Retirement Income
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Don’t Call Them Investments

By Kerry Pechter *Mon, Jun 10, 2013*

It’s not rational self-interest that makes retirees avoid life annuities. It’s how we ‘frame’ life annuities that puts them at a disadvantage.

HOW WORD CHOICES AFFECT CONSUMER PREFERENCE FOR LIFE ANNUITIES

	Investment Frame	Consumption Frame
Life annuity	Mr. Red **invests $100,000 in an account which earns** $650 each month for as long as he lives. He can only withdraw **the earnings he receives, not the invested** money. When he dies, the earnings will stop and his investment will be worth nothing.	Mr. Red **pays $100,000 at retirement so he can spend $650** each month for as long as he lives in addition to Social Security. When he dies, there will be no more payments.
Savings account	Mr. Gray **invests $100,000 in an account which earns** a 4% interest rate. He can withdraw some or all of the **invested** money at any time. When he dies, he may leave any remaining money to charity.	Mr. Gray **pays $100,000 at retirement so he can choose an amount to spend** each month in addition to Social Security. How long his money lasts depends on how much he **spends**. If he **spends** only $400 per month, he has money for as long as he lives. When he dies, he may leave the remainder to his children. If he **spends** $650 per month, he has money only until age 85. He can spend down faster or slower than each of these options.
Results	**In this ‘frame,’ only 21% chose the life annuity over the savings account.**	**In this ‘frame,’ 68% chose the life annuity over the savings account.**

Source: Brown, Jeffrey R., et al. “Framing Lifetime Income” (NBER Working Paper 19063, May 2013).

When people tell you that annuities aren’t the answer, maybe it’s because you’re not asking the right question. Or maybe because you’re asking the right question the wrong way.

Jeffrey Brown, Ph.D., of the University of Illinois has spent much of the last decade studying the way that ordinary people (as opposed to advisors or economists) respond to questions about life annuities. He focuses on how annuities are “framed” or contextualized.

People tend to favor life annuities over other retirement income solutions, he’s found, when the context plays to the strength of annuities—maximizing income and consumption—than when it plays to their weakness—minimizing exposure to market risk and upside potential.

In the end, it comes down to a matter of word choice. Brown has learned through surveys that when you use words like “spend” and “payments” when discussing annuities instead of words like “invest” and earnings,” people tend to like annuities a whole lot better.

At first glance, it sounds too easy: As if kids would eat more broccoli if you called it chocolate cake. But Brown is proposing something closer to: More kids will choose broccoli over chocolate cake if you ask, “Which is more nutritious?” than if you ask, “Which tastes better?”

Although Brown’s research isn’t exactly intended to promote the sale of annuities, he thinks it can’t hurt.

“Our goal is to better understand consumer behavior and what it implies for our theories of consumer choice,” he wrote to *RIJ* in an email. “[But] My basic sense is that advisers share many of the same behavioral biases as consumers do. That is to be expected, as these biases are deeply ingrained. My hope is that by framing the conversation in a more appropriate way with advisers as well as with consumers, we may get some traction.”

Refining the concept

In a just-released paper, Framing Lifetime Income (NBER Working Paper 19063), Brown and co-authors Jeffrey Klinger (Congressional Budget Office), Marian Wrobel (Health Policy Commission) and Sendhil Mullainathan (Harvard) offer some refinements to Brown’s previous findings about annuities, framing and consumer choice.

In the experiment described in the paper, researchers wanted to answer several questions:

1. When comparing annuities with some other income solution, are people discouraged from choosing annuities if you mention the amount of the purchase payment/investment? In order words, does the mere mention of a large dollar amount make people afraid of losing liquidity or principal?
2. If the criterion for choosing an annuity was its ability to generate a threshold monthly income, would more people be attracted an annuity, or would they appeal to a narrower audience, i.e., those with a specific gap between their retirement needs and their savings?
3. If you guarantee a full or partial return of principal when offering an annuity, will people be more likely to choose it over another solution?
4. Do prospects’ gender, age, marital status, children or health status affect their preference for annuities under different frames?

To test these questions, Brown collected survey data from about 4,000 people in 2007 and 2008. Of those respondents, 43% were women and 57% were men. More than half were over age 60 and about one-third were over age 65.

On the first, second, and fourth questions, the researchers found little difference. That is, the advantage of the consumption frame over the investment frame stayed much the same whether or not you mentioned the dollar amount of the premium, whether you established a threshold income that only a life annuity could meet, or whether the respondent was male or female, younger or older, or had children or not.

On Question Three, however, the results did show that, in the investment frame, people were about twice as likely (43-47% vs. 20-24%) to prefer a life annuity with principal protection over a savings account paying 4% annual interest. It didn’t matter very much whether the life annuity offered guaranteed return of at least 80% of principal or 110% of principal.

“Within an investment framework,” the researchers wrote, “annuities appear more attractive when they include principal protection, an insight that may explain why consumers who do annuitize are often partial to including period certain guarantees in their products, despite the fact that these guarantees essentially reduce the insurance value of the products.”

These results could have important implications for life annuity issuers who want to increase sales, Brown believes. “Quite a few [annuity markers] have told me this line of research has influenced their thinking. I am not sure that I should name names, however, but most of the big annuity providers are very familiar with the work,” Brown told RIJ. He added that his findings also support proposals to report 401(k) account accumulations in terms of monthly retirement income projections instead of or in addition to account balances.

Brown’s research confirms what a lot of life annuity issuers have learned from experience: that annuities make more sense when viewed as retirement income vehicles than as investments, that consumers prefer annuities to a degree to which they are not aware, and that when advisors ask, “What’s the internal rate of return on a life annuity?,” they’re not asking the right question.

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