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Income "Bucket Planning" is Just a House of Cards

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For years I have had many intuitive thoughts regarding the weaknesses of the income planning strategy that uses staggered or laddered annuities scheduled for annuitization; also referred to as "bucket planning." I have been very concerned that consumers who are buying into this strategy (and the agents who are using it) are unaware of the far less problematic alternatives available to them for income planning.

The concepts that are implemented in a buckets strategy have many failings. First, using average rates of return for the forecasting of future values has many weaknesses in itself. The use of average returns implies a steady rate of return earned each and every year; however, this is not the way the stock market creates returns. The returns vary, sometimes greatly. In an income planning scenario, if a concentration of negative returns were to occur (in the case of an EIA, a zero percent return) there could be an erosion of the principal value. If the erosion is too great, the plan becomes doomed to fail because the interest earned in future years is never enough to compensate for the income needs of the client. Like a house of cards, the use of average rates of returns implies certainty where none actually exists. But there are superior methods available: Monte Carlo Simulations and historical back testing.

Second, annuitization of laddered deferred annuities also implies safety and security for the customer where it doesn't exist. The mere fact that the income from a future annuitization schedule is guaranteed incorrectly implies that the client will receive that income amount, guaranteed. This is a small matter of contention for advisors, but it is a large one in the client's mind, who feels the schedule is a promise of future income. Since the deferred growth is being projected based on an average rate of return, there is little, if any, confidence of the promised income projection becoming reality.

Third, the idea that the reduction of income taxes for non-qualified accounts provides substantial benefits for the customer is overblown. I do agree that the exclusion ratio provided by the annuitized income does reduce the taxable income; however, the exclusion ratio actually decreases incrementally for each leg that is annuitized because the cost basis decreases. I also agree that the greater the client's income, the more his Social Security becomes taxable, but in my analysis the tax savings were minimal and never compensated for the loss of interest earned had the entire principal been in a deferred state. Additionally, due to the reduced cost basis of the final bucket or leg — the deferred annuity — the tax implication to a beneficiary is exacerbated. In the case of bucket planning I found no tax benefits to the beneficiary.

My research is summarized below. For a copy of the complete 20-page analysis, please use the "Contact this Author" link at the bottom of this article and I'd be happy to send it to you.

For the bucket-planning scenario, I chose to use commonly sold EIA products that in literature received from a national FMO, were specifically recommended for agent use in bucket strategies (for exact products used, refer to the Bucket Analysis white paper).

Bucket Planning Scenario

Bucket/ Leg	Income Years	Annuity Type
Leg #1	1 - 5	Immediate Annuity
Leg #2	6 - 10	Deferred EIA Annuity

Leg #3	11 - 15	Deferred EIA Annuity
Leg #4	16 - 20 Deferred EIA Annuity	
Leg #5	20+ Replacement	Deferred EIA Annuity

For the annual withdrawal scenario, I used a deferred EIA product selected after analysis made using specialized software. This is also disclosed in the white paper.

The white paper analysis included $50,000 of savings assets that are either entirely qualified or entirely non-qualified. Income produced from the qualified investments was taxed at an annual rate of $2,000. This applied to the entire income from the withdrawal plan and qualified bucket plan.

Annual Income Schedule

Non-qualified Bucket	Qualified Bucket	Deferred EIA
$ 20,000	$ 22,000	$ 22,000

The analysis covers two 20-year time periods: 1970–1990 and 1985–2005 to test the plans over two very different market environments. I have shared the results of the latter period here.

My initial thoughts about the problems with bucket planning were realized as I concluded my study. I found no empirical evidence that the bucket planning strategy offers superior income planning results for a very typical client scenario. My hope is that that you can take these results and allow them to impact your future income planning solutions.

Non-qualified Account Results

Scenario 1985 - 2005	Bucket Strategy	Withdrawal Strategy	Difference
Ending Value	$1,126,141	$1,466,683	$340,542
Tax Basis	$269,699	$480,000	$210,301
Beneficiary Tax (40%)	$342,576	$394,673	$52,097
Net Total (After Tax)	$783,565	$1,072,010	$288,445

Qualified Account Results

Scenario 1985 - 2005	Bucket Strategy	Withdrawal Strategy	Difference
Ending Value	$1,029,754	$1,466,683	$436,929
Tax Basis	$0	$0	$0
Beneficiary Tax (40%)	$411,902	$586,673	$174,771
Net Total (After Tax)	$617,852	$880,010	$262,158

The evidence and analysis clearly points to the use of a deferred annuity, and that meeting income needs with simple withdrawals is superior to bucket planning. In the analysis, every benefit was given to bucket planning. However, not only is there substantially less money at the end of all 20-year scenarios, but the draw-down on bucket planning is also greater. This leads one to the conclusion that not only is the bucket strategy inferior in regard to prospects for growth, but it also carries greater risk. This makes it highly inefficient: truly a financial planning house of cards.

One final comment. It some have proposed to enhance the bucket strategy by using stocks as the last bucket for clients who need more income than is reasonably possible from savings vehicles (annuities) alone. Proponents feel empowered to recommend stocks in a bucket strategy because the NASD allows projections of stock returns at an average annual rate of 12 percent. However, a 12 percent annual constant rate projection is worthless, if not entirely misleading.

In all fairness, there are some additional phantom benefits to using stocks, which include a reduced taxability on the gains, but as my mother used to say, “Many a slip between the cup and the lip.” Tax rates change. The market fluctuates. The tax rate that is now lower may be higher at the time of

account liquidation, or the variance of the stock market returns (such as those seen in recent times) may be such that the stock account is 40 percent less than the prior year. Yes, a sharp stock market correction can certainly help to eliminate taxes since there is less gain.

The point I am trying to make is that stocks used within a bucket strategy are subject to many problematic issues, namely that all the investable assets are segregated for use only in the stage they are appropriated to. The developers of Modern Portfolio Theory assert that the benefits of diversification come from the combination of varied investment performance, making way for the benefits of portfolio rebalancing. Well-known studies have shown that rebalancing can increase a portfolio's return by as much as three percent a year. When stocks are used within a bucket strategy, they are isolated and therefore all interrelated activity with other asset classes is eliminated.

In conclusion, please don't find yourself lured to the potential returns offered by the use of average rates of return in income planning, as it can be disastrous for both you and your clients. Monte Carlo Simulations (which applies randomly selected rates of return in random order) and historical back testing (which looks at actual returns over different time periods) are far superior methods. I'll discuss these methods in detail next month.

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