Market Bulletin

November 26, 2018

The annuity advantage in a new normal economy: Part II

In a recent publication, *The Annuity Advantage in a New Normal Economy*, we considered the question of what an actuary might say at your 65th birthday party about how many more times you would blow out the candles. The actuary wouldn't know, of course, although they could make some very precise statements about the *average* life expectancy of the other roughly 10,000 Americans turning 65 that day. It turns out that, averaging over health, wealth and gender, someone turning 65 today has about a 50% chance of living another 21 years to age 86 and about a 5% chance of living another 33 years to age 98.

It is from this fact that annuities derive their most basic advantage. An insurance company can distribute money based on *average* life expectancy, while an individual funding their own retirement, would have to take a smaller income each year if they wanted to be 95% sure that they didn't run out of money. We also noted that this annuity advantage was even more important in a "new normal" economy, with low expected returns, since more of the distribution from a retirement plan would be in the form of returned principle.

However, annuities have a second critical advantage that is also more important in a low return environment.

Suppose, having dismissed the actuary from your birthday celebration, you now turned to your favorite market strategist and asked them to tell you, year-by-year, the expected returns from the stock and bond markets over each of the next 21 years. They would, of course, tell you that that was impossible to say, but they could give you a pretty good estimate of average *long-term* returns.

It is from this fact that annuities derive their second basic advantage.

The problem, for an individual paying themselves an income out of their retirement plan, is that how long that money lasts depends crucially on the particular year that they begin to take income from the plan. If you start taking income just before a bull

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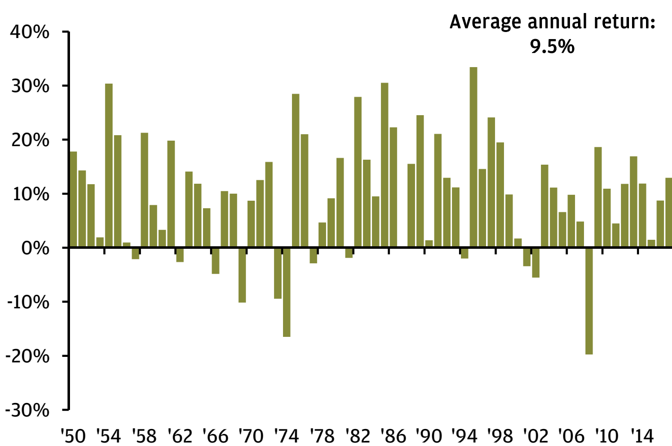
market, no problem. But if your first year of distribution is at a market peak, then the combined effects of distributions and losses could reduce your savings so much that you don't have enough left to benefit from a market rebound and so you eventually run out of money. An insurance company, that can remain fully invested in the market due to new contributions and that can average over many market cycles can avoid this risk. And today, when returns going forward are expected to be much lower than in the past, this difference is even more important.

For example, since 1950, if someone had been invested in a 60/40 stock bond portfolio they could have enjoyed average returns of 9.5%. This number is truly impressive (and very unlikely to be repeated going forward) – but it is an average. In Exhibit 1 below, we show how that number would have varied each year since 1950. What's more, the timing of withdrawals would have been important. If an investor had invested $500,000 and withdrawn 9% of their original stake each year, they would still have had money in their account at the end of 21 years in 35 of those 47 periods. The problem is the other 12.

EXHIBIT 1: 60/40 STOCK AND BOND PORTFOLIO

Annual total returns, 1950-2017

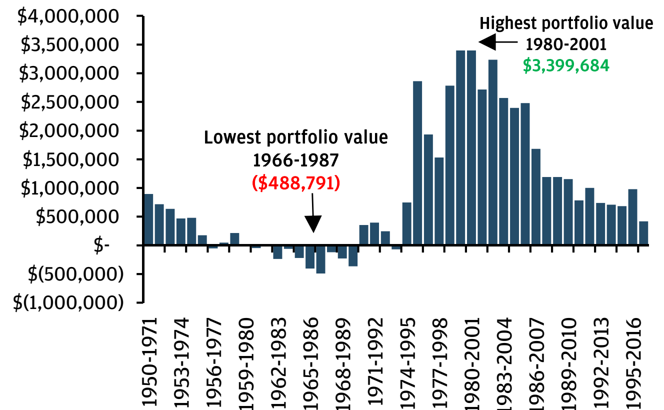


Source: Barclays, Bloomberg, FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2017, blended 60% stocks and 40% bonds. Stocks represent the S&P 500 Shiller Composite and bonds represent Strategas/Ibbotson for periods from 1950 to 2010 and Bloomberg Barclays Aggregate thereafter. Data are as of November 20, 2018.

For an insurance company, even paying a distribution of 9% per year to such a person would have been very profitable, since they could have stayed fully invested in markets throughout to take advantage of the long-term tendency of markets. However, for an investor, who began to take distributions from their own account in, say, 1972, their losses in the mid-1970s would have been so significant that they would not have had enough cash at work to take advantage of the 1980s bull market.

EXHIBIT 2: FINAL PORTFOLIO VALUE OF $500,000 60/40 PORTFOLIO OVER 21-YEAR PERIODS WITH ANNUAL 9% DISTRIBUTIONS

Annual total returns, 1950-2017



Source: Barclays, Bloomberg, FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2017, blended 60% stocks and 40% bonds. Stocks represent the S&P 500 Shiller Composite and bonds represent Strategas/Ibbotson for periods from 1950 to 2010 and Bloomberg Barclays Aggregate thereafter. Average life expectancy of 21 years based on Centers for Disease Control estimates. Data are as of November 20, 2018.

In fact, from 1950 to 1996, an individual investor would have had to restrict their distribution to 7.9% of the original portfolio value, to be "95% sure" of not running out of money. At a 7.9% of original portfolio level, there would only be two 21-year periods, those starting in 1965 and 1966, where an investor would have run out of money.

Since an insurance company can stay fully invested in the market throughout your retirement, and can invest over multiple market cycles, an annuity should be able to provide a significantly better income in

retirement, independent of the issue of life-span.

Finally, it is worth noting that this advantage will be even more important going forward. While a 60/40 portfolio has produced an annual return of 9.5% over the past 68 years, few expect it to do as well going forward.

Suppose instead we assume that such a portfolio produces just 5.5% over the next 10 to 15 years. If such a portfolio had the same volatility as has been seen over the past 68 years, then a withdrawal rate of 6% of the original principal would have a more than 20% chance of resulting in an investor running out of money within 21 years. Conversely, an insurance company, by staying fully invested and averaging over cycles, should be able to provide such an income very comfortably.

In summary, the annuity advantage does not depend just on the ability of an insurance company to average over life-spans but also on its ability to stay fully invested through the ups and downs of many market cycles and as the gradual withdrawal of funds by one group of investors is replaced by the fresh money of a new group.

In a new normal economy, these annuity advantages are more important than ever. Some may be tempted to invest for themselves throughout their retirement. However, the uncertainties they face around both their own life-spans and the swings in markets as they draw down their retirement savings, highlight the advantages of a steady annuity income over the speculations of both actuaries and market strategists.

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