Can Superior Investment Performance Beat Lifetime Annuity / Pension Income?

MAXIMISING RETIREMENT INCOMES
PART1/3

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CAN SUPERIOR INVESTMENT PERFORMANCE BEAT LIFETIME ANNUITY/ PENSION INCOME?

Many investment professionals hold the view that annuities are poor value. When they talk about longevity protection, they think of traditional annuities – which shield customers from both investment risk and longevity risk. Guaranteeing both is costly and risky for the insurer to provide but does not have to be the case.

Annuities can be "unbundled".This article shows an example of a product where investment performance flows through to the member, but longevity risk is insured. The team at Optimum Pensions believe superannuation professionals, financial planners and related professionals must know about alternative retirement products that are available to maximise member outcomes.

This article does not consider that the choice of retirement products is an either / or question, rather it highlights that traditional thinking is no longer valid as new products emerge. It is the first of a three-part series that addresses different aspects to consider.

A WORKED EXAMPLE

To illustrate this point, the team at Optimum Pensions has developed the following example.

Let us consider a 70 year old single male who has $300k in superannuation. **Chart 1** below shows a year-by year projection of his income from superannuation at each age in today's dollars. The projection assumes a 6.5% per annum gross return and 2.5% per annum inflation. To highlight longevity risk, note that 25% of these 70 year old Australians are expected to die somewhere within the range shown by the red arrow[1].

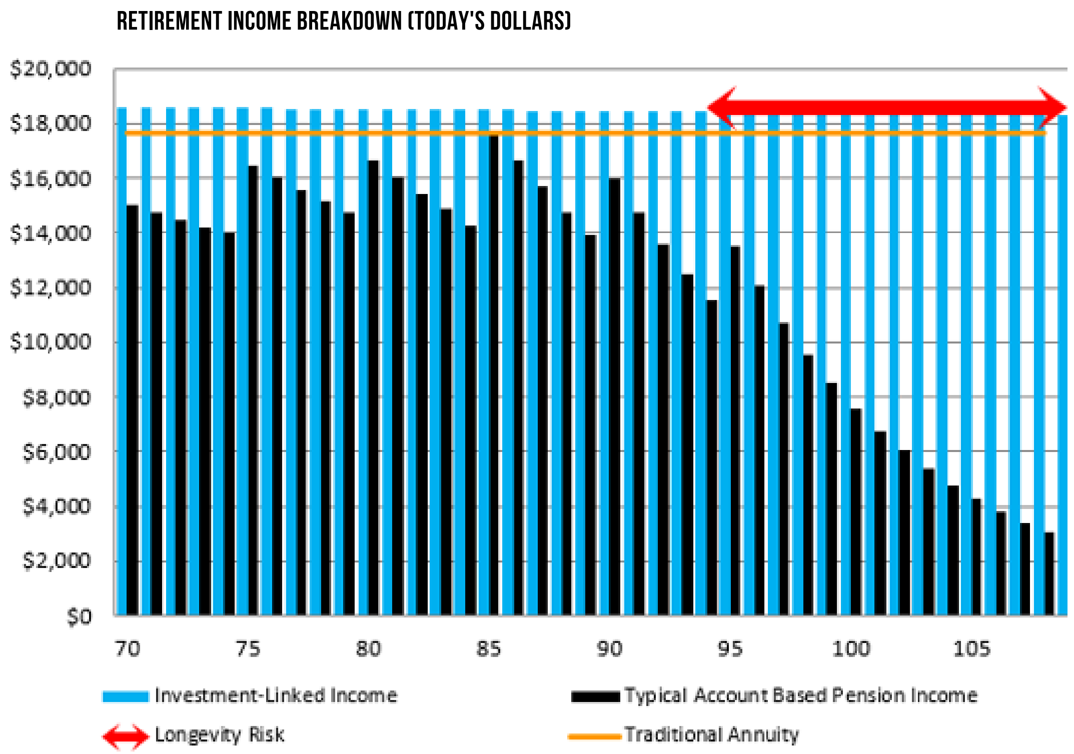
The black lines show the projected income from a typical account based pension (ABP) product in retirement. The member is assumed to draw income based on the minimum account-based pension rules – to try and avoid the risk of outliving their savings. An assumption of 0.6% per annum of assets was made for administration, trustee, and investment etc fees.

If he put all his superannuation balance into a traditional annuity, then based on market rates [2], he could purchase an inflation-linked lifetime income of $17,664 per annum. This is shown by the orange line on the chart. But if investment performance is greater (or lower) than 6.5% per annum, the member would not benefit from any upside (or suffer from any downside).

We can unbundle the lifetime income product to only provide longevity protection, but still pass on investment performance to the member. The blue lines in **Chart 1** show projected income from an investment-linked lifetime income design[3] that superannuation funds can white label as part of retirement income strategies. The member is assumed to keep the same investment mix as the ABP – and enjoys the same gross investment return and fees of 0.6% per annum of assets. An additional fee of 0.5% per annum of assets was made for the longevity protection.

A lump sum is payable if the retired member dies earlier in retirement, which helps to ensure they receive at least their initial investment back (including total income paid to date). The cost of this death benefit reduces the income slightly.

CHART 1: RETIREMENT INCOME PROJECTIONS BASED ON 6.5% GROSS RETURN



You can see in **Chart 1** that both the lifetime annuity and lifetime investment-linked design deliver a higher year 1 income than the ABP that has been drawn down using the minimum rates. Based on a 6.5% p.a. gross investment return they also both deliver higher income for life that will not run out.

The way these products outperform the ABP is by re-purposing the death benefits that would otherwise be paid by the ABP to beneficiaries particularly in respect to members in their 80s and 90s [4]. This money is instead used to maximise retirement income for the survivors.

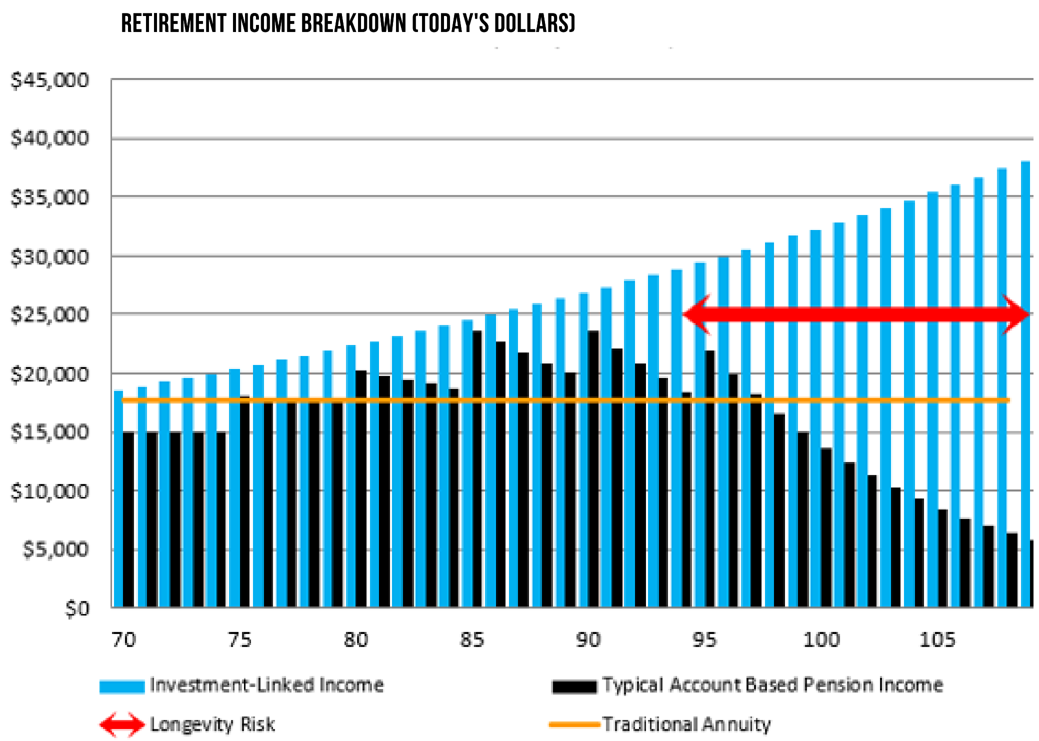
THE IMPACT OF HIGH INVESTMENT PERFORMANCE

Where investment managers use a strategy to achieve relatively high investment performance this doesn't only improve the benefits for the ABP. The income from the investment-linked design would also improve. **Chart 2** shows how each product would perform if the gross return were 8.5% per annum instead of 6.5% per annum.

This highlights that good investment strategies, on their own, are not able to maximise retirement income - irrespective of the member's investment risk profile.

The choice of product type is vital.

CHART 2: RETIREMENT INCOME PROJECTIONS BASED ON 8.5% GROSS RETURN



CONCLUSION

Expert investing can add a lot of value for retirement products. But those who believe longevity risk can be managed via good investment performance using an ABP on its own, need to consider these issues very carefully – to ensure they act in the Best Interests of all retired members.

From 1 July 2022, trustees are required to 'maximise' retirement income for their members. Paying significant death benefits (to non-members) after the age of 80 may not be in their best interests – unless it can be justified that death benefits to non-members are indeed a higher priority than income to retired members and their spouses. This does not seem to be the purpose of superannuation.

Research has shown that the 3 major things that retirees value are:-

1.Health –where you do not have good health, life is not as easy,

2.Amount of income – so that a reasonable standard of living can be enjoyed in each future year of life, and

3.An income that is regular and is payable for life.

END NOTES

[1] Based on the Australian Life Tables 2015-17 with 25 year mortality improvement assumptions

[2] Based on Challenger Liquid Lifetime rates on 12 September 2022.
https://www.challenger.com.au/personal/products/lifetime-annuities/lifetime-annuity-payment-rates

[3] Based on Generation Life's LifeIncome rates with a 2.5% LifeBooster feature.

[4] Both products still pay a death benefit in the earlier years of retirement – to protect the member's investment if they experience an untimely early death. However, most retirees die in their 80s and 90s and the benefit design at these ages is what matters most. https://www.actuaries.digital/2020/08/12/standard-deviation-around-life-expectancy-is-eight-years-what-this-means-for-retirees/

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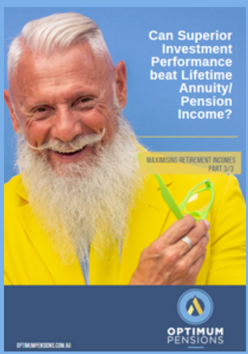

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