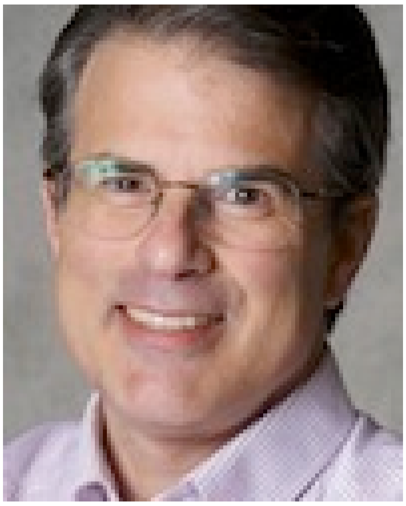
A Simple Idea for Increasing Annuity Sales

By Kerry Pechter *Thu, Dec 21, 2017*

'Annuitization decisions can be improved by getting people to think about how annuities help people avoid running out of wealth in old age,' said the Wharton School's Olivia Mitchell, co-author of new research about annuity purchasing behavior.



If you're a financial advisor struggling to describe the value of a lifetime income product to retirees, you might first try explaining how hard it is for anyone to arrive at an optimal spending rate in retirement so that they don't run out of money before they die or die before enjoying enough of their money.

Then you can say that an annuity might solve that problem.

That's one takeaway from a scholarly but practical new article from a notable group of retirement researchers. Published this month by the National Bureau of Economic Research, the work was underwritten by the TIIA Institute, perhaps for application by TIAA's own advisors. Anyone selling annuities could take a lesson from it.

One of the authors of the paper, Jeffrey Brown of the University of Illinois, has long maintained that the reason so few Americans purchase income annuities is not because they don't like them, but because they incorrectly "frame" annuities as investments (which they are not; they're insurance).

Other prominent researchers share that view. The "tiny market share of individual annuities should not be viewed as an indicator of underlying preferences but rather as a consequence of institutional factors about the availability and framing of annuity options," wrote 2016 Nobel Prize-winning economist Richard Thaler, Shlomo Benartzi and Alessandro Previtero in 2011.

Brown's new paper, "Behavioral Impediments to Valuing Annuities: Evidence on the Effects of Complexity and Choice Bracketing" (co-authored by Olivia Mitchell of the Wharton School, Erzo Luttmer of Dartmouth, and two professors from the University of Southern California's Center for Economic and Social Research, Arye Kapteyn and Anya Samek) introduces a solution to this "annuity puzzle."

The authors set up a crafty experiment to find out how well people understand the value of an guaranteed income.

"We first asked respondents to advise a hypothetical person how much he should be willing to pay to buy additional annuity stream (the 'buy' condition), versus how much money he should require to reduce his annuity holdings (the 'sell' condition)," Olivia Mitchell, who is director of the Pension Research Council, told *RIJ*.

"Generally speaking, respondents advised people to pay very little to purchase an additional annuity, but to demand a large sum of money to give up a portion of annuity income.”

The authors interpreted this discrepancy as a sign that those individuals underestimated the ability of an annuity to take some of the uncertainty out of spending rates in retirement. Then they varied the experiment by telling some of the volunteers the following anecdote:

“Mrs. Smith is a single, 65-year old woman with no children, and she is as healthy as the typical 65-year old woman. She just retired and receives her monthly Social Security check. She is talking with her financial adviser on how to spend her substantial savings in retirement. Her advisor explains that she could decide to spend down her savings relatively quickly. In this case, she will be more likely to be able to enjoy her money during her lifetime. But she also runs a risk of running out of money while alive and having to cut back on her spending as a result. Her advisor explains that she could also decide to spend down her savings relatively slowly. In this case, she will be less likely to run out of money. But now she runs a risk of not getting to enjoy all her money during her lifetime.”

When the researchers introduced this anecdote into the mix, the volunteers’ spread between the price of buying or selling part of the Social Security benefit shrank on average. The researchers took it as a sign that the volunteers’ appreciation of the value of an annuity was more “rational” and that, by implication, they were more likely to consider buying an annuity.

“The consequences message narrowed the buy-sell spread, in particular by raising the buy price,” Mitchell said. “In other words, annuitization decisions can be improved by getting people to think about how annuities help people avoid running out of wealth in old age.”

An individual’s intelligence also affects their ability to understand the value of an annuity, but financial advisors can’t change that, the authors observed. On the other hand, a little homily may make a big difference.