No Tower of Babel, or Babble, from Babbel

By Editor Test *Wed, May 16, 2012*

If you're engaged in selling or marketing income annuities, you must read this 2007 white paper by Wharton professor David Babbel. It's an enduring classic.

Whenever the topic of selling income annuity arises (and it arises more frequently these days than ever) David Babbel's white paper on income annuities, "Investing Your Lump Sum at Retirement," inevitably comes to mind.

The paper, written by the Wharton School professor in 2007 under the sponsorship of New York Life, makes the case for buying an income annuity better than any glossy marketing brochure you are ever likely to find.

No photos of sailboats or white-haired captains in this document. No his-and-hers Adirondack chairs at the end of the dock.

Anyone who markets or sells income annuities for a living should not only read this document but carry a creased, dog-eared and heavily-underlined copy of it in his or her coat pocket at all times.

Babbel supplies the background that someone new to annuities might need, then tackles what he calls the seven—a magic number in gambling and in advice manuals; just ask Stephen Covey—myths about annuities and provides a bullet-proof response to each one.

If you have time, I urge you to read the entire paper. For those who don't have time, I'll summarize his call-and-response below. First the annuity myth, then a summary of Babbel's rebuttal.

1. They cost too much. When you calculate the expense ratio that you pay year after year on an actively managed mutual fund, the one-time commission that you pay when buying the typical income annuity will seem quite small.

2. What if I get sick? An income annuity, especially one that offers accelerated payments in case of serious illness, can be a versatile and thrifty alternative or supplement to long-term care insurance.

3. What if inflation returns? Won't my fixed payments become worth less? Many of today's income annuities offer inflation-protection, either in the form of an annual increase or a peg to one of the versions of the Consumer Price Index.

4. Isn't it cheaper to use some sort of homemade strategy that mimics the behavior of life annuities? That way I can cut out the insurer! Babbel articulates the insurance principle and compares not having an annuity to playing Russian roulette with your financial security.

5. If I put all of my money in a life annuity, will there be anything left for my kids? If you buy an annuity that covers your basic needs, you may be able to give part of the remainder of your wealth to your children today, rather than making your death the prerequisite of an inheritance.

6. If I purchase an irrevocable life annuity at retirement, don’t I lose control over those funds? Yes, says Babbel, and that’s a good thing! An income annuity can remove the burden, the anxiety and the risk of handling stocks and bonds at an advanced age.

7. Shouldn’t I wait to buy in case interest rates go up? You can—but life expectancies may also go up, making annuities more expensive in the future. And while you’re waiting, your investments could lose value. Indeed, what if rates go up and trigger a stock market crash? You might have less money to invest in an annuity.

And here’s Prof. Babbel’s stirring conclusion:

> When individuals consider the list of positive attributes associated with life annuities, i.e., guaranteed payments you cannot outlive, low cost, access to invested capital, and reasonably priced features such as inflation adjustment and legacy benefits, the argument for this income solution in retirement is compelling.
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> By covering at least basic expenses with lifetime income annuities, retirees are able to focus on discretionary funds as a source for enjoyment. Locking in basic expenses also means that the retiree’s discretionary funds can remain invested in equities for a longer period of time, bringing the benefits of historically higher returns that can stretch the useful life of those funds even further.
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> Income annuities may also be a vehicle that enables retirees to delay taking Social Security benefits until they are fully vested, bringing substantially higher payments at that point.
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> The key in all of this is to begin by covering all of the basic living expenses with lifetime income annuities. Then, to provide for additional desirable consumption levels, you will want to annuitize a goodly portion of the remainder of your assets, while making provisions for extra emergency expenses and, if desired, a bequest.
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> These last two items can be accomplished through combinations of insurance and savings. When this is undertaken, you can enjoy your retirement without the burden of financial worries and focus on more productive uses of your time and attention!