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We Can Build Better Retirement Products, But Will Anyone Buy Them?

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Those planning for retirement face an overwhelming array of choices of investment and insurance products. What they actually need are fewer and simpler products that better meet retirement-planning needs. There's a dilemma, however, because the products that best meet consumer needs are not necessarily the ones desired by the distribution intermediaries (e.g., investment companies, insurers or financial salespeople).

This is a two-part essay in which I'll first describe three products I believe are well suited to meet retirement needs. Then I'll address the distribution barriers such products will face and whether there might be a way to overcome these obstacles.

Social Security Delay Product

In the past few years there has been considerable financial planning research highlighting the importance of optimizing the claiming strategy for Social Security benefits. For reasonably healthy individuals, this typically involves delaying the commencement of benefits to age 70, and for couples involves somewhat more complicated coordination strategies. For example, the high earner in a couple may delay to 70, and the other member of the couple may start worker benefits earlier. Much has been written on the subject, and a comprehensive treatment can be found in "Maximizing Social Security Retirement Benefits," by Mary Beth Franklin.[1] There are also a number of software products that can be utilized to recommend optimal claiming strategies, an example being "Social Security Solutions" developed by William Meyer and Baylor professor William Reichenstein.[2]

What is missing is an investment product that could be used to implement the optimization. Here's an example of how such a product could work:

Let's say a 66-year-old individual with $750,000 in a 401(k) wants to retire immediately but delay Social Security claiming to age 70. Further, we'll assume her age-66 benefit would be $24,000 per year and delayed claiming would increase this benefit by 32% to an annual $31,680. Where the product idea comes in is that an investment company could offer a ladder of Treasury Inflation Protected Securities (TIPS) at age 66 that would provide inflation-adjusted income beginning immediately that would transition into inflation-adjusted Social Security income at age 70. Rather than recommending the individual delay Social Security until age 70 and somehow use retirement withdrawals from savings in the meantime, this product would provide an enhanced inflation-adjusted income stream immediately.

This would be straightforward for an individual. For couples, the software utilized for recommending coordinated strategies that might start benefits at different times could be enhanced to design the complementing TIPS investment strategy. This would build an inflation-adjusted mix of a TIPS ladder and Social Security benefits to provide a smooth inflation-adjusted income stream beginning at retirement.

For our example of a 66-year-old individual, the product funding would work in this way. Yields after inflation on short-term TIPS were close to zero as of late October 2017, so the individual would need to set aside roughly four times the age-70 Social Security of $31,680 (approximately $127,000) to fund the TIPS ladder. This would generate an income stream of $31,680 that would increase with inflation each year. The first four years would come from the TIPS ladder and the remaining payments would be the Social Security benefits enhanced by the credits for delayed claiming. This product's major advantage is that it makes Social Security optimization much easier to manage and, therefore, more appealing.

1 Mary Beth Franklin, *Maximizing Social Security Retirement Benefits* (Detroit: Crain Communications Inc., 2017).

2 *http://www.socialsecuritysolutions.com/index.php.*

Improved Inflation-Adjusted SPIA

An inflation-adjusted single premium immediate annuity (SPIA) pays a lifetime income with annual inflation increases and, therefore, is a natural add-on to Social Security. Continuing our previous example, let's assume the individual has estimated her retirement budget for basic living expenses at $45,000 per year, increasing with inflation. She'll receive $31,680 by utilizing the Social Security delay product but will require an additional inflation-adjusted $13,320 to match her basic living expenses.

Based on rates from the pricing service CANNEX as of October 2017, it would cost about $298,000 to purchase an inflation-adjusted SPIA paying an initial $13,320 per year in monthly installments. The total cost for the Social Security delay product and the SPIA would be about $425,000 for this example, leaving $325,000 in liquid funds. The individual would have the peace of mind of having lifetime income to cover basic living expenses plus additional funds for discretionary spending.

Although the product structure of the inflation-adjusted SPIA is a natural fit for generating retirement income, the product pricing could be improved. We can gain some pricing insights by comparing inflation-adjusted SPIAs to SPIAs that offer fixed percentage increases in payouts each year. Expected future inflation, based on the difference between yields on regular Treasury bonds and TIPS, is about 1.9% as of October 2017. Again, based on CANNEX pricing, we could construct a SPIA that provides annual increases of 1.9%. The cost of such a SPIA to produce an initial $13,320 of annual income increasing at 1.9% per year would be $260,156, about $38,000 less than the cost of a SPIA with adjustments for actual inflation. However, this product would carry the risk of not keeping up with inflation if price changes were to average more than 1.9%.

There could be a way to have both better pricing and full inflation protection. Insurers could set up an investment segment to support inflation-adjusted SPIAs by investing in their usual fixed-income investments without inflation adjustments and executing swap transactions that would involve substituting TIPS for regular Treasury bonds. The effect would be to create synthetic inflation-adjusted bonds with the same credit spreads insurers achieve on their regular fixed-income investing. A conversation with an investment professional familiar with such swaps indicated the swap cost would be about 2% of the SPIA price, so in the example, the $260,156 price would be raised to about $265,000. This would still represent a price reduction of 11% compared to current pricing, while offering the same guarantees, and freeing up an additional $33,000 for discretionary spending.

Life Care Annuity

Dealing with the potential need for long-term care is perhaps the most vexing issue retirees face. The potential costs are substantial, but insurers have had a difficult time providing products that effectively address the needs. However, SPIA products could be enhanced to at least partially mitigate the risk.

About a dozen years ago, economist Mark Warshawsky proposed the Life Care Annuity.[3] This would be a standard SPIA but would pay an additional pop-up monthly income if the annuitant needed LTC as defined by claim criteria (e.g., at least 90 days lacking two or more activities of daily living or suffering significant cognitive impairment). The pop-up income could be set to double or triple the basic SPIA payouts, and the product could be offered with minimal underwriting because of the close correlation between potential LTC need and diminished longevity.

I did a rough pricing of a three-times pop-up for this example that would increase the annual SPIA payments from $13,320 annually to $39,960 (both with inflation increases) when there was an LTC claim. Total income to cover essential expenses would increase from an annual $45,000 to $71,640. This would likely not be enough to provide full LTC coverage but could make a substantial contribution before tapping other funds or relying on LTC insurance.

I estimated the present value of the projected LTC payments to be about 8% of the SPIA price. If we added some margin for risk and profit, the cost might

3 Mark J. Warshawsky, "The Life Care Annuity," in *The Future of Life-Cycle Saving and Investing*, 2nd ed., eds. Zvi Bodie, Dennis McLeavey and Laurence B. Siegel (Charlottesville, VA: The CFA Institute, 2008).

be similar to the 11% benefit shown above for the enhanced SPIA. It might well be feasible to build a product that would be competitive with today's inflation-adjusted SPIA pricing and provide the significant addition of an LTC pop-up benefit.

Obstacles

The biggest challenge in getting these types of products to the public will likely not be in product development but in distribution. If all those planning for retirement were actuaries and economists, we might expect products like these to be instantly popular. However, we are dealing with entities that recent Nobel laureate Richard Thaler refers to as "humans" as opposed to "econs," and behavioral economics has taught us that people often don't make the most sensible financial choices.

Since all three of these products incorporate guaranteed lifetime income, what is known as the "annuity puzzle" comes into play. Briefly stated, economic theory based on rational choice would expect retirees to annuitize much more of their wealth than they do in practice. Consider that annual SPIA sales in the U.S. run about $10 billion annually, and this amount has remained at that level for many years. A very rough calculation based on the number of retiring Americans, and assuming "rational" annuitization, would place the expected sales at 50 to 100 times this amount.

One possible response to these product ideas might be, "Nice try, but it's clear from past experience people won't want these products." Behavioral economics has reared its head.

But there is another lesson we can learn from behavioral economics, which is that the way people respond to choices is heavily influenced by the way choices are framed. Related to annuitization, economist Jeffrey Brown, who has done considerable research on annuities, has led studies using surveys of individuals to demonstrate that annuitization holds much more appeal when presented in a "consumption" framework rather than as an "investment."[4] Other survey research led by economist John Beshears has demonstrated that framing SPIAs in terms of total lifetime income tilts choices heavily in favor of inflation-adjusted SPIAs over level-pay versions.[5] This result contrasts sharply with actual sales where level-pay SPIAs dominate. So we should not necessarily accept the lack of appeal for SPIAs as inevitable.

My personal view is that the annuity puzzle is more a reflection of the aversion of those responsible for selling or distributing the products than buyer aversion and that attempts by economists to explain the puzzle have focused too much on consumers and not enough on the intermediaries. When it comes to annuities, most people buy what they are sold; the corollary is that they don't buy what they aren't sold. For the particular products ideas I have presented above, we need to focus on distribution barriers and how they might be overcome.

Brief comments on distribution channel barriers follow:

- **Investment companies such as Vanguard, Fidelity Investments or Charles Schwab** typically have a bias against products that reduce assets under management, characteristic of both Social Security delay and SPIA purchase.

- **Retail financial professionals including insurance agents and stock brokers** generally prefer more complex products with sales pizzazz like variable annuities and indexed annuities, or active investment solutions that generate more broker income.

- **Financial planners** tend to rely purely on strategies involving systematic withdrawals from savings rather than utilizing annuities.

- **Employers and plan sponsors,** with a few exceptions, are concerned with any offerings that could create legal liability or add complexity to a basic 401(k) approach.

- **The United States' strong bias against government programs that compete with or**

4 Jeffrey R. Brown, Jeffrey R. Kling, Sendhil Mullainathan and Marian V. Wrobel, "Framing Lifetime Income," National Bureau of Economic Research working paper no. 19063 (May 2013), *http://www.nber.org/papers/w19063*.

5 John Beshears, James J. Choi, David Laibson, Brigitte C. Madrain and Stephen P. Zeldes, "What Makes Annuitization More Appealing?" NBER working paper no. 18575 (June 2013), *http://www.nber.org/papers/w18575*.

supplant private market activities prevents implementation of pension plans such as the UK's National Employment Savings Trust (NEST) retirement system.

- **Robo-advisers like Betterment or Personal Capital** have so far focused on accumulation rather than retirement and lack the financial resources to build strong name recognition through advertising and promotion.

- **Direct distribution,** through a do-it-yourself approach, should be feasible with simplified product choices; however, it will be difficult to overcome the pervasive belief that financial stuff is too complicated for DIY.

Is there any hope? The obstacles are certainly daunting.

I can foresee several possible ways to break through the challenges. One would be if a major, well-recognized investment company made a strategic decision to shed its investment bias and adopt a broader focus to incorporate products like those discussed above. (There are, indeed, major investment companies that offer annuities—a first step—but these companies heavily favor investment solutions.)

Another possibility would be an entrepreneurial venture to build a major company focused exclusively on retirement. This would likely require support from a player with considerable financial resources, for example, a foundation associated with a prominent name like Buffett, Bloomberg or Gates.

Under either approach, the basic idea would be to greatly simplify things for people planning for retirement and to offer both products and planning services. This would be getting away from all the complexity and confusion of today's services, the bulk of which provides no real value. A simplified menu of products and options, including the products highlighted above, would mean advice could be delivered much more efficiently and less expensively than today.

Sometimes things that should happen simply take a long time. Index funds offer an example from the investment world. These funds were introduced over 40 years ago, supported by numerous studies in the ensuing years demonstrating their performance advantage. However, it has only been in the past few years that indexing has really caught on with the general public. Success with better products for retirement planning may require not only good ideas and lots of effort but also lots of patience.

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