Can Superior Investment Performance Beat Lifetime Annuity / Pension Income?

MAXIMISING RETIREMENT INCOMES
PART 2/3

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THE IMPACT OF DRAWING DOWN FROM THE ABP AT A HIGHER RATE -

In a previous article, “Maximising Retirement Incomes – Can superior Investment Performance beat lifetime annuity/pension income?”, the Optimum Pensions team challenged the traditional thinking that Investment performance in an account based pension (ABP) would outperform an annuity.

Annuities can be ‘unbundled’ in order to separate the investment and longevity risks. Superannuation funds can now create much more value by not securing the investment risk forever, instead having investment income linked to the performance that's generated from the product according to its unit price. This affords the flexibility to be able to change those investments as risk profiles change or as market conditions change.

This second article further challenges the traditional thinking by considering the impact of drawing down from the ABP at a higher rate than the prescribed minimum rate.

A QUICK REMINDER

Firstly, a quick reminder of the base case example used in the previous article.

The example is for 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.

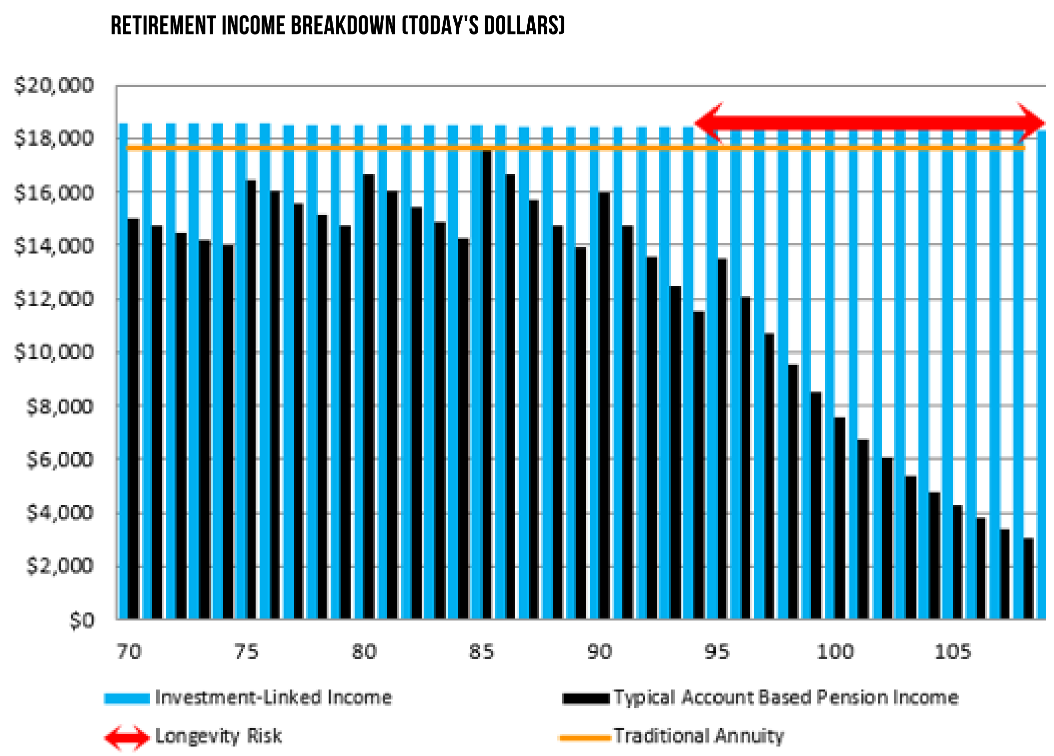
If he put all his superannuation balance into a traditional annuity, then based on market rates[2], he could purchase an inflation-linked lifetime income of $17,664 per annum. This is shown by the orange line on the chart. But if investment performance is greater (or lower) than 6.5% per annum, the member 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.

You can see 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 following example has been used to illustrate the issue of using a higher draw down rate.

CHART 1: RETIREMENT INCOME PROJECTIONS BASED ON 8.5% GROSS RETURN



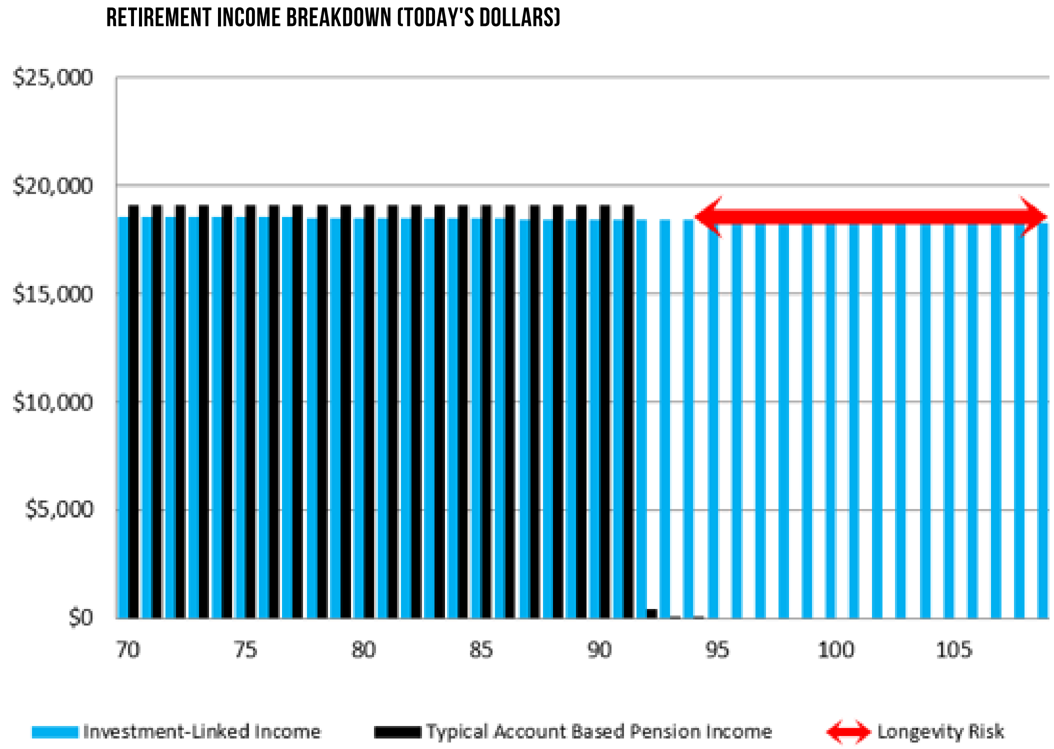
ABP DRAWDOWN WITH 'RUN OUT' AGE 92

In order to maintain a better lifestyle, some retirees may decide to draw down the balance at a higher rate than the minimum rules to get a higher level of annual income. For our 70 year old this delivers more income up to, and slightly past, average life expectancy as per **Chart 2** below. But if he is in the large and increasing number of retirees who live longer than this then he would run out of super.

In **Chart 2**, the ABP drawing level has been set in order to consume the person's entire balance by age 92 (based on a 6.5% gross return). The investment-linked design in Chart 1 is the same as Chart 2. Here the investment-linked product pays a similar but slightly lower level of annual income to this modified ABP. But once the ABP is exhausted, the investment-linked product continues paying income for life.

Fewer people are still alive at these higher ages, but superannuation trustees should be catering for the Best Interests of all members and thus all potential lengths of life – as less than 3% of retirees die at their life expectation – NOT 100%.

CHART 2: ABP DRAWDOWN WITH 'RUN OUT' AGE 92



It is important to know that over half of couples who retire today will see one spouse live to age 95 [4] and data shows that those with higher balances are more likely to be in the longer living groups. Research that was highlighted in the Retirement Incomes Review indicates that retirees are uncomfortable drawing down their account balance quickly. This makes sense in order to minimise longevity risk i.e. outliving your savings. Retirees know that some people live to the ages shown by the red arrow in these charts, and it could be them!

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 must take care. This article 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 – to ensure that superannuation trustees act in the Best Interests of all retired members.

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.

Drawing down the ABP at a higher rate may provide a marginally higher income, but it comes with the risk of running out of money while the retiree is still alive. If there are periods where the investment performance underperforms, the ABP will run out sooner, whereas the annuity would continue to be paid (albeit it may be at a lower rate until investment performance improves).

END NOTES

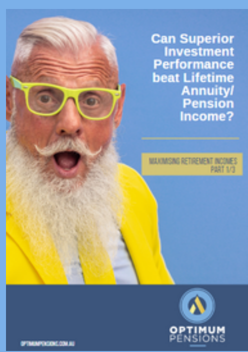
[1] Based on the Australian Life Tables 2015-17 with 25 year mortality improvement assumptions

[2] Based on Challenger Liquid Lifetime rates on 12 September 2022.

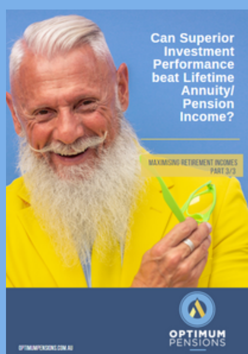
https://www.challenger.com.au/personal/products/lifetime-annuities/lifetime-annuity-payment-rates

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

[4] https://actuaries.asn.au/Library/Miscellaneous/2020/RNLifeExpectancy.pdf



READ ARTICLE 1/3



READ ARTICLE 3/3

FOR MORE INFORMATION

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