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Private Wealth Management

# Behavioral Obstacles in the Annuity Market

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Pages 71-82 | Published online: 02 Jan 2019

Cite this article <https://doi.org/10.2469/faj.v63.n6.4928>

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## Abstract

As Baby Boomers age, they are increasingly concerned for ways to generate income for retirement. A significant focus for the industry is annuities, which provide a steady stream of income. However, annuities are often perceived as risky investments, and many Baby Boomers are less likely to purchase them. This article examines the behavioral obstacles that prevent Baby Boomers from purchasing annuities and discusses strategies to overcome these obstacles. The authors argue that the industry should focus on addressing the behavioral obstacles that prevent Baby Boomers from purchasing annuities, such as the perception of risk and the lack of understanding of annuities. They suggest that the industry should provide more information and education to Baby Boomers about annuities and their benefits. They also suggest that the industry should offer more flexible annuity products that can be tailored to the needs of Baby Boomers. Finally, they suggest that the industry should work to reduce the perceived risk of annuities by providing more information about the safety and security of annuities.

guaranteed lifetime income that was formerly provided by defined-benefit pensions. But a natural replacement for a DB pension is a lifetime income annuity purchased from retirement savings. Why most retirees do not purchase longevity insurance in the form of lifetime annuities is a long-standing puzzle.

This study applies the lessons of behavioral finance to understand how well-documented anomalies in decision making under risk may affect the annuity purchase decision, even when longevity risk is the only risk being considered. The investment industry's success at helping manage retirees' longevity risk will depend heavily on understanding these powerful behavioral influences on the way retirees evaluate annuity products.

We demonstrate that mental accounting can explain the unpopularity of annuities because it causes individuals to view annuities as gambling on their own lives. When annuity outcomes are segregated from their impact on total retirement spending, then purchasing an annuity appears to be a gamble that increases overall risk rather than a form of insurance that can reduce risk. Loss aversion exacerbates the distortion by making the potential loss (from not making back the initial investment) loom larger than the potential gain. We also explain the prevalence of "period certain" annuities, which guarantee a minimum number of payouts. These annuities effectively combine a bond portfolio with an annuity that starts payouts in the future, and mental accounting

may give rise to a preference for period certain annuities over lifetime annuities. The immediate need for cash may lead to a preference for period certain annuities over lifetime annuities. The date of retirement may also influence the choice.

Finally, we show that the choice between period certain and lifetime annuities may be more influenced by mental accounting than by the actual expected outcomes. If, for example, the expected outcomes are more certain, the choice may be more influenced by mental accounting. If, for example, the expected outcomes are less certain, the choice may be more influenced by the actual expected outcomes. If one is more risk averse, the choice may be more influenced by mental accounting. If one is more risk seeking, the choice may be more influenced by the actual expected outcomes.

To combat the puzzle, annuity marketers should consider the behavioral influences on the retirement decision. Normative research suggests that the choice of annuity should reduce the overall risk of retirement spending. The choice of annuity should be based on the individual's risk preferences and the individual's expected outcomes. The choice of annuity should be based on the individual's mental accounting and the individual's expected outcomes.



the need for precautionary saving and thus allow annuity holders to consume more in retirement.

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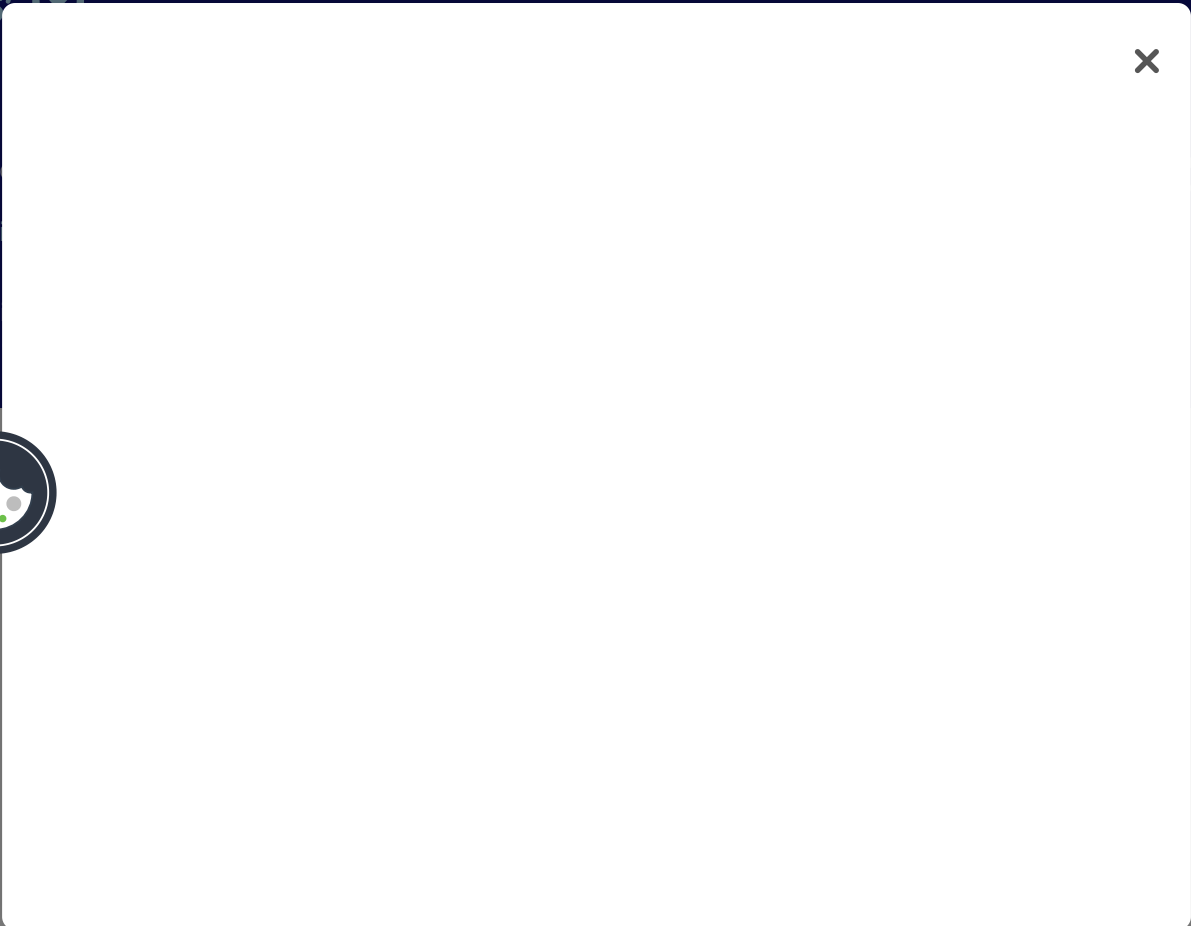
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