Behavioral Barriers: The Role of Biases in the Public's Aversion to Fixed Annuities

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You could call it an anomaly of human cognizance; the strange phenomenon of how a seemingly rational investor can flip a mental switch and instantly become so bigoted towards a product/solution designed to provide them with the relief from financial burden that they so desperately seek. Whether it be the trusted family advisor or the slick salesman wearing alligator loafers, initiating a conversation that includes an annuity solution is cause enough for many clients to not only balk at the recommendation, but even go as far as to reconsider their entire planning engagement altogether. Perhaps it is the lost link in Maslow's Hierarchy, or Pavlovianly ingrained in our psyche by constant media bombardment; regardless, the issue remains that fixed annuities are scrutinized for everything they are not and cast aside for everything they are. Putting aside the controversies surrounding their variable counter-parts, it is apparent that the publics' aversion to these products is rooted in something much deeper than inappropriate distribution by a questionably motivated sales force, but largely psychological factors, rooted deep in personal biases and manifested in specific behaviors. It is the role of these negative biases and the corresponding mental conditioning that prevents the average investor from even considering a fixed annuity as a viable option for a portion of their overall retirement plan, despite exhibiting the exact behavioral symptoms that such a solution seeks to alleviate.

The Mounting Challenges

Increased cause for financial anxiety and concern surrounding retirement needs is most certainly warranted. As the baby boomers continue to grey, and their needs shift from accumulation to distribution/decumulation, the demand for sustainable sources of income that can last throughout a prolonged period of retirement become paramount. With Social Security (a system never intended to provide for more than a fraction of income needs) growing more and more strained, coupled with the paradigm shift of employers moving from traditional defined-benefit plans to more predominantly defined-contribution plans, more and more pre-retirees are forced to reevaluate what their impending retirement will look like. Include advancements in medical care with an increasing standard of living, clients now find themselves having to stretch their incomes even further than originally expected. Increased longevity has dictated to the prudent advisor that a client reaching age 95 is no longer an anomaly, but rather a reality, or in some cases, a distinct possibility. Thus a rational person would think that such circumstantial uncertainty would be the ally of a solution that promises fixed payments for a set duration (potentially for life), however in the case of fixed annuities, that correlation is missed more than made and aversion to such a solution continues to exist.

Health Implications

Despite this seemingly irrational repugnance, the demand for a consistent and reoccurring retirement income scheme remains prominent. If we were to breakdown and simplify fundamental retirement expenses into three general baskets; needs, conveniences, and luxuries, we find that client tend to mentally account for the economic decisions that go into addressing such concerns. The satisfaction of the most basics of needs is prioritized first, as it translates into good health, both physical and mentally. Nutrition, exercise, adequate shelter, proper medical care, and a comfortable family situation are all the components required for good health, and are necessary for a person to continue to enjoy their retirement with a true sense of human dignity. We also observe that a great deal of non-medical mental impairments can be traced back to the stresses associated with the management of personal finances. Thus not having to worry about continued service of those basic needs through consistent income is crucial to preserving good physical and mental health, and should be uncompromisingly planned for before conveniences and luxuries can be taken into consideration.

Real Retirement Satisfaction

What is the rationale behind this cognitive impairment? Why does such apathy exist in the potential exploration of a solution that seeks to provide the level of retirement satisfaction universally sought? To the average pre-retiree, large amounts of assets or high degrees of liquidity are not necessarily all that are needed for them to feel safe and secure to enter retirement. Research into the emotional aspects of the retirement mindset illustrates that retiree's prefer the comfort of knowing they have a steady stream of income into perpetuity, rather than being relatively "rich" at retirement (defined as a large amount of their own money readily available to be spent as they wish). In addition, the heavier the reliance on the social insurances, the less satisfaction they have with their own retirement. When personal consumption is financed with guaranteed streams as opposed to liquid savings, those with greater levels of annuitization tended to be more satisfied during retirement and maintained their satisfaction levels longer throughout.[1] Greater satisfaction was also expressed by individuals who engaged in long-term planning; from attending a retirement-planning meeting, or through the purchase of product, such as an insurance policy for long-term care. Retirement satisfaction itself is derived from employing the correct behaviors, not simply achieving or maintaining a certain asset level. It is the behavior itself that was identified as the root of given retirement satisfaction. Note that the opposite is true as well. A study from the Boettner Center for Pensions and Retirement Security at The Wharton School of the University of

Pennsylvania tabulates the strong positive relationship between the lack of a fixed retirement income distribution scheme (explicitly a fixed annuity) and the number of depression symptoms. It is not difficult to understand why an uncertain retirement income plan for a pre-retiree can have such dire consequences.

Perceptions of Retirement

With systemic obstacles mounting and an explicit desire to maintain living standard levels, it would seem rational that fixed income contracts be presented in the suite of solutions available to a client. Experienced advisors know that this assumed rationale is generally missing in clients and know well the aversion (mainly due to the negative connotations of any annuity-named product) and some have even come to accept such behavior as simply the norm. They seek to avoid being placed in the unenviable position of either broaching the unpleasant topic with the client, or taking the path of least resistance and offering another solution. This can be a troublesome predicament for the advisor not only from an ethical point of view, but also a competency point of view choosing the sale over the solution, as well as a reinforcement of the public's misconception of what resources will actually be required to replicate and sustain their desired lifestyle throughout their golden years. Moreover, most suitability analysis should offer such decisions as fixed streams and hence it is a competency issue as well – being psychologically forced into offering an inferior/unsuitable solution because of client behavioral biases dictate so. The risks of outliving assets, increasing medical expenses, and the complexities of capital markets are all downplayed by this appeasement and reinforce the view that as long as current habits are maintained (e.g. contributing to the match of one's retirement plan, and saving cash when possible), desired retirement outcomes are achievable. This perceived lack of risk can be responsible for the inadequate allocation of resources and mar the reality of retirement with misconceptions and denial. To the client, failure to take such actions does not in turn frighten them, nor does the anticipation of taking action in the future delight them into action either. Unless the advisor chooses to challenge the mindset and risk the relationship, cognitive dissonance continues.

Confirmation Bias

Upon experiencing a personal financial success, clients tend to find outlets to share such accomplishments with others. War-stories about incredible entry points in equity positions, or intuitions about large commodity market swings where they experienced a significant upside, are traded with other like-minded individuals who demonstrate the same behavior and provide reinforcement. The development of abundant social media forums has exacerbated such behavior, allowing clients to form confirmation biases, reinforced by the online community. Research in this area has again demonstrated that people will seek out information only when it is consistent with client's prior beliefs. This causes the client to ignore any conflicting views and data or to simply dismiss its validity because they are convinced that they are right and all who disagree are wrong. A bias (psychological name - availability heuristics) is triggered in us that our preconceived notions were actually true and real (perceptions that are now believed to be "confirmed" as correct) and that their predictions will have a greater likelihood of actually occurring. Finally, the bias becomes entrenched as a heuristics; in the case of fixed annuities, the bias will result in recalling only the negative information and not the advantages, and conclusions that this product could possibly afford. With such an attitude, the proper product due diligence is not even performed.

Value of Discussion

Given misguided retirement perceptions and the role of such biases, we can begin to see from a behavioral standpoint, where an aversion to the product can stem from. As the goal of most retirees to secure an income stream for their remaining years, it is the role of the advisor to revisit this discussion and probe to find if the aversion is based in experience or rooted in deeply entrenched biases. The financial counseling provided by the identification, understanding, and discussion of relevant biases can be just as important to maintaining a client's overall financial health as much as portfolio performance. Value can also be provided by not skirting the issue and addressing detrimental behaviors together, in order to move into a much deeper level of the advisor/client relationship. ■

Footnote:

1 Panis, Constantijn W.A. "Annuities and Retirement Well-Being." RAND Corporation Working Paper, DRU-3021. Santa Monica, CA. 2003. Pg. 260-270.

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