Mortality Credits: Sweet and Sour

By Kerry Pechter *Thu, May 4, 2017*

'The only way to get closer to meeting your spending goals is through some sort of partial annuitization strategy,' said Michael Finke, dean of The American College of Financial Services, at the Retirement Industry Conference in Orlando last week.

The thrust of Michael Finke's presentation on the value of income annuities in retirement was amiable in its delivery but fairly brutal in its logic. In a world where equity and bond gains are poised to deliver lousy returns and lots of people are going to live longer than they expect to, mortality credits—the alpha of annuities—are the only safe haven for retirees.

Finke, a professor who recently became the dean and chief academic officer of The American College of Financial Services after establishing his reputation as a retirement income authority at Texas Tech, was speaking at the 2017 Retirement Industry Conference, the event staged in Orlando last week by the LIMRA Secure Retirement Institute and the Society of Actuaries.

Finke (right) didn't say much new about life annuities that he, Wade Pfau, Curtis Cloke or David Blanchett hadn't already said or written. (Not that they all agree on every point.) But, in an hour-long overview of the investment and longevity landscape, he pleasantly asserted that life annuities—those ugly ducklings of the financial barnyard—should be a no brainer for many retirees or near-retirees.

"The only way to get closer to meeting your spending goals is through some sort of partial annuitization strategy," he told the 400 of so attendees of the conference—which felt lightly attended. The lead sponsors were Cannex, hannover re, and S&P Indices. (Todd Giesing, assistant research director of the LIMRA Secure Retirement Institute, said however that attendance was on par with the same event last year.)

"If you annuitize 25% of your assets with a QLAC [Qualified Longevity Annuity Contract], you can cut your risk of running out of money in half," he said. Lest anyone think that he was talking only about helping "constrained" retirees, he added that, because of its tax advantages, a QLAC would provide longevity insurance to a high net worth retiree without diminishing any planned legacy.

"The QLAC costs nothing in terms of legacy goals," Finke said. The fact that they are not more popular is baffling to me."

Without a prayer

To accept Finke's argument that mortality credits—the dividend that comes from pooling your longevity risk with others and accepting the fact that other members of the pool might enjoy some of your savings after you die—you had to accept his premise: That stocks and bonds, at current prices, have almost no prayer of matching their past appreciation rates.

"If you look only at historical returns, you might believe that taking more investment risk in retirement is better," he said. But with price/earnings ratios of stocks in the mid-20s and bonds at historically low rates (i.e., at historically high prices), it makes no sense to expect the risk premia of the past.

Pointing to one of his slides, Finke noted, "In the past, when the P/E ratio was around 20, stocks averaged a return of about 90 basis over the next decade on an inflation-adjusted basis. When the P/E was over 25, stocks average 50 basis points [of real return] per year. Stocks may continue to rise because people are willing to pay more for equities than in the past. But the equity premium is probably not going to persist into the future."

As for bonds, Fed policy isn't the primary cause of low yields, Finke said. Yields are low because demand from retirement savers has driven up the price of safe assets. The result is that, because of both increasing longevity and falling bond yields, the cost of buying $1 of safe lifetime income has doubled over the past 20 years.

If that's true, it means that savings rates need to be twice as high. If in the past a savings rate of 7% a year over one's lifetime was necessary to fund a secure retirement, it will take a savings rate of 14% today to fund the same level of retirement security with the same asset mix, he said. A higher saving rate during the working years implies less consumption or, in other words, a lower standard of living, all else being equal.

Out of the ivory tower

To those who might argue that retirees with a 30-year time horizon in retirement need risk exposure at least as an inflation hedge, Finke countered that most people become more risk-averse as they get older and that retirees care less about rates of return than about knowing exactly how much they will be able to spend.

The substance of Finke's presentation contrasted with panel discussions and break-out sessions at the conference that involved the fate of the Department of Labor's fiduciary rule, now under review by the Trump administration, and about the future of indexed annuity and variable annuity sales, which have been hurt by uncertainty over the rule's impact on brokers and agents.

The rule, in its current form, makes it more complex for independent brokers and agents to sell equity-linked annuities on commission to rollover IRA clients. But the rule has little impact on the career agents at mutual insurance companies who sell the bulk of income annuities.

Given the fact that indexed and variable annuity sales are orders of magnitude greater than income annuity sales, Finke’s argument may have seemed somewhat academic to many of the executives from publicly-held insurance companies and from brokerages or insurance marketing organizations in the room.

On the other hand, if Finke’s assessment of future investment returns is correct, and if more advisors adopt a holistic, retirement income planning state-of-mind, then income annuities, with their grim but rewarding mortality credits, may finally be ready to descend from the ivory tower and onto the street.