Behold! The Mortality Credit

Five 95 year-old widows are sitting around a kitchen table, drinking tea, and reading the June 2010 issue of *LIFE&Health Advisor*. As the group was concluding their discussion as to why the current issue was the best the group had read in quite some time, Hilda had an idea.

"I saw on bankrate.com that 1 year CDs are yielding 1.58%. Why don't we each kick in $1,000 and when the CD matures, split the money among those of us who are still standing?" Her four friends quickly agreed.

Shortly before the CD matured, Gertrude, who was particularly observant of actuarial tables, passed on. A few weeks later, as Gertrude's four friends were basking in the nearly 27% return on their risk-free investment, Hilda poured a second cup of tea and sighed, "Ahh, the power of mortality credits!"

While, the power of mortality credits is more dramatic with 95 year olds in a tontine (a conceit stolen shamelessly from Moshe Milevsky), they can still be useful income boosters in any retiree's portfolio. Why then, don't more investors share Hilda's appreciation for them?

The most common product that employs mortality credits is the life-contingent immediate annuity. The objection most frequently cited to immediate annuities (life-contingent or otherwise) is "loss of control". Why is fear of "losing control" so difficult to overcome? Consider the cohort now on the cusp of retirement:

In their working lives, the onus for financing their retirement security shifted from their employer and the government to them. They responded by diverting a meaningful chunk of their paycheck to fund this gap. Now as they surrender their ID badge, they surrender their ability to generate a paycheck and must rely upon a lifetime of forgone spending to sustain them against an unpredictable future. Asking them to hand over 10%, 20% or 30% of their portfolios to an insurance company upon retirement is asking them to perform some pretty remarkable psychological gymnastics.

While it is easy to empathize with retirees' desire to maintain "control" over their assets, we need to start helping investors understand that "control" is largely illusory. Let's look at control in the context of selecting investments, ongoing portfolio management, and mortality.

Selecting investments

Many investors choose actively managed funds. Most will have wished they didn't. There are several "it is easier for a camel to pass through the eye of needle than a money manager to consistently outperform an index" statistics one could cite. Consider these from Standard & Poor's:

Fund Category	Benchmark Index	Percentage of funds that under-performed benchmark 2004-2008
Large-cap	S&P 500	71.90%
Mid-cap	S&P MidCap 400	79.06%
Small-cap	S&P SmallCap 600	85.45%

Ongoing portfolio decisions

DALBAR's 2009 Quantitative Analysis of Investor Behavior found that investors consistently underperform the market. As illustrated in Figure 1, for the 20-year period ending in 2008, investor returns did not even keep up with inflation.

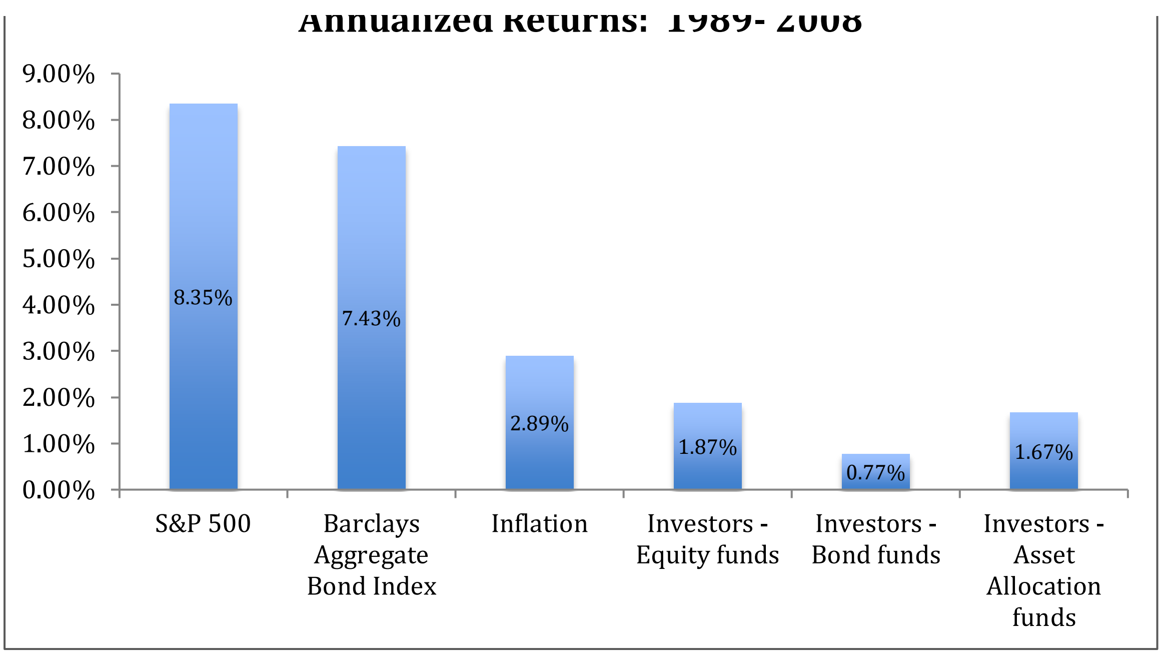

Figure 1. Source: DALBAR's 2009 Qualitative Analysis of Investor Behavior (QAIB)

It is not fund managers underperforming indices, but investor behavior that is to blame for these dismal results. The QAIB found that the average mutual fund holding period during the time frame averaged from 3.18 years for equity funds to 4.26 years for asset allocation funds. Investors were done in by the erroneous belief they could beat the market (greed), or selling at the wrong time (fear).

Relative performance of annuities
Based on the rates quoted by www.immediateannuities.com in May 2009, a $100,000 single life immediate annuity would pay a 65 year-old $661 per month for life. This works out to an annual return of over 7.9%. At ages 70 and 75, those annual returns increase to 9.1% and 10.7% respectively. Mortality credits allow investors to earn equity-like returns without the volatility or market risk. If interest rates increase from their current historic lows, the effective returns of immediate annuities will be higher.

<u>What about my heirs?</u>
Most investors have a bequeath motive. Since life-contingent payments end upon the insured's death, mitigating longevity risk and bequeathing assets appear to be mutually exclusive goals. That is not necessarily the case.

Meet Bob. When Bob retired at 65, he had has amassed a retirement nest egg of $1 million, allocated 60% to the S&P 500 and 40% to the Barclays Capital U.S. Treasury Index. He planned on withdrawing about $40,000 per year to meet expenses in excess of Social Security, and figured those expenses would increase by about 3% annually. Bob was feeling pretty good about his plan.

Unfortunately, Bob's retirement party coincided with his millennium party. At the end of his first decade in retirement, Bob's portfolio is worth about $590k.

Will Bob's savings get him to his 100th birthday?

One way to address this question would be employ a sophisticated model to give us the likelihood of success at different confidence levels. Let's instead keep it simple and assume the next 25 years looks exactly like the last 25 years. Should that come to pass, Bob will be penniless by age 90.

If instead of electing to "control" his entire retirement portfolio, Bob allocates 1/3 of his nest egg to a life-contingent annuity upon retirement, holding everything else the same, he will have about $960k when his original portfolio flamed out. At 100, he will still have more than $285k. What about his bequeath desires?

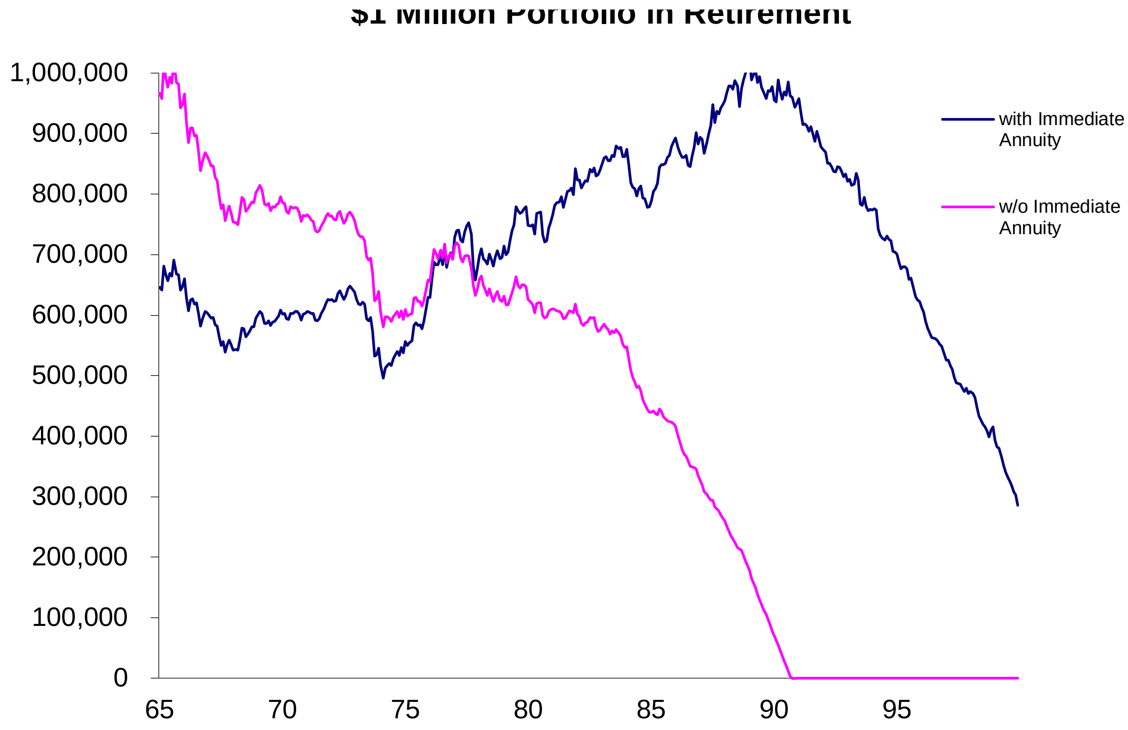

Figure 2. Source: String Financial, LLC

As Figure 2 illustrates, not only does the annuity provide longevity protection, but it also enables a greater bequest if Bob dies at any time after age 75 than if Bob maintained full "control" of his assets. The loss Bob's heirs would experience if he dies unexpectedly early is modest compared to the gain they (and, more importantly, Bob) reap if he lives to a ripe old age.

This is but a single scenario. The point is not that immediate annuities belong in every portfolio, but that many objections are based on misconceptions. If we can help investors better understand the costs, benefits, tradeoffs, and risks inherent in all of their options, we can help them make better decisions.

To achieve the lofty goal of preparing investors to enjoy retirement, the industry needs to rethink its approach to education and companies need to recast themselves as solution providers. The product-centric approach the industry has historically pursued has allowed confusion to flourish. Most investors (and too many advisors) cannot differentiate between SPIAs, and EIAs, VAs, or FAs; they are all part of the same confusing alphabet-soup of "annuities", about which they know little more than to be wary of those who coming bearing them.

Since we are a nation of under-savers, mortality credits should play a more prominent role in the retirement income solution. However, until we figure out how to connect with investors, they cannot be optimally leveraged. It is, to be sure, a mammoth challenge. As early education efforts fell short of expectations, it is not difficult to understand why individual insurers have shifted their focus to making income products more palatable. Providing access to principal or death benefits placated investors' objections and makes products easier to sell, but in neutering the mortality credit, many investors are not as well served.

Insurers are uniquely equipped among financial institutions to help retirees manage the risk of outliving their assets, but to capitalize on their inherent advantages, they must be willing to get creative and try new approaches to help investors appreciate the power of the mortality credit.

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