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Outside the Box

Opinion: Buying this annuity guarantees that you'll lose out on big money

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By Gary N. Smith

Qualified longevity annuity contracts offer even worse returns than standard life insurance

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I wrote recently that people who buy life insurance are effectively loaning money to

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companies and a lousy investment for the policyholders.

(QLACs), which are

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QLACs are annuity contracts that pay a guaranteed monthly income for as long as a person lives. What distinguishes QLACs from standard annuities are: (1) the annuity payments are deferred in that they don't begin until several years after the contract is purchased; and (2) they can be bought with tax-free withdrawals from retirement accounts (the annuity payments are taxable income).

A recent Wall Street Journal article noted that QLACs are typically bought by people nearing retirement who are worried that that they might outlive their retirement savings. One example is a 65-year-old (let's call him Bob) who buys a $200,000 QLAC at age 65 and starts receiving monthly payments of $11,175 at age 85. That's $134,100 a year, which sounds like a great return on a $200,000 investment.

Except this conclusion ignores two realities. The first is the miracle of compound interest. If Bob instead invests the $200,000 in stocks and averages a 10% annual return (roughly the historical average return on U.S. stocks), he will have more than $1.3 million when he is 85 years old. Second, 54% of all 65-year-old U.S. males don't live to age 85. If Bob dies before 85, that's $200,000 down the drain.

Bob can buy a QLAC with a death benefit that returns the $200,000 to his heirs, minus any annuity payments that have been made, but in that case his monthly annuity payments are reduced from $11,175 to $7,000. It is tempting to think that a QLAC with death benefits is an attractive option because the heirs get back the initial cost. But that myopic thinking again ignores the power of compound interest. There is an expensive opportunity cost of giving $200,000 to an insurance company and getting it back without interest 10-, 15-, or 20 years later.

What is the implied rate of return on a QLAC? It's complicated, but a durable rule to remember is this: "If someone who is pretty smart offers to sell you an investment and it is really difficult to figure out the rate of return, the odds are that the rate of return is pretty bad."

That is certainly the case here. To calculate the average rate of return for a QLAC, taking into account all the possible ages at death, we need life tables showing the probability of death each year for men and women of different ages, and a computer algorithm for calculating the implicit rates of return with different levels of monthly income over an uncertain horizon.

When these factors are taken into account, it turns out that the implied average rate of return on QLACs is even worse than the 2.5% average return on life insurance policies. Specifically, for the examples given in the Journal article, the implied average annual rates of return for individuals or couples of various ages range from 1.1% to 1.3%

The only way QLACs could ever be financial attractive is if you live many, many years past your life expectancy. For example, if Bob buys a QLAC with a death benefit and lives to 100, his implied annual return is 7.7%, which is getting closer but still not as good as stocks.

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Of course, there is no guarantee that even the healthiest 65-year-old will live to 100. Accidents and unanticipated illnesses do happen. Just 0.7% of all 65-year-old men make it to 100. QLACs are certainly more attractive for people who expect to live a long time but for someone to assume, at age 65, that he or she will live to to 100 or beyond is delusional.

More realistically, suppose that Bob is so healthy that he has the annual death probabilities of someone five years younger. So at 65 he's as healthy as someone who is 60; when he is 66, he has the death probability of someone 61, and so on. The implied average rates of return in that scenario are bumped a bit — to 2.3% with a death benefit and 2.7% without a death benefit, but QLACs are still a lot more financially attractive for companies selling them.

Many investing strategies are based on the presumption that people are risk averse, but QLACs go beyond risk aversion into risk-phobia. Buyers are sacrificing a lot to get very little. A more likely explanation for the appeal of QLACs is that buyers have no idea how bad the implied returns are.

Perhaps QLACs are just an expensive way of protecting people from making other bad decisions, like investing too cautiously (cash buried in the backyard?) or too impetuously (bitcoin anyone?), or living far beyond their means. For most people — who have other assets, Social Security income, and children who can help out if needed — loaning money to an insurance company at a 1%- to 2% interest rate is a lousy investment.

Gary Smith, Fletcher Jones Professor of Economics at Pomona College, is the author of dozens of research articles and 16 books, most recently, "Distrust: Big Data, Data-Torturing, and the Assault on Science" (Oxford University Press, 2023).

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