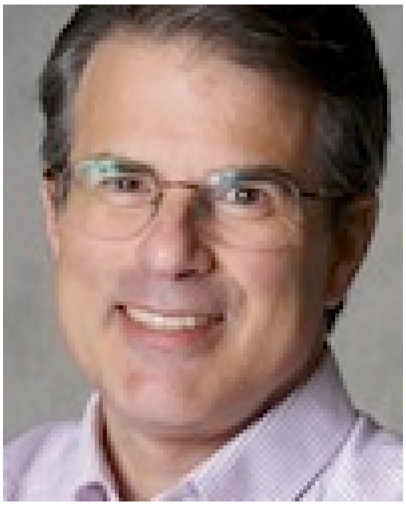
Sneak Preview of New Book on Behavioral Finance

By Kerry Pechter *Thu, Jul 26, 2018*

In a chapter of a forthcoming book, four Ivy League academics discuss the possible reasons why so few people buy life annuities. I add a few theories of my own.



I've spent the past third of my life observing annuities, as an annuity marketer at Vanguard, as author of *Annuities for Dummies*, as editor of *RIJ*, and as a fly-on-the-wall at dozens of annuity conferences. Over that time, I've developed a few personal theories about why it's so tough to sell annuities, especially income annuities.

Here are three reasons I think annuities aren't more popular:

Few people spend two hundred big ones all at once, on anything. Most people value liquidity highly, and the purchase of an annuity means a cliff-like loss of liquidity. No one I know pays for insurance of any kind with a lump sum; their spouses would veto the transaction. The most sensible way to buy a retirement annuity is the way you buy your Social Security benefit from Uncle Sam: With a little bit of every paycheck, over a lifetime.

"Deadstick" landings are unpopular. When an airplane loses all propulsive power and the pilot has to emergency-land onto an airstrip or highway or cornfield (or the icy Hudson River, famously) with no way to regain altitude, that's a deadstick landing. No matter how old, many people still hope to get rich someday. And they reduce their chances if they annuitize too much of their money. They feel less powerful.

Jack Bogle is not an avid fan. Vanguard has always preached that if you stay the course (keep expenses low, don't try to market-time, and always have a few losers in your portfolio), then reversion to the mean and the equity premium will see you safely through and you won't need to insure your investments. If St. Jack were a cheerleader for annuities, sales would be higher.

If you're wondering if any of my hypotheses were ever tested in double-blind studies or published in peer-reviewed journals, they weren't. And none of them shows up in the forthcoming *First Handbook of Behavioral Finance* (Elsevier), edited by Douglas Bernheim, Stefano DellaVigna and David Laibson.

In the just-published draft (NBER Working Paper 24854) of a chapter in the book called "Behavioral Household Finance," authors James Choi of Yale and John Beshears, David Laibson and Brigitte Madrian of Harvard, review the best available research on the causes of the annuity puzzle. Here are the factors they collected and shared:

'Actuarially unfair' annuity prices. Several studies suggest that life-only income annuities don't offer good value. According to one estimate, the average annuity owner only gets back between 75 and 85 cents for every dollar of purchase premium, with insurance company costs eating up the difference. To me this means: most people don't expect to live long enough to be "in the money" on their contract.

A high fraction of household wealth is already annuitized in the form of future benefits from Social Security and private pensions. This seems intuitively right. For many people, the present value of their Social Security benefit can make up more than half of their net worth. On the other hand, the fact that most people minimize their benefits by claiming ASAP makes me wonder if they understand that Social Security *is* an annuity.

A bequest motive plus the opportunity to invest in equities can suppress annuity demand. It makes sense, as the authors observe, that people who are primarily thinking of their children's inheritances would prefer individual stocks over annuities, especially where the investments aren't held in qualified accounts. On the other hand, research shows that the bequest motive is fairly weak.

Married couples have built-in partial longevity insurance. On the principle that one can often live cheaper than two, or that a surviving spouse needs less income than an elderly couple, the book suggests that "when one member dies earlier than expected, there are more resources available to help meet financial needs if the other member lives longer than expected." This explanation seems less than intuitive, although it makes sense that the high cost of many joint-and-survivor annuities, relative to single-life annuities, might hurt their appeal to couples.

Annuities are not popular in bull markets. "Annuity take-up is negatively correlated with recent stock market returns. Households appear to extrapolate when forming beliefs about future stock returns and therefore prefer lump sums that can be invested in equities when recent returns have been high," the book says. Conservative investments don't hold much attraction when the world seems to be ignoring risk. A smart near-retiree, you might hope, would sell inflated equities to lock in safe lifetime income. But most people don't think that way.

Uncertainty regarding future health care needs. "Households may refrain from purchasing annuities and instead use accumulated wealth to self-insure against the risk of health shocks," the book says. This sentiment could be especially strongest among people who dread the prospect of needing Medicaid-funded long-term care. At the same time, anyone with a health problem that reduces longevity expectations would obviously lose interest in life annuities, unless a discounted or "impaired risk" annuity were available.

Institutional factors don't make it easy for plan participants to buy annuities. Since 401(k) plans generally do not include education that emphasizes the importance of turning savings into retirement income, most people don't arrive at retirement with an understanding of or appreciation for annuities–or a well-marked path toward the purchase of one. "Few defined contribution retirement savings plans provide annuities as an option in the investment menu, and small frictions in the process of purchasing an annuity may decrease annuity take-up substantially," the book says.

Not everyone is smart enough to make a sensible annuity choice. Is it dumber to buy an annuity or not to buy an annuity? It seems to depend on the situation. On the one hand, it takes a certain amount of financial sophistication to understand and appreciate the value of an annuity. Also, smart people tend to be wealthier, and wealthier people tend to live longer, so smart wealthy people, you might think, would value longevity insurance. On the other hand, people who are financially sophisticated are often confident enough in their investing ability not to feel the need for such a conservative financial instrument.

There you have them: Eleven answers to the annuity puzzle. Eight of them are deemed worth mentioning in an authoritative new textbook. Three of them come from my gut. Sellers of annuities should feel forewarned, if not forearmed.