -- topped out at just under 6.5% in late 2008. Since then, yields on such bonds have trended steadily downward, recently dipping below 4%.

So if someone had been considering buying an immediate annuity in early 2009 but decided to wait until interest rates returned to their 2008 peaks, that person would still be waiting nearly three years later.

As for the notion that waiting is worthwhile because you'll be older and, all else being equal, qualify for a larger payment, there are two things you might want to consider.

The first is that since you're older, you'll collect that higher lifetime payment for a shorter period.

The second is that while you're waiting, you'll have to do something with the money that would have gone into the annuity. If you don't do a good job investing that money or the financial markets sink or you end up spending much of it, you could have a lot less than $100,000 when you eventually decide to spring for the annuity. In which case, you may not end up with a higher payment even if rates have risen.

Even assuming rates do rise, that won't put an end to your dilemma. Instead of pondering whether you should hold off buying an immediate annuity until rates rise, you'll be asking yourself: Should I wait for rates to go up even more?

Fact is that no one really knows what interest rates are going to do. So anytime you buy an immediate annuity there's the chance that you might have gotten a bigger payment had you bought earlier -- or perhaps have done better if you'd bought later.

So what should you do given this inherent uncertainty?

First, hold off on putting any money into an immediate annuity until you're really sure you want to start collecting income for life. For some people, that may be at the very moment they retire. They may simply crave the security of knowing from the start that Social Security and annuity payments will cover a certain portion of their expenses.

Others may prefer to wait awhile -- a few months, a few years, a decade -- after retiring to get a better idea of how their expenses play out and how much income they actually need before committing to buying the annuity.

Once you decide to turn on the lifetime income spigot, it makes sense to annuitize in stages. Maybe do a third of the total amount you plan to devote to annuities, then the second third maybe a year later, and then the final amount a year or so after that. Or you could do it in two or four phases for that matter.

This strategy has two benefits. First, it gives you more of a chance to see how much you're spending and how much assured income you need. Who knows, you may find that you've got sufficient cash coming in for now and would prefer to keep the rest of your portfolio in assets you can dip into later should the need arise.

The second advantage is that the gradual method prevents you from stashing all your dough in an annuity when rates are at a trough. Of course, this approach also assures all your money won't go into the annuity when rates are at a peak. But that's the point of diversifying. You protect yourself from the extremes.

So instead of trying to time the bond market, I suggest you consider annuitizing in stages. And while you're at it, you might also want to take a look at how to combine an annuity with a traditional portfolio to boost the chances of your nest egg lasting for life.

Or, you can sit back and wait for rates to go up. And hope that you don't run through your money before they do.