How to Best Annuitize Defined Contribution Assets

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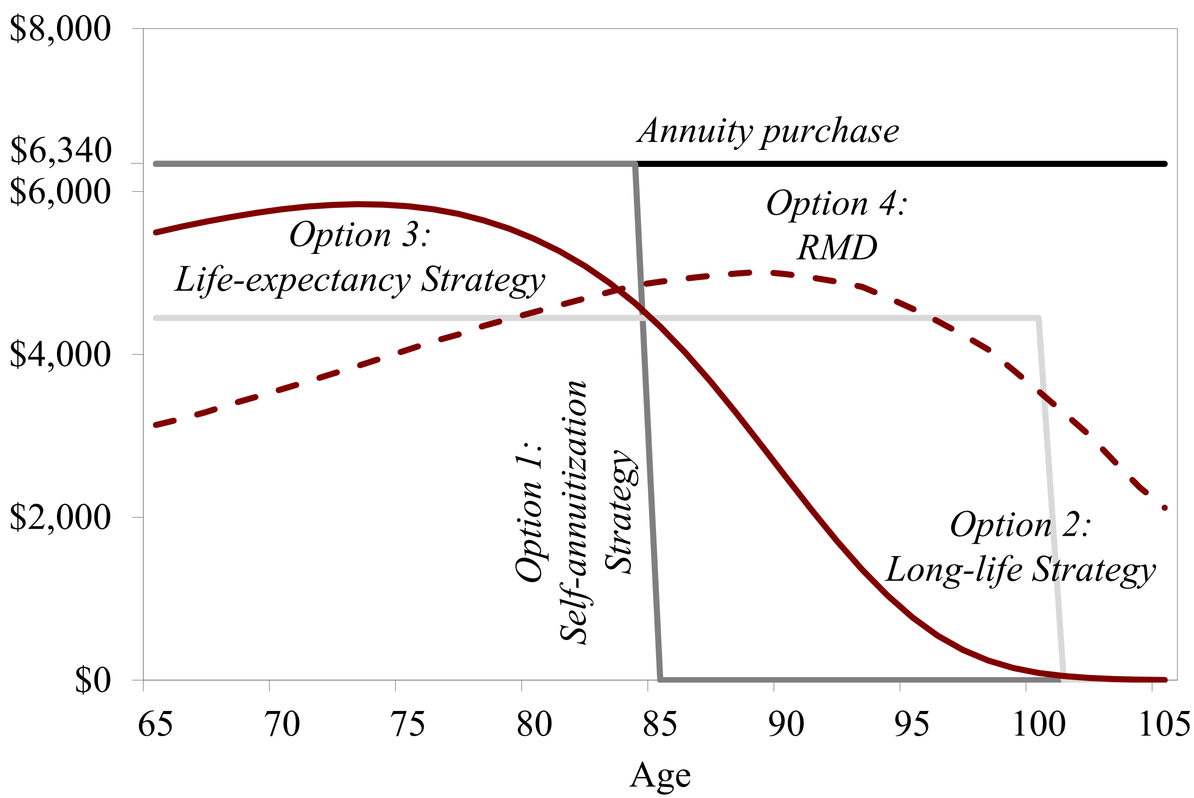
Annuities provide more income and security than individuals can attain on their own.

Income Produced from $100,000 by Drawdown Strategy



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.
  - For higher-wealth households, less wealth is required to exhaust the possibility of delayed claiming.

- Individuals consume following the RMD rule of thumb.
  - 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.

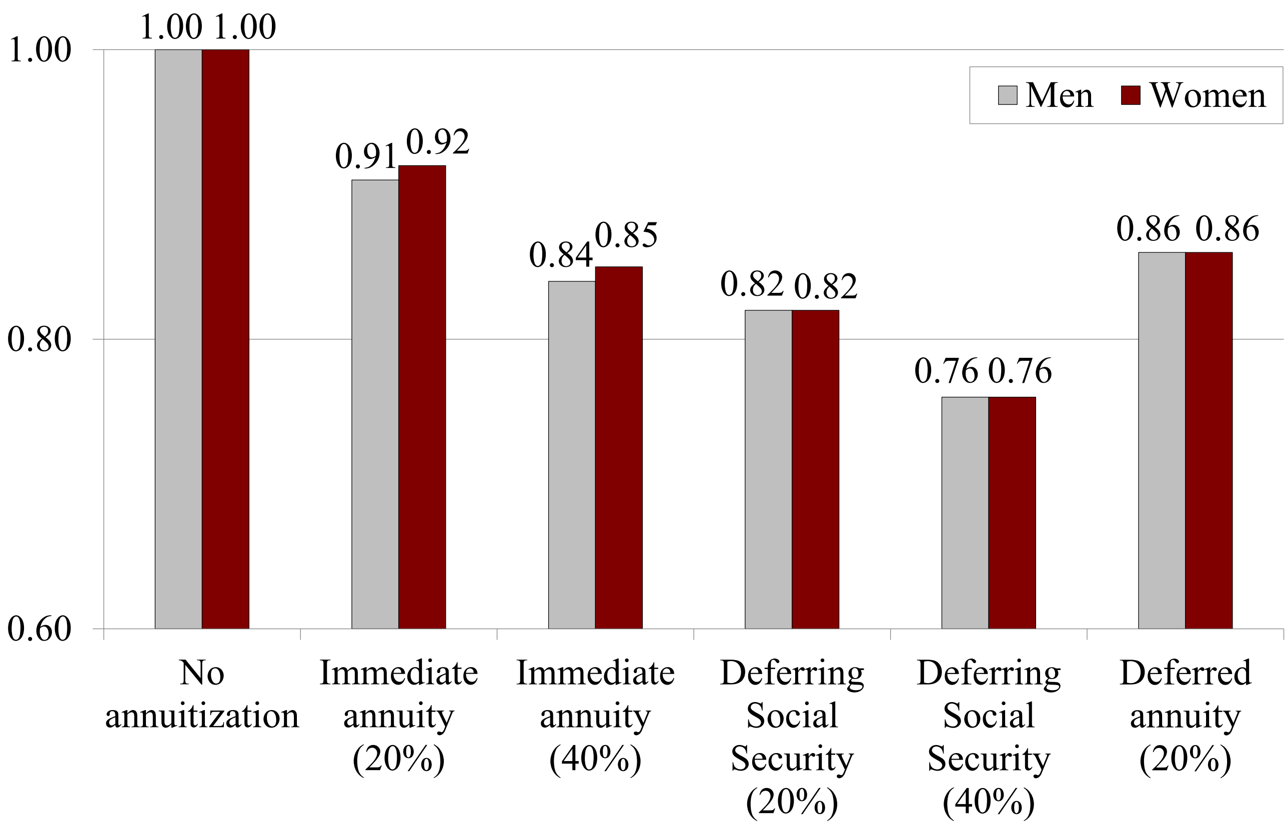
- Market returns and variance are calibrated to historical data.
  - Assets are allocated to equities and bonds following a Vanguard TDF.

- 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.

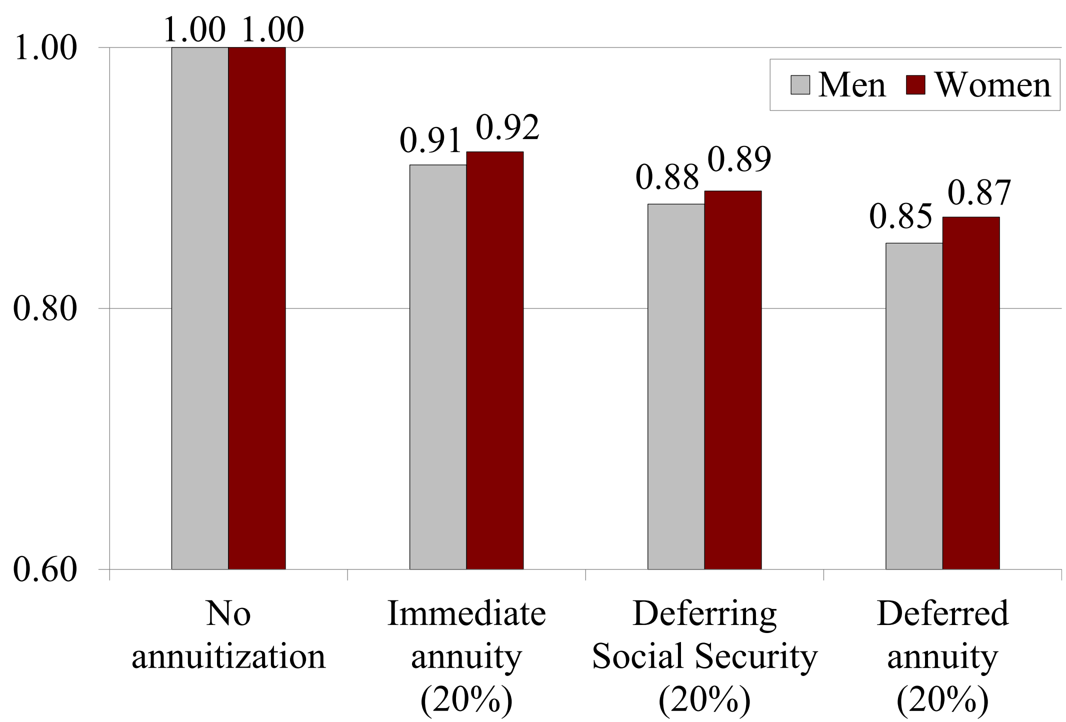
Equivalent Wealth for Single Households of Median Wealth, by Strategy



Source: Alicia H. Munnell, Gal Wettstein, and Wenliang Hou. 2019. "How Best to Annuitize Defined Contribution Assets?" Working Paper 2019-13. Center for Retirement Research at Boston College.

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

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



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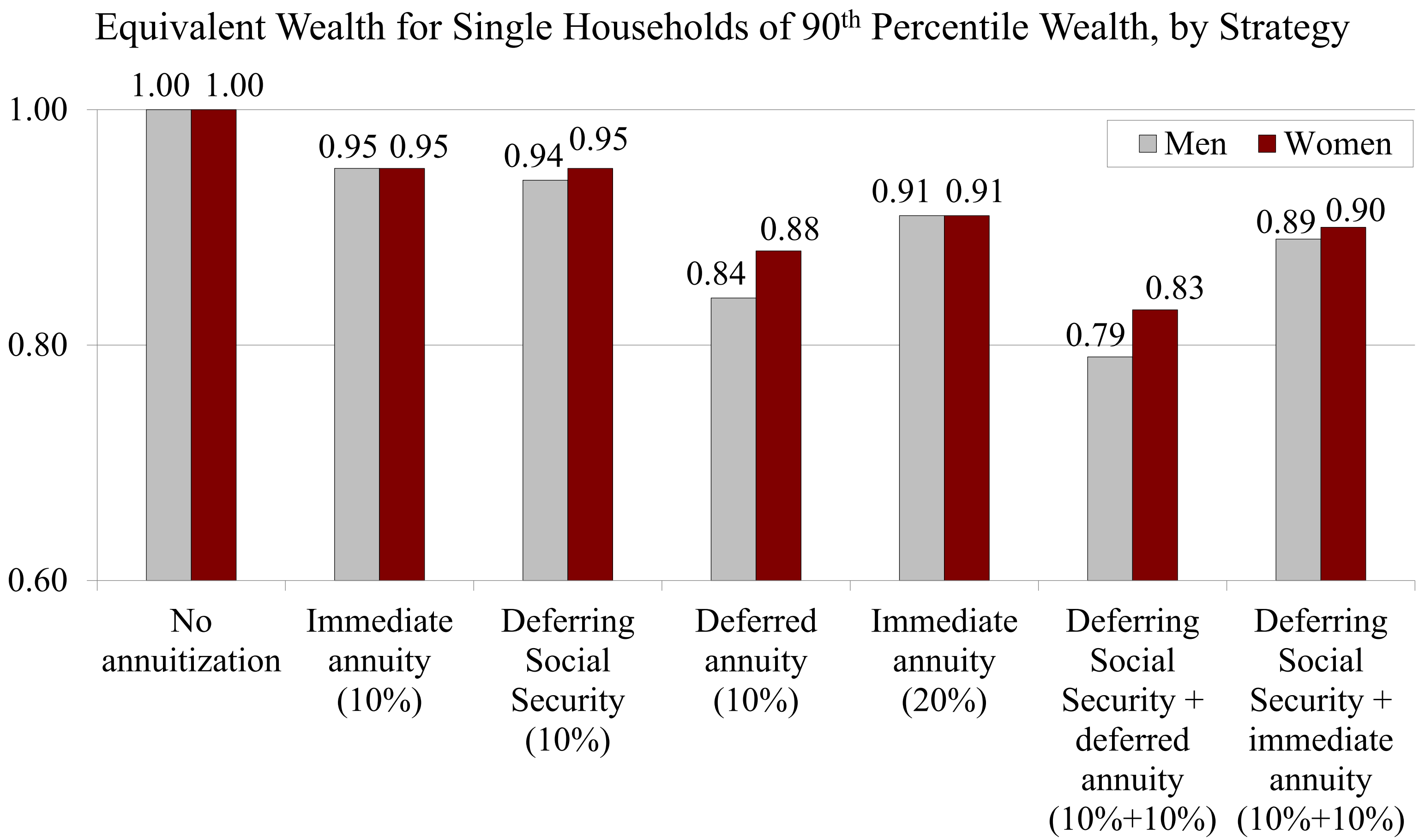
Even for the wealthiest, the bridge is a component of the best-performing portfolio.



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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!

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