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Why Some People Do (And Don't) Use Annuities

By Tamiko Toland

Annuities are uniquely positioned to save average Americans in retirement! Annuities are a rip-off! Wait, which is it? There is more going on here than a food fight over the validity of the annuity value proposition.

I hear wildly divergent opinions about annuities and, often, cautiously narrow framing of the few circumstances under which "good" annuities are useful. Like most products, the field of annuities is broad, with varying designs, features, and benefits that can potentially solve one or many client needs. Don't assume they all work the same way: most serve a financial plan best when used for a specific purpose, whether it is for guaranteed income, guaranteed returns, a guaranteed floor, or a guaranteed death benefit.

This is as far as I will go here talking about the nuances of annuities and their ideal implementation because these (important) facts are only part of the story. The other part is the reality that familiarity with an investment plays a significant role in what people prefer to use or not use in the financial planning process.

For annuities in particular, one key factor to bear in mind is continual innovation over the last two decades. The proliferation of products and features breeds confusion and also means that a well-aged objection may not apply today, assuming it did in the first place.

The Curse of the Familiar

Behavioral finance research shows that people gravitate towards familiar investments, often to the detriment of diversification. We found the same results in the Protected

Retirement and Income Planning study conducted in 2021 in partnership with the Alliance for Lifetime Income. Specifically, we asked the question: "A new investment opportunity has developed in an industry or area that I have a lot of knowledge in."

Half of consumers said this situation would influence them a fair amount or more and another 30% admitted it would influence them "a little." And financial professionals are not immune from the effect of familiarity bias, either. This piece, by Prof. Vicki Bogan at Cornell's Dyson School, explains how it affects both individual investors and investment professionals.

What does this mean for annuities?

Ultimately, most people —investors or financial professionals—are going to turn to familiar solutions for protected growth or income. This means that they may prefer bonds or bond funds for safe accumulation even if an annuity offers a competitive risk-adjusted return. Or they might consider a bond ladder or dividend stocks to generate income even if an annuity provides income that is guaranteed and will not fluctuate in the future.

The Boon of Confidence

In the context of research, familiarity bias is an impediment to good investment practices—and it certainly is when people simply ignore a sound strategy that otherwise makes sense. However, maybe we need to cut people some slack when it comes to an investment that is complicated or tricky to implement. In that case, ignorance is far from bliss.

The unfamiliar may carry real unknown risks, not phantom prejudice. There are many kinds of annuities and even a single flavor can come with an array of features that have their own rules and restrictions. Nobody wants to make a costly mistake in selecting the wrong contract or missing a key provision.

Understandably, the unfamiliar looms intimidating and risky. Even if somebody accepts the premise that an annuity can give a better outcome in a plan, without adequate information, it is perfectly rational to be reluctant to take the leap. These decisions are best made with confidence, which is the benefit of familiarity rather than the curse.

Across the board, the barrier to sufficient product knowledge can be very high. Furthermore, for financial professionals, how well integrated are annuities into the planning process? And what kind of support is available for selection and configuration? These may seem like picayune concerns, but these practical considerations are crucial for the real-world implementation of any investment or product, not just annuities.

Better integration and transparency of annuities are not just helpful but necessary if we expect people to use them more. Despite their complexity, it is possible to simplify and quantify the value proposition for accumulation or income. Developments in technology are significantly moving the needle on this objective, but we still have a long way to go.

Sure, there are strong biases that still keep many people away from annuities. Fundamental education on how they can be beneficial is indispensable but so is the acknowledgement that it is not irrational for people to be reluctant to use an unfamiliar solution that comes with a commitment of years—or a lifetime.

Are you one of those naysayers? If so, I hear you. Annuities have changed (continually) over the past few decades and your skepticism is healthy. These products have gotten more confusing and also more specific to the use case. That may make it harder to get comfortable using an annuity, but it's worth it because they can really help a lot of people, especially those who want to escape uncertainty in retirement.

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