Stock Market Returns and Annuitization: a Case of Myopic Extrapolation*

Alessandro Previtero†
University of Western Ontario
Ivey Business School

February, 2011

Abstract

Managing retirement wealth is one of the major financial decisions that individuals face. In this setting, I document a strong *negative* relationship between stock market returns and annuitization. Using a novel dataset with more than 103,000 actual payout decisions, I find that positive stock market returns decrease the likelihood of employees choosing an annuity over a lump sum, and vice versa. More precisely, only *recent* market performance drives annuitization with almost no weight assigned to returns two years before the decision date. Several explanations can account for these findings: wealth effects generated by movements of the stock market; endogenous timing of retirement; volatility of stock market returns and time varying risk aversion; and expectations about labor income or inflationary periods. After addressing these explanations, I present evidence consistent with employees extrapolating from recent stock market returns. I conclude showing that this *myopic* extrapolation – based on very recent stock market performance – can bear serious welfare consequence and significantly reduce retirement wealth if, for example, individuals annuitize too early because of a market drop.

Keywords: Household Finance, Annuities, Myopic Extrapolation, Wealth Effects

JEL Classifications: D14, G11, G22, H55

*Acknowledgments: I would like to thank Shlomo Benartzi, Antonio Bernardo, Bruce Carlin and Mark Grinblatt for their useful comments. I'm grateful also to Timothy Conley, Dora Costa, Amy Finkelstein, Mark Garmaise, Hanno Lustig, Javier Perez-Estrada, Eduardo Schwartz, Rossen Valkanov; participants at the Russel Sage Summer Institute in Behavioral Economics; seminar participants at UCLA, University of Washington, Notre Dame University, University of Western Ontario, HEC Montreal, University of Amsterdam; participants and discussants at the Netspar International Pension Workshop and the Northern Finance Association Meetings. For providing data used in this paper, I'm indebted to an anonymous data provider; Federico Castellanos and Kathleen Roin from IBM; and Matthew Drinkwater from Limra International.

†Contact Previtero by e-mail at: aprevitero@ivey.uwo.ca