Puzzled?

Solve the Mystery of Low Income Annuity Sales

By Lowell Aronoff

There are few concepts on which academics or economists agree, yet virtually all experts agree that an optimal retirement income portfolio for most retirees would include a large portion of assets invested in income annuities (also known as Single Premium Immediate Annuities, SPIAs or Fixed Immediate Annuities). However, as crucial as these income annuities are, sales do not reflect this need. So how is the industry reacting to this information and actively addressing these issues?

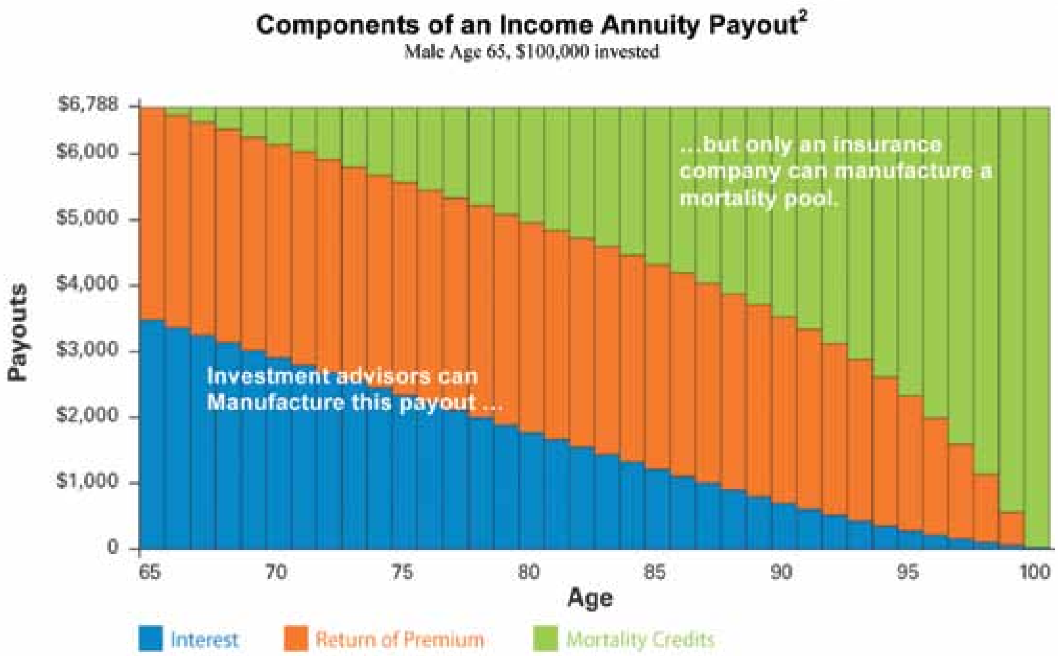
A decumulating portfolio must be managed differently from an accumulating portfolio because when the client stops working or generating new assets the portfolio becomes subject to new risks, including:

1. Longevity - the risk of outliving assets is best mitigated when the clients work longer into their retirement years;
2. Inflation - while most salaries keep up with inflation, retirement portfolios must be managed to do so;
3. Market volatility – this can be advantageous when accumulating for people who are saving regularly; through dollar cost averaging they tend to buy more shares when the market is down. The same forces cause clients that are not actively managing their decumulating assets to sell more shares to meet their financial needs in a down market;
4. Impulsively buying items beyond the client's means is a human frailty that has a much bigger impact when assets are no longer growing.

Including income annuities in a client's portfolio can help mitigate all these risks. Furthermore, retirees appreciate the additional income they receive from income annuities and the guaranteed paycheck for life – an attribute of income annuities. Many studies have shown that retirees are more concerned about running out of money than they are about death[1]. DB Pension clients, whose retirement income is promised as an income annuity, tend to keep the annuity when given a choice.

Income annuities *always* provide more income than bonds with similar risk and duration profiles. (see graph), because in addition to providing income from principle and interest, an annuity adds 'mortality credits' – the effect of risk pooling. When a member of the pool dies, their assets go to the other members of the pool.

[1] National Underwriter, June 2011



Studies show that people who own income annuities are happy with the product and are happier in general[3]. *Macromonitor* found that retirees who purchased income annuities were 2 ½ times as likely to be satisfied with their household's current financial situation and their ability to meet long term financial goals[4]. This may be because using income annuities may provide a welfare gain of up to 16% for a 65 year old[5].

So if retirees ***need*** income annuities, ***like*** the features the product provides and are happy when they purchase the product, why are sales so far below market need?

The Annuity Puzzle

This question has been the subject of considerable academic research for the last half century – since a mathematician showed that in the absence of a bequest motive and a few other minor constraints, a retired investor is always better off with an income annuity than a portfolio of bonds[6]. Yaari could not explain the lack of sales and famously called this contradiction "The Annuity Puzzle."

In recent years, significant progress has been made in understanding this puzzle, as well as some progress in addressing the issues. This progress has arguably resulted in regular increases in recent sales—including a 7% increase in sales[7] in the past year—despite the product, like long term bonds, being more expensive than at any time in the last half century.

More needs to be done to help consumers make better retirement income decisions. There are three categories of challenges:

1. Behavioral finance issues;
2. Aligning income annuities to advisor practices; and
3. Awareness and Educational issues.

Behavioral Finance Theory vs. Traditional Economic Theory

In the last decade, work in the field of Behavioral Finance has shown the belief that people always act in their own best interests, a core tenet of traditional economic theory, is wrong. People are more complex than traditional economists would have us believe. We want to make decisions that improve our well being, but our emotions often get in the way. Here are just a few examples of how these emotions lead to suboptimal retirement income choices:

Avoidance:

Retirement income planning is scary, complicated and daunting because it involves a major change in life and finances in ways that most consumers do not understand, at an age or when we're set in our ways. It's easier to avoid than address. A recent survey showed that 94% of retirees would rather change a dirty diaper than plan their financial future[8]. But it's not surprising that people avoid making irreversible decisions they don't understand at an age when their ability to learn new things has declined. We have

[2] New York Life and David Blake
[3] Panis, 2003
[4] Macromonitor, 2008-9
[5] Yogo, 2011
[6] Yaari, 1965
[7] LIMRA, 2012

tools which break key concepts into manageable chunks to help children with learning disabilities. These methods can potentially help teach seniors how to improve their welfare in retirement.

Loss Aversion:
Most investors feel the pain from a financial loss about twice as acutely as the pleasure from a financial gain[9]. Furthermore, retirees are five times more risk averse than most investors and giving up control of their money is viewed by many as a type of loss[10]. This loss of control is often cited as the most important reason retirees give for their reluctance to buy income annuities[11]. But a portion of most clients' assets is needed to cover their essential expenses for the rest of their lives. If they spend these assets, retirees have a high probability of destitution in old age. In other words, clients need to understand that they do not have real control over the assets required to meet their essential expenses, so they are not giving up anything by locking into an income annuity. For many clients, the potential of a financial loss due to an early death trumps the much higher probability of destitution in old age. To address this, the industry has been focusing on the sale of Cash Refund annuities which guarantee that the annuitant will never lose money. The industry is also developing more products with liquidity features to mitigate the perceived loss of control felt by many consumers that buy income annuities.

Framing:
When income annuities are framed as guaranteed income that cannot be outlived, they are perceived as safe and desirable. But when the same product is presented as an investment, it's perceived as risky because the annuitant may 'get hit by a bus'[12]. With new income planning tools that look at the client holistically, the industry is beginning to assess investments impact on the success of the client's whole retirement portfolio and rely less on inaccurate client perception of risk. In other words, while we need to acknowledge the client's concern of a financial loss in the event of an early death, we need to put this in the context that the same income annuity which generates poor returns in the event of an early death will generate very high returns if the annuitant lives a long life. More importantly, it will help mitigate the risk of destitution in old age.

> "The industry is also developing more products with liquidity features…"

There are many other ways in which human perceptions and emotions push us into suboptimal retirement income portfolios. The best advice is provided by licensed advisors trained in retirement income planning, because only advisors can take individual needs and emotions into account when developing a retirement income plan. Properly addressing retirement income is more complex and requires more advisor time than addressing an accumulation portfolio, but advisors are often not as well compensated for this effort. By selling an income annuity, the advisor may be doing what's best for the client but it often doesn't feel that way, because the client's consolidated statement shows a decrease in assets and the advisor reduces his Assets Under Management (AUM), a key statistic which many advisors use to measure their overall success as an advisor. To address this issue, a RIIA committee consisting of the largest carriers, distributors and vendors in the income annuity industry has recently agreed upon a standard method of valuing income annuities. Detailed information on this new method is available from CANNEX's web site. This standard value should form the basis of AUM credits for income annuities sold by advisors and should, with time, find its way to client consolidated financial statements.

To optimize their retirement income portfolios, both retirees and their advisors need to be aware of the unique features that income annuities provide. They also need to have access to high quality, unbiased, dispassionate tools that provide information specific to individual client circumstances and break down the education of a large number of issues into manageable chunks, ideally available in multiple media, all this while refraining from pitching any particular product. To address this, NAFA has teamed up with several other organizations to form the Society for Annuity Facts and Education (SAFE). Tools to address the need for retirement income and income annuity education will be available to the public at no charge from fixedannuityfacts.org in the near future. ■

Lowell Aronoff is CEO of CANNEX Financial Exchanges Limited, an organization that facilitates the sale of a variety of financial products. CANNEX compiles data and calculations about a variety of financial products and makes that information available to subscribers. Lowell focuses most of his energies on fixed income annuities and how they fit into a client's holistic income plan. For more information, visit www.cannex.com.

[8] MORI, 2011
[9] Kahneman and Tversky,
[10] Eric Johnson
[11] LIMRA Retirement Income Preferences, 2006
[12] Jeffrey Brown