Decumulation Confusion: The Annuity Conundrum

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Last month, we explored the topic of decumulation, or the spending of retirement plan asset during retirement years. While many retirement plan participants and plan sponsors understand the importance of accumulating assets, how to prudently spend those assets once a participant reaches retirement is often a source of confusion.

The presence and promotion of annuities as a decumulation solution is one of the most perplexing aspects for retirement plan participants and retirees. We shared in last month's article that the primary fear for many retirement plan participants is that they will outlive their money. Annuities are a type of insurance that may guard against this. With an annuity, an individual purchases an insurance policy that provides guaranteed payments each year for the rest of his or her life (or in some cases, the lives of two individuals).

While the concept of an annuity as a method of decumulation is good, participants and retirees should understand how it works in the full context of a retirement plan. First, the fear of running out of money is often unfounded, and many retirees do not spend everything they have saved. Therefore, annuities may be insurance that individuals do not actually need. Additionally, most individuals will receive Social Security, which is a type of annuity payment. Others (e.g., governmental employees) are entitled to a defined benefit plan, which is another type of annuity. While these annuity payments may be modest and may not provide all of one's retirement income, they decrease the likelihood that an individual will run out of money entirely.

Secondly, annuities have a well-deserved reputation for being expensive, and, even worse, having fees that are exceedingly difficult to understand. The overhead expenses for private insurers to administer these annuities, pay commissions to the people who sell them, and enjoy a profit margin, is estimated to be between 30 and 40%. Compare that to Social Security and its paltry 0.7% overhead, and it is easy to see why most annuities are expensive. While there are some low-cost annuity products available, it can be challenging to tell the low-cost products from the expensive ones.

To add to the problem, many retirement plan participants, particularly those in 403(b) plans, have already purchased annuities and do not even know it, as the stable value fund in their investment array is actually a fixed annuity.

Furthermore, for many public K-12 and other small plans, some or all of the remaining investments in their plan are annuities as well (known as variable annuities). However, many participants do not understand that these investments are actually annuities, since instead of electing to receive guaranteed payments from the products at retirement age, the participants opted for a lump-sum or other form of retirement plan withdrawal. Hence, these participants paid the cost of the annuity benefit without receiving it.

While some individuals may find that low-cost annuities can be an important part of an effective decumulation strategy, for most, the high fees and confusing pricing structure make them an unpopular solution. Despite the confusion, annuities may become more prevalent in retirement plans of the future, as proposed legislation seeks to make it easier for plan sponsors to offer in-plan annuities.

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