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JIM: Did you know last year they changed the rules where you could reduce the amount of required minimum distribution on your IRAs if you're over 70-1/2? Well, joining us today is Curtis Cloke, president and founder of Thrive Income Distribution System, a company that provides software and educational training programs for retirement income and estate planning solutions for financial professionals. He's a speaker and author, and has spoken around the country on the topic of retirement income planning, and he's here to share with us today some techniques that he teaches other advisors to use as well as this new rule that will allow you to minimize what you have to take out of your IRAs each year. Welcome, Curtis.

0:43

CURTIS: Hello, Jim.

0:45

JIM: It's great to have you back. There's been so many things happening and consumers are hearing so much information, what's good, what's bad, and I see all this focus on products and the different tools and techniques, and a lot of times I know you go around the country and you're talking about predictable income streams, and I dare say the dirty word annuity, and people are always looking at things as just strictly investments, and really when you're looking at the immediate annuities, it's really not so much an investment as it is a strategy to help somebody with predictable income, and there's a type of annuity out there called a DIA, or deferred income annuity, and you've gone around the country talking about this, and I don't think a lot of our listeners have ever heard of the concept DIA. Share with us, Curtis, what is a DIA?

1:33

CURTIS: A DIA is a short acronym for deferred income annuity, and it gets easily confused with a long term, pretty popular annuity type called deferred annuity, and it's not to be confused with the deferred annuity because they're not even close to being the same product. Unfortunately they do share the same name, they're all annuities, but they're completely different types of annuities. They're not taxed the same. One has potential fees, the other one has no fee drag. There's not very much resemblance in terms of how they work. One is for accumulation and potential liquidity. The other one is purely an income play, and so a deferred income annuity is really close to the sister of a deferred income annuity called a SPIA, or a single premium immediate income annuity.

A single premium immediate income annuity is something that you purchase where you make a deposit for income that's going to begin within the next 12 to 13 months. A deferred income annuity is a deposit that you put into an account for which a stream of predictable income is to be created 13 months or longer. In fact, the products that exist, that could be anywhere from 13 months up to about 40 years in the future before incomes would necessarily have to be paid out.

2:46

JIM: And my understanding, and correct me if I'm wrong, Curtis, if you look at things like social security or pensions, really all those are is annuities because they pay an income stream over the lifetime of the recipient, and then there's variables of course with survivorship options, things like that, but really the pure essence of it is, it's an income stream that typically goes over a person's lifetime, right?

3:06

CURTIS: Yeah, now, it's typically, I hate to use the word typical and in the same text call it lifetime, because when we first discovered the DIA back in 1999 we did not utilize it as a lifetime play. We used it as a laddered play, just like if you were to ladder bonds for example, or laddering certificates of deposit, we would ladder period certain DIA contracts.

Maybe we're getting ahead of ourselves when we already outline a DIA and then we put it in the same breath with life contingency in terms of payout. Unfortunately, the environment, the industry, and most consumers believe that a deferred income annuity is only a longevity play. It's only one of many of the different types of DIAs that exist, Jim.

3:38

JIM: Now, a lot of people, they might be familiar with the deferred annuities, not to be confused with deferred income annuity, but a deferred annuity which is more of a savings vehicle where you put money in, it grows tax deferred, it has rules kind of like an IRA where if you withdraw before 59-1/2 there's a tax penalty, those are set up where you could get income later and draw on the account, so why wouldn't a person just to a deferred annuity, keep control of their money versus getting a contract for income at some point in the future, why not keep control of the money?

4:19

CURTIS: The answer is this, and it's not intuitive, and it certainly wasn't intuitive to me back in 1999 and I discovered this product, but here's the reality. Let's say for a minute that I buy a deferred annuity that has maybe a surrender period of, let's just say five or 10 years. When the interest rate that's going to be paid on that contract established by the insurance manufacturer, basically they're going to price the performance of that based upon the maturity period of five or 10 years, but let's say I buy a DIA where I have a period of 10 years of delay and I have a period of 10 years of payout. They're going to price that based on 20 years because that's the term for which the insurance manufacturer gets to price that money, a part of their general assets, a part of their portfolio, and so I'm going to get a much higher IRR, internal rate of return on a 10-year payout from a DIA that delays for 10 years because that spans a 20-year period of time as opposed to only giving the insurance manufacturer the knowledge that they may have access to that money during a period of surrender say 10 years, and they won't know because I have control whether you're going to annuitize or liquidity that money at the end of that 10-year time frame, so therefore when you annuitize 10 years later for maybe say a 10-year payout, the performance that you're going to get is like 10-year immediate payout money again.

In other words, you're going to get a much higher overall rate of return on a period certain DIA where you have a period of delay and a period of payout, than you will if you buy a deferred annuity where you're delaying and you may later choose to get an annuitization, and the best example I can give of this, and I actually looked at this just recently, if you were to go out and buy a 10-year period certain immediate income annuity today, your rate of return would be under 2%, and if you were to go out and buy a 10-year deferred annuity with a guaranteed rate for the entire 10 years, your rate would be somewhere around 3.2%.

Well, if you would buy a deferred income annuity where it delays for 10 years, and I'm basing this on the best in class price that I would shop for the universe of products that I can find in the markets today, I'm just under 4% for a deferred income annuity for both the deferral period, the 10 years of deferral, and for the 10 years of distributions, so when I look at the total income payout as opposed to the deposit that I put in, I'm going to be able to get a lot more money for the same deposit in a DIA contract than a deferred annuity for which I may choose later on to annuitize for a period of time or to say it differently, if I want the same level of income, I could certainly put less money in the DIA to get to the same income level as the same amount of money at the income level I would get for a much bigger deposit in a deferred annuity that I would later annuitize. I hope I said that in a way that was comprehensible.

7:02

JIM: I will tell you what, Curtis, as you're going through that, this is the reason why when you're doing planning, you need to talk to a professional that understands the tools and techniques that are available, buzz what you're saying basically, if I were to summarize that in a nutshell, there's a trade-off to have absolute control of your money all the time with no risk, you might be looking at a money market or savings account where there's no penalties, and what's the interest rate you get? Well, if you're willing to give up some of that control and put money in a CD, you're going to get a little bit better interest rate, so if we look at that kind of the same analysis, you're basically saying you can use these different insurance products, and the more you're willing to give, in other words you're willing to give up control, you're able to get a little bit more back on the back side, so now it comes down to prioritization and what's really important.

I think you do it very well, Curtis, when you go around the country talking to people, you talk about buckets of money and where is the best place to put money, and if you have money for a specific purpose, instead of the old way of looking at things, I've got a diversified portfolio and we'll just kind of draw on it as we need it, strategizing, okay, I'm going to use this money for now, I'm going to use this money for later, and I'm going to use this money for passing on to my kids, depending on what the need or use or priority for that money is, is getting it in alignment with what is going to give you the best result, and one of the challenges that we have today with the volatility in the market, we look at investments as a place to grow money long term, but if you're going to need income, really these products are the best way to generate income when you have a need for a predictable cash flow, it's a great way of building it into the portfolio.

It is a complicated subject, and we wanted to give everybody the basis of this because now there are some new treasury rulings that create some opportunities in retirement accounts, and that's something I want to talk about a little bit later after the break, so please stay tuned.

[BREAK]

9:57

JIM: Welcome back, as we're meeting with Curtis Cloke, and Curtis Cloke is one of the foremost experts when it comes to income strategies and income planning. I know he teaches advisors all around the country. I had the good fortune of going to one of his weekend classes for advisors, and as a matter of fact I think it was his first one, it was fantastic. It took me awhile to get my head around this because I'm an investment guy, and I'm always looking at what's the investment return, and I've had to really train myself to looking at not what it is, but what it does. I've changed my philosophy on how I'm advising my own clients right now because of the volatility in the marketplace, because of what bonds and the interest rate environment that we have, we have to look at things differently than we did maybe five, 10, 20 years ago.

There are some new products that have come into the marketplace lately as well as some tax planning opportunities with these products in the area of DIAs, and we have this new thing called the QLAC. What is the QLAC, Curtis, and how can people take advantage of that?

11:00

CURTIS: The QLAC stands for quality longevity annuity contract. The QLAC final regulations were published on July 2, 2014, and the whole purpose of the QLAC is two-pronged. Number one is that the federal government realizes with the update to recent US mortality for both males and females, and husbands and wives, I think it was October of last year when the society of actuaries updated most recent mortality tables. For those that actually live to 65, it's amazing that virtually every category across the board from the time that they had reported on this back in 2000, 2001, had increased two years, so the average life expectancy across the board for just about everyone gender and every class was two years.

So what they're saying now, those that make it to 65, males on average will live to 82 and females on average will live, if I remember right, I think the study indicated it was 87 on females, and if you were husband and wife there's a pretty good chance that one of you will live into your 90s. What the federal government is realizes is that as people live longer and they have to sustain a portfolio of investments during much lower interest rate environments with the pressure of potential increase in taxation and the fact that markets and the volatility of markets aren't behaving the same today as they used to behave, and when digging into that a little bit they realized the reason for that is because we have algorithm with smart MIT graduates who are building software programs to strike price millisecond trading on the markets where buy and hold strategies 30 years ago simply won't have the same response 30 years from today the way they did before, and holding a portfolio making it last, when people are living this long has been more difficult, and when they don't, when they live longer and their money doesn't last they end up on federal programs.

One of the federal government's goals and missions is to help people and is incentify them to find a way to make money last, and one of the ways to do that is to take a sum of their pre-tax dollars, in this case their 401(k), their IRA, their 403(b), their Traditional IRA funds, and give them an option to kick part of those assets down the road instead of being required to take required minimum distributions on all their pre-tax money at 70-1/2. They can actually take 25% of their pre-tax dollars up to $125,000, you have to have about $500,000 of pre-tax to do that, and this is good for both spouses, and you can actually purchase this QLAC and delay taking any distributions, so no RMDs, up to age 85.

So it does two things, it creates tax efficiency between 70-1/2 and 85, but when you get to 85 it takes pressure off of performance of a portfolio because you've got a certain sum that you bought many years before that you've kicked the can down the road, and then when the income turns on on that qualified longevity annuity contract, which is another form of a DIA, technically a DIA but it's qualified as a QLAC, you have longevity and insurance protection. In other words, you've got an income stream that's predictable that you'll be able to sustain for your lifetime, and you can sustain it for the lifetime of both you and your spouse, so even though it's maybe the husband's pre-max money that you're using to buy the QLAC, you can have a joint life payout with both spouses with the husband's pre-tax dollars.

14:13

JIM: That's a huge planning tool, and the first time I heard about this, I looked at so many different opportunities. I look at clients that don't need their RMDs right now but with inflation and longevity might need it in the future, so a way to not have to make those withdrawals, especially if you can delay the withdrawals, a lot of clients in retirement are paying taxes on their social security.

Well, if you can lower your RMDs maybe you can avoid or reduce the taxes on your social security year after year after year. That's all money that can be saved and used for those spouses later on in life if they don't need the money, and the other thing is I've seen a survey awhile back that they looked at the greatest fears, and I know for the age group over 65, the number one fear was running out of money, and the beauty of these types of contracts is you can guarantee them for whatever period of time you want as you talked about before the break, but you can guarantee them for lifetime, and then the QLAC, does it have to be a lifetime payout?

15:11

CURTIS: It does in the QLAC have to be a lifetime payout, and there are a lot of objections that coming, like right away, Jim, as soon as we get as far as we have in the conversation about QLAC, so let me share a couple of other quick pointers that negate some of those fears or some of those observations.

The first with is, well, Curtis, what happens if I fund the QLAC at 60 with my pre-tax dollars that I'm able to do, and then I die before I get to age 85. Well, you don't have to risk what if I die too early. You can actually buy a single or a joint lifetime payout, and you can put an installment refund or a cash refund, and basically what an installment or cash refund allows is it allows in the event you die before the payments begin or before you live long enough to get a sum of payments that at least returns your initial deposit, that if you have heirs, your heirs can continue to receive either in lump sum if it's a cash refund or the installment of the income payments that you would have received had you lived, a hundred percent of a full return of the deposit that you put into the QLAC account at its inception.

So opportunity force you to lose the principle dollars that you put in, and then another objection is, well, Curtis, what happens to inflation by the time I get out there if I buy this at 60 and I'm not turning income to 85? Well, you can also buy a COLA adjustment on these QLAC contracts.

Another question that comes up is, Curtis, well what I say 85 but gosh I wish I would have done it at 80. Well, most of these DIA contracts that are now getting qualified to be a QLAC also allow a change to the income start date, so let's say you picked 85 when you purchased the contract, if you buy the right product with the right features inherently in them, and I'm not finding for those that allow this kind of flexibility that you give any performance up, is to make sure that you elect one that gives you the right to make a decision to change the date, so if I wanted it five years early or five years later, we're recommending that people consider when they do the QLAC targeting 80, 81, or 82 because you can move back and forth up to that five-year, you've got a lot of flexibility in terms of starting this thing.

Now, you can't start earlier than 72 on a QLAC and you can't start later than 85, so if you pick mid point in terms of your target and you buy a product that gives you flexibility with the start date, you can have some flexibility built in for a decision that's to be made later.

17:28

JIM: All of those things that you're talking about reinforces in my mind, you don't want to do this alone. You want to make sure you work with your insurance professional or financial advisor to make sure that you're getting the right fit for what your goals and objectives are.

I've got to ask you though, Curtis, I remember back in 1999 there was a survey where they asked people, what would you consider a good rate of return, it was an open rated question. The average respondent return was 37%, that's what people expected. Now, that was just before the dot com bubble and all those things, it was happening in Y2K, and it's amazing how far we've come where people's expectations aren't quite 37% anymore, but I also look at when you talk about 2%, 3%, 4%, we have a very low interest rate environment right now. Does it make sense for people to lock in at today's low interest rates? Would it be better just wait? What are you telling people that think 2%, 3%, 4%, what does that do for me?

18:23

CURTIS: First of all, it's a misnomer to believe these returns at such a high level, and I think we all would agree that 37% is ridiculous, but there are even some radio show personalities and TV show personalities out there, without mentioning names, that suggest 12% is a reasonable long term average to consider, and let me tell you why that just isn't so. There's a study out there, it's a whitepaper that's on public domain, you could go Google it, and it's put out by Thornburg Investment, it's called Thornburg Investment real real return, and they've been doing this study for about 15 years, and what that study reveals quite frankly is it says, look, if we just look at 30 years of the S&P, and so the latest study that's out there is the one released at the end of August of 2014, and it's looking at the end of 2013 and 30 years back to 1983, and they've been doing this 30-year look back in this whitepaper for about 15 years, and what you'll find is pretty consistently with a range somewhere in the one and a half to one and three-quarter range, the S&P always somewhere around 10% to 11%, that's about what the raw return of the S&P is if you just look at the pure raw returns.

The reality is nobody gets that return, and here's why. Nobody lives in a world where you don't have any fee drag, don't live in a world where you have no taxes, and you don't live in a world without inflation. Look at Thornburg Investment real real return, what they're talking about is that's the raw return of the S&P but what does the general public generally get, and the answer to the most recent report which isn't that far out from all of them, is just under 6%. Then you need to understand that assumes only a single deposit 30 years before for which you're holding for an entire 30 years in one sector of the market, the S&P 500, and that assumes no behavior. It assumes perfect behavior.

When you use the same period of time and you go to the DALBAR study which is a measurement of people's behavior in investing money, the DALBAR reveals that when I do a 50/50 equity/bond blend and I have behavior involved, my average nominal return over the same 30-year time frame, and we're not talking about minus fee drag and minus taxes or inflation now, we're talking about actual nominal return, the average return over the last 30 years that ended in 2013 was 2.2%, so I want you to understand that these returns we're talking about in the deferred income annuity world are pure returns.

In other words, they're the returns after the insurance company's calculated their spread. There's no ongoing fee drag involved in an income annuity, and I'm competing against trying to perform net of fees, net of fee drag a traditional investment in the market, and we're talking about assets that are only held hostage to finance cash flow. We're not talking about long term investible assets, and we're not talking about a lump sum of emergency assets. When you understand that nominal returns based on average client behavior, average consumer behavior in the US economy in a 50/50 plan over 30 years is not even 3%, and you also understand that in today's world, trying to position a portfolio that generates a 4% return without any fee drag, that's discounted to tax if you have nonqualified money you've got some different taxing order that goes on, and you can mitigate inflation with an inflation protection built into the pay

The performance as it compares to nominal returns is greater than what one perceives, and it become not impossible but less likely that if you position these products appropriately, that you can beat what the performance is in these products based on what I've just described. When you consider again taxes and fee drag in the discount and the efficiencies that are created, I'm not saying that it's possible, I'm just saying they're very competitive pure returns.

21:53

JIM: I know you've coined the term, buy income, invest the difference, and I've become a real believer in that, and it took me a couple of years. I know you've developed software and you put the math and science behind these numbers, and you've proven to me that these are a worthy consideration in a portfolio for someone that is planning on getting a steady retirement income stream, it's not right for everybody and it's not necessarily something that everybody should put all their money in the one basket, don't misconstrue Curtis' comments on that.

What he's talking about is the money you need for a predictable income stream, this is definitely a worthy consideration because it takes the volatility of the market and the sequence of returns, and that risk that you have off the table for which you need month in and month out, but you're long term investments as you so well put still should be invested in long term strategies that you can buy and hold and look at those long term returns.

Curtis, one last question I have, and I know we're running a little long, but this has been awesome, what do you say to people, as you're looking at using insurance companies for these contracts. It's really the only place to get a predictable income stream by contract is through an insurance company. What happens if the company goes bus?

23:05

CURTIS: There are really three layers of protection to these products, and it's not generally understood, not even sometimes by those within the industry, how this works. First of all, you have the general claims of capability of the insurance manufacturer that backs the contractual payments that are promised inside these contracts. Understand that any time an insurance manufacturer provides a contractual insurance claim, I'm going to give you an example of some simple contractual insurance obligations that get created with an insurance contract.

For example, car insurance, if you have a wreck, there's a parameter that says after a deductible, here's what they're going to pay. On a home, same thing; same thing would be true of a disability policy or a life insurance policy. See, these are contracted obligations, and any time there's a contractual obligation of an insurance company offering such obligation, insurance company has actuaries that value the present value of those contracted obligations into present value today, and they generally, under the rules, have to have approximately $1.05 for every dollar of the actual present value.

Now understand, when you're buying an immediate income annuity or a deferred income annuity, unlike other types of annuities, you have an income, not an asset but an income stream that's being guaranteed and protected in the same way as a car policy, as a home policy, as a disability policy, and et cetera, and depending on how long before the payments begin, usually a much larger portion of the premium deposit that goes in those income annuities has to be actuarially reserved at $1.05.

If the company goes belly up, those reserve dollars, those statutory reserves that that insurance manufacturer is required to keep, is taken over, that block of investible assets is taken over by the domiciled insurance department of the state of that insurance manufacturer, whether that insurance manufacturer is domiciled, whatever state that is, that's the state insurance department that then takes over the responsibility of the assets of that insurance company, and they basically hire folks to manage the portfolio of the statutory reserves so that if a death claim comes in while they're looking for a suitable take over, they can pay the death claim. If a car gets in a crash, they can pay the car claim. If there's a house that burns down, they can pay for the house, et cetera, and the same way if an income annuity start date comes and goes, it's contractually ordered from the statutory reserves.

So only if those statutory reserves fail, do we get to the third level. Now, the third level involves the states which we cannot talk about to the public, but as long as you understand there is more than one level, if that insurance companies goes belly up, we still have these statutory reserve assets that are being monitored on a regular basis and they have to have roughly $1.05 of every actual present value in statutory reserves for that contracted obligation, and so these products are the safest products for an income cash flow that you can provide in an insurance issued instrument.

25:54

JIM: Curtis, I really appreciate you joining us today, and this has been awesome. Curtis has so much information that he shared with you today, and I hope that you take that to heart, because really today when you look at one of the biggest risks that people have in retirement, it's longevity, because the other risks that are faced, health care, inflation, volatility in the market, those risks we all live with day to day in retirement, but they are all compounded by the longevity risk, and there is no better vehicle to deal with longevity than a contract that guarantees you an income stream, whether you live 10 years, 20 years, or 30 years, or even more in retirement, it's a way of taking care of that risk.

So it's not the answer for everything, but you need to look at the new QLACs, especially with retirement accounts, individual IRAs, the 401(k)s, people have large balances in there. I know with a lot of clients that I work with when they're 70-1/2 they don't think they have to take the money out and they just kind of kick the can down the road, and all of the sudden if they don't need that money, they're paying unnecessary taxes on their social security and they're paying taxes on that money, and they wish there was a way they could push it off, well, now they have a way to do it, and being that that law just passed, you said it was in July of last year, right?

27:09

CURTIS: That's correct, July 2, 2014, was when the final regs were passed.

27:13

JIM: I know when I saw you back in January at a meeting that we both attended, you said there were one or two companies that had these types of products available that met the requirements. I'm sure in the next several months we're going to see a lot more companies come into the marketplace, so you're going to want to make sure that you take a hard look at that for your retirement dollars.

Curtis, thanks for joining us.

27:33

CURTIS: Jim, I might just add one quick comment, if you don't mind.

27:35

JIM: Sure.

27:36

CURTIS: There are technically three QLACs that now exist. There's 18 DIA contracts, every one of them are filing for QLAC status, so within the next two quarters we'll probably have a lot of variety, and there is a web site that would encourage you to go check out, incomeannuitiesforlife.com is a consumer web site. You can go out and test some quotes, and then there's a PBS special that's being played out across the nation at a variety of locations on your PBS network called the Don't Worry, Retire Happy, with Mr. Tom Hegna, and when you go to incomeannuitiesforlife.com, Mr. Tom Hegna will greet you with some commentary and a brief video that you can watch, and you can certainly go test some rates on that web site.

28:14

JIM: Awesome. Thanks again, Curtis.

28:15

CURTIS: Thanks, Jim.

28:16

JIM: Thanks for joining us this week, and tune in again next week as we explore another phase of the Real Wealth process, and remember, if anything you heard in today's show you'd like to get more information about, contact your Real Wealth advisor. Also if you feel that any of this information would be helpful to a friend or family member, just click the forward to a friend button.