Retirement Income
JOURNAL

Wharton professor challenges value of annuities

By Editor Test   *Thu, Jun 27, 2013*

A Wharton School professor, Kent Smetters (left) and a Congressional Budget Office researcher suggest that the low level of annuitization by Americans demonstrates their common sense.

"We find that most households should not annuitize any wealth. The optimal level of aggregate net annuity holdings is likely even negative."

So write Kent Smetters of the Wharton School and Felix Reichling of the Congressional Budget Office in their introduction to a research paper that was disseminated by the National Bureau of Economic Research this week. It is an extension of work published in 2004 by Smetters.

The authors were not immediately available for comment.

The introduction defines annuities as "investment wrappers" rather than as insurance contracts. According to a preface to the paper, they discussed its content with several members of the RIJ community, including Zvi Bodie of Boston University, Jeff Brown of the University of Illinois, and Boston-area advisor Rick Miller.

The papers offers two main arguments against tying up money in an annuity:

- Illness or mishap might shorten your lifespan and/or create demand for cash to pay medical bills or make up for lost wages.
- By shifting purchasing power toward the end of your life, it deprives you of spending power earlier in life, when you might value it more.

"We find that 63% of households should *not annuitize any wealth*, even with no transaction costs… The 'true annuity puzzle' might actually be that we do not see more *negative* annuitization [i.e. life insurance]," the authors write.

But they acknowledge that annuities have a role.

"For retirees, annuitization becomes more desirable at larger values of wealth," they write. "After a negative survival shock, a wealthy retiree has enough assets to pay for any potentially correlated long-term care cost from the annuity stream itself… Hence, a wealthy retiree can 'hold to maturity,' in much the same way that a long-term bond holder is less concerned with duration risk."

In an email to *RIJ*, the University of Illinois' Brown wrote, "In spite of [Smetters'] work, I still believe [annuities] make sense as a way of ensuring that real people don't outlive their resources."