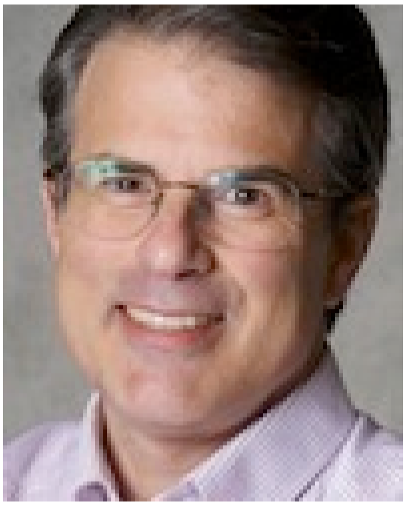
Of Ponies, Manure Piles, and Annuities

By Kerry Pechter *Wed, Jun 11, 2014*

An article about deferred income annuities in last Saturday's New York Times looked at DIAs through the "investment frame" rather than the "insurance frame." That's the wrong way to evaluate annuities.



In the *New York Times* article on deferred income annuities last Saturday, the writer seemed to focus on whether DIAs are a “wise buy.” Like most articles on annuities in mass media, this one presented annuities in what’s known as the “investment frame.”

Here we go again.

Viewed through the investment lens (“as through a glass eye, darkly,” to borrow Mark Twain’s assessment of James Fenimore Cooper’s dim literary vision), life-contingent annuities tend to look dumb.

When using the investment frame—i.e., when comparing annuities with investments like no-load mutual funds—annuity expenses seem ridiculously high. The costs of income annuities, though hidden in the payout rate, run (according to a recent presentation by Wade Pfau of The American College) as high as 15% of premium for distribution, administration and (largest of all) adverse selection. And that doesn’t count the potential 3.5% state tax.

It gets worse before it gets better. When a writer frames annuities as investments, the value of the so-called survivorship credit or mortality credit tends to be discounted. (Or, if mentioned at all, it becomes a sad reminder, as behavioral economist Meir Statman once said, that annuities “smell of death.”) To banish the odor, many people elect a cash refund option. But that just adds another cost, and another reason not to buy the product. Opting for the cash refund or a period certain (although not a terrible idea) is like *buying insurance for your insurance.*

Using the investment lens to evaluate a DIA is like looking at a burning match through a welding mask. The flame won’t be very bright. For DIAs or SPIAs (single-premium immediate annuities) to make sense, you have to view them through what Jeff Brown of the University of Illinois and others have called the “insurance frame.”

In a nod to the insurance frame, the *Times* reporter conceded that “you might view the purchase [of a DIA] as an insurance policy.” But that understatement only added to the confusion. An annuity *is* an insurance policy. And insurance policies cost more than investments because you’re paying insurers to relieve you of a chunk of your market risk and longevity risk. When you buy stocks or bonds, *you* retain the risk.

The cost of annuities is akin to the pile of manure in the barnyard parable that Ronald Reagan made famous. According to The Gipper's brand of cowboy optimism, a manure pile meant that a pony must be nearby. If we admit that annuity costs are like manure—a necessary evil, if you will—then you have to ask, where's the pony?

For a retiree, the pony is: more spending power, relative to a 3.5% systematic withdrawal plan from a mutual fund portfolio; the extra risk you can take with your other money; the cash you don't have to hoard against the risk of living to 95; the assurance that if the stock market blows up, your retirement won't; the freedom to ignore CNBC and sleep heartburn-free. These ponies, invisible to anyone wearing investment glasses, are reasons to tolerate the manure pile. You buy insurance so you can do fun stuff that you wouldn't otherwise be able to do, because of the risks.

When you've spent all your life thinking with your investment side of your brain, it's tough to switch to the insurance side. But it would be refreshing to see a *Times* article on DIAs that quoted, for example, Curtis Cloke, the Iowa adviser who uses period certain DIAs to give ultra-HNW clients free rein with the rest of their wealth. Or Faisal Habib at Cannex, whose PrARI modeling tool shows how to squeeze more income with less risk from the same-size nest egg by blending mutual funds and income annuities.

Or the *Times* might have called David Laibson, the Harvard behavioral economist who has become interested in retirement and annuities. Last February, in a keynote at the Morningstar institutional investor conference, Laibson described good bets and bad bets. The strategy of buying a life-contingent income annuity with a fraction of your savings is a good bet for retirees, he said.

If you live a long time, he reasoned, the annuity's survivorship credits will pay off. And if you die early, so what? Your heirs won't be cheated *because you won't have had the time or the need to spend the bulk of your savings.* The annuity asset may vanish (or shrink), but so will the liability. That's using the insurance frame.

We're not here to exalt annuities. If you (or your clients or customers) can afford to retain market risk and longevity risk in retirement, so much the better. It would be nice, however, if mainstream journalists would look at income annuities with fresh eyes and see them through insurance lenses.