Social Security: The Cheapest Annuity in Town

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The Center for Retirement Research at Boston College has just released a new study that shows that the best way for people to turn their 401(k) balances into a stream of income is to "buy" an annuity from Social Security. Many people don't recognize that Social Security is in the annuity business, but it is and it has the cheapest product in town.

As more people approach retirement with 401(k) plans as their only supplement to Social Security, they face the challenge of how best to use their accumulated 401(k) assets to support themselves once they stop working. They could invest in safe assets and try to live off the interest, but the value of the assets would erode as prices rise and interest income would fluctuate as nominal interest rates rise and fall. They could invest in a portfolio of stocks and bonds and draw out some percent each month, but to avoid outliving their assets that draw is now about 3 percent. They could take some of their money to an insurance company and buy an annuity, but commercial annuities tend to be expensive because they are designed for people with above-average life expectancy and involve considerable marketing costs.

A much better alternative is for the household to "buy" an annuity from Social Security. They can make this "purchase" by using their savings to pay current expenses and delaying claiming to get a higher monthly benefit at an older age. The savings used is the "price" and the increase in monthly benefits is the annuity it "buys."

For example, consider a retiree who could claim $12,000 a year at age 65 and $12,860 at age 66 – $860 more. If he delays claiming for a year and uses $12,860 from savings to pay the bills that year, $12,860 is the price of the extra $860 annuity income.[1] The annuity rate – the additional annuity income as a percent of the purchase price – would be 6.7 percent ($860/$12,860). Remember that Social Security benefits are indexed for inflation, so the retiree is buying a real annuity. Vanguard – a wonderful company – also sells real annuities but it pays much lower rates.

The reason that Social Security annuities are a better deal than those in the private market is that Social Security can offer a product that is actuarially fair – they are based on the life expectancy of the average person (not those people whose parents lived into their 90s) and Social Security doesn't have to worry about marketing costs or profits. Moreover, in this period of very low rates, Social Security is an especially good deal because the increase in benefits is not based on current rates but rather is a basic feature of the system. So buying an annuity from Social Security, especially in today's low interest rate environment, is the best deal in town.

So read the study and tell your friends with some 401(k) assets to use them to delay claiming their Social Security benefit. *Alicia Munnell, the director of the Center for Retirement Research at Boston College, is a weekly contributor to "Encore.*