

Making difficult decisions more effectively: the annuity choice

Do you consider yourself a good driver, better than average, say? Research famously shows that well over 50 percent of drivers consider themselves better than the mean. This is unlikely for a statistically representative sample. Perhaps the problem is the question. We should be asking ourselves rather whether we are the best drivers that we can be. It's the same with our decisions. We like to think that our decision-making is better than average. We would do better to satisfy ourselves with making the best possible decisions, usually by making optimal use of the available information.

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Our decision-making would benefit from recognising our flaws. A substantial body of evidence has been built showing that our decisions are characterised by systematic bias. In truth, most of us are risk avoiding, over-confident and myopic.

What does this mean? We habitually assign a higher weight to the possibility of loss than of gain. We believe that our decisions are better than they in fact are. This also contributes to our tendency to choose heroes and then trust them beyond reasonable limit. We are short-sighted. In time, we tend to consider near-term impacts more heavily than their longer-term counterparts. In space, we trust the familiar more than the distant. This in turn helps to explain the dangerous consequences of the echo chambers stimulated by social media, and its users.

The annuity puzzle

This article applies these decision dynamics to a long-established conundrum in social protection and financial circles. Across markets and over time, retirees have strongly tended to fund their retirement by drawing from their accumulated saving rather than purchasing annuities that guarantee income for life.

Is the guaranteed lifetime annuity always the rational choice. No, it isn't. Sound reasons exist for postponing an annuity purchase or permanently avoiding it. These reasons could include personal circumstances. The retiree may have significant assets or undetected annuity arrangements outside of their pension savings, permitting them the luxury of drawing down from their savings. They may have a strong bequest motive, in other words a desire to leave assets to their dependents on their death. They may be in very poor health.

The reasons might include market considerations, like temporarily very low interest rates and hence poor terms on guaranteed annuities, though many have founded on the false assumption of *temporary*.

Still, the research generally shows that, even when adjusting for rational reasons for avoiding the guaranteed

annuity, the tendency to rely on the financial markets and an ongoing ability to make sound decisions remains much more common than expected. National Treasury recently disclosed that some 90 percent of retirees preferred to manage their own risk rather than purchase a guaranteed annuity.

The elephant in the room

The problem is that the key reason cited by retirees for avoiding a commitment to a lifetime annuity is that they will *lose the money if they die soon*. This may be correct as a statement of fact, but it ignores two facts.

The first is that insurance covers a risk, in this case the risk of long life. You may indeed pass way soon after retirement and should be wary of purchasing what is technically known as *longevity insurance* if your medical prognosis is not good. But if you are in good health, then longevity risk is exceedingly difficult to self-insure, primarily because when the risk becomes real, it is too late. At that stage you become dependent on others.

The second fact is that, when you purchase a guaranteed annuity, you are effectively rewarded for survival. Ten thousand retirees purchase lifetime annuities at age 65. The assets underlying these annuities produce returns in the first year, let's say eight percent. But at the end of that year, the 10 000 has been reduced by one percent, down to 9 900 precisely because the remaining 100 have passed away. The available assets are shared by the survivors, so the eight percent is effectively nine.

That isn't how it happens, you protest. The money isn't shared out between participants. It is guaranteed in advance. You are correct. But this is how the insurer determines the relationship between the purchase price of the annuity and the income that it provides. If they fail to do so then, in a competitive market, they will not be able to sell their product. Research has shown that this market is indeed largely competitive. Your insistence on making sound decisions and searching for good value for money contributes to this competition.

The short-term fear of an adverse outcome is rational, even coldly logical. But it should not overshadow the real long-term longevity risk. Furthermore, few understand the additional return that accrues to surviving annuitants. They prefer instead to trust their own (or somebody else's) ongoing ability to manage market risk. Rob Rusconi