T. Rowe Price

A behavioral case for annuities

In the Spotlight
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Key Insights

- Most retirees manage savings to preserve or increase their assets by lowering their spending or lifestyle. Wealthier retirees decrease their spending the most.
- To avoid dipping into their savings, retirees adjust their essential spending to match their level of guaranteed income.
- More positive framing of annuities as a way for retirees to preserve assets and maintain lifestyle—rather than to prevent running out of money—could help adoption.

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Conversations about money are usually dominated by savings—how much to save, how to invest, how much savings is enough to retire, and so on. Comparatively, very little attention is paid to how to spend savings. Yet, one might argue that spending down retirement savings is more challenging, at least from a decision-making point of view.

The challenge of deciding how to spend retirement savings comes from different directions. First, there are the big uncertainties—longevity, health shocks, inflation, market volatility, etc. Then there are personal preferences—desire to leave an inheritance, ticking some bucket list items, etc. But above all, spending down savings must be constantly weighed against the possibility of running out of money. As a result, retirees might start to question every spending decision—is it too much?

Annuities can alleviate a large part of this decision-making burden because they provide the following advantages.

Longevity Protection: As noted above, retirees face many uncertainties, but from a planning perspective, the biggest of them all is the uncertain life span. This generates the fear of running out of money. Although Social Security guarantees that retirees will never run out of money, Social Security income alone is often not enough for many retirees to maintain their lifestyle and could mean a drastic change in lifestyle that many retirees might associate with an unsuccessful retirement. For them, peace of mind may come from having additional guaranteed income that sustains their lifestyle as long as they live—in other words, annuities.

Different Income Guarantees: In their simplest form, annuities provide a fixed level of guaranteed income for the lifetime of an individual. But different individuals have different needs and fears. Some may need such a guarantee only if they live a very long life; others could fear that they might not live long enough to make the purchase of an annuity worthwhile. Annuities have evolved to address these concerns. For example, deferred annuities provide late-life income protection, and period-certain annuities along with variable annuities provide protection against an early demise while also maintaining income for life. Bottom line, different annuities provide different types of guarantees that meet the needs of different people.

Hedging Sequence of Returns Risk: One of the key benefits of annuities is that they help to hedge against "sequence of returns" risk. If a retiree follows a relatively fixed withdrawal strategy, such as the 4% rule, then her portfolio could become more vulnerable to sequence of returns risk if the markets experience large drops in the initial years of retirement. But if she could fund her spending needs with annuity income, then her portfolio would have the time to recover and could avoid untimely liquidation.

Tax Advantage: Annuities can provide several tax benefits. Income and investment gains from nonqualified contributions made to variable annuities grow tax-deferred and, in certain cases, could even be withdrawn with tax-favorable distributions. In addition, investment changes or annual rebalancing of a portfolio might not trigger a taxable event. Finally, an existing variable annuity contract can be exchanged for a new one, when appropriate and suitable, without paying any taxes on the income and investment gains from the existing contract.

Preserve Assets: This is probably the least publicized advantage of annuities, and one that we'll focus on. There are two channels through which annuities can help preserve assets. The first is mechanical, a product feature of newer annuities. These days, annuity contract holders who want to generate guaranteed income from their annuities have two options—annuitization or use of a guaranteed income rider. Annuitization involves giving up control of one's funds, but those utilizing guaranteed income riders can maintain control of their funds. The trade-off is usually lower monthly payments. But this helps people overcome a key fear associated with annuitization—losing their money.

However, our focus for this paper will be on the second channel through which annuities can help preserve assets—by controlling retirement spending.

Retirees want to preserve their assets

For a long time, we had an oversimplified understanding of how retirees spend down their savings. Economists predicted that retirees will systematically spend down their savings to fund retirement. So financial professionals came up with efficient ways of doing it, such as the 4% rule. However, a body of new research on retiree behavior suggests that many of the commonly held assumptions are not, in fact, what people do.

To better understand this, as part of our seventh annual Retirement Savings and Spending Study, we asked retirees how they spend their savings. Nearly 70% of retirees said that they manage their money to preserve their assets. Only a small minority of retirees say that they use their savings to fund their current consumption. Data on retirees' drawdown patterns support this. In a 2018 study,[1] the Employee Benefit Research Institute (EBRI) found that during the first two decades of retirement, retirees spent down their assets very slowly. The research also showed that more than a third of retirees with more than $500,000 in non-housing wealth had increased their assets

Nearly

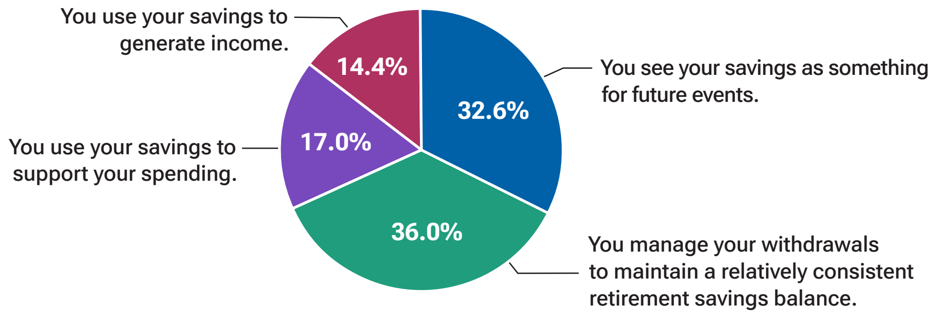
70%

of retirees manage their money to preserve their assets.

[1] Sudipto Banerjee, "Asset Decumulation or Asset Preservation? What Guides Retirement Spending?" EBRI Issue Brief, no. 447 (Employee Benefit Research Institute, April 3, 2018).

Majority of retirees want to preserve their savings for the future

(Fig. 1) A small minority of retirees use savings primarily to fund consumption



Source: T. Rowe Price Retirement Savings and Spending Study (2021).
Question: When you think about how you are managing your retirement savings, which of the options below most closely and least closely resembles your approach?

during this period. Other studies[2] have also reported very little change in asset levels during retirement years.

How do retirees preserve their assets?

This raises the obvious question: How do retirees manage to do this? If they don't have earnings from work and if they are reluctant to spend down their savings, how are they funding their spending needs?

The answer is both simple and complicated. The simple answer is: Retirees cut down their spending.

On average, inflation-adjusted retiree spending goes down by 2% every year. This helps retirees to maintain their savings. Moreover, wealthy households that were in the top 20% in terms of their net worth (total assets minus total debt), i.e., a net worth of $667,000 or more, cut down their annual spending even more aggressively, by 3.1%. This helps them to slow down their asset decumulation.

But how do retirees decide how much to spend? This is where it gets slightly complicated and where annuities could enter the picture.

Retirees match essential spending to guaranteed income

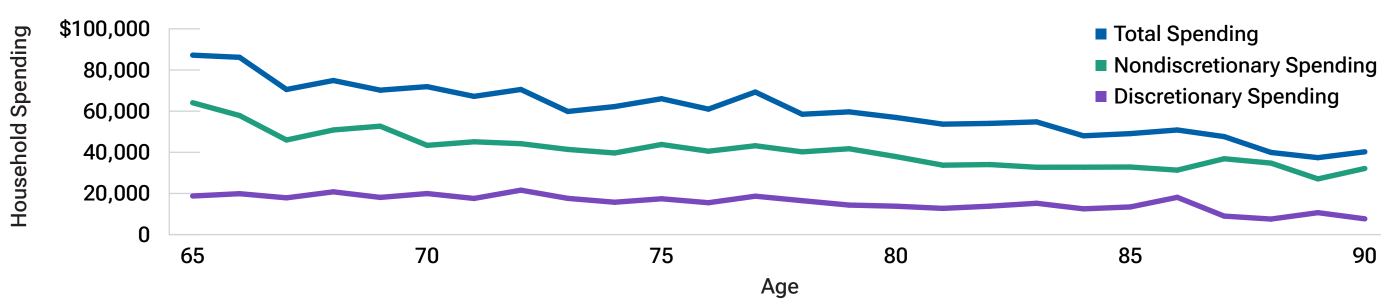
Nondiscretionary (see Appendix for details) items, such as mortgage or rent, groceries, gas, health care, etc., make up for the bulk of retiree spending. On average, they account for 75%–80% of total spending throughout retirement.

Retirees adapt their spending to match their income and do so by matching their nondiscretionary or essential spending to their guaranteed income, which includes Social Security income and if they have any pension or other annuity income. We demonstrate this by estimating the ratio of nondiscretionary spending to guaranteed income. This ratio quickly approaches one after retirement and remains there for the rest of the retiree's life. This implies that rather than dipping into their savings for their day-to-day spending needs, retirees adjust their essential spending to match their guaranteed income.

[2] James Poterba, Steven Venti, and David Wise, "What Determines End-of-Life Assets? A Retrospective View," in D. Wise, ed., Insights in the Economics of Aging (Chicago, University of Chicago Press, 2017), 127–157.

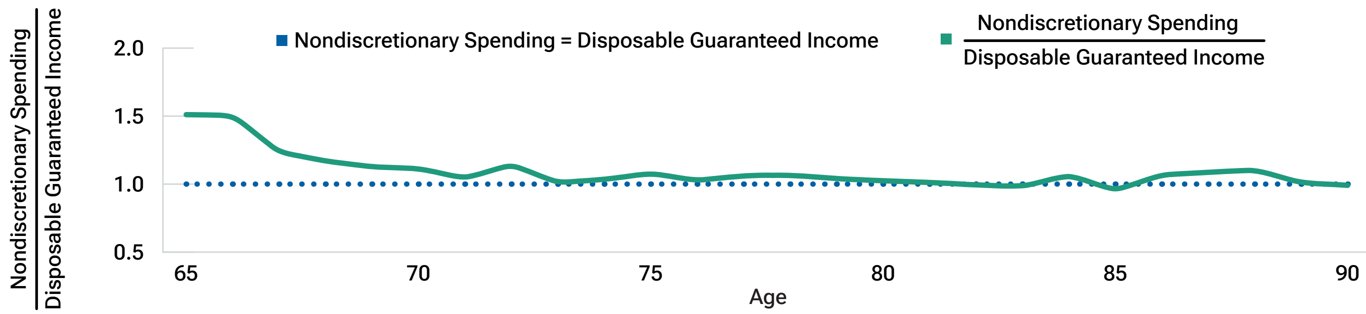
Reduced spending in high-net-worth households is driven by reduced nondiscretionary spending

(Fig. 2) Median household spending declines 3.1% ($1,879) annually for the top 20% of net worth



Retirees adapt spending to their income

(Fig. 3) After age 65, nondiscretionary spending quickly becomes aligned with disposable guaranteed income



Can annuities help to preserve assets?

Our research tells us two things. First, a vast majority of retirees either want to maintain their level of assets or increase it. Second, spending patterns suggest that retirees use guaranteed income as an anchor for their essential spending. This keeps them from using their savings to fund their day-to-day expenses.

To show the extent to which annuities might help retirees preserve their assets, we look at pensions. After all, pensions are, in fact, annuities.

Comparing two groups of retirees, those with and those without pensions, the EBRI study[3] showed that after 18 years of retirement, non-housing assets of pensioners dropped by only 4% compared with a drop of 34% for those without a pension.

This is not an obvious finding, and to some extent, is counterintuitive. If the fear of running out of money is the primary driver of asset preservation, then households with higher levels of guaranteed lifetime income should spend down their savings more freely. Instead, we find the opposite happening. This has two implications. First, households have a strong preference for asset preservation, i.e., in addition to consumption, they also derive satisfaction from the level of assets they hold. Second, higher levels of guaranteed income help them preserve assets more successfully.

Final thoughts

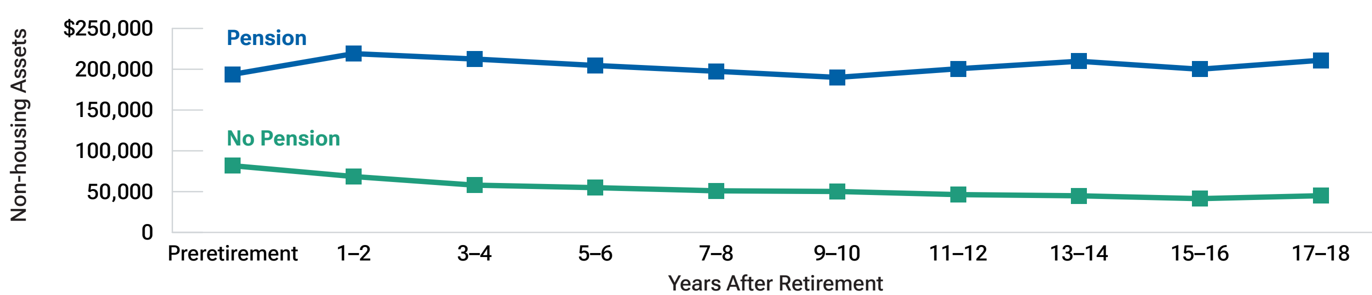
Annuities have long been projected as the best hedge against longevity risk. They can protect people from running out of money late in life. This type of framing could make people think that they will not benefit from annuities if they don't live long enough. But annuities can be marketed in a more positive way, i.e., they can help retirees to preserve their assets. Such a framing might help people rethink the utility of annuities and use them as a tool to achieve their current financial goals, rather than as a fail-safe in the event of an extreme outcome.

It is also clear from the data that, to a large extent, the lifestyle of retirees is determined by the level of their guaranteed income. So, if an individual wants to maintain a certain lifestyle, they should maintain a level of guaranteed income that can support that lifestyle. Simply having the money in the form of savings will not help because, in that case, preserving the savings would take precedence over maintaining a certain lifestyle.

[3] Sudipto Banerjee, "Asset Decumulation or Asset Preservation? What Guides Retirement Spending?" EBRI Issue Brief, no. 447 (Employee Benefit Research Institute, April 3, 2018).

Pensioners are highly successful at preserving their assets

(Fig. 4) Median non-housing assets before and after retirement for households with and without pension income[4]



Source: Employee Benefit Research Institute estimates from Health and Retirement Study.

[4] All numbers measured in 2019 dollars.

Appendix

Nondiscretionary Spending: Mortgage, rent, utilities, homeowners' or renters' insurance, property taxes, home repairs and maintenance, housekeeping supplies, auto payments, auto insurance, auto maintenance, clothing and apparel, health insurance (including supplemental insurance), prescription and nonprescription medication, health care services, medical supplies, food and beverages (excluding dining out), gasoline.

Discretionary Spending: Trips and vacations; household furnishings and small equipment; charitable and political contributions; cash or gifts to family or friends; dry cleaning and laundry services; home cleaning services; supplies and services for gardening and yard; personal care products and services; tickets to movies, sporting events, and art performances; gym and other sports activities; hobbies and leisure equipment; dining out and takeout food.

About our research

We use data from the Health and Retirement Study (HRS)[1] and its supplement Consumption and Activities Mail Survey (CAMS). CAMS started in 2001, and we used data from 2001 through 2019. Income data corresponding to each CAMS wave are used from HRS.

More importantly, we used data only from the original CAMS cohort first interviewed in 2001 and then every other year since then. Therefore, this is a panel data analysis as we follow the same group of retirees from 2001 to 2019.

However, we used some filters to make the data suitable for analysis. First, to ensure the integrity of the panel, we kept households that were observed in at least two consecutive surveys. Second, to contain spending outliers, we dropped observations in the top 1% of the total spending distribution and households whose total household spending exceeded three times their total household income in any given year. To calculate disposable income, we assumed the median household pays an effective tax rate of 16%, the top quintile pays an effective tax rate of 19%, and the bottom quintile pays an effective tax rate of 0%. Our final analysis sample consisted of 1,470 households.

All spending and income numbers were inflation adjusted using the consumer price index and presented in 2019 dollars.

[1] Health and Retirement Study, public use dataset. Produced and distributed by the University of Michigan with funding from the National Institute on Aging (grant number NIA U01AG009740). Ann Arbor, MI.

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Important Information

Earnings are taxed as ordinary income when withdrawn. There may be a 10% federal tax penalty on withdrawals before age 59½.

An annuity is a long-term, tax-deferred investment designed for retirement. It will fluctuate in value. It allows you to create a fixed or variable stream of income through a process called annuitization. It provides a variable rate of return based on the performance of the underlying investments. An annuity isn't intended to replace emergency funds or to fund short-term savings goal.

You should also know that an annuity contains guarantees and protections that are subject to the issuing insurance company's claims paying ability. But these guarantees don't apply to any variable accounts that are subject to investment risk, including possible loss of your principal.

An annuity is a contract between you and an insurance company, and it's sold by prospectus. You should read these documents. They describe risk factors, fees and charges that may apply to you. Variable annuities have fees and charges that include mortality and expense, administrative fees, contract fees and the expense of the underlying investment options.

Riders may be available to help you customize your policy and provide additional benefits. Riders are optional and available at an additional cost. There is no guarantee that the benefits received under the terms of rider may not exceed the cost to include the rider on your policy.

All withdrawals or partial surrenders will reduce the death benefit. Additionally, once in the income phase, excess withdrawals will reduce subsequent future payments.

Variable annuities are sold by prospectus. Both the product and underlying fund prospectuses can be obtained by contacting the issuing insurance company directly. Before investing in this fund or any competing fund, carefully read and consider the fund's investment objectives, risks, charges, expenses, and other important information contained in this and the underlying funds' prospectuses.

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