

research snapshot

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Life Annuities Are Rarely Appreciated — Even by Financial Advisors



What is this research about?

Around the age of 70, Canadians have the option to buy a life annuity from an insurance company or to convert their Registered Retirement Savings Plan (RRSP) into a Registered Retirement Income Fund (RRIF). They can also select a mixture between the two. For a lump sum of money, a life annuity provides a person with a fixed stream of payments for the rest of his or her life, similar to a corporate pension plan, for those Canadians who still have one. There are a number of reasons why a retiree may decide against purchasing a life annuity with their RRSP funds. Some annuities can be expensive and others are confusing. Also, traditional annuities leave behind no inheritance. In some cases it may be better to wait to purchase an annuity – to see if prices decline and interest rates rise. But waiting around for prices to drop is risky. As life expectancy rises, insurance firms might increase the prices of annuities. In contrast, an RRIF risks under-funding a person's retirement but also provides more control to the investor and the option to leave an inheritance. In short, what role might fixed and variable income annuities – and the life insurance they provide – play in a retirement portfolio? In the research language of financial economics, what is the optimal “product allocation” to annuities?

What you need to know:

As you get closer to retirement, make sure you understand your options and the role annuities might play in your financial plan.

What did the researcher do?

Professor Moshe Milevsky at the Schulich School of Business, York University, interviewed and spoke to financial advisors, individual consumers and insurance company executives to learn more about how these different groups position and understand the costs and benefits of these products. There was a statistical component to his research in which he compared North American annuity prices over the last 20 years to examine their relative attractiveness. He examined life annuity payout ratios and the size of the annuity market for a range of age groups. Sophisticated mathematical models were employed to understand both the behaviour of annuities and the real option to delay purchasing.

What did the researcher find?

Life annuities are under appreciated but will become a very important component of retirement income financing, as employers in Canada continue to reduce the availability of traditional pensions and post-retirement benefits. However, the industry will have to do a better job of explaining the value of these instruments and to design products that are both cheaper (for investors) and more closely aligned with the risks they face in retirement.

How can you use this research?

This research may help retirees to determine if and when they should buy annuities. It may help to maximize their wealth and maintain a desired standard of living during retirement. It also recommends improvements that can be made to existing annuity products. More research on annuities, in general, would improve our understanding of annuity purchases, product and market design, and the option to wait.

About the Researcher

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