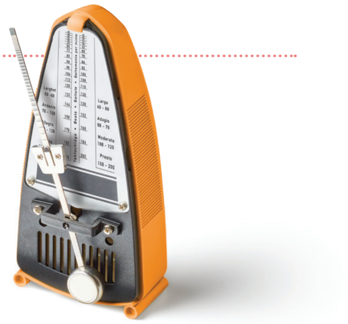
DISPELLING THE MYTHS ABOUT ANNUITIES – A TIME TO REFLECT



"Let me be clear: no one will ever have to buy an annuity again"
(George Osborne, Budget speech, 19 March 2014).

This was a watershed moment for retirement income planning. It opened a new window of possibility in many people's minds, and cast annuities as out of date and inflexible.

But is this right? Is there really no longer a place for a product that provides a guaranteed income for life? Is it really true that annuities offer no flexibility?

Flexibility vs certainty

If your client invests in a drawdown plan, they have flexibility in accessing their pension pot. But every time they make a withdrawal they're spending their capital. The more they spend, the more likely they are to run out of money before they die. Once they've spent the capital, they can't draw an income from it any more.

Your client could take a 'natural income' as a strategy – drawing only the income produced from their investments – but this will fluctuate. It'll result in them being able to pass on capital when they die.

A guaranteed income for life solution (GIfL) provides a degree of certainty – in that your client will buy a guaranteed income to last a lifetime.

So what's more important? The flexibility of drawdown? Or a guaranteed income?

A key question for your clients should be: what matters most to you, flexibility or certainty when it comes to retirement income?

Look for the best market rates – it makes a big difference

Poor-value GIfLs provide certainty, but at a significant cost.

For example, take a male with moderate health conditions buying an income with £50,000. If he buys a plan with a single-life basis and a five-year guarantee there's a 1.67%[1] gap between the worst and best standard rates.

Taking his health and lifestyle into account, the gap between the worst standard rate and the enhanced rate that could be offered by Just rises to nearly 14%[2].

Perhaps using the open market option and best underwritten rate should be made mandatory for those who want a guaranteed income for life? Maybe this would change the perception of the value that a GIfL can provide?

Meeting the needs of longevity

Longevity isn't about how long people live on average. It's about how long they might live.

Let's take the example of a 65-year-old in average health (in other words, not suffering from any serious illness). They might be a little overweight or have slightly high blood pressure. Or maybe they're taking medication for high cholesterol. Someone like this could live until 90, if they're male, and 93, if they're female.

[1] Standard rates taken from The Exchange from Iress 21.04.17. Based on an RH2 7RT postcode. We have assumed an adviser charge of 2%, and the income is paid monthly in advance with a five-year guarantee, no escalation, no value protection and no dependant's income.

[2] Moderate scenario rate taken from Just and compared to the lowest standard annuity rate offered via The Exchange from Iress 21.04.17. The example is based on an RH2 7RT postcode. We have assumed an adviser charge of 2%, and the income is paid monthly in advance with a five-year guarantee, no escalation, no value protection and no dependant's income. Based on moderate health conditions: a 65-year-old who was diagnosed with type 2 diabetes five years ago, supplied HbA1c readings, and is currently prescribed one daily medication. They also drink 22 units of alcohol per week.

The thing is, 50% of people will live longer than this. For males, there's a 25% chance of living to 96 and for females this rises to 98[3].

So what does this mean?

Well, if a male lives to 90, based on the best in market standard GIfL rate of 4.9%[1], this equates to a return of almost 123% of their original investment.

If this male is one of the 25% who live to 96, this increases to 152%.

So, in this case, this person would get their money back and an additional return of 52%.

But no one knows how long they'll live. They might be one of the 25% who only live to 83 if they're male and 86 if they're female.

A GIfL provides an insurance against how long your client will live. The longer they live, the better the value. That's why choosing not to insure your income is a bit like gambling on how long your pension pot will last.

After all, how many people living into their 80's and beyond want the complexity and risk associated with investment markets?

GIfL rates and improved life expectancy

It isn't just fixed interest yields that affect GIfL rates – it's also improvements in life expectancy.

Since 1991 there's been over a 30% improvement in life expectancy for males age 65[4]. Who's to say people won't carry on living longer?

Against this background, a GIfL provides a lower rate of income than 20-30 years ago, but for a significantly longer time period.

The true value of a GIfL can only be gauged when someone dies. But based on the above longevity stats, it does look like an attractive option.

Death benefits – a GIfL doesn't need to die with you

Gone are the days when the benefits of an annuity died with the recipient. GIfLs offer the flexibility of a choice of death benefit options.

For example, it's now possible to guarantee the income will be paid for many years – in our case, this is for 30 years. So if our male of 65 dies as expected at age 90, income payments could continue for a further 5 years. This guarantees the individual will get value from their annuity – if you measure value as getting a positive return on the capital invested.

Your client can also choose to protect the value of their pension savings by opting for our value protection feature. This means that any unused pension savings will be paid as a lump sum to their beneficiaries. This will be tax-free if they die before 75, and will be taxed at the beneficiary's 'marginal rate' after that.

The value of pooling

We deliver better value because of the size of the pool of people who buy GIfLs. We can make guaranteed lifetime income payments, assuming people die on the date expected.

You can't do this as an individual and that's why no one can ever replicate the value of certainty offered by a GIfL. If a person takes a guess at how long they'll live, they'll probably be wrong. Being wrong means either ending up with too much money, or running out of money early.

The benefit of pooling resources with others is that you'll never run out of money. Some will be real winners, but no one will be a loser. And they'll all enjoy the certainty of guaranteed income for life – a priceless commodity.

For each year your client is in drawdown, they run a higher risk of running out of money in their pension fund. As time goes on, the investment return they'll need to maintain the same level of income will have to increase. This is called 'mortality drag'. As your client gets older, the effect of this mortality drag increases.

[3] Just longevity calculator page: Justadviser.com/financial-planning/calculators/longevity/

[4] Life expectancy National Statistics website release 4 November 2015.

With a GIfL you achieve 'mortality cross subsidy' – the opposite of mortality drag. Let's not ignore this hidden benefit of GIfLs – worth around 1% each year of your total return at 70. This rises to over 3%[5] each year if your client defers until they're 80.

If your client goes it alone (for example, through drawdown), they'll need to guarantee an additional rate of return of this amount. They need to consider it over and above the return needed to support their income at the outset. Basically, the longer your client leaves it the greater the mortality drag they'll experience.

"No one will ever have to buy an annuity again" – but many will

Despite the former Chancellor's comments, a GIfL remains an attractive option for many people. That's why people are still buying them.

A GIfL is perfect for those who:

- want to secure a guaranteed retirement income;
- are risk averse; and
- don't want the uncertainty of stock market investment.

A financial intermediary makes sure every client who buys a GIfL gets the best available rate on the open market. Then their client can get on with enjoying their retirement.

[5] Mortality cross-subsidy and mortality drag sales aid: justadviser.com/documents/mortality-cross-subsidy-sales-aid-1312549.pdf

FOR MORE INFORMATION

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05/2017