YMCA Retirement Fund's
RESOURCE TOOLKIT
FOR YMCA LEADERS

VOL 2 NUMBER 7 JUNE 2011

THE ANNUITY PUZZLE

Everyone wants to enjoy a long, financially-secure retirement. However, too many people with 401(k)'s and other defined contribution plans make risky decisions with their retirement savings by rejecting the guaranteed lifetime income that comes from buying an annuity.

A June 5, 2011 *New York Times* article by University of Chicago economics professor Richard Thaler discusses what economists call the "annuity puzzle." Despite the security and predictable lifetime income that annuities provide, very few people purchase them.

➔ A QUICK LOOK

- The shift from defined benefit plans to 'building wealth' through defined contribution plans has resulted in greater self-reliance, and risk, for retirees
- Life annuities provide a source of monthly income that cannot be outlived
- Retirees who are opposed to buying annuities avoid them for a number of reasons, some emotional and some based on false assumptions

TRADITIONAL PENSION VS. LUMP SUM OPTIONS

The author asks us to imagine two workers who plan to retire, both 65-years-old, with accumulated retirement benefits of equal worth in dollars. However, one has a traditional defined benefit plan and can expect a lifetime retirement benefit of $4,000 per month. The other has a defined contribution plan and, at retirement, is paid a lump sum that must be self-managed.

The worker with the defined contribution plan must now decide the best way to convert this nest egg into a sustainable stream of retirement income, a challenge made especially difficult since their own life expectancy and future expenditure needs are, at this point, a mystery. The fact of the matter is, the average new retiree today will spend nearly two decades in retirement. A large and growing number of retirees will likely spend three or even four decades in retirement.

According to the Bureau of Labor Statistics, the average retirement age is now 61.6 for men, 62 for women. This has been on a downward trend for the past 60 years, from age 66.9 for men and 67.6 for women the 1950's. Meanwhile, life expectancy is increasing. The Social Security Administration reports that a man turning age 65 now has an almost 20% chance of living to age 90. A woman at age 65 has nearly a 30% chance. More potential in retirement means a greater risk of exhausting one's resources.

LUMP SUM OR ANNUITY?

If the worker puts the lump sum in a conservative bond portfolio and spends $4,000 per month—drawing from the interest earned and the principal—the nest egg will run out within 20 years. If, instead, the worker draws down only $3,000 per month, the nest egg could last 35 years (in case the worker makes it to age 100), but this will provide the retiree with much less income than the other retiree whose defined benefit plan is providing $4,000 per month, guaranteed for life.

To mimic the retirement payouts of a traditional defined benefit pension plan, the worker with a defined contribution plan could purchase an annuity. The annuity is the only private-sector financial product that will provide a guaranteed lifetime stream of income that cannot be outlived. This guaranteed income provides insurance against a drop in one's standard of living during the later years of retirement.

THE ANNUITY PUZZLE

Yet, despite the security they offer, annuities are not popular options among workers with 401(k)'s and other defined contribution plans. This is what economists call the "annuity puzzle"—the arguments for purchasing annuities make sound financial sense, yet most soon-to-be retirees are averse to purchase them.

In attempting to solve the annuity puzzle, economists look for explanation. What makes the annuities such a hard sell? What is holding retirees back from recognizing their value? The reasons can be psychological, emotional, and even based on misconception. Many are potentially solvable with improved education.

HEIRS

One reason people may view annuities with cynicism is out of concern for their heirs. An annuity would cover one or two individuals' retirement expenses (in the case of a joint & survivor annuity), but leave nothing behind after death. A proven way to meet this challenge is to annuitize a portion of the savings after setting aside an amount for bequests.

By contrast, if the retiree opts to manage without an annuity, they risk exhausting all of their retirement income, and in the worst case scenario, turning the tables and having to rely on those heirs for support.

FEAR AND PERCEPTION

Emotion is a powerful motivator. Surely the thought of taking one's nest egg—the savings built over a 40-year career—and entrusting it to an outside insurance provider can evoke some uncomfortable emotions. Since most workers will have to look outside their own company for an annuity provider, their options are numerous, complex and sometimes paralyzing.

There is also the misperception that buying an annuity is a gamble—a gamble your survivors will lose should you die before you have collected your entire nest egg. Thaler proposes that workers instead should view annuities as *insurance*. Annuities will insure steady and predictable income in the event that one lives to age 85, 90 or beyond.

This predictability can also help workers determine when to retire. A single lump sum offers no clues pointing to the best age or year to begin retirement. Yet, if the worker plans to convert that lump sum into an annuity, projections can be made that would help the worker get an idea of what to expect each month.

Thaler suggest that, for the assurance of a steady lifelong income, annuities should play a central role in the retirement planning of those workers who participate in defined contribution plans.

The study, "Annuities and the Puzzle of Income" by Richard H. Thaler appeared in the Sunday, June 5, 2011 edition of the New York Times. Richard H. Thaler is a professor of economics and behavioral science at the Booth School of Business at the University of Chicago.