RETIREMENT PLANNING SOFTWARE, INC.

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A Needs-Based Approach to Decisions to Annuitize at Retirement

The decision to annuitize some, all, or none of invested assets at retirement is, despite its importance, rarely analyzed with any care by retirees. The percentage of people who elect annuitization over other options in defined contribution plans is generally reported to be less than 1%. Presumably, even fewer convert non-qualified funds to annuities.

In large measure, this is probably because most retirees don't understand, or aren't even aware of, annuities. But it is also because there is a lack of good tools and methods for educating them about this option.

We think we've come up with a promising new approach to evaluate annuitization, an approach that might encourage more people to take advantage of this option when it's appropriate.

The Financial "Plus"

Financial performance does not, apparently, drive most consumer decisions about annuities. Annuities can be a very good financial deal, but most people are understandably skeptical.

In January of 2002, PriceWaterhouseCoopers released a study commissioned by the National Association for Variable Annuities. The study demonstrated, using a moderately sophisticated statistical and actuarial analysis, that "variable annuities are an attractive option for investors seeking to supplement lifetime retirement income." Or did it?

What the study really showed was that if you live to a ripe old age (specifically, an age that only 5% of the population is expected to achieve), a variable annuity significantly outperforms similarly invested mutual funds. Well, it could hardly have come out otherwise. An annuity is essentially an insurance product, where the average person gets back roughly the economic value of what s/he put in, but where the losers (people who die early) subsidize the winners. In the PWC/NAVA study, only the outcomes of the winners were examined, i.e., people who live well into their nineties. It was inevitable that annuities would look good to this one select group.

Still, even though the results of the study were completely predictable, they do point to two genuinely favorable characteristics of annuities in general (whether fixed or variable):

1. Annuities provide lifetime income, no matter how long one lives. For people of modest means, the only other way to be assured of not outliving income is to invest the principal and live off the interest alone.

2. Annuities use a pooled arrangement to safely amortize principal as well as pay interest, so that monthly payments are much higher, in almost all cases, than one could safely achieve by living off of interest alone.

So annuities generally provide *higher* monthly income, as well as *lifetime* monthly income. Who wouldn't want them?

The Psychological "Minus"

Apparently, almost everybody wouldn't want them. Even the people who do actively consider annuitizing their funds usually decide not to do it. The main objections are:

1. If you die soon after taking out the annuity, you "lose." In addition to being dead, which is bad enough, you just put a big wad of cash into an annuity that is now going to stop paying you back. The real problem may simply be that people don't like the idea that they will both die early and die looking dumb. Fortunately, this effect can be ameliorated by opting for an annuity with a guaranteed minimum number of payments (usually 5 to 20 years' worth), or a joint annuity, although this means reducing the pay-out.

2. People also don't like the idea of losing control over their money. Surveys show that loss of control is a major concern of older people. When people retire, they give up positions of authority and/or expertise, and the empowerment that goes with all that. They usually have little opportunity to acquire new money, and must learn to live with what they have. Meanwhile, they anticipate a more limited lifestyle as their bodies and perhaps their minds weaken with age. Cash in the bank gives them options: how to invest it, how to save it, whom to leave it to when they are gone. Furthermore, they might *need* the cash for medical care, or for some other emergency. Letting a pension fund or annuity company keep their cash is seen as relinquishing even more of one's already limited options.

A Needs-Based Compromise

Our conclusion from all this is that we need a way to help people balance the financial plusses and the psychological minuses of annuitization. This means recognizing when people *need* to annuitize, and when they need to *not* annuitize – and also when they can afford, financially and psychologically, to do some of both.

The psychological needs might be the easiest to deal with. The most direct way is to ask the person or couple how much cash or investment they feel they need to retain under their own control to feel comfortable that (a) they have the flexibility that they want, (b) they will have enough to cover medical emergencies, and (c) there will be something left behind. These amounts are then reserved and not available for annuitization.

The financial needs are trickier, because we have to find out whether the household already has the financial wherewithal to provide an adequate standard of living even if at least one person lives to a very old age. If not, then annuitization of some portion of household assets will generally alleviate (if not entirely rectify) the shortfall. In a previous paper, we have addressed this issue. (See "A Needs-Based Approach to Post-Retirement Withdrawals from Savings", at www.StillRiverRetire.com/Downloads/Needs-based_Withdrawals.pdf) By testing financial security under adverse mortality scenarios, both with and without annuitization, we can determine in specific situations whether annuitization will help or not.

There are three possible outcomes:

1. **No annuitization** is advised: either there is not enough cash left to annuitize once the psychological needs have been met, or else, because of the mortality characteristics of the household and the cost of the annuity, annuitization actually makes things worse. (We found that this latter situation often prevails in two-adult households where *individual* annuities are being considered – because if one person dies early, the reduction in income is too severe. *Joint* annuities, however, often work fine in these situations.)

2. **Complete annuitization** of the unreserved amount is advised. This outcome usually indicates that the household is likely to run out of cash if one or more persons live well into old age – or that the current standard of living would have to be reduced more than desired in order to prevent this. The advantages of annuitization give immediate and permanent financial support – although even this boost might not be sufficient, of course, depending on the situation.

3. **A split approach** is advised: some of the unreserved amount is annuitized, some of it is not. This outcome indicates that complete annuitization is probably not required in order to meet household needs, even under adverse mortality assumptions. Furthermore, even if no annuitization is really required, it might still be advisable. If both the psychological and financial needs of the individual or family have been met, and there is money left over, it makes sense to split the difference in some manner, so that there is more cash available than the minimum required, but there is also more income than the minimum required.

We think that this approach is more sound than what is being done now, which is mainly limited to: (a) qualitative arguments in favor of (or against) annuitization; (b) illustration of an annuity product in the absence of an analysis of the financial need; or (c) financial analyses like the PWC/NAVA study that are detached from the real-life conditions that can invalidate their application.

An Invitation

The ability to model the kind of analysis we propose should have been available decades ago. In its absence, however, we have been experimenting on our own, and we invite your review and comment.

Specifically, we invite you to try out our prototype. (You can download it for free from our website: www.StillRiverRetire.com; select the RetirementWorks® download, plus the PDF file that documents the "Retirement Income Annuitization" calculator.) The current model is relatively simple, and we realize that it could be made a lot more thorough and complex. For now, we prefer a simple model that we can build on later, once the underlying approach is validated. Your comments will go a long way toward making a model that really works well for most people.

Still River Retirement Planning Software, Inc., provides both web-based and desktop software offering specialized calculations related to retirement plans and retirement planning.

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