Why Are Income Annuities Underutilized?

With the disappearance of private sector pensions and retirement longevity rivaling that of careers, income annuities should feature prominently in retirement portfolios. They don't. Investors age 65+ have about $7 trillion in retirement assets. According to LIMRA, only about $12 billion of income annuities were purchased in 2018 (less than 2/10th of a percent of retirement assets). What explains investors' reluctance to purchase income annuities? Two frequently cited reasons[1] are:

1. Fear of giving up "control"
2. The belief that guaranteeing income and leaving assets for your heirs are competing goals

The Illusion of "Control"

Whether it is driving skill, sense of humor, or investing acumen, people consistently overestimate their abilities (a phenomenon known in psychology circles as "cognitive bias of illusionary superiority"). People are hesitant to turn their assets into income because once that happens, they will no longer be able to control their assets; all they'll get is a check every month. Most people think "*I can probably do better myself.*" The data show they can't.

Since 1994, DALBAR has been comparing the returns investors actually realize (a function of the investments the choose and when the decide to buy and sell) against equity and bond indices. The results are always the same; investors, left to their own devices, always do worse than the index. In the 20-year period between 1997 and 2016, the S&P 500 returned an average of 7.68% per year. DALBAR found the average equity fund investor earned 4.79% over that time period. On a $100,000 investment, maintaining "control" would have cost the typical investor $184,323 (42%), compared to simply buying the index and doing nothing for the next 20 years.

Investing skills aside, "control" is illusory. Investors can decide to buy and sell, but they have no control over which way the market goes. Absent risk-free investments, investors cannot control how much money they will have in the future. By contrast, an immediate annuity gives you *complete control* over how much money you will receive. If you buy an annuity for $X, you will get $Y per month, every month.

Income vs. Inheritance: a False Dilemma

Many retirees have the dual goals of generating income and wanting to leave assets to their heirs. Because most income annuities are life-contingent, many investors intuit that income annuities necessarily reduce the amount available to bequeath to their heirs. However, because income annuities reduce the amount you must draw down from your savings, the opposite is often true, particularly the longer one lives.

The case study below compares a traditional drawdown approach to two strategies using income annuities and illustrates a range of outcomes for both income security and bequeath motives.

[1] The baggage strapped to the word "annuity" may be a greater challenge still, but that is the topic of much longer article.

Case Study: Doris

Meet Doris. Doris is 65 years-old, divorced, with three adult children living in different parts of the country. Doris has been a cyclist for many years, and is looking forward to beginning competitive bike racing and visiting her far-flung children in retirement.

Doris has amassed a retirement nest egg of $1 million invested in a conservative mix of blue-chip stocks and high-quality bonds. She estimates that all-in, her expenses will be about $6,000 per month, and she will receive $2,540 from Social Security. Like most retirees, Doris is concerned about making sure she doesn't outlive her assets, while at the same time would like to leave something for her children and, hopefully one day, her grandchildren.

Doris is considering 3 options for meeting her $3,460 in monthly expenses in excess of Social Security:

1. Drawdown on her retirement savings
2. Purchase an immediate annuity that will provide her with $3,460 of monthly income for life. The cost of the immediate annuity is $615,000.
3. Purchase a Guaranteed Income Ladder® for $725,000. $615,000 is used to provide Doris with $3,460 of lifetime monthly income now, and the remaining $110,000 is used to purchase additional lifetime income in roughly equal installments every 5 years until age 90.

Results

Figure 1 illustrates the risk of running out of money under each strategy. While the risk under the drawdown strategy may be tolerable until age 90, the chance Doris becomes penniless rises to 1 in 3 by age 100. An immediate annuity reduces that risk by two-thirds, and the income ladder reduces the overall risk of ruin by age 100 to less than 2.5%.

	Risk of running out of money at…		
Strategy	**Age 90**	**Age 95**	**Age 100**
Drawdown	5.5%	19%	33%
Immediate annuity	0%	2%	10.5%
Income ladder	0%	0.2%	2.5%

Figure 1

Figure 2 illustrates the inheritance values assuming median returns*. If Doris only lives to 90, the drawdown strategy will leave heirs with a 30% to 45% larger inheritance. However, as the risk of ruin increases at age 95, the difference falls significantly. By age 100, the results flip and Doris' heirs would stand to inherit more under either of the annuity-based strategies.

	Median inheritance value at…		
Strategy	**Age 90**	**Age 95**	**Age 100**
Drawdown	$1,030,000	$925,000	$676,000
Immediate annuity	$785,000	$805,000	$800,000
Income ladder	$640,000	$705,000	$795,000

Figure 2

Figure 3 illustrates the inheritance values if returns come in at the 25th percentile. In all cases Doris heirs would do as well or better under the annuity-based strategies. Under the drawdown strategy, Doris would be out of money before 100.

	Inheritance value at 25th percentile at…		
Strategy	**Age 90**	**Age 95**	**Age 100**
Drawdown	$485,000	$190,000	$0
Immediate annuity	$500,000	$435,000	$300,000
Income ladder	$450,000	$450,000	$445,000

Figure 3

**See "Assumptions"*

Final Thoughts

No investment strategy is appropriate for all investors in every situation, and income annuities are no exception. However, the objections against their use are oftentimes misplaced. The tension between guaranteed income and investors bequeath motives is understandable, and the idea that income annuities can often help preserve assets to pass on heirs is counterintuitive for most investors. The industry needs to more effectively communicate that income and asset preservation are not mutually exclusive goals. The issue of "control" will be more challenging to overcome because it is rooted not in the product itself, but in human nature. Providing investors with tools they can use to see for themselves how different income annuity options might impact their retirement outcomes can help address that need to control their own destiny.

About the author

Jay DeVivo has been enamored with the mortality credit since reading Moshe Milevsky's paper on the Advanced Life Delayed Annuity. He is the Founder of CoFunder where he is evaluating opportunities in InsurTech and consulting with startups. Jay also leads the Risk Management function for a large reinsurer of variable annuities. Previously he ran a consulting business, working primarily with venture-backed startups helping clients refine their go-to-market strategy, negotiate partnerships, and manage early stage product development. Prior to that, Jay worked in early-stage venture.

Assumptions

- Market returns were run using a stochastic model of 1,000 monthly scenarios over 50 years using an average annual return and volatility of 6% and 8%, respectively.
- Social Security COLA was assumed to be the 10-year average of 1.36%.
- Inflation was modeled at 2% per year.
- Annuity income was modeled using data from www.immediateannuities.com.
- The Guaranteed Income Ladder© returns amounts not annuitized before age 90 as a death benefit to beneficiaries.

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