RETIREMENT INCOME INSTITUTE
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Who Should Read This Insight:
Retirement investors, policymakers, financial professionals, annuity manufacturers, research scholars

Institute Research Agenda Topic:
New takes on the annuity puzzle; understanding differences in consumer behavior and decision-making.

Insight: THE IMPORTANT ROLE OF FAIRNESS IN CHOOSING ANNUITIES

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

LINDA S. JAMISON

is an author, public speaker, and consultant who has served in senior executive positions in the US government, including in the White House. She has worked at the United Nations and was a senior leader with the Center for Strategic and International Studies, where she was the founding dean of an international leadership academy. Jamison has trained and advised policymakers and political leaders in the art and practice of leadership both in the United States and abroad. She has a master's degree from American University in Washington, DC, and a bachelor's degree from the University of Denver.

Authors, Titles and Publication Dates of the Articles Addressed in the Insight

Suzanne B. Shu, Robert Zeithammer, and John W. Payne. 2018. "The Pivotal Role of Fairness: Which Consumers Like Annuities?" Financial Planning Review 1 (3–4): e1019. https://doi.org/10.1002/cfp2.1019

Suzanne B. Shu is Associate Professor, Anderson School of Management at University of California, Los Angeles (UCLA). Robert Zeithammer is Professor of Marketing, Anderson School of Management, UCLA. John W. Payne is the Joseph J. Ruvane Professor of Business Administration at the Fuqua School of Business at Duke University.

IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

As retirees make decisions on how to spend down their assets, or decumulate, they face the trade-off of wanting to maintain their quality of life against the uncertainty of how long they will live. Suzanne B. Shu, Robert Zeithammer, and John W. Payne's article examines why the demand for annuities is so low, although economic data support the benefits of annuities. Shu and colleagues undertake two studies to find reasons for this puzzling behavior. They contend that, although most of the study respondents replied that they dislike annuities, they are more inclined to have a positive opinion about them when they believe that annuity products are fair. The article discusses how the perception of fairness can guide financial professionals' advice for consumers on the best way to decumulate their assets.

PRINCIPAL INSIGHTS

Over the past several decades, the popularity of **defined-contribution plans** has increased, resulting in increased savings during the "accumulation" part of life. The challenge of **decumulation** has not received much attention in the past, but recently has moved to the forefront of the debate on how best to help **retirees** draw down their assets. If they spend their wealth too quickly, they could run out of money and be destitute in old age; this is known as **longevity risk**. If they spend it too slowly, however, they could use fewer assets than they need and die with unused wealth. In their article, Shu, Zeithammer, and Payne discuss the approximately 10,000 Americans a day who enter retirement and face several related challenges about how to spend their retirement savings. These decumulation challenges, with their complex financial and psychological aspects, range from the uncertainty of life expectancy, to family and health considerations, to decisions about the timing and rate at which to draw down assets. As the authors emphasize, these challenges are also affected by individuals' attitudes about the fairness of lifetime income products, feelings of control, and expectations about the future.

The authors begin by describing the options that retirees have when they decumulate. One option is to self-manage their money with the help of **financial professionals**; these professionals generally advise retirees that they should draw down no more than 4–5 percent annually to avoid longevity risk. Another option that financial professionals endorse is to convert a portion of assets into a lifetime **annuity**. The authors point to research that supports the primary advantages of an annuity, namely, higher rates of return than self-managed accounts and income for life. The perceived disadvantages of annuities that they highlight are the lack of asset transfer to beneficiaries and the lack of liquid funds that retirees could use to respond to unexpected expenses such as medical emergencies.

The authors stress that, within the academic economic literature, there is significant agreement that annuities are a sensible and reasonable solution to the problem of wealth decumulation during retirement. But although economists prefer annuities, the public does not, giving rise to what is known as the **annuity puzzle**. The authors list four possible reasons why public demand for annuities is lacking: retirees already have the guaranteed monthly income of Social Security checks; the **bequest motive**, or desire to reserve some assets for heirs; the worry about having enough liquid assets to cover unexpected expenses such as medical emergencies; and the concern that the **annuity distributor** might default. Shu and colleagues point out, however, that these reasons do not fully explain the annuity puzzle and that more studies on psychological factors are needed.

The authors conducted two separate studies of consumer preferences for annuities. They measured the attitudes of adults aged 40–65 in American households from a nationally recognized database. They collected data on individual differences that might affect the individual's attitude toward annuities. For example, the authors measured a range of psychological attitudes toward risk often called **risk tolerance**, uncertainty over health and economic issues, trust and branding of companies, and the issue of fairness, and then overlaid those attitudes with demographic data (age, gender, race, marital status) and **financial literacy**. As for the issue of fairness, the authors intended to contrast those participants who were agreeable to some type of annuity with others who were not amenable to any type of annuity.

Study 1 included 363 participants and concentrated on demographic and psychological factors that shape attitudes toward annuities. These factors included but were not limited to attitudes about making bequests, family information, **appetite for risk**, and understanding annuities. In Study 2 the 334 different participants were given the same psychological factors as in Study 1, but in addition were provided with calculated estimates on the value of annuities. All study participants were given the same 20 choice tasks, in random order, and were asked to complete them. These tasks included decisions about three defined annuities and one self-managed product.

What the authors found were two general categories of responses about annuities among participants from both studies: those who were against annuities no matter what, and those who chose at least one annuity option. In Study 1, 22 percent of respondents chose the self-managed option in all 20 task choices. In other words, none of these participants selected any of the three annuities that were presented to them 20 times. In Study 2, the result was nearly the same: 20 percent of the participants chose no annuities, even when the annuities demonstrated a yield of $200,000 with an initial outlay of $100,000. After they were provided with more information about the value of annuities over time, however, the percentage of those disliking annuities dropped to 16 percent in Study 2. Shu and her colleagues concluded that the participants who never selected an annuity could be labeled annuity haters. In Study 1 the annuity haters were more likely to be women over the age of 60 with a low tolerance for risk, and with retirement savings of more than $150,000. Study 2 did not yield those demographic conclusions, but did find a significant difference in participants' ability to work with numbers compared to Study 1.

The factor that repeated across both studies was the issue of fairness. To measure the fairness of annuities, the authors asked all participants to rate how fair they perceived a lifetime annuity to be along a four-point scale: very unfair, somewhat unfair, acceptable, and completely fair. The participants who viewed annuities as somewhat unfair, acceptable, and completely fair were more likely to choose an annuity. Even when overlaying other factors such as risk tolerance, financial literacy, and life expectancy, perceived fairness of annuities was still a significant predictor of whether a participant would choose an annuity.

The authors concluded that the issue of fairness was actually the most significant factor in both studies of predicting who would be inclined to purchase an annuity. In an extensive discussion at the end of the article, however, Shu and colleagues suggest that fairness as a predictor of consumers who would purchase annuities needs more examination in order to know the mindset of influences that might lead consumers to decide if an annuity distributor is fair, particularly when it comes to those who are less averse to financial loss. They also conclude that standard demographic information such as gender, age, marital status, and income alone are insignificant predictors of a retiree either liking or disliking annuities. Finally, both decumulation decisions and the choice of who likes and who dislikes annuities require a better understanding of the individual needs and preferences of clients.

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

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

annuity distributor: *An annuity distributor is anyone who is involved in the sale of an annuity to a consumer.*

annuity puzzle: *The annuity puzzle 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.*

appetite for risk: *The level of market risk you are comfortable with.*

bequest motive: *A bequest motive is 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.*

decumulation: *Decumulation refers to the de-accumulation of (or the drawing down of) assets in order to maintain quality of life in retirement.*

defined-contribution plan: *A defined-contribution plan is an employer-sponsored retirement plan that is typically tax-deferred, like a 401(k) or a 403(b), in which employees contribute a fixed amount or a percentage of their paychecks to an account that is intended to fund their retirements.*

financial literacy/illiteracy: *Financial literacy is the ability to understand and effectively use various financial skills, including personal financial management, budgeting, and investing. The lack of these skills is called financial illiteracy.*

financial professional: *A qualified person who can help you understand your options and help you make financial decisions to work toward your financial goals.*

lifetime annuity: *A lifetime annuity is an investment vehicle that functions as a personal pension plan.*

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

retiree: *Someone who has retired, regardless of age or investments.*

risk tolerance: *The level of market risk you are comfortable with.*

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