ALDAs Make the Most Sense: Financial Engines

By Editor Test *Sun, Jun 7, 2009*

Life annuities will be more popular when offered at a discount well before the income start date, the authors argue.

In the latest in a series of research papers on the merits of longevity insurance, scholars at Financial Engines suggest that retirees pay for retirement out of invested assets until about age 77 and to rely on income from life-contingent deferred income annuities—also called ALDAs, for advanced life deferred annuities—from then on.

"Our investor would fund all consumption between the ages of 65 and 76 with financial market securities and all later life consumption with annuity market assets," the authors said.

The paper, **"What Makes a Better Annuity?"** was published in May as a working paper of the Pension Research Council at the University of Pennsylvania's Wharton School. It was written by Jason S. Scott, John G. Watson and Wei-Yin Hu of Financial Engines, the Palo Alto, California consulting firm associated with Nobel laureate William Sharpe.

The authors recommend longevity insurance over single premium immediate annuities (SPIAs). Retirement income experts have long debated whether retirees should put off buying immediate annuities until age 75 or so, when the payout rate (including mortality credits) is bigger than the anticipated yield from equity investments.

But the Financial Engine authors say that life annuities make more sense when purchased at a discount well before the income start date. They imply that if the discount is large enough it can overcome resistance to the drawbacks of life annuities.

"Given access to a complete [annuity] market, we find all individuals only purchase annuity contracts with a significant time gap between purchase and payout," the study says. "At a minimum, enough time must pass between purchase and payout to build up a mortality discount sufficient to overcome the cost of creating the contract."

On the basis of this, the authors assert that single-premium immediate annuities (SPIAs) are not going to play an important role in Boomer retirement. "Since most existing annuity products, such as immediate annuities, do not have this feature, few current annuity contract configurations are likely to survive significant product innovation," they wrote.

Immediate annuities are too expensive, they argue. "The difficulty associated with writing and monitoring a survival-contingent contract suggests annuity markets will never offer actuarially fair pricing nor will they likely approach financial markets in terms of flexibility. For example, suppose an annuity market is characterized by a money's worth percentage of 85%. For our sample cohort, survival rates don't drop below 85% until age 77."

Note: The “money’s worth” of an annuity is defined as the ratio of the expected discounted value of its future payments to its initial purchase price or policy premium. Money’s worth percentages are used to determine the degree to which private market annuity prices deviate from their actuarially fair value. Source: Brown, Jeffrey R., et al. The Role of Annuity Markets in Financing Retirement (MIT Press, 2001).

“In a world with costly and limited annuity products, we find that participation gains are most likely for new annuity products that focus on late-life payouts which offer a large price discount relative to their financial market analogues,” they conclude.