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A NEW TAKE ON THE ANNUITY PUZZLE

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INTRODUCTION

Sound economic models of rational human behavior predict that individuals planning their retirement will buy an annuity to protect themselves against the risk of running out of money. Why, then, do so few people who are planning for retirement buy an annuity that would provide guaranteed lifetime income? That question is known as the annuity puzzle (Brown et al. 2017).

People rarely make financial decisions in a vacuum, however. Economic models do not fully take into account the power of emotion, biases, and other countervailing forces in any financial decision. This essay will explore the countervailing forces and propose additional research and solutions geared to solve the annuity puzzle. Finally, it will propose a new retirement puzzle, of which an annuity is an essential piece.

For purposes of this essay, reference to annuities, unless otherwise noted, will be to annuities that provide a fixed guaranteed stream of income for life, regardless of whether immediate or deferred.

IMPACT OF FINANCIAL LITERACY

Financial literacy is a significant factor in all financial decisions, including whether to buy an annuity. According to a recent survey by the Secure Retirement Institute, only 46 percent of workers with poor annuity knowledge (as measured by 10 annuity knowledge questions) are likely to invest in an in-plan annuity, compared with 64 percent of those in the high knowledge category (Secure Retirement Institute 2020). Knowledge of financial matters helps people to budget, manage debt, and establish a short- and long-term financial plan, as well as to anticipate and protect against investment and life-event risks that are inherent in any financial plan.

Financial literacy and auto-enrollment/auto-default features are often portrayed as mutually exclusive tools to help individuals save for their retirement, but they are in fact complementary. Auto features respond to inertia. Financial literacy helps individuals understand and establish short- and long-term financial goals. Younger workers who understand dollar cost averaging and compound earnings, and how to manage their finances to absorb shocks, will be best prepared to plan for their short- and long-term financial security.

REASONS MANY CONSUMERS DO NOT CONSIDER ANNUITIES

The following are a few of the countervailing forces that individuals and financial professionals need to consider and address to solve the annuity puzzle:

1. It is difficult for many to envision their life in retirement, how long it will last, how much to save, and expected spending in retirement. Many people simply guess[1]. Individuals need to consider how long they want

1. Almost half of workers (49 percent) who provided an estimate of their retirement savings needs indicated they guessed the amount needed. Twenty-two percent estimated this goal based on their current living expenses. Just 10 percent used a retirement calculator or completed a worksheet (Collinson 2018).

to work, how they will spend their retirement years, and how long they will be physically and mentally active compared with the amount of time they will need care (and the money they will need to pay for the care). Prospective retirees often either fail to appreciate or are not prepared to face many of these issues.

2. Individuals cannot predict with any certainty how long they will live, and so cannot fully assess the risk of outliving their savings. Mortality tables are only somewhat helpful in predicting longevity since, by their nature, 50 percent of people will outlive or die prior to their life expectancy. Often individuals point to their parents' age at death, ignoring the impact of medical advances and their presumably healthier lifestyle on their own longevity. Finally, expectations are often confused and based on gut reaction. In a recent survey by the Aegon Center for Longevity and Retirement (2019), workers estimated that they would live until age 80, in line with actuarial projections, but when asked at what age they expected to retire and live in retirement, the cumulative age came to 85 years, consisting of a retirement age of 65 years with a further 20 years spent living in retirement.

3. Even assuming an individual is prepared to plan for the spend-down phase of their life, inertia or deer-in-the-headlights freeze can result from being overwhelmed by the number of possible solutions. Should each person have a portfolio of staggered bonds and dividend-paying stocks? Periodic distribution from mutual funds? If an annuity, what kind? Fixed, indexed, variable (with principal protection), immediate, deferred (with an inflation rider)? The number of choices makes comparative valuation difficult without first framing the problem to be solved.

4. The high fees associated with annuities compared to mutual funds is often cited as a reason that annuities are to be avoided at all costs (no pun intended). In addition, the complexity and variations of annuities have led to consumers' increased confusion.

5. Many consumers' lack of trust in insurers and financial advisors cause them to avoid annuities. The lack of trust is often based on stories of bad sales practices, perceptions of families and friends, and influencers derailing annuity products.

6. After taking responsibility for building their own retirement nest egg, many individuals find it difficult to hand over control of a portion of their hard-earned savings to an insurer, especially without access to those funds in case they need liquidity. In addition, many believe they cannot afford to take the money out of the market to purchase an annuity since they will need to gamble on the market gains to fully fund their retirement.

7. Financial decisions and attitudes often reflect the state of the economy at the time the decision is made, which can work against the purchase of an immediate annuity at retirement[2]. Consumers nearing retirement during a bull market are more likely to minimize the risk that a market downturn will either occur or impact their lifetime savings. Conversely, while a bear market could promote interest in annuities to protect against additional market losses, many consumers do not want to liquidate their investments at a loss to purchase an annuity. In addition, a low-interest-rate environment might make the fixed annuity less valuable and limit its availability.

8. The popularity of Social Security, the ultimate annuity, does not translate into support for a commercial annuity. Social Security does not entail a choice of providers or a decision about whether to contribute. In addition, contributions into the system are made in installments with each paycheck. If consumers were asked to consider transferring control of a portion of their personal savings to the government in return for a guaranteed lifetime income stream, it is likely that consumer support for Social Security would diminish significantly.

ROLE OF AN ADVISOR

Financial advisors play an important role in solving the annuity puzzle. Financial advisors can help address consumer biases and provide the financial education that even many professionally successful adults admit they lack. Financial advisors can ask the right questions and help their clients chart their life course through

2. A 2017 Gallup Poll conducted by Wells Fargo found that 78 percent of investors, up from 69 percent in the prior measurement in 2014, felt confident they will have enough money to maintain the lifestyle they want throughout retirement, perhaps a by-product of the continued bull market. This includes 31 percent feeling "highly confident," up from 26 percent in 2014. Meanwhile, the percentage not confident has fallen from 31 percent to 22 percent (Wells Fargo/Gallup 2017).

the various stages of retirement, with the appropriate financial solutions. The spend-down phase of life in retirement is extremely difficult due to lack of earnings to absorb shocks and unknown variables such as healthcare needs and the date of death. Simply put, just like climbing Mount Everest, the ascent is easier and more exciting than the more treacherous descent. An expert guide, in the form of a financial advisor, can help chart the best course.

However, in order to experience the full benefit of financial advisors, three major issues need to be addressed: (1) trust, (2) institutional barriers, and (3) either access by, or a better planning model for, nonaffluent consumers.

Lack of *trust* in financial advisors results from their portrayal as having financial interests in conflict with that of their clients. In addition, many financial advisors are primarily focused on wealth management, and derive their business and compensation from managing and growing assets, and not from protecting them. Some of these financial advisors are themselves biased against annuities, claiming that they can obtain better results in continuing to manage their clients' investments. While this might be true, there are no guarantees.

An *institutional barrier* that needs to be acknowledged results from the different regulatory regime for annuities. Although insurance regulation adds to the strength of the annuity product, it could also mean that a financial advisor lacking an insurance license might not suggest an annuity option for addressing risk. Many advisors also choose not to sell annuities and other insurance products due to the added layer of regulation and complexity. Consumers often fail to appreciate the impact of the regulatory divide and expect their advisor to offer all relevant solutions.

Finally, the 2016 Department of Labor fiduciary rule resulted in many advisory firms eliminating the commission-based compensation model and moving their clients to a fee-based proprietary account. Fee-based proprietary accounts are not affordable for many *nonaffluent consumers*. While the 2016 fiduciary rule has been invalidated by the courts[3], many advisory firms have not reinstated commission-based compensation models. New ways of reaching nonaffluent individuals who could benefit from a guaranteed income stream in retirement need to be considered. Robo advice and other on-line tools help, but fall short of the personal, hand-holding confirmation a financial advisor can give.

Training and the affirmation of the best interest standard could help eliminate lingering trust issues and biases of financial advisors. In fact, complaints against annuities sold have substantially decreased in recent years[4].

BEHAVIORAL SCIENCE INSIGHTS

There are several insights into decisions about annuities that behavioral science can offer to solve the annuity puzzle (Brown et al. 2019).

Age morphing, or digitally enhancing a photo to show the person decades older, has been used to help consumers connect to their older self and therefore to the need to financially plan for that stage in life (Allianz Global Investors 2011). Perhaps the primary benefit of age morphing is to help people realize that just continuing to work is not a guaranteed solution to inadequate retirement savings. Poor health, as well as unforeseen events (job loss, caregiving responsibilities, etc.) could result in someone being unable to continue working.

A compelling behavioral science theory that provides insights into the annuity puzzle is narrow choice bracketing (Brown et al. 2019) or making choices in isolation rather than exploring the consequences of various choices together (broad choice bracketing). Insurance decisions are often made in isolation due to institutional barriers and to the common industry belief that insurance is "sold, not bought." Individuals are less inclined to proactively choose insurance for their own protection than they are to cover risk when required by law (e.g., automobile insurance), by lenders (e.g., homeowner's insurance), or to support obligations to others (e.g., life insurance). Presenting individuals with the various options of how to spend down their assets in retirement, along with each option's associated risks and rewards, can help individuals to better value an annuity option[5]. A risk versus reward comparison will lead individuals to understand survey shows that 61.5 percent

3. On June 21, 2018, the Fifth Circuit Court of Appeals issued a mandate vacating the controversial fiduciary rule issued by the U.S. Department of Labor in 2016.
4. According to National Association of Insurance Commissioners (NAIC) records, the number of closed complaints (those deemed to be valid and have been resolved) have decreased 57 percent since 2016 (NAIC 2019).

of all workers (and 76.1 percent of lower-income workers) say tax preferences are very important in their decision to contribute to a retirement plan; if the tax incentives were taken away, 25.6 percent say they would contribute less. Incentives encourage both individuals to consider annuities and financial advisors to discuss the annuity option. While many economists claim that tax incentives do not encourage new behaviors, but only change the nature of existing behaviors, properly designed tax incentives should encourage people both to consider annuities as a spend-down option and to increase the value of the option (through deferred taxation) (Friedman 2016).

Perhaps the most valuable insight in solving the annuity puzzle can be gained from the success of the workplace-defined contribution plan system in driving good financial behaviors[6]. The workplace defined-contribution plan system is the primary source of information about investing for most people, and is based on several key factors grounded in behavioral science: (1) saving is easy and automatic through payroll deduction; (2) the contribution decision is made prior to employees' actual receipt and control (for the same reason, many over-withhold for taxes as a form of automatic savings); (3) employees trust their employers to design a plan and designate investment options appropriate for the employee population; (4) employer incentives (e.g., matching contributions), tax incentives (e.g., deferred taxation), and auto-enrollment help provide the nudges for employees to save in the retirement plans; and (5) the accounts are accessible to the employee for defined hardship events or through limited loans.

ADDITIONAL BEHAVIORAL EXPERIMENTS TO BE CONSIDERED

Further consideration of the role of consumer demographics in annuity decisions is warranted. While extensive data exist on the challenges of women in planning for retirement[7], as well as the median income level of annuity purchasers[8], race and other demographic information should also be considered. In particular, the age or life stage of annuity purchasers deserves further attention. The assumed optimal time for purchasing annuities has been at retirement when the individual can most benefit from a guaranteed income stream. However, market conditions and other countervailing forces could preclude an individual from seriously considering an annuity purchase. A recent study by the Secure Retirement Institute (2020) found that younger workers are more attracted to the idea of being able to start planning for income in retirement earlier than are older workers (35 percent to 21 percent).

Another recommended study is the impact of financial stress on retirees' health and well-being. Workplace financial wellness programs have increased in popularity as employers acknowledge the extent to which market volatility, increasing debt, and other factors impact employees' financial stress, and, in turn, their productivity and healthcare costs[9]. Various studies reveal low financial well-being among retirees, with up to 40 percent concerned about outliving their retirement savings[10]. Health is a key contributor to longevity, and understanding the impact of financial stress on health in retirement would provide tremendous insight. It should be noted that financial stress is not the sole purview of those with limited financial resources. Corporate executives have benefited from financial wellness programs as they face the financial pressures of trying to maintain a socioeconomic lifestyle commensurate with their position, regardless of earnings, and of continuing to support that lifestyle in retirement[11]. The case can therefore be made that even affluent consumers can benefit from an annuity for the sole reason of peace of mind.

Additional research on the impact of harnessing rules of thumb in making complex investment decisions is warranted. A well-known rule of thumb for investing is that the percentage of assets held in stocks should be equal to 100 minus the individual's age. With increasing longevity,

5. All too often a focus on disclosures mandated by regulation and fear of lawsuits counter the benefits of broad choice bracketing by overly complicating and clouding the initial decision. While full transparency and disclosure of the structure, fees, solvency and other matters should be made and understood by the consumer, care should be taken to ensure that they do not add unnecessary complexity to the initial evaluation of key risks and rewards of various options to managing assets in retirement.
6. A 2019 survey by T. Rowe Price found that auto-enrollment almost doubles plan participation and successfully gets participants who might not have otherwise saved saving (Dietch and Choukhmane 2019).
7. Transamerica Center for Retirement Studies, a nonprofit, private foundation, conducts an annual survey on women and retirement.
8. According to the 2013 Survey of Owners of Individual Annuity Contracts, most individual annuity owners are in households with moderate incomes. Their median annual household income is $64,000, while the average is just over $81,000 (Gallup Organization and Mathew Greenwald & Associates 2013).
9. Fifty-one percent of investors who have total investable assets of $500,000 or more report concern about being financially secure in retirement (French 2017). The Urban Institute research reveals that one in ten high-income families has no retirement income at all (Fortrell 2018).
10. Lusardi, Mitchell, and Oggero (2020) note that 40 percent are concerned about running out of money.
11. Transamerica Center for Retirement Studies Survey (Collinson, Rowey, and Cho 2018) reveals that, when asked about their greatest retirement fears, 37 percent of retirees most frequently cite outliving their savings and investments.

many have changed this rule to 110 minus their age, but the concept is the same: individuals should increasingly reduce their exposure to volatile markets as they get closer to retirement. Should a new rule of thumb be created regarding the percentage of assets to be in the form of a guaranteed income stream in retirement (including Social Security, employer pensions, reverse mortgages, and annuities)? While this rule of thumb might not be appropriate for everyone, it would avoid people having to face the unknown and would facilitate planning.

Arguably, the ultimate behavioral experiment has been made possible by the SECURE Act[12]. Contribution rates to in-plan annuities will test the various reasons that consumers are reluctant to buy annuities. When an annuity can be purchased in plan, the choice of annuity provider will be made for the plan participant. In addition, the plan participant will make incremental contributions to a lifetime income product. Finally, the concern about annuities' high fees will be mitigated by institutional pricing.

PUTTING IT ALL TOGETHER: RECOMMENDED INTERVENTIONS OR STRATEGIES

Behavioral science and the success of the defined contribution plan system in increasing retirement savings has taught us a great deal about how to help individuals and families make wise financial decisions. From these lessons—and thanks to recent legislative changes—the following are two suggested models to help and enable individuals to respond to the risk of outliving their income in retirement.

In the Workplace

Workplace-defined contribution plans are a proven mechanism for individuals who are saving for retirement. They are the primary source of individuals' financial education, make savings and investment easy, and provide incentives to savings.

The following reforms will help retirement plans to evolve from a savings vehicle to a retirement vehicle. Enhancement of financial wellness programs and employer education materials will complement these reforms to help employees prepare for a secure and happy retirement.

Annuities are expected to increasingly be included as an investment option in workplace-defined contribution plans as a result of the SECURE Act's provisions that require annuity illustrations and that address significant barriers to providing in-plan annuity options through auto-portability and limits on employer liability.[13] In-plan annuities enable the participant to take advantage of institutional pricing and dollar-cost averaging. Target-date funds that provide for an allocation to annuity contracts are also expected to be more widely offered. When participants use the annuity illustration to compare the value of their savings as a monthly income in retirement to their current expenses, they are expected to be nudged into both saving more for retirement and starting to plan for the spend-down phase of their lives. Educational materials provided by the employer and plan administrator will support the nudge by helping participants understand the need to plan for the spend-down phase of their lives, as well as the available incentives for doing so.[14]

The benefits of the annuity illustration have been boosted by the U.S. Department of Labor's rule issued in 2020 that permits electronic delivery of required notices under ERISA as the default option. Employers will increasingly be able to drive plan participants to a website that contains the annuity illustration and calculators that participants can use to model different deferral rates and lifetime income outcomes. The impact on behavior and outcomes of both e-delivery and the annuity illustration is well documented. A study commissioned by the SPARK Institute in 2015 found that participants electing e-delivery saved at a rate that was twice that of their counterparts (SPARK Institute 2015). A survey of

12. The Setting Every Community Up for Retirement Enhancement (SECURE) Act was signed into law on December 20, 2019.
13. Under the SECURE Act's auto portability provision, a plan participant may roll over an annuity into an IRA without penalty if it is no longer available through the plan. The SECURE Act also clarifies the employer's liability and due diligence responsibilities in selecting an annuity provider. According to findings from an Allianz Life online survey in March 2020, 77 percent of those who currently are enrolled in employer-sponsored plans would consider adding an option that offers guaranteed lifetime income (Allianz Life 2020). Fifty-nine percent indicated they would specifically consider adding an annuity.
14. A current incentive to consider an annuity is the exclusion from minimum distribution rules up to a 25 percent of a participant's account balance that is invested in a deferred annuity.

the Federal Thrift Savings Plan conducted by Aon Hewitt in 2013 found that 73 percent of separated participants agreed that the estimate of monthly retirement income on the annual statement is helpful, and 29 percent of active participants reported that they took some action based on the monthly income estimate, most often either increasing the amount they contributed or revising the investment mix (Aon Hewitt 2013).

Online calculators should be expanded to allow plan participants to model the impact of their lifestyle choices and health in retirement on their spending needs, and to show the risk of outliving their savings based not only on the spending habits but also on predicted health and long-term-care costs. Artificial intelligence, predictive analytics, and other tools can improve the accuracy of the spend-down calculator. Plan participants should be able to input all sources of guaranteed income in retirement and model different Social Security claiming strategies, and so on, to get a full picture of their guaranteed lifetime income and how well it will cover expected expenses in retirement.

Education provided in connection with workplace retirement plans and financial wellness programs should be enhanced to complement the spend-down calculator by providing the employee with information on the various stages of life in retirement (including working longer) with the attendant risks. Guides to government benefits and their limitations, the cost of long-term care, and protection against elder fraud should also be included. Finally, resources should be provided to help employees develop an action plan to better prepare for the spend-down phases of their lives, including saving more, maintaining skills to enable work into an older age, adjusting their retirement lifestyle goals, and changing diet and exercise to improve health.

The next phase of changes to retirement plans that policymakers should consider is implementing auto-enrollment of a percentage of retirement plan savings directly into an annuity. Auto-enrollment would harness the inertia of plan participants to allow incremental investment in an annuity that will provide a guaranteed income stream at retirement.

Finally, future legislation should also require that participants be given the choice of having a portion of their account balance distributed in the form of a guaranteed lifetime income (without requiring spousal consent) in addition to a lump sum. Although the SECURE Act facilitates the offering of annuities as a distribution option and participants can roll over a portion of their retirement accounts into an income annuity, the defined contribution plan success and behavioral science teaches us that streamlining the process as much as possible will produce better results.

RETAIL / FINANCIAL ADVISOR

Financial advisors can most effectively represent their clients by reframing their client conversations to provide a more holistic or broad bracketing approach to financial decisions. Financial advisors should understand and chart their clients' life plans, goals, and obligations in retirement prior to discussing risks or financial products. When, how, and where to retire; whether support of children and other family members is required or desired; as well as how to plan for possible dementia and healthcare needs are critical questions fraught with emotion. Powers of attorney and living wills in anticipation of dementia as a life stage should be executed, and actions to diminish the risk of elder fraud should be discussed. Financial advisors should involve client family members in the discussion since the family members will likely be called on to provide care and take over control of finances of the client in the event of dementia or incapacity. Financial advisors must carefully consider the client's life plans, goals, obligations and risk tolerance in order to assess how much income will be needed in retirement, the risk of outliving one's retirement savings, as well as other financial risks in retirement and how to protect against those risks. Annuities are a powerful tool to reduce the risk of elder fraud since the principal amount funding the annuity cannot be accessed and therefore diverted for a purpose other than providing a monthly income to the client. Annuities also ease the burden on family members called on to manage a loved one's finances in the event of the onset of dementia.

15. In 2014 the U.S. Department of the Treasury stipulated that qualified defined contribution plans could provide lifetime income by offering, as investment options, a series of target date funds (TDFs) that include deferred annuities among their assets, even if some of the TDFs within the series are available only to older participants. Providing for auto-enrollment into an annuity option is the next step.

Financial advisors and individuals must also consider sources of income in retirement other than personal savings and outline anticipated expenses in each stage of retirement as well as strategies for when to begin to claim Social Security. Only then should financial solutions be considered that will enable the consumers to realize their goals and manage their risks.

CONCLUSION: THE NEW RETIREMENT PUZZLE OF WHICH AN ANNUITY IS AN ESSENTIAL PIECE

Recent legislation, financial education, calculators and other tools, financial wellness programs, research, and lessons learned from the current financial crisis increase critical awareness of the need to reduce the risks inherent in trying to accurately spend down retirement savings in retirement. It is time to apply this knowledge to reframe the annuity puzzle. The annuity puzzle question of why individuals do not protect themselves against the risk of outliving their retirement savings by purchasing an annuity should be reframed as the retirement puzzle in which annuities are an essential piece in solving the question of how to protect against longevity and other risks in retirement.

The new retirement puzzle will allow individuals to see the various phases of retirement as pieces of the retirement puzzle, along with their inherent costs and risks. Sources of income and products to manage risk are critical pieces needed to complete the retirement puzzle. Viewing the retirement puzzle in this manner will help individuals plan for those risks appropriately in the manner that best works for them. This approach will be facilitated by nudges, incentives, and simple incremental steps such as investing in an-in plan annuity over time. Perhaps we should update the board game of Life and extend it to the phases of retirement, with the annuity card as a way to provide guaranteed income for life. Planning for all eventualities will result in a happy and secure retirement.

The novel coronavirus pandemic and resulting economic crisis, just 10 years after the Great Recession, has sensitized workers to the need to increase savings to protect against the financial risks that come with such events. This is the time to broaden the awareness to the financial risks in retirement, which are greater than in an individual's working life since there is much less time and opportunity to recover.

AUTHOR

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