ANNUITY ANALYTICS

BY BOB SEAWRIGHT

GAO Report: Buy More Annuities!

THE UNITED STATES GOVERNMENT Accountability Office recently released its long-awaited (and long!) report on retirement income — *Retirement Income: Ensuring Income throughout Retirement Requires Difficult Choices*. The GAO is an independent, nonpartisan agency that works for Congress and investigates how the federal government spends taxpayer dollars. The headline conclusions of the report are pretty straightforward: Consumers should delay taking Social Security and buy more annuities.

To conduct the study, the GAO created sample retiree profiles at varying income levels and then asked various experts within the financial services industry, academia and an unnamed retiree interest group what they would do to protect their income over the long haul. The GAO was careful not to offer advice directly, but describes the expert advice in some detail and does not offer conflicting viewpoints, allowing us to see the apparent GAO view by inference. The experts recommended familiar strategies: (1) retirees should delay the start of their Social Security benefits; and (2) retirees should consider buying income annuities to cover some basic expenses for the rest of their lives.

The GAO began by stating the obvious: "The risk that retirees will outlive their assets is a growing challenge." For consumers facing fewer and at-risk traditional pension plans, increased life expectancies, highly volatile financial markets and substantial losses to home equity over the recent past, "growing challenge" seems like a major understatement. Indeed, a husband and wife who are both 65 years old have roughly a 47 percent chance that at least one of them will live until 90 and, according to data from the Employee Benefit Research Institute, roughly half of near-retirees today are likely to run out of money and not be able to cover their basic expenses and uninsured health-care costs later in life.

Given that difficult reality, delaying Social Security to obtain a better payout makes great sense. Social Security allows recipients to take reduced payments as early as age 62 while providing "full benefits" at age 66 for those born from 1943 to 1954 and extending to age 67 for those born in 1960 or after. Social Security also provides for increasing payouts for those who delay taking benefits up to age 70. Since monthly benefits received at age 70 are increased by at least 32 percent compared with taking them at age 66, the study recommends waiting. But this is a choice that is rarely selected. In fact, nearly three-quarters of people begin taking Social Security payouts prior to age 65.

Obviously, delaying Social Security is good advice for those who can afford it or who have up-to-date skills and good health. In 2010, more than 29 percent of Americans aged 65 to 69 worked at least part-time and nearly 7 percent aged 75 or older were employed. But simply working longer is not always an option as the vagaries of health and the job market cannot be controlled. Sadly, the real picture does not always look like that depicted in retirement planning commercials.

For most retirees — 64.8 percent according to the GAO — Social Security is the primary source of household income. Unfortunately, too few retirees supplement Social Security with other forms of guaranteed income. An immediate (income) annuity purchased from an insurance company guarantees income for life. These can help to protect a retiree against the risk of underperforming investments, "sequence" risk, longevity risk and, when an inflation-protected annuity is purchased, the risk of inflation diminishing purchasing power. As the GAO points out, "annuities provide income at a rate that can help retirees avoid overspending their assets and provide a floor of guaranteed income to prevent unnecessarily spending too little for fear of outliving assets." Moreover, "annuities can also relieve retirees of some of the burden of managing their investments at older ages when their capacity to do so may diminish…." That's why they make so much sense for so many people.

The experts the GAO consulted suggested that while high-income households generally don't need them, middle- income households (defined in the study as having a net worth of about $350,000) should consider using a portion of their savings to purchase an inflation-adjusted annuity to cover basic expenses; lower-income families need to accumulate some cash savings before an annuity makes sense. As I have written previously in this space, I would expand the usage of income annuities more broadly than that. The vast majority of retirees with sufficient savings would benefit from having basic expenses covered via guaranteed income — whether from Social Security, a pension, an annuity payout, or some combination thereof. Because of risk-pooling, income annuities save purchasers 25-40% over self-insuring even after fees and costs. Moreover, when the alternative is being destitute when highly vulnerable, guaranteed income sources that cannot be outlived are highly desirable. Indeed, recent research has established that more people fear outliving their money than they fear death.

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Unfortunately, consumers too infrequently take advantage of the guaranteed income options that are available to them. The fraction of older workers leaving their jobs who convert their defined contribution balance to an annuity (either through an in-plan option or externally) is somewhere between 3 percent and 4 percent. In defined contribution plans that offer in-plan annuities, the annuity option is chosen only around 6 percent of the time. Indeed, the GAO acknowledges that even deferred annuities are only converted to a lifetime income stream less than 6 percent of the time. Where consumers have a choice, they tend not to select guaranteed income.

We all tend to think we're smarter than average ("*I won't make investment mistakes and end up with no money*") and luckier than average ("*I won't lose the capacity to manage my money later*"). Most investment decisions are made by men, who take more risks than women generally and, since we typically die first, leave the problem (and it's a big problem) to our wives and (perhaps) children. Our thoughts are dominated by confirmation bias ("*Annuities are a bad deal*" — so I can hang on to more of my money), superiority bias ("*I've done an exceptionally good job with my money*") and recency bias ("*I've done an exceptionally good job with my money so far so it will work out*"), all of which conspire against buying an income annuity. Yet making a mistake here means that retirees (or more likely — just the widow) will be flat broke at a time of extreme vulnerability. That outcome should simply be unacceptable to most people, especially since it can be prevented. I want a guarantee that that won't happen — not just a chance. Deciding otherwise would require that I depend upon luck. I might win. But, to my way of thinking, the costs of failure are simply too high to pay.

There is not really anything new in the GAO's report. Even so, the GAO surveyed retirees to see if they were following some of the advice offered and found, in general, that they were not. Therefore, the report can and should be used to undergird policy initiatives already under consideration that would encourage companies to offer annuity choices to their retiring workers. Moreover, anything that can be used to help people to plan better for retirement and to make better choices with their money is a good thing.

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