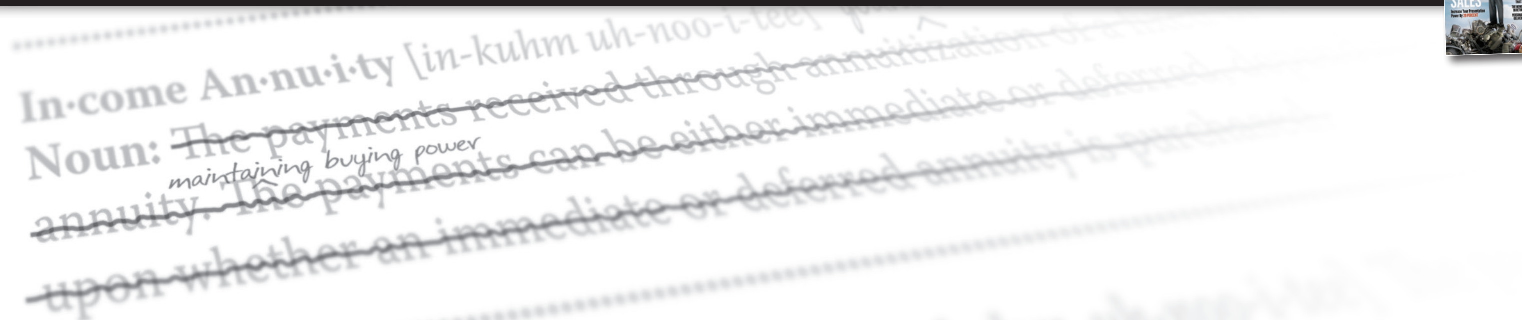

Redefining Income Annuities

For a Consumption World

With lackluster sales, it's time to rethink the way IAs are presented

BY JOHN RAFFERTY

We are a nation and a world of standards and classifications. It helps us to categorize everything from the natural world of plants, animals and minerals on down to man-made inventions ranging from automobiles to financial products.

Because we are so serious about defining "what" something is, there actually was a U.S. Supreme Court case from 1893 that considered whether a tomato is a fruit or a vegetable. Botanically speaking, the tomato is a fruit, because it is the ovary and seeds of a flowering plant. But legally speaking, there was more at stake. U.S. tariff laws at the time imposed a duty on vegetables but not on fruits. The Supreme Court settled the matter by declaring that the tomato is a vegetable, based on the popular definition that classifies vegetables by use, and that they are generally served with dinner and not dessert (Nix v. Hedden (149 U.S. 304)).

It's amazing that we can get the Supreme Court of the United States to rule on the classification of a little red vegetable (fruit?), but we still can't figure out what to call an income annuity. Is it an investment or something not yet defined?

Unfortunately, because we haven't spent enough time defining what financial genus or phylum an income annuity inhabits, the market has defined it for us in terms of the way it is traditionally presented and evaluated by financial professionals and their clients. And the way it has traditionally been evaluated and presented—by using the investment lexicon—has probably not helped.

Sales volumes have been perennially disappointing relative to other products, despite the fact that millions of Americans desperately need the benefits that only income annuities are uniquely suited to provide.

The context and language in which income annuities are traditionally presented may be the root cause of poor income annuity acceptance, according to a recent study conducted by The Retirement Security Project, a coalition of policy researchers and academics from Harvard, the University of Illinois, and The Brookings Institution. The objective of the Retirement Security Project (RSP) is to apply behavioral thinking to economic contexts, and from this glean academic, product and policy insights.

The hypothesis that the RSP wanted to test was fairly simple. They were inclined to believe that income annuities appealed to consumers who were conditioned to think with a consumption mind-set, and did not appeal to those who were primed to think with an investment mind-set.

In December 2007, the RSP tested the hypothesis and conducted an Internet survey of 1,342 individuals over the age of 50, with respondents being offered small incentives to participate. The survey participants were each presented with a series of forced-choice questions, all asking "Who has made the better choice?" in the financial decisions made by a pair of fictitious retirees, each with $100,000 at their disposal. Specifically, those choices involved selecting either a life income annuity or products such as a savings account or a bond. All choices were actuarially equivalent and were disclosed as such.

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The survey participants were divided evenly, with half of the participants presented with the questions in a consumption frame, and the other half presented the same questions but with an investment frame. The consumption frame told respondents how much each product—life annuity, savings account, bond—would allow its owner to consume and for how long they could consume it. Words associated with consumption such as "payment" and "spend" were heavily used, and the words "account," "account value" and "rate of return" were avoided. The investment frame did the opposite – it presented the same choices but avoided consumption-focused words and used investment-related words such as those just described.

The results of the survey were very powerful in their implications. Just 21 percent of those respondents who were presented the choices—life annuity, bond, savings account—in the investment frame thought the fictitious retiree who selected the life annuity had made the best choice. In compellingly stark contrast, a whopping 72 percent of those respondents who were presented the choices in the consumption frame selected the income annuity as the best choice.

And there's the rub. As long as a life annuity continues to be presented as the gamble that any investment is, we should not expect to see much growth regardless of growing demographic need. Countless advisors and their clients continue to throw the income annuity in the analysis meat-grinder, performing the old standby "internal rate of return" analysis on income annuities, in which they determine what the equivalent rate of return on the single premium income annuity is if the client lives until life expectancy, say 84. Invariably, the IRR numbers come back in the very low single digits, impressing no one, and a different product is selected to meet the income needs.

This, despite the fact that no other product can provide the level of guaranteed consumption opportunity as that provided by an income annuity. Consider this dead-reckoning estimate: for every $100,000 of retirement assets that is not annuitized at age 65 for a male retiree, he is likely forfeiting about $2,000-$4,000 a year in consumption opportunity if he selects a typical asset drawdown strategy of 4 to 5 percent or elects to get his income from interest yields. That consumption opportunity—let's round it off to $3,000 annually—could at today's prices pay for a cruise for two every year, dinner out to a very nice restaurant at least monthly for a couple, many rounds of golf and golf accessories—you name it.

So let's put this consumption theory to the test with a couple of questions. Let's assume a fictitious retiree purchased a $100,000 life-only annuity at age 65. Doing so allowed him to enjoy those dinners, take those cruises or play those rounds of golf because the income annuity not only gave him more income than the alternatives, but also he could depend on that income for the rest of his life.

Let's also assume he dies at age 75 and has only collected back 70 percent of the original SPIA premium. Put on your consumption goggles before you answer the following question: Did he make the wrong choice in selecting the income annuity? If maximizing consumption opportunities in retirement was a priority for the retiree, it would be hard to argue against the income annuity as the right solution. INN

***John Rafferty**, vice president of annuity marketing for American General Life Companies, oversees marketing strategy and direction for the individual and group annuity business lines. He can be reached at john.rafferty@aglife.com.*