JUST.

THINK

A FRESH PERSPECTIVE

INCOME THAT LASTS A LIFETIME – WHAT'S THAT WORTH?

'Value', when applied to a guaranteed income for life (GIfL) provided by an annuity, tends to focus on the amount of income offered in exchange for a customer's pension pot. This rate of return is usually compared with products in an investment context. But is this misleading? And does the amount of income paid to a retiree from a GIfL directly dictate whether it's 'good value'?

Achieving the most amount of income for capital with a GIfL is important. Advisers who achieve the best 'rate' for their clients use underwriting and the open market to get the most competitive rate they can. But there's a deeper question regarding how a GIfL's value is quantified. And this relates to whether a GIfL is viewed as an investment or an insurance product.

Problem is, GIfLs straddle both the investment and insurance worlds. They fulfil an investment need, but there's also an argument that they're an insurance product. This is because they operate on a pooled risk basis. This means the insurer pays a guaranteed income for the life of the individual (and when they die, the option to pay to their beneficiaries) however long that may be.

It's this pooled risk approach that differentiates GIfLs from investment products. With GIfLs, the insurer rather than the individual takes on the risk. This is where longevity becomes important. A GIfL is effectively a longevity hedge. And the insurance it offers is that the customer will never run out of money, for as long as they live.

With a pure investment product such as drawdown, a customer has to manage capital and income requirements to make it sustainable. And there's no guarantee their money will last a lifetime.

So, why is longevity important? And why should it measure the value of a GIfL? Firstly, we need to work out what longevity actually means.

When you ask someone about longevity and their life expectancy, they'll tell you what age they think they'll live to. Fair enough. Problem is, no one knows exactly how long they'll live. Lifestyle and health of previous generations aren't much use to today's retirees when it comes to the question of longevity.

Longevity is difficult to predict because it's a moving target. Several UK studies into longevity all point to a population increasingly living for longer. And this trend is predicted to continue with UK statistics showing:

- Over a third of people in the UK are aged over 50.
- There are over 15m people aged 60 and above.
- There are now 11.4m 65-year-olds.
- There are more over-60s than under-18s in the UK.

Added to these figures, the number of UK centenarians increased by 72% between 2004 and 2014, to 14,450. Now that is a lot of telegrams from the Queen...

A better way of approaching the 'average age of death' issue might be to consider the probability of survival for a given group of individuals, over a period of time.

Using specific percentiles with ages plotted against them, a person can see they'd have a 75% chance of living to a certain age, a 50% chance to an older age, a 25% chance to a much older age; and so on. This creates an individual longevity curve that paints a picture of a person's life expectancy. It also shows their probability of surviving beyond that. For many, the results are surprising.

The ONS offers this kind of longevity calculator. Their calculations are based on UK population projections but don't take into account a person's health. At Just, we also offer a longevity calculator that does the same thing. Ours includes health and is based on Continuous Mortality Investigation data so offers more specific results.

Using the ONS calculator, a 65-year-old male has a 50% chance of living to 86, and a 25% chance of reaching 94. With 'average health' included, our calculator returns ages of 90 and 96 respectively. By taking health into account, our calculator gives this 65-year-old a 1 in 4 chance of living into their mid-90s. In terms of retirement planning, this might mean they'll need another ten years' worth of income.

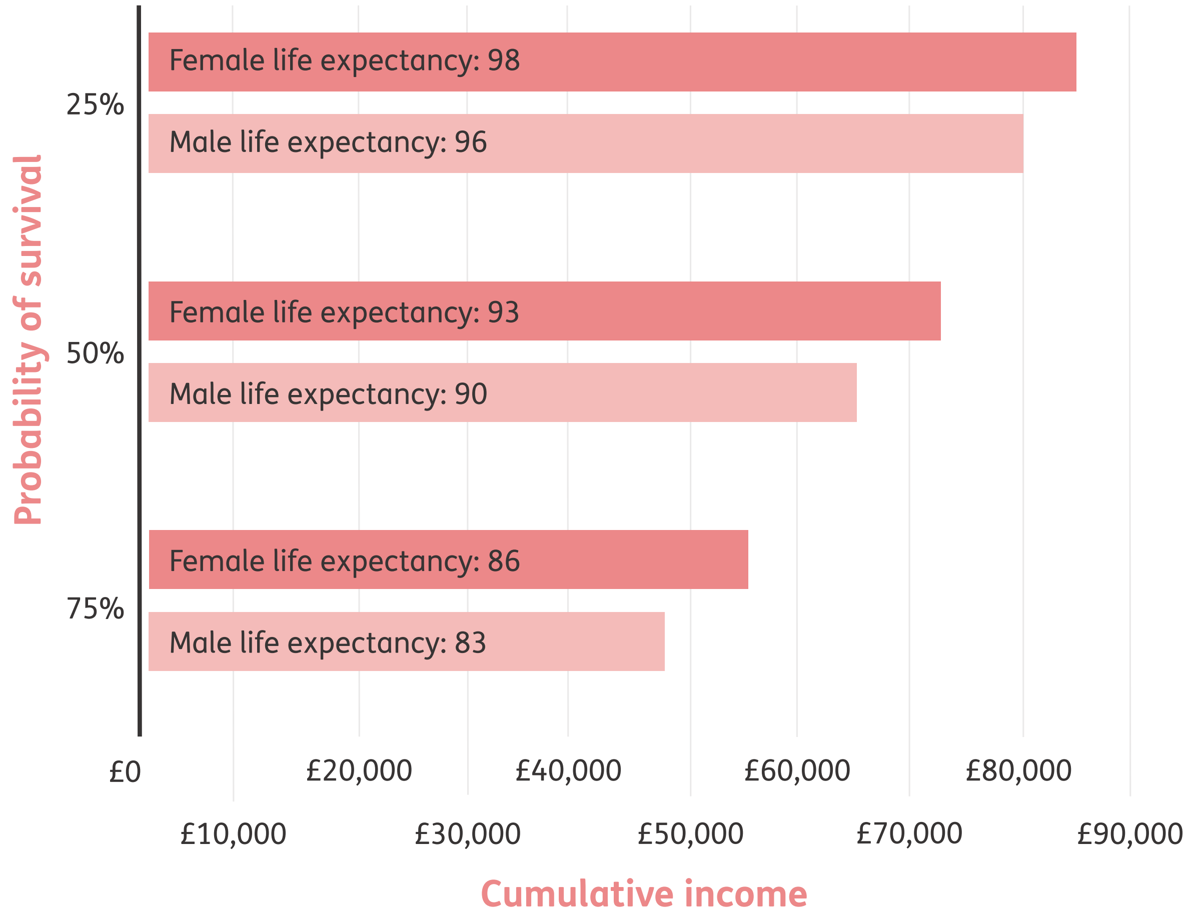
It's this unknowable factor that GIfL plans provide for. And that, in turn, demonstrates their value. We all know we're going to die, just not when. If retirees are relying on income during retirement then 'peace of mind', clichéd as it is, forms an integral measure of that value.

To relate this value back to return on capital invested, we can plot potential income payable over time against likelihood of survival. This shows what a customer might expect to get back in cumulative income, should they survive beyond a certain age.

The chart below is based on a GIfL of £50,000 after deduction of tax-free cash, for a 65-year-old in average health. Using our calculator, this pays £2,490 each year.

From this we can see that a male has a 3 in 4 chance of reaching 83. At this point they'd have had 95% of their capital returned as income.

A female is expected to have a 3 in 4 chance of reaching 86. This means the capital would have been paid back, plus an additional 10% on top.



Taking a 50% survival age as average, a male would get a 129% return on their capital. And as well as 50% of females having a chance of living beyond the average age of 93, they'll also have a 25% chance of living to receive a 169% return on their capital.

The above shows that value needs to be quantified differently when it comes to GIfLs. They're a breed apart from investment solutions such as drawdown, and offer different perspectives.

There is a counter argument that a retiree could die unexpectedly early, resulting in lost capital. But changes to death benefits rules (post pension freedoms) have largely put that to rest.

Retirees can now add options such as extended guarantee periods – for example, 20 years – to ensure a return of capital (in most cases) to either their estate or their beneficiary, if they die early. Either way the value is retained.

Alternatively, value protection covers off the same issue by insuring up to 100% of the remaining capital. This will be minus income taken, and minus any potential marginal rate of tax for the beneficiary. The death benefits will be taxed in exactly the same way as drawdown, for example tax free if the client dies before 75. Taking away the 55% tax charge has made sure GIfL plans are no longer shackled to the past.

Conclusion

Ultimately, no one considers living for a very long time as a 'risk'. But with current generations living longer than before, many retirees want to secure a continued income stream ahead of legacy planning.

Our GIfLs are designed to eliminate this risk. They provide a guaranteed income for life, no matter how long that life lasts.

So does a GIfL offer good value? Assuming a retiree lives to their life expectancy, there's a very good chance they'll not only get their money back, they'll also get an additional return. It sounds great but it's a concept still very difficult for many retirees to grasp.

That's why it's time to help retirees understand that the value of a GIfL isn't just about the income rate they can get today. It's also about how long that income will continue. If they're lucky, it might be for a very long time.

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FOR MORE INFORMATION

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