WHY CONVERTING 401(K)S TO ANNUITIES REQUIRES NEW MIND-SET

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Are we hard-wired to shun certain retirement investments? Some new research suggests so, and that has implications as the government gives the green light to annuities in 401(k)s and IRAs.

In a research brief for the Center for Retirement Research at Boston College, Prof. Jeffrey Brown of the University of Illinois notes that more than half of pensioners elect to keep their monthly payout rather than convert to a lump sum, but very few 401(k) owners elect to turn their balances into annuities.

This “may suggest a strong bias in favor of the pre-existing default rather than rational, well-informed decisions,” Brown wrote. He also found consumers are way off the mark when they try to value monthly benefits.

Using Social Security benefits as a proxy for annuities, he found most individuals were only willing to pay a very small amount for a $100 increase in monthly benefits — an amount they could recoup in payouts in 30 months — and were only willing to give up $100 in benefits for a much higher price.

“Individuals were internally inconsistent,” Brown said in an interview. In other words, the same individual would demand an unrealistically cheap price to buy into a higher monthly benefit, but if he had a monthly benefit, would demand a much higher price to convert it to a lump sum.

What about legitimate concerns individuals might have about private annuities, including the risk of default of a carrier or their potential to lag behind inflation?

The study didn’t factor in those concerns, but aimed to demonstrate that individuals have a difficult time — and some more than others, depending on their cognitive abilities — making an informed decision about annuities, Brown said.

“We’ve conditioned people to think that the default is to take a lump sum and focus on wealth accumulation, but if we could make [the 401(k) market] a little more friendly to annuities, we could really move the needle” on shoring up retirees’ income picture, he said.

The 401(k) mentality stressing flexibility and transparency, at times works against our best long-term interests, said Terry Burnham, author of “Mean Markets and Lizard Brains: How to Profit From the New Science of Irrationality.” In other words, too much choice and too much information can be a bad thing, he said.

So what’s a retirement saver to do? Consider these tips:

1. Know your limits - Be aware of some of the mind games your brain can play, particularly as you age.

“Economists assume we will act rationally, but in fact emotion drives most of our financial behaviors, to our detriment,” said Peter Geismar, founder of Confident Choice, a consulting firm to financial and insurance companies.

“The closer we get to retirement age, the more our confidence in having enough money shifts in a negative direction,” Geismar said during a recent webinar for the Retirement Income Industry Association. “Uncertainty about the future increases, fear of bad outcomes increase, and the complexity of decisions that must be made increases.”

Avoid making huge all-or-nothing bets on retirement investments at a time like this, experts advised. You can buy into annuities over time, for example, just as you may have dollar-cost averaged into investments during your working years.

2. Frame your feelings - Be aware of the concept of framing, or the notion that the manner in which a topic is presented determines the response. A financial adviser might ask how you feel about annuities, or may ask how important it is to you to have a stream of income you can’t outlive.

If you would have two very different answers to those questions, take some time to clarify your own priorities.

3. Process, not product - Geismar counsels advisers not to leap into discussions about particular investment products before truly finding out what their clients want or need. Consumers should do the same for themselves, he said. How much of your fixed expenses would be covered by Social Security and traditional pensions? If it’s a high percentage, for example, maybe your goals for your investments should be more about flexibility than guarantees.