How to Best Annuitize Defined Contribution Assets

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Annuities provide more income and security than individuals can attain on their own.

Notes: The annuity amount is from a quote as of 7/1/19 for a 65-year-old male in Massachusetts. The other calculations assume a 3-percent nominal annual return, based on the yield on AAA corporate bonds with 20-year maturities in August 2019. Sources: The website “immediateannuities.com,” and authors’ calculations.
But few people annuitize. Potential explanations are:

• bequest motives;

• cost of annuities, due to adverse selection and loading;

• crowding out by Social Security, family members, and self insurance;

• precautionary saving; and

• irrational resistance.
Embedding annuities within DC plans may address some barriers.

- But only 7-10 percent of employers offer such an option.

- The three leading examples of embedded annuities are:
  - TIAA’s Traditional Annuity;
  - United Technologies Corporation’s Lifetime Income Strategy; and
  - Guaranteed Withdrawal Lifetime Benefit products.
An alternative to commercial annuities is additional Social Security income.

- Thaler and others have proposed buying an annuity directly from the Social Security Administration (SSA).
- SS income has advantages over private annuities, as it is:
  - guaranteed by the government;
  - inflation adjusted; and
  - its price would not include marketing costs or profits.
- This proposal is straightforward, but involves:
  - legislation;
  - additional administrative staff at SSA; and
  - transaction costs, as people must actively buy the product.
Another way to get additional annuity income from SS is by delaying claiming.

- Benefits claimed at age 70 are 76 percent higher than at 62.

- Households can tap defined contribution (DC) wealth to “bridge” between retirement and postponed claiming.

- The bridge would pay out the individual’s Primary Insurance Amount every month, between ages 60 and 69 or until the assets allocated to the bridge run out.

- The bridge can be adopted by plan sponsors now – maybe even as a default – without legislation.
This paper compares the Social Security bridge to immediate and deferred annuities.

• The analysis assumes that immediate and deferred annuities are bought at 65, with the deferred payouts beginning at 85.

• 20 or 40 percent of assets are allocated to lifetime income for median-wealth households.
  o For higher-wealth households, less wealth is required to exhaust the possibility of delayed claiming.

• Individuals consume following the RMD rule of thumb.
  o For deferred annuities, remaining assets are steadily consumed until exhausted at age 85.
The analysis computes the “equivalent wealth” of each option relative to no annuitization.

• Each option is assigned the amount of starting wealth required to attain the same utility as when no wealth is annuitized.

• This dollar amount is then normalized by starting wealth, so that the equivalent wealth of no annuitization is 1.

• The better the option, the lower its equivalent wealth (i.e., less wealth is needed to attain an equivalent level of utility).
The model also accounts for several risks.

- Market returns and variance are calibrated to historical data.
  - Assets are allocated to equities and bonds following a Vanguard TDF.

- Health shocks occur with probability 0.1, at a magnitude corresponding to the 90th percentile of health spending by age.
  - Shocks are paid out of assets; when they are exhausted, out of income.
  - Consumption has a floor of $10,000 (Medicaid income test).

- Households are assumed to retire at 65, with mortality from SSA tables.
In utility terms, the “bridge” is the best option for median-wealth households.

Equivalent Wealth for Single Households of Median Wealth, by Strategy

For wealthier households, the bridge and deferred annuities are similarly beneficial.

Equivalent Wealth for Single Households of 75th Percentile Wealth, by Strategy

Even for the wealthiest, the bridge is a component of the best-performing portfolio.

Equivalent Wealth for Single Households of 90th Percentile Wealth, by Strategy

Drawdown of retirement assets is a challenge that is only really beginning.

- The first cohorts completely dependent on DCs are still early in their retirement.

- Lifetime income products can provide both insurance and guidance on how quickly to consume.

- The Social Security bridge option has many advantages over commercial annuity products.
  - The “bridge” may be the best option for median households, and a promising component of the drawdown portfolio for wealthier ones.
Thank you!