Why Do People Hate Immediate Annuities?

By **Scott Stolz** | June 27, 2018 at 01:00 PM

Annuities can generate income in retirement — so where's the love?

About 25 years ago, I sat in a packed room at a National Association for Variable Annuities conference (now the Insured Retirement Institute). There, I watched Dick Austin, one of the original annuity pioneers, deliver a compelling argument for the inevitable substantial growth in immediate annuity sales.

The argument was as sound then as it is today: Baby boomers were going to retire en masse and would need guaranteed income to replace the pensions that were quickly disappearing. Boomers have indeed been retiring — at a rate of 10,000 per day, and most do lack a sufficient level of guaranteed income. Yet, according to LIMRA's U.S. Individual Annuities report for the fourth quarter of 2017, total immediate annuity sales in 2017 were $8.3 billion, just over 4% of total industry sales. What went wrong? What, if anything, can we do to make Dick Austin's vision finally come true?

Immediate Annuities Secure an Income for Life

Uncertainty makes retirement planning difficult. There are three things we don't know: 1. How long the client will live 2. The average portfolio return and the sequence of those returns (also known as "sequence of returns risk") 3. Whether or not there will be unexpected expenses in retirement, such as health care

Incorporating a single-premium immediate annuity or a deferred income annuity in a client's financial plan can help solve most, if not all, of the first two unknowns. With these products, your clients can purchase an annuity contract with a single premium payment. That annuity contract then pays a guaranteed income that starts immediately (SPIA) or at a time in the future (DIA).

By securing income for as long as the client lives, the immediate or deferred income annuity becomes a way to insure against living too long — mitigating unknown number one above. In addition, the client and financial advisor know it is far less likely to be necessary to reduce income levels in response to poor returns in the early years of retirement, thereby mitigating risk number two above.

Not only do these products reduce some of the uncertainties associated with retirement planning, but with an income guaranteed for life, these annuities can create a "personal pension plan" for the growing number of clients that find themselves without a pension. Clients can consider an immediate or deferred income annuity as a supplement to Social Security — a role pension plans held previously.

What's to Hate?

Sounds pretty good, right? A stream of guaranteed income for life to replace disappearing pension plans and supplement a client's portfolio and Social Security. So, why do people long for pensions and love Social Security, but find an immediate annuity so unappealing?

For many clients, just the word "annuity" is enough to make them tune out any presentation that outlines the benefits that they may otherwise find so appealing. But even if the industry succeeds in drowning out the very vocal annuity haters, other obstacles still exist for both SPIAs and DIAs.

Below is a list of challenges these products face and why I believe advisors and clients don't use them more often:

Misconception of the purpose: Rather than focusing on the primary purpose of the annuity — securing an income for as long as they live and protecting against the sequence of returns — clients worry they will die before receiving payments at least totaling the amount invested, thereby allowing the insurance company to "win." They forget that, like any other form of insurance, what they are really doing is insuring against risk.

Focusing on returns: Rather than view an annuity as a way to insure against living too long, many clients tend to think of an annuity as just another investment. Therefore, they often become too concerned about the return on that investment. Immediate and deferred income annuities should be positioned as a source of guaranteed income, not return generation. In fact, studies by Professor Jeffrey Brown of the University of Illinois concluded that consumer demand increases when an annuity is presented in terms of income streams as opposed to an investment alternative. (See “Behavioral Impediments to Valuing Annuities: Evidence on the Effects of Complexity and Choice Bracketing” by Brown et al, National Bureau of Economic Research Working Paper, December 2017).

Self-funded income: I believe that while everyone would like a pension, few are willing to fund it out of their own pocket. While I would argue that individuals with a pension and Social Security recipients did indeed fund these income payments — paying 6% from each paycheck — no one had to write a separate check to fund them. When an investor sees a large amount deducted from his or her investment account, it creates a very different reality.

Regulations and compliance: Academic studies indicate the most efficient retirement portfolio allocation for some savers — particularly those with between $400,000 and $2 million — could call for as much as 40-50% of the portfolio to be allocated to either an immediate annuity or a combination of an immediate annuity and deferred income annuity. (See “Why Bond Funds Don’t Belong in Retirement Portfolios,” by Wade Pfau, AdvisorsPerspectives.com, Aug. 4, 2015). This allocation could provide a sufficient amount of income, similar to pension plans historically, and transfer some risk from the investments in a portfolio. However, regulators likely would view such an allocation negatively and, therefore, an allocation like this would not likely clear a firm’s compliance hurdles. Even if it did, most clients would likely balk at handing over so much of their retirement savings to an insurance company.

Awareness: A recent Insured Retirement Institute/Jackson National Life study (“The Language of Retirement 2017”) found that only 46% of investors realize that annuities provide guaranteed income for life. With this statistic, it is easy to see the industry faces a significant awareness and education issue in the annuity space.

Mispricing the true cost of income: Brown’s study also demonstrates that investors tend to badly misprice the value of guaranteed income for life and how much it really costs. When asked how much they thought a 60-year-old male should be willing to pay to get an income of $100 per month for life, the median answer was $5,875, a fraction of the approximately $20,000 it would actually require. Advisors see this every day when some clients believe they can retire on just $250,000 and/or safely withdraw 10% of their portfolio each year. This would also explain why virtually every lottery winner elects to take the lump sum rather than the lifetime income and most people take Social Security at age 62.

What’s Next?

Given all the obstacles standing in the way of immediate annuity sales, why should you make them a regular part of your retirement income planning process? Let me answer that question with another one: Is it easier to plan for retirement for a client who has a pension or one who does not? Rather than look at an annuity as a drain on the client’s assets, think about how much more investment flexibility you have with the rest of the portfolio when an annuity is part of the overall retirement plan. With a sufficient guaranteed income for life, you can reduce the uncertainty around a client outliving his or her savings, reduce sequence of returns risk, and implement an appropriate target growth for the remainder of the client’s portfolio. Outside of a single client’s retirement plan, to make Dick Austin’s dream of substantial growth in the immediate annuity space a reality, we need to do the following:

1. Shift the paradigm so clients understand an annuity as a risk transfer tool rather than an investment. The purpose of the immediate annuity is to secure income for a client’s life and transfer both the longevity risk and the sequence of returns risk to the insurance company. It is not to provide an investment return to the portfolio.

2. Position immediate and deferred income annuities as a supplement. With pensions continuously disappearing, an immediate annuity’s guaranteed income for life can create a “personal pension plan” and work hand in hand with Social Security like pensions have historically.

3. Educate clients on the true financial value of lifetime income. Studies have indicated it takes much more to fund lifetime income than clients believe it will. Just as no one will exchange a $20 bill for five $1 bills, they are not likely to buy an annuity until they understand the true cost of securing an additional $1,000 per month for life.

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SIDEBAR: A Quick Annuity Lesson Looking for a way to help educate your clients on the true cost and, therefore, true value of lifetime income? I would suggest taking the client’s expected Social Security benefit and then working backwards on one of the many immediate annuity quote engines. Calculate how much money it would take to fund that level of income.

As an example, let’s assume we have a husband and wife who both elect to begin taking Social Security at 65 and are both expected to receive their own benefit of $2,250 per month, or $4,500 total for the two of them. Let’s further assume that this payment increases at 1.5% per year. Because they both are receiving their own benefit, the survivor will continue to receive $2,250 per month when the first spouse dies.

Your clients would likely be surprised to learn that it would take just over $1 million to fund an immediate annuity with similar terms. They also would likely have a much greater appreciation as to why Social Security is going to be such a financial drain on the federal government.

—*Scott Stolz*