RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Financial professionals, policymakers, regulators, retirement plan providers, retirement savers

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

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

EMERSON SPRICK *is a policy analyst at the Bipartisan Policy Center in Washington, DC. He earned a master's degree in economics from Georgetown University and a bachelor's degree from the University of Missouri.*

Authors, Titles and Publication Dates of the Articles Addressed in the Insight
Daniel G. Goldstein, Hal E. Hershfield, and Shlomo Benartzi. 2016. "The Illusion of Wealth and Its Reversal." Journal of Marketing Research 53 (5): 804–13. http://dx.doi.org/10.1509/jmr.14.0652

Insight: LUMP SUMS VS. ANNUITIES: DIFFERENT EFFECTS ON SAVING INTENTIONS

IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

Research findings by Daniel Goldstein, Hal E. Hershfield, and Shlomo Benartzi suggest that pre-retirees are better able to imagine their projected wealth in retirement when those projections are presented as lifetime monthly income rather than as lump sums. Among pre-retirees with less than $1 million in projected retirement wealth, those who think of their retirement wealth as a monthly income are more likely to save at a higher rate than are pre-retirees who consider their wealth only as a lump sum. The reason for this difference is likely that pre-retirees can more easily compare projected monthly income to their current budget, especially with regard to expenses billed monthly, such as rent or mortgage payments, car payments, and utilities. As a result of these findings, the authors suggest that financial professionals and retirement plan providers should focus on monthly income projections more than on lump-sum projections when consulting with pre-retirees.

PRINCIPAL INSIGHTS

In the process of planning for **retirement**, **pre-retirees** can view their accumulated wealth as a **lump sum** (e.g., $100,000) or as the projected lifetime income that such a lump sum could buy as an **annuity** (e.g., $500 per month for life starting at age 68). In "The Illusion of Wealth and Its Reversal," Daniel Goldstein, Hal E. Hershfield, and Shlomo Benartzi explore whether pre-retirees have different perceptions of retirement wealth that is presented as a lump sum versus wealth that is presented as equivalent monthly amounts. The authors were motivated by the US Department of Labor's proposal that annual 401(k) statements display the projected lifetime income that the account will be able to buy in retirement. That proposal went into effect in 2021 as part of the Setting Every Community Up for Retirement Enhance (SECURE) Act of 2019.

Using three online surveys, the authors show that, at lower wealth levels, pre-retirees view lump sums as representing more wealth than monthly annuities; this effect, known as an illusion of wealth, reverses at higher wealth levels. As a result, the saving plans of pre-retirees were more sensitive to projected changes in wealth at retirement when that wealth was presented as a stream of monthly amounts than as lump sums, a finding with significant implications for the **annuity puzzle** and for Social Security benefit claiming decisions.

In their first survey, the authors asked 278 adults to evaluate the adequacy of seven amounts of retirement wealth. Respondents were randomly assigned to evaluate either lump sums ($25,000–$1.6 million) or equivalent monthly annuity amounts ($160–$10,217). The second survey replicated the results of the first but with greater precision: each of 960 respondents, ages 45–64, evaluated only one amount—either a lump sum or an equivalent monthly annuity. The second survey also converted lump sums ($100,000, $200,000, $1 million, and $2 million) to monthly annuity payments ($500, $1,000, $5,000, and $10,000, respectively) using a rule designed to present both lump sum and annuity amounts as round numbers in order to avoid potential bias, since investors tend to prefer round numbers.

The results of the two surveys showed that respondents were significantly more sensitive to changes in wealth when it was presented as a monthly annuity than they were to changes in wealth presented as a lump sum. In other words, increasing the monthly annuity amount boosted respondents' perceptions of the adequacy of the amount significantly more than equivalent increases in a lump sum. Respondents thus rated relatively low lump sums as more adequate than equivalent annuities, with a reversal of that relationship for higher lump sums. The authors briefly explore the application of the illusion of wealth to the tendency of Americans to claim Social Security benefits early, and conclude that the lump sum amount gained by claiming one year later will likely appear significantly larger than the monthly increase in lifetime payments.

To determine the implications of the illusion of wealth for saving behavior, the authors performed a third survey with 959 new participants, ages 45–64, and with annual household income between $40,000 and $150,000. The survey asked each respondent to suppose that their current saving rate would cause them to accumulate, by the time they retire, one of the eight amounts—four lump sums and four monthly annuities—from the second survey. All respondents were then asked how they would change their saving rate, given the amount they were assigned. On average, all the respondents, regardless of which of the eight projections they considered, indicated they would increase their saving rate. At low amounts (lump sums of $100,000 or $200,000 and their monthly annuity equivalents), however, respondents who were presented with a monthly option said they planned to save significantly more than respondents presented with a lump sum amount. This relationship reversed for those presented with a lump sum of $1 million or $2 million and their monthly annuity equivalents.

Goldstein, Hershfield, and Benartzi posit that increased sensitivity to changes in wealth presented as monthly annuities stems from the relative ease with which individuals can compare monthly annuities to their current budget and other reference points, especially expenses billed monthly, such as rent or mortgage payments, car payments, and utilities. Therefore, instead of providing only account balances, **retirement plan providers** should help savers think more accurately about their spending needs in retirement—and their saving behavior until retirement—by providing pre-retirees with their projected monthly income at retirement based on what they are currently saving toward retirement. The authors also point out that these monthly income projections should be more prominent than lump sum projections on retirement plan statements.

The authors conclude that the results of these surveys reveal the power of information architecture (i.e., the way that information is provided) in designing retirement account statements. Whether projections of wealth in retirement are presented as lump sums or as equivalent monthly annuities significantly affects pre-retirees' perception of the adequacy of the amount as well as whether they plan to change their saving rates. This effect has major implications not only for retirement plan providers and **financial professionals**, but also for policymakers.

KEY TERMS *indicated at first use with bold font*

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

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.

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

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

pre-retiree: Adults age 45 and up who have not retired.

retirement: Where you are in terms of your financial priorities and needs; for instance, growing your money or drawing from your money later in life.

retirement plan provider: A company or employer that offers a retirement plan, such as a financial firm that sells annuities.

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