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The Real Value of Annuities for Mass Affluent Retirees

Morningstar finds annuities offer little benefit to retirees at low risk of going broke. But there's more to the story.

By **Jason Fichtner and Michael Finke** | October 31, 2022

Recent research released by Morningstar (https://www.morningstar.com/lp/lifetime-income-strategies-assessment) addresses the potential benefits of annuities in defined contribution (DC) retirement plans. This is a much-needed analysis at an important time when many employers and/or advisors are considering whether to add an annuity (https://www.thinkadvisor.com/2022/10/25/4-major-themes-that-will-shape-the-dc-retirement-market-in-2023/) to a DC plan.

The authors primarily judge the benefit of annuities using a failure rate method, which measures the probability of running out of savings (https://www.thinkadvisor.com/2022/10/18/even-millionaires-worry-about-being-able-to-retire-comfortably-natixis/). Failure rate analyses are an imperfect measure not commonly used by economists to estimate optimal retirement income strategies (https://www.thinkadvisor.com/2022/08/31/income-for-life-strategies-to-avoid-running-out-of-money-in-retirement/).

The Morningstar report provides an excellent overview of retirement income planning options, and we wholeheartedly agree with the conclusions that more Americans should bridge spending to delay claiming Social Security.

We agree with many of the broad conclusions of the report, but question the analytic findings that compare the value of annuities to investments for most retirees — especially mass affluent investors for whom Social Security cannot come close to replacing their pre-retirement lifestyle. The report concludes that annuities “do not add much value when a participant is already well-prepared for retirement.”

These findings are not consistent with our own analyses (https://www.protectedincome.org/research/welfare-improvements-from-default-annuitization-in-defined-contribution-plans/), nor do they reflect findings from the existing economic literature on optimal annuitization.

One of the most widely cited articles in this literature, “Annuities and Individual Welfare (https://www.aeaweb.org/articles?id=10.1257/000282805775014281)” (co-authored by Nobel laureate Peter Diamond) finds that partial annuity strategies are optimal and the failure to annuitize is likely driven by “psychological or behavioral biases.”

Another Nobel laureate, Richard Thaler, described the low rates of annuitization among American retirees as the “annuity puzzle (https://www.nytimes.com/2011/06/05/business/economy/05view.html).”

The consensus among economists is that retirees would be better off with more annuitized income.

The Consequences of Failure

Failure rates merely show the probability of running out of money while ignoring the consequences.

Consider two retirees. Mary has a pension and Social Security that provide a combined $60,000 of annual income. John only has $25,000 in Social Security. Are the consequences of running out of savings the same for Mary and John? Is John worse off if he buys an annuity that increases his lifetime income to $60,000 but increases the probability of running out of savings?

Probability of success can be misleading and provides guidance that is clearly suboptimal when making decisions around guaranteed income.

If we use the probability of success to determine the optimal initial withdrawal rate from a portfolio, the recommended spending level would be the same whether the retiree is already receiving $10,000 or $100,000 in guaranteed income. By definition, the withdrawal rate should be greater (https://www.financialplanningassociation.org/article/journal/NOV18-anuitized-income-and-optimal-equity-allocation) if the existing level of guaranteed income is higher because the overall magnitude of "failure" is lower.

In other words, retirees with a greater base of guaranteed income or a lifetime withdrawal benefit from a portfolio will optimally spend more each year than a retiree who faces the risk of a sharply lower lifestyle if markets fall.

Perhaps the greatest value of partial annuitization is simply the ability to optimally spend more each year from savings free of the worry that poor market returns or a long lifespan will jeopardize a retiree's lifestyle.

Retirees gain no benefit in expected lifestyle by bearing the idiosyncratic risk of spending with an unknown lifespan. Annuities improve efficiency by allowing these retirees to transfer this risk to an institution, and by transferring this risk they can achieve a more secure retirement. Our concern with these analyses is that retirees won't live as well as they could in the absence of income guarantees.

It's exciting to finally see the growing interest in annuities today among both DC plan sponsors and financial advisors. The attention toward the merits of annuities and how they can play an important role in allowing retirees to spend more with less risk by protecting against the idiosyncratic risk of unknown longevity is long overdue.

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