Are Annuity Buyers Smarter than Other People?

By Kerry Pechter *Wed, Apr 8, 2015*

"The observed lack of annuitization does not necessarily mean that people are better off without annuities," write retirement specialists Jeff Brown, Olivia Mitchell and others in a new research paper. They link low financial literacy to low annuity sales.

In the first quarter of 2015, almost a quarter of a million people bought immediate or deferred single premium income annuities, according to CANNEX. More than half were ages 55 to 70, and 40% of their purchase payments were between $75,000 and $200,000.

Why *those* people? Were they different from their peers who *didn't* buy income annuities? And if so, *how* were they different?

It's possible that they were smarter, better educated or more financially literate than their peers, and therefore better able to appreciate the long-term value of annuities, according to a new paper by a panel of researchers that included Olivia Mitchell of the Wharton School and Jeff Brown of the University of Illinois.

Mitchell, Brown and co-authors Arie Kapteyn of USC and Erzo Luttmer of Dartmouth, tested the hypothesis that many ordinary people—like kids who don't understand the potential long-term gains from eating the broccoli on their dinner plates—avoid annuities because they can't tell whether the price is fair or not.

To find out if people have difficulty analyzing the present value of an annuity, they asked members of a survey group to tell them either how much they would pay to get an extra $100 a month in Social Security income or how much they would demand to compensate them for giving up $100 a month in Social Security income.

It turned out that the spread between asking and offering prices was very wide, suggesting that many people can't easily evaluate an income stream. The spread was widest for people with the least cognitive ability (as measured by education level, financial literary and numerical ability).

"If valuing an annuity is difficult, research indicates that individuals will only be willing to buy or sell when the deal is clearly advantageous: the respondents would only be willing to buy an additional $100 a month at a low price, and would only sell $100 a month at a higher price. Thus, the gap between the two prices should be significant, and the gap should widen as cognitive ability declines," the researchers wrote.

"The figure shows that most respondents were only willing to buy the $100 annuity when the price was very low. The median price they were willing to pay was $3,000 – an amount they would recoup in monthly payments in just two and a half years. And they were only willing to sell the $100 annuity at a much higher price: the median selling price was $13,750. As a point of reference, the actuarial value of $100 in Social Security benefits – using mortality and interest rate assumptions from the Social Security Administration's Trustees – is $16,855."

Through further experiments, the researchers ruled out the possibilities that other behavioral factors—the so-called "endowment" effect, "anchoring" effects, or mere lack of money—might account for wide range in ability to put an accurate present value on the incremental income.

"Many individuals, on their own, are unable to make good decisions about managing their money in retirement," the researchers asserted, adding that "the observed lack of annuitization does not necessarily mean that people are better off without annuities."

Other explanations have been suggested for the low demand for annuities, a phenomenon that has long baffled behavioral economists. It's been noted that almost every American retiree already has a life annuity in the form of Social Security. It's been noted that few investment advisors recommend income annuities, in part because they prefer to sell investment products.

It's also been suggested that people who *can* accurately value annuities know that the price includes a premium of about 15% to cover the costs of distribution and adverse selection. And, clearly, annuities face a public relations headwind. Annuity purchasers might also be more risk-averse than others, or have been personally touched by someone's decision to buy or not buy an annuity, or are especially wary of inflation.

A wide range of studies have shown that many if not most Americans are, in fact, financially illiterate. But the idea that most people aren't equipped to manage their own retirement savings isn't likely to be politically popular, even if it's true.

In the U.K., ironically, the Tory government recently decided that people *do* know how to manage their own money, and they've ended the long-standing requirement that retired Britons buy annuities with their tax-deferred savings. The new policy went into effect this week.