Annuity Puzzle Solved: Don’t Buy Them

By Gil Weinreich, ThinkAdvisor | July 2, 2013

For nearly 50 years, financial economists have scratched their heads wondering why more people, at least those without significant bequest motives, didn’t buy annuities.

They provide higher income than bonds and protect against the risk of outliving one’s wealth. Why people would refuse to feast on what may be the only free lunch economics offers—higher consumption and elimination of risk at the same time—has so bothered academics that the question has its own catchy nickname: “the annuity puzzle,” which legions of aspirants have sought to solve.

Now, defying all the conventional wisdom, a team of two researchers, Felix Reichling of the Congressional Budget Office and Kent Smetters (left) of the University of Pennsylvania’s Wharton School, have published a new working paper on annuity optimization that concludes that low demand for annuities is no puzzle at all.

In fact, the authors state that the optimal level of annuity ownership may actually be negative, such that the true annuity puzzle may be why people are not shorting annuities.

Reichling and Smetters’ thesis, though not yet formally published, is likely to spark significant debate within the academic and financial services communities. To get an early briefing for financial advisors, AdvisorOne spoke with co-author Smetters, who is especially known among advisors as the founder of middle-market financial planning firm Veritat Advisors, which LPL acquired from him in 2012.

A distinguished scholar, Smetters did not hastily launch into this controversial finding. He said he has been thinking about the issue for about a decade and has been taking his time getting the mathematics right while honing a computer model that has been crunching through hundreds of thousands of optimization problems.

**AdvisorOne: So who should and who shouldn't be buying annuities?**

Smetters: The conventional wisdom has been that people should annuitize a lot, and the big mystery was why don’t they annuitize a lot.

The point of our paper is mainly to simply ask: Does it actually make sense that people should buy annuities as much as conventional wisdom says? And the answer is “no” for most Americans.

The average American should probably not annuitize any of their wealth. Younger people should not. Even most people at retirement should not.

Those who should buy annuities have already incurred health costs or are quite elderly and would get large value for buying an annuity. Those are very exceptional cases.
But most younger people should negatively annuitize, which they can do by buying a fair amount of life insurance.

Your paper seems to argue that the reason for negatively annuitizing turns on the health care risks that people face at various life stages. Can you elaborate?

The simple explanation is that people assume uninsured risk throughout their lives.

For workers, the big risk they face is that they could become disabled. For retirees, it is the uninsured medical costs not covered by Medicare or even Medigap policies.

When you have one of these shocks—disability or a long-term care need—at the very same time your longevity outlook goes down. Had you bought an annuity ahead of time, you then have this disability shock and you have a need for income at that point. You could sell your annuity at that point because of the income that you need. There is a secondary market where you can do that.

What happens though is the value of that annuity has also gone down because you just had a disability and therefore your longevity [expectation] has gone down. What we find is that even if you can undo your annuity position, the value that anyone’s going to pay for your annuity is much lower.

Annuities have been portrayed as low-beta. We’re coming around and saying it’s a higher beta asset because it’s coordinated with health care shocks.

So how exactly does someone short annuities as a hedge against future health care shocks?

You can get a negative annuity by buying life insurance. It is well known since [Menahem] Yaari and others that whereas an annuity pays me for living, life insurance pays me for dying. What happens when I get sick is that my life insurance increases in value. You can cash that out and get protection against uninsured expenses.

Annuities are a common tool in advisors’ product tool kits. What might they do differently in light of this research?

What financial advisors should be thinking harder about is the extent to which the people they are giving advice to face uninsured health costs—they should think about long-term care insurance for older people, and for younger people, disability insurance.

If a person you’re giving advice to, if they have a fair amount of uninsured health expenses in the future, they shouldn’t be buying annuities unless they’re quite old (in their late 80s), in which case they can get a very large return.

Only 1 in 10 U.S. households have a long-term care policy, and they’re becoming more expensive and harder to collect on. According to an annual Fidelity survey, a couple retiring today will face almost $230,000 in health care expenses that are not reimbursed by Medicare. With a good long-term care policy, they’ll have a very low chance of having uninsured health care costs in retirement.