

Problems with Annuities as payouts of retirement funds

Submitted by:

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Two of the problems with annuities as payouts of retirement funds need only brief mention:

1. Many annuities have excessive costs and/or sales commissions. The industry should be encouraged to develop better products, or it may be necessary to increase regulation. Such lowering of costs should be possible if the annuities are a regular part of retirement savings payouts made available by the employer, rather than being sold by individual brokers to individual customers.

2. At present annuities are guaranteed by state agencies, creating two problems. First, the guarantees often have a relatively low limit such as \$100,000 to \$250,000. While those sums unfortunately exceed the amounts too many retirees have already saved, those amounts are inadequate for a decent standard of living in retirement. Second, because they are state programs, they may generate problems for our highly mobile senior population.

A more fundamental problem is whether annuities can be made financially solid at a reasonable cost.

Will actuaries be able to predict accurately the many components needed to plan annuities?

- What if life expectancies become longer than expected? We may improve our diets, exercise, family life, health care, accident prevention, etc.
- What if inflation is worse than anticipated? If the annuities are not indexed for inflation, inflation may impoverish annuitants receiving a steady stream of decreasingly valuable dollars. If the annuities are indexed for inflation (as Social Security is), the cost to the annuity provider may become substantial. The bailouts and stimulus packages in the U.S. and internationally are pouring trillions of dollars and dollar-equivalents into the world economy, ideally avoiding a deflationary spiral like the Great Depression, but perhaps risking serious inflation.
- What if market returns are less than expected? Vast sums are being borrowed by the governments of the world for current expenses, rather than being invested in increasing productivity. Preventing global warming and improving the environment will produce benefits not included in market returns. Perhaps the market returns of the past century or two are products of technological and societal changes that cannot be repeated indefinitely.

Annuity issuers might be bankrupted by a combination of increased life expectancies, increased inflation (if annuities are indexed for inflation, and if not so indexed the annuitant may be impoverished), and reduced market returns.

Many pressures encourage those responsible for both public and private pensions to underestimate costs and to over-estimate future benefits, each error engendering current support but jeopardizing the future. This phenomenon has resulted in serious underfunding for many pensions in industry and government, including Social Security.

Even if the annuity issuers successfully estimate all these variables and thus succeed in being able to pay the promised annuities, to do so is likely to require significant expenses to hire talented personnel, to use derivatives appropriately, and to create necessary reserves, expenses ultimately born by the annuitants.

There is another approach: Have the pensioner be the risk bearer. To suggest that individuals may be better risk bearers than are large institutions might appear counter-intuitive. The following paragraphs outline why the individual may be the better risk bearer.

To pay from a portfolio a fixed and rising stream of income creates many risks, as outlined above. Here is an additional risk: One will be selling more stock when markets are down (thus increasing the “selling low” investors try to avoid) and less when markets are up (thus minimizing the ideal of “selling high”). It is the evil reversed image of the wonders of dollar cost averaging.¹ The problem is worsened if instead of withdrawing a fixed dollar amount, one withdraws a fixed dollar amount but increases that amount each year for inflation.

A different strategy will allow the retiree to avoid this risk. Each month, instead of withdrawing a fixed amount, the retiree would withdraw a fixed percentage of the portfolio. If 4% is an amount of a portfolio that one could expect to withdraw indefinitely, the retiree might withdraw $\frac{1}{3}\%$ each month.² To avoid too great a variability in monthly income, a retiree would want a cushion or shock absorber of a year or more of expenses in CDs or money market funds. The retiree each month would withdraw $\frac{1}{12}$ of the cushion (if one year’s expenses were in the

¹ Here is a numerical example:

Suppose that one invested \$1000 each month, and the stock price varied as shown in the table, so that the price of shares was inversely related to the number purchased:

<u>Price</u>	<u>Shares Purchased</u>
\$4	250
\$5	200
\$8	125
\$10	100
\$12.50	80

One will have spent \$5000 to purchase 755 shares, at an average price of \$6.62 per share (rounded), even though the average of the purchase prices is \$7.90 per share (the greater the volatility, the greater the difference). Thus the average of the prices paid per share is \$1.28 less than the average of the prices on the days of the transactions. This is good.

If, however, one were selling \$1000 worth of stock each month (rather than buying), one would be receiving an average of \$1.28 per share less than the average of the prices received per share on the transaction dates. This is bad. Worse, one may be depleting one’s portfolio too swiftly.

² ($\frac{1}{3}\%$ each month) X (12 months) = 4% annually.

shock absorber, $1/24$ if two years, etc.). This cushion would be maintained by periodic small liquidations of the personal account, the suggested $1/3$ % monthly (part of which would be distributions of dividends or interest, rather than sales of securities).³

People in retirement should be able to deal with fluctuating incomes, with those fluctuations damped by the shock absorber, much as those people did while they were working. When working they sometimes had fewer than 40 hours per week and sometimes had lots of overtime; commissions or business profits usually fluctuate; most people experience periods of unemployment; etc. The retirees would go to restaurants less and eat simpler food in lean times. They would buy clothes less often and of a less expensive nature. They would buy less expensive cars, drive them less, and make them last longer. There would be less travel and it would have to be cheaper. If the lean times continued, they would buy or rent less expensive housing. When markets improved, the pensioners would eat, dress, drive, and travel more and better, they would live in nicer places, and they might perhaps provide more help to children and grandchildren and charities.

To the extent that one annuitizes a portion of one's savings (much as with having a defined benefit retirement pension), one is deciding that that portion of one's wealth will not survive for the next generation. Although large inheritances risk stratifying a society, modest inheritances have long been a hardly-objectionable norm. Parents in the past might have left to their children the family's home (but now the home may be highly mortgaged), farm (but now only a very small portion of the population owns farms), fishing or trading boat (as with farms, the proportion of the population owning commercial boats has shrunk), tools and work bench (likely soon obsolete now), etc. To live off only a portion of one's retirement savings avoids the risks and expense of annuitizing and produces an intergenerational benefit. The parents can bequeath the unexpended remainder of the retirement savings to the next generation or the next, providing security to that generation when its own savings are still small, increasing resources for pensions for retirement, disability, or survivors (Social Security is a minimal safety net, so having something more generous would be desirable).

If retirees were encouraged to pursue an alternative to annuitizing, that alternative should be limited, to protect the high returns and low expenses needed and to provide security. The retirees who do not annuitize thus should be encouraged to use a distribution system such as outlined here, and not merely to withdraw larger amounts or a lump sum.⁴ The choice could be partial, with some of the retirement savings annuitized and the remainder used as outlined here.

³ For example, if the personal account held \$300,000, twelve months before retiring its owner would begin monthly transfers of \$1000 ($1/3$ % of the account) to a "cushion" of CDs or a money market fund. Once retired, that owner would withdraw $1/12$ of that cushion each month for living expenses, while continuing to transfer each month $1/3$ % of the personal account to the cushion. Fluctuations in the personal account (i.e., the account could easily change 10% over a few months, and then change back) would be damped by the cushion; the cushion would allow gradual adjustment to sustained, long-term increases or decreases in the value of the personal account (i.e., the account could easily change 20% or more from year to year).

⁴ For a suggestion that older investors should simplify their finances to avoid age-based drops in skills, see Karen Blumenthal, *Investors Should Act Their Age*, WALL ST. J. (Feb 13, 2010), available at

The system of withdrawals outlined here would produce smaller amounts than annuitizing would produce, because annuities return not only income but also a portion of the initial investment with each payment.⁵ But the retiree should be allowed to take the lower withdrawals of not annuitizing, hoping to leave more to future generations.

<http://online.wsj.com/article/SB10001424052748704878904575031123176714354.html?ru=MKTW&mod=MKTW>, and Georeg Korniotis & Alok Kumar, *Do Older Investors Make Better Investment Decisions?* REVIEW OF ECONOMICS AND STATISTICS, Forthcoming, available at <http://ssrn.com/abstract=767125>.

⁵ The system of withdrawals could be expected on average over the long term to produce increasing payments, to the extent that their investments produce returns in excess of 4%. The long-term return of the stock markets appears to be about 7%.