Rational Decumulation Summary

Wharton Financial Institutions Center
Policy Brief: Personal Finance
Investing Your Lump Sum at Retirement

The Wharton Study – University of Pennsylvania, School of Business
Professor David F. Babbel of The Wharton School and Professor Craig B. Merrill of The Marriott School of Management at Brigham Young University

Two year in-depth study of Fixed Indexed Annuities
Six Ph.D. Economists & Two Senior Actuaries

• "Since inception in 1995 many FIA's have outperformed corporate and government bonds, equity mutual funds, and money markets in any combination."

• "Not in a year here and there but in every year!"

As Americans grapple with the challenge of potentially outliving their retirement savings, a new Wharton School study has found that lifetime income annuities (FIA) are the most cost-effective and secure asset class for generating guaranteed retirement income for life. The study also found that income annuities (FIA) can provide secure income for one's entire lifetime for 25-40% less money than it would cost to provide a similar level of secure lifetime income through traditional means.

The research finding, co-sponsored by the Wharton Financial Institutions Center at the University of Pennsylvania and New York Life Insurance Company, are outlined in a paper entitled "Investing Your Lump Sum at Retirement," which is based on an academic study co-authored by Professor David F. Babbel of The Wharton School and Professor Craig B. Merrill of The Marriott School of Management at Brigham young University. He study explores financial options for retirees and compares income annuities with other asset classes in retirement.

DUELING ASSET CLASSES: THE WHARTON STUDY DEMONSTRATES THAT LIFETIME INCOME ANNUITIES (FIA) ARE THE BEST ASSET CLASS FOR FINANCIAL SECURITY IN RETIREMENT

Income Annuities Top Other Asset Classes By Mitigating Risk of Outliving Retirement Savings

The Wharton academic study revealed that:

- Income annuities (FIA) can provide secure income for one's entire lifetime for 25-40% less money than it would cost an individual to provide a similar level of secure lifetime income through traditional means, thanks to an insurer's ability to spread risk across large numbers of people;

- Consumers are not annuitizing enough of their portfolios even though income annuities are low-cost, available from creditworthy insurers, and provide guaranteed payments for life. Equities, fixed income and other investment products like mutual funds carry the risk of outliving one's next egg;

- By covering at least basic living expenses with income annuities (FIA), consumers have much greater flexibility in other areas of a retirement plan, including the ability to take more investment risk with the remaining portfolio;

- Recent innovations in income annuities, such as annual inflation adjustments, legacy benefits and access to capital in emergencies, have helped elevate the product to a desirable asset class in retirement.

"Living too long is fast becoming the major financial risk of the 21st century," said Professor Babbel. "Combined with the challenges facing Social Security and the decline of corporate pensions, this adds up to a "perfect storm" for retirees who might outlive their retirement next egg. Compounding our concern is that those who have chosen to annuitize their wealth through private annuity purchases are relatively few today. **Our research shows that only lifetime income annuities can protect individuals in an efficient way from the risk of outliving their assets and that this simply cannot be duplicated by mutual funds, certificates of deposit, or any number of homegrown solutions. We believe we've shown that income annuities clearly should be more widely used, given that highly rated insurance companies are reliable and inexpensive sources of guaranteed income streams in retirement."**

"With long standing sources of guaranteed retirement income under stress, lifetime income annuities can play a pivotal role in helping consumers manage risk and establish the foundation for a secure and fulfilling retirement," said Paul Pastiris, senior vice president of New York Life. **"Today's income annuity offerings are also designed to address many of the traditional consumer concerns discussed in the Wharton research, including access to cash when needed, inflation protection, and the ability to leave a legacy for one's heirs, all while providing welcome peace of mind in retirement."**

Professor Babbel said, "Finally, markups have come down from 6-10 percent to less than half that today. Combined with the modernization of income annuities in recent years, insurers have eliminated most, if not all, of the reasons why consumers may have avoided these products in the past. With our academic findings now defining the enormous consumer benefits of income annuities, the arguments are compelling in favor of adding these products to retirement portfolios."

Prof. David F. Babbel (Wharton) and Prof. Craig Merril (BYU, Wharton) have conducted extensive studies on the optimal level of annuitization under a wide array of financial circumstances.

Their findings emerge at a time when the decline in the number of Americans covered by defined benefit pension plans has alarmed economists in light of the confluence of economic and demographic changes underway. Prof. Babbel and Prof. Merrill found that it is optimal to annuitize a large portion of one's wealth at retirement. As smaller portions are provided by corporate pensions plans and Social Security, income annuities provide individuals with a guaranteed stream of monthly income for life in exchange for a lump sum payment to an insurance company. The professors found that the optimal portion one should annuitize depends upon the total accumulated wealth at retirement, the profit margins embedded in annuity pricing, age, risk tolerance, and the returns in the bond and stock market alternatives. They also found that, contrary to conventional wisdom, annuitization of substantial portion of one's wealth actually assists a retiree in providing a bequest for his/her heirs, and that the lack of annuitization renders one's heirs, in effect, residual claimants with financial interest opposed to those of the retirees. According to the professors, the flexibility of modern annuities renders obsolete many of the criticisms that have been raised in the past.

Key findings revealed in the study also included:

**Income annuities offer the advantage of risk pooling. The Wharton study found that because insurers can share the risk of outliving one's savings across a large group of policyholders, income annuities can offer financial security throughout retirement using 25-40% less money than would be required to provide an equivalent level of financial security through a retirement portfolio that does not incorporate income annuities.
A benefit no other financial product can provide**.

- **No other asset class can address the risk of outliving one's next egg without requiring much more money**. Current mortality tables show that an average healthy American male at age 65 today can expect to reach approximately age 85, but that same individual also has a 50% chance of living beyond age 85 and a 25% chance of living beyond age 92. As a result, people who plan to cover their economic needs to their "life expectancy", in this case age 85, still face a 50 % chance of failure.

- The Wharton study explains that only lifetime income annuities can mitigate the financial risk of living too long by relieving consumers of the need to set aside the far greater sums, they would otherwise need to allocate to other asset classes, to ensure they would not outlive their retirement savings.

- **Equities, fixed income and other investment products are not substitutes for income annuities.** Professor Babbel and Professor Merrill demonstrate that, unlike income annuities, other asset classes fail to address the risk of living too long. In addition, the study shows that consumers who place their retirement wealth in an investment product like mutual funds are subjected to greater risk, typically higher expensed, and returns that are unlikely to keep pace with annuity returns, when investment risk is taken into account.

- Covering basic living expenses with income annuities can enable significantly greater flexibility in other areas of a retirement plan. According to the study, if basic expenses are covered by income annuity payments, individuals can keep their discretionary funds invested in equities for a longer period of time, providing benefits of historically higher returns. This approach can also enable retirees to delay taking Social Security benefits until they are fully vested, providing substantially higher payments.

- Several insurers have added consumer friendly innovations to the income annuity product platform, virtually eliminating the traditional reasons for not purchasing. According to the professors, features such as annual inflation adjustments, access to capital in emergencies, legacy benefits, interest rate protection, and the ability to increase or decrease payments at a future date make historical reasons (for not purchasing income annuities) no longer valid.