RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

**Who Should Read This Insight:**
Employers, financial professionals, retirement investors, and researchers.

**Institute Research Agenda Topic:**
Understanding differences in consumer behavior and decision making.

Definitions of **bolded key terms** are at the end of this article.


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**Authors, Titles and Publication Dates of the Articles Addressed in the Insight**
*Alessandro Previtero. 2014. "Stock Market Returns and Annuitization." Journal of Financial Economics 113 (2014): 202–14. http://www.aleprevitero.com/wp-content/uploads/2014/06/previtero_JFE_2014_extrapolation.pdf.*


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# *Insight:* STOCK MARKET RETURNS AND ANNUITIZATION

## IDEAS IN THIS INSIGHT YOU CAN PUT INTO ACTION

Consumers should be aware that recent stock market returns could be influencing their decision whether to annuitize their retirement savings. Annuity plan providers should consider the effects of recent stock returns when they promote annuities, especially in light of the commonly held belief that individuals should guard against the risk that they will lose money if the value of stocks they own declines as they age. When designing policies that encourage annuitization, policymakers need to take into account the effects of recent stock returns on the individual's decision to annuitize; this effect is especially significant among older consumers.

## PRINCIPAL INSIGHTS

With more than 30 million Americans planning to retire in the next decade, it is important to understand **consumers'** decisions about whether—and, if so, how—to **annuitize** their retirement savings. **Longevity risk**, or the chance of outliving one's retirement savings, is a challenge for households. Alessandro Previtero used empirical data to explore which factors influence **annuitization** decisions; his article shows that stock returns in the preceding 12 months have a significant effect on individuals' decisions whether to annuitize; this is particularly true among older adults. The article also provides insights into how adults' beliefs about investments change as they age, and the implications of those changing beliefs for public policies that are designed to encourage annuitization.

Numerous studies have explored the question of why some individuals choose not to annuitize their retirement savings despite longevity risk; this question is known as the **annuity puzzle**. Many researchers have looked at factors contributing to the annuitization decision, including gender, marital status, life expectancy, and **bequest motives**. But only one study to date has examined the relationship between the annuitization decision and S&P 500 returns over the preceding 12 months. And, due to the difficulty of obtaining data at the individual level, few studies have used empirical evidence to better understand the factors influencing the decision to annuitize. To conduct this study, Previtero used individual-level data representing nearly 120,000 actual retiree decisions whether to take a **lump sum** or to annuitize their retirement income from **defined-benefit plans**.

This article finds a strong negative relationship over the past 25 years between the number of **annuities** sold and recent stock returns. In other words, individuals are *less* likely to annuitize their retirement savings if recent stock returns are *positive*, and *more* likely to annuitize savings if recent stock returns are *negative*. Previtero estimates that the potential losses of annuitizing retirement savings too early or not at all range from 5 percent to 10 percent, or the equivalent or working an additional two to five years. He identifies the inverse relationship between current stock returns and the decision to annuitize while also considering factors of age, gender, benefit amount, interest rates, types of retirement plan, and whether an individual lives in an urban or a rural area.

Importantly, the effect of recent stock returns on annuitization increases considerably with age: the effect is 2.0 times larger in the age group of 60–69 and jumps to 5.2 times larger in the age group of 70–75, as compared with the baseline age group of 50–59. This result confirms findings from previous studies that older adults rely more heavily on recent information when making investment decisions. This conclusion is meaningful because it contradicts the common approach that, as individuals age, they should decrease risk that they will lose money if the value of stocks they own declines.

In addition, this article reviews previous research that looks at how beliefs change over time. As individuals age, they tend to examine less information, consider fewer options, experience a decline in memory, and change their opinions. The article explores two possible explanations for the inverse relationship between stock returns and annuitization decision, both of them suggested by prior research. First, Previtero considers how some older adults' naïve expectations about future stock returns may affect their opinion about annuities' attractiveness, and thus their subsequent demand for annuities. For instance, individuals who watch stock market returns drop might expect those negative returns to continue into the future, and so to consider annuities to be a more attractive way to guard against economic downturns. But Previtero also finds that the second explanation for the inverse relationship—that extrapolating from stock returns over the preceding 12 months influences annuitization decisions—is more likely to explain the inverse relationship. And, although he considers whether older Americans have experienced significantly different stock returns during major events like the Great Depression, he concludes that more-recent stock returns have a larger effect on these individuals' annuitization decisions.

To learn more, visit the Retirement Income Institute at
*www.allianceforlifetimeincome.org/retirement-income-institute*

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA.

**annuitization:** *The process of converting an investment into a series of periodic income payments by buying an annuity or beginning an income flow from an annuity.*

**annuitize:** *When you turn your current account balance into a series of periodic income payments, either for a specific period of time or for your whole life.*

**annuity:** *A financial product that can offer protected lifetime income and even potentially grow your money.*

**annuity puzzle:** *This refers to the fact that few people choose to annuitize even a portion of their accumulated savings even though they have many good and rational reasons to do so.*

**bequest motive:** *An owner's desire to give assets such as stocks, annuities, bonds, jewelry, and cash to individuals or organizations, through the provisions of a will or an estate plan. Bequests can be made to family members, friends, institutions, or charities.*

**consumer:** *Someone who invests in annuities.*

**defined-benefit plan:** *An employer-sponsored retirement plan where employee benefits are computed using a formula that considers several factors, such as length of employment and salary history.*

**longevity risk:** *The chance that you may live longer than your income will last.*

**lump sum:** *A single payment of money, as opposed to a series of payments made over time.*

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