The Annuity Advantage

Market Bulletin

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Annuities represent an important source of retirement income for Americans, a role that has become even more important in recent decades with the gradual decline in traditional pension plans and lower long-term interest rates. However, even in the absence of these market trends, annuities have always provided two crucial advantages. These advantages are derived from the ability of insurance companies to average over many different life spans and market cycles. This allows annuities to provide higher levels of life-time income than an investor could generate themselves if they wanted to be confident that they wouldn't outlive their money. Moreover, these annuity advantages are likely to grow even more important in the years ahead due to the prospect of lower long-term returns.

> **For those whose principal investment goal is producing income for retirement, annuities have significant advantages because of the ability of issuers to diversify across lifespans and market cycles.** *- Dr. David Kelly*

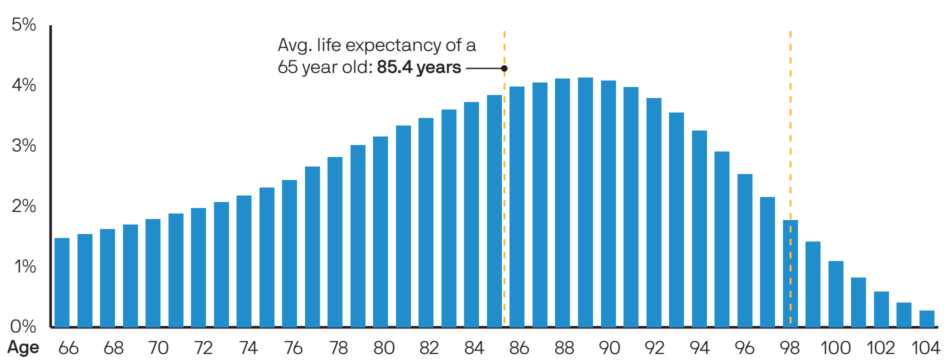
Averaging over Lifespans

Suppose you invite an actuary to your 65th birthday party and, just as you get ready to blow out the candles, you ask him, in his professional opinion, how many more times you will get to perform this ritual.

His brow will furrow over. Even if you tell him that he can ignore gender, genes, wealth and current health, he will dodge giving a straight answer. The reason is simple: he doesn't have any idea. According to the Centers for Disease Control, as of 2021, there was a 50% chance that an individual turning 65 would live another 20 years to age 85. But there was a 25% chance that they would make it to 91 and a 5% chance they would live another 33 years to age 98.*

An individual has to plan for the worst—but an insurer only has to plan for the average

Exhibit 1: Percentage of 65 year-olds who pass away at each age



Source: National Center for Health Statistics, National Vital Statistics System, mortality data file, 2021. J.P. Morgan Asset Management. All information is shown for illustrative purposes only.

*For more detailed longevity projections, please see the JPMorgan *Guide to Retirement,* pages 4 and 5.

If, on the other hand, you ask the actuary how long the average American celebrating a 65th birthday will live, his face will clear. “That’s easy”, he’ll say. “Almost certainly to between 84 and 86 years”.

It is very difficult to estimate how long a specific 65-year-old individual will live but it is very easy to estimate, on average, how long a large group of 65-year-olds will live.

Guaranteed income-producing annuities all leverage this simplest of advantages. Armed with a very good idea of the average longevity of annuity-holders, insurers are able to provide higher income streams—and with higher certainty that payments will last a lifetime—than the average investor could do for him or herself. An individual has to plan for the worst. An insurer only has to plan for the average.

If you are an individual turning 65 today, in order to be 95% sure that you are not going to outlive your retirement plan you will need to generate income for **33 years.** However, an insurance company constructing an annuity only needs to provide an income stream that lasts for 21 years. 12 fewer years of payments means the payments themselves can be substantially larger.

To make this more concrete, **exhibit 2** shows the average annual return on a 60/40 portfolio between 1950 and 2023 which was 9.3%. A $500,000 portfolio that earned 9.3% each year and was designed to exhaust itself after 33 years could provide an annual payment of $49,102. However, if the same portfolio was required to last just 21 years, the payment could be $54,991 or 12% more.

Averaging over Market Cycles

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

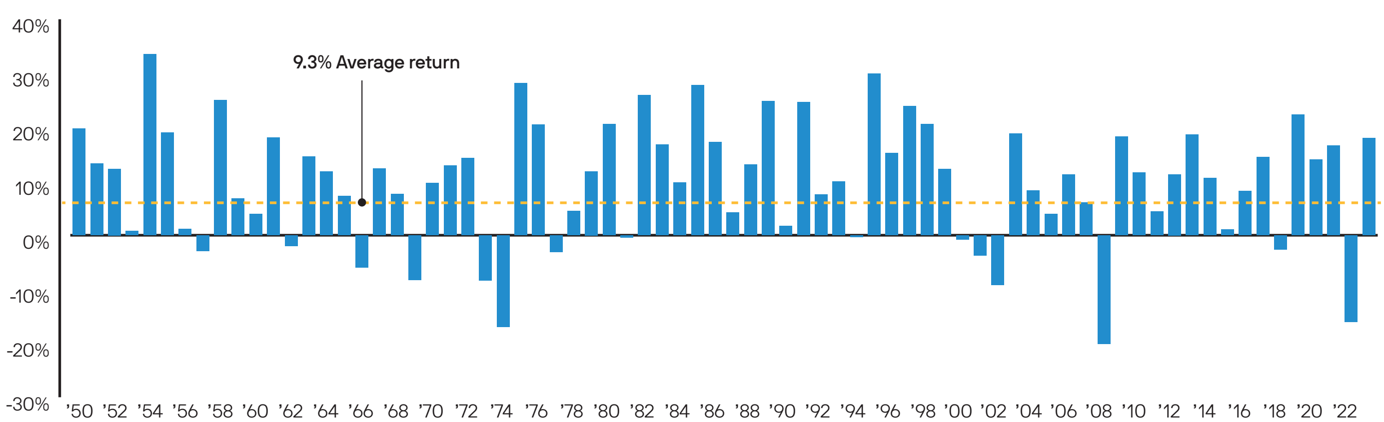
It is from this fact that annuities derive their second basic advantage.

One problem, for an individual withdrawing income from a 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 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.

For example, as noted earlier, since 1950, if someone had been invested in a 60/40 stock bond portfolio, they could have enjoyed average returns of 9.3%. This number is truly impressive (and very unlikely to be repeated going forward) — but it is an average. What’s

Since 1950, 60/40 returns have varied

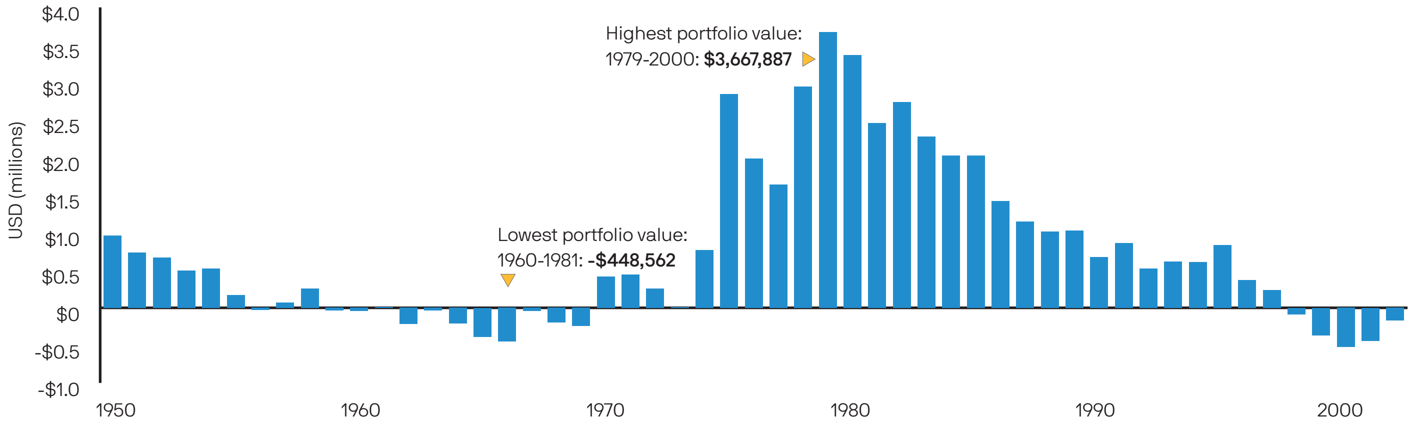
Exhibit 2: Total returns on a 60/40 portfolio — 1950 to today



Source: FactSet, Standard & Poor’s, Bloomberg, Ibbotson/Strategas, J.P. Morgan Asset Management. The 60/40 portfolio is 60% invested in the S&P 500 Total Return Index and 40% invested in the Bloomberg U.S. Aggregate Total Return Index. U.S. fixed income total returns from 1950 – 1975 are estimated using data from Strategas/Ibbotson. The portfolio is rebalanced annually. Data are as of December 31, 2023.

Ending balance on a 60/40 portfolio with a 9% withdrawal rate, rolling 21-year periods

Exhibit 3: Annual total returns, 1950-2022



Source: FactSet, Standard & Poor's, Bloomberg, Ibbotson/Strategas, J.P. Morgan Asset Management. The 60/40 portfolio is 60% invested in the S&P 500 Total Return Index and 40% invested in the Bloomberg U.S. Aggregate Total Return Index. U.S. fixed income total returns from 1950 – 1975 are estimated using data from Strategas/Ibbotson. Average life expectancy of 21 years based on Centers for Disease Control estimates. Data are as of December 31, 2023.

more, the timing of withdrawals would have been important. In **exhibit 3** we show that if an investor had invested $500,000 and withdrawn 9% of their original investment or $45,000 per year at the end of each year, they would still have had money in their account at the end of 21 years in 37 of those 53 periods. The problem is the other 16.

Since 1950, an insurance company could have broken even, paying a distribution of $54,991 per year to such a person since they could have stayed fully invested throughout to take advantage of the long-term return from a 60/40 portfolio. However, for an investor, who began to take distributions from their own account in, say, 1969, 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. In order to have been 95% sure that they wouldn't run out of money over a 21-year period due to bad timing, they could only have withdrawn $37,561 per year. In other words, an insurance company that was not concerned about the sequence of returns could have provided an extra 46% in income per year.

The Annuity Advantage in a Lower Return Environment

It should be emphasized that because insurance companies naturally have to cover their costs and attempt to make a profit from annuity sales, the annuity advantage from being able to diversify across different lifespans and different market cycles would be smaller than in these stylized examples. It should also be noted that very few strategists expect returns on long-term assets to be as strong going forward as in the past. If, more realistically, we assume a 7.0% long-term annual return from a 60/40 portfolio then the cash flow from both annuities and do-it-yourself investing falls.

However, interestingly, in this lower return environment, the annuity advantage in percentage terms is even larger. In particular, as we show in **exhibit 4**, the advantage in being able to diversify across many different lifespans rises from 12% assuming an average return of 9.3% to 18% assuming an average return of 7.0%.

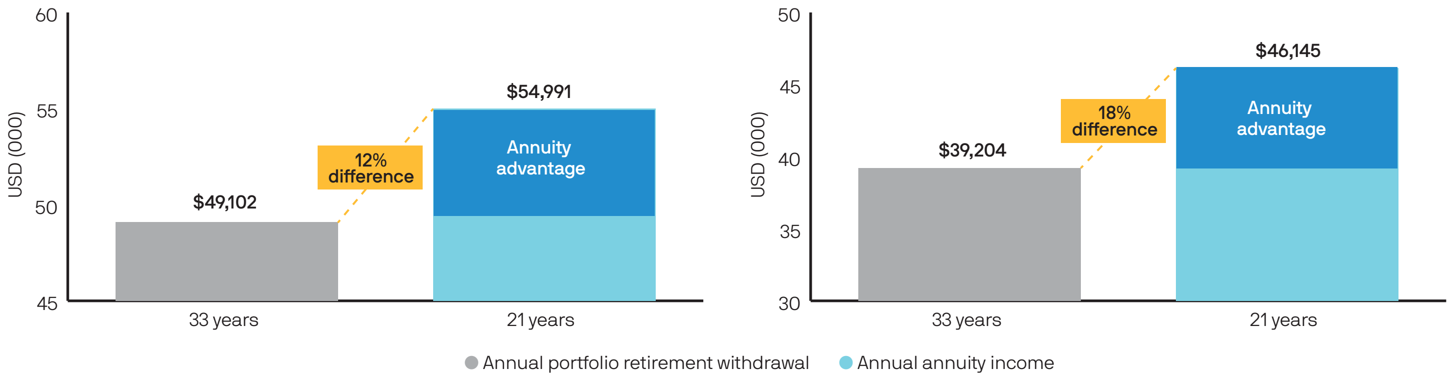
It needs to be stressed that these are purely hypothetical examples. However, they illustrate an important point. The annuity advantages derive from the fact that an insurance company, by averaging across different lifespans and different market cycles, can safely eat into principal more quickly and still be confident of providing a lifetime of income for their investors than any individual investing for themselves. When expected returns are lower, this return of principal is a correspondingly more important share of that income stream.

Whether interest rates remain high or revert lower, annuities offer an advantage

Exhibit 4: The annuity advantage in a lower return environment

Market performance — 1950 to today: assumes 9.3% return

"Slow growth, low inflation" economy: assumes 7% return



Source: J.P. Morgan Asset Management; data as of December 31, 2023. All information is shown for illustrative purposes only.

In summary, for those whose principle investment goal is producing income for retirement, annuities have significant advantages because of the ability of issuers to diversify across lifespans and market cycles. These advantages are particularly important for those who worry that they may be blessed by good health in the long run and cursed by bad markets in the short run. And finally, if we are entering a period of lower long-run returns, while overall income expectations are necessarily lower, the annuity advantages, in percentage terms, are even greater.

Next Steps

Please visit the Annuity Insights page to view the latest insights and resources to help clients plan and invest for retirement.

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