Can Superior Investment Performance Beat Lifetime Annuity / Pension Income?

MAXIMISING RETIREMENT INCOMES
PART 3/3

BY
DAVID ORFORD
JIM HENNINGTON
PETER ROWE

OPTIMUMPENSIONS.COM.AU

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INTRODUCTION

In our two previous articles on "Maximising Retirement Incomes", the Optimum Pensions team challenged the traditional thinking that investment performance in an account based pension (ABP) can outperform a lifetime annuity.

The critical point is that a lifetime annuity product does not have to provide investment guarantees. Annuities can be unbundled so that an insurer takes on the longevity risk, but the investment management remains the same as the ABP - so that any superior investment performance gets passed on to members.

This article deepens the explanation of why these products easily outperform account based pensions when it comes to maximising retirement income. The techniques apply no matter how superior a superannuation fund's investment performance is.

DEATH BENEFIT DESIGN

The Retirement Income Review noted that ABPs ultimately pay some 38%[1] of aggregate assets as death benefits to people who are not members. Products that are able to capture this 'leakage' can deliver higher incomes to those members still alive.

The reason ABPs pay such high death benefits in retirement is because nobody knows the exact year of their death. It means it's not possible to accurately spend down your ABP balance to zero when you die. Most retirees instead err on the side of caution and draw down their ABP frugally (to avoid outliving their assets). This means they die with unused superannuation. But retired member cannot live on their death benefits!

The Australian Government Actuary estimated that retirement income can be increase by between 15% - 30% through more efficient design of retirement products. If the primary purpose of superannuation is to maximise retirement incomes, then if a superannuation fund is paying a high proportion of aggregate retirement assets as death benefits not income, then it's not efficiently aligning with this purpose.

EFFICIENT USE OF AGGREGATE ASSETS

To illustrate how the design of Death Benefits impacts retirement outcomes, **Table 1** below shows a comparison of an ABP product and an investment-linked lifetime product for 1,000 retirees. The table shows the projected total assets in each product over time, total income payments made to retirees, and total lump sum death benefits paid from each product at five-year intervals.

The investment-linked product is based on Generation Life's design which can be white labelled by superannuation funds. The product does pay a (reducing) death benefit to protect customers if they die soon after purchasing the product, but in this example, there is no death benefit payable after age 82. Instead all these assets are used to provide higher incomes – that are guaranteed to continue for life.

The ABP modelled in **Table 1** assumes retirees draw down their balances cautiously in line with the standard ABP minimum rules. As per article 2, if they draw down an ABP faster than this it simply increases the chance they outlive they money. As per previous articles, the example used here is based on single males aged 70 year with $300,000 of superannuation in a balanced option.

You can see from the below **Table 1** that:

- The ABP product pays out much more of the fund's total assets as lump sum death benefits over time (column F) than the investment-linked product (column I).
- Whilst the investment-linked product does pay a lump sum benefit in the event of an untimely death, the total amount of assets needed for this is low.
- Total retirement income paid from the investment-linked product is higher at all ages.

Table 1: Comparison of outcomes at Product Level[2] [3]

MEMBERSHIP DATA			ACCOUNT BASED PENSION PRODUCT				INVESTMENT LINKED ANNUITY PRODUCT		
Age	Number of Members Alive	Number of Deaths (Cumulative at end of period)	Total ABP Balances at this age ($'000)	Total Incomes paid at this age ($'000)	Lump Sums paid to those who die at this age ($'000)		Total balances (reserves) at this age	Total Incomes Paid at this age ($'000)	Lump Sums paid to those who die at this age ($'000)
(A)	(B)	(C)	(D)	(E)	(F)		(G)	(H)	(I)
70	1000	13	300,000	15,000	3,705		300,000	18,581	3,900
75	926	74	287,261	17,236	5,249		257,496	19,249	3,584
80	822	178	250,941	17,566	7,382		202,242	19,475	2,192
85	563	437	189,599	17,064	10,670		145,564	17,737	0
90	430	570	104,812	11,529	11,281		94,179	12,990	0
95	193	807	36,824	5,155	6,071		60,667	6,584	0
100	53	947	6,875	963	1,785		51,599	2,042	0
105	7	993	653	91	241		60,144	0.305	0

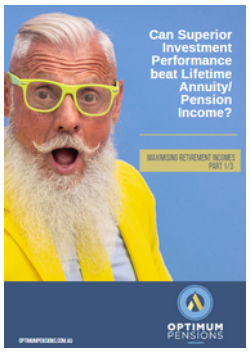
There seems to be a growing consensus in Australia about not paying death benefits from superannuation in old age (e.g. after age 80). Often retirees have other assets to leave as an inheritance, including the home and other personal assets. Therefore, the member outcomes in Column I of the table may not appear to be in the retired members' best interests.

Each of us has only one life – so each retiree might as well enjoy what is left of their life (their children should insist on this). Regular income helps maintain health and increase lifestyle and thus happiness[4].

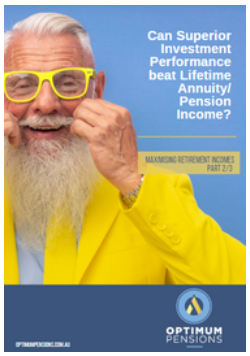
CONCLUSION

Again, we acknowledge that 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 out significant death benefits (to non-members), when the retired member is over 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. But this does not seem to be the purpose of superannuation.



READ ARTICLE 1/3



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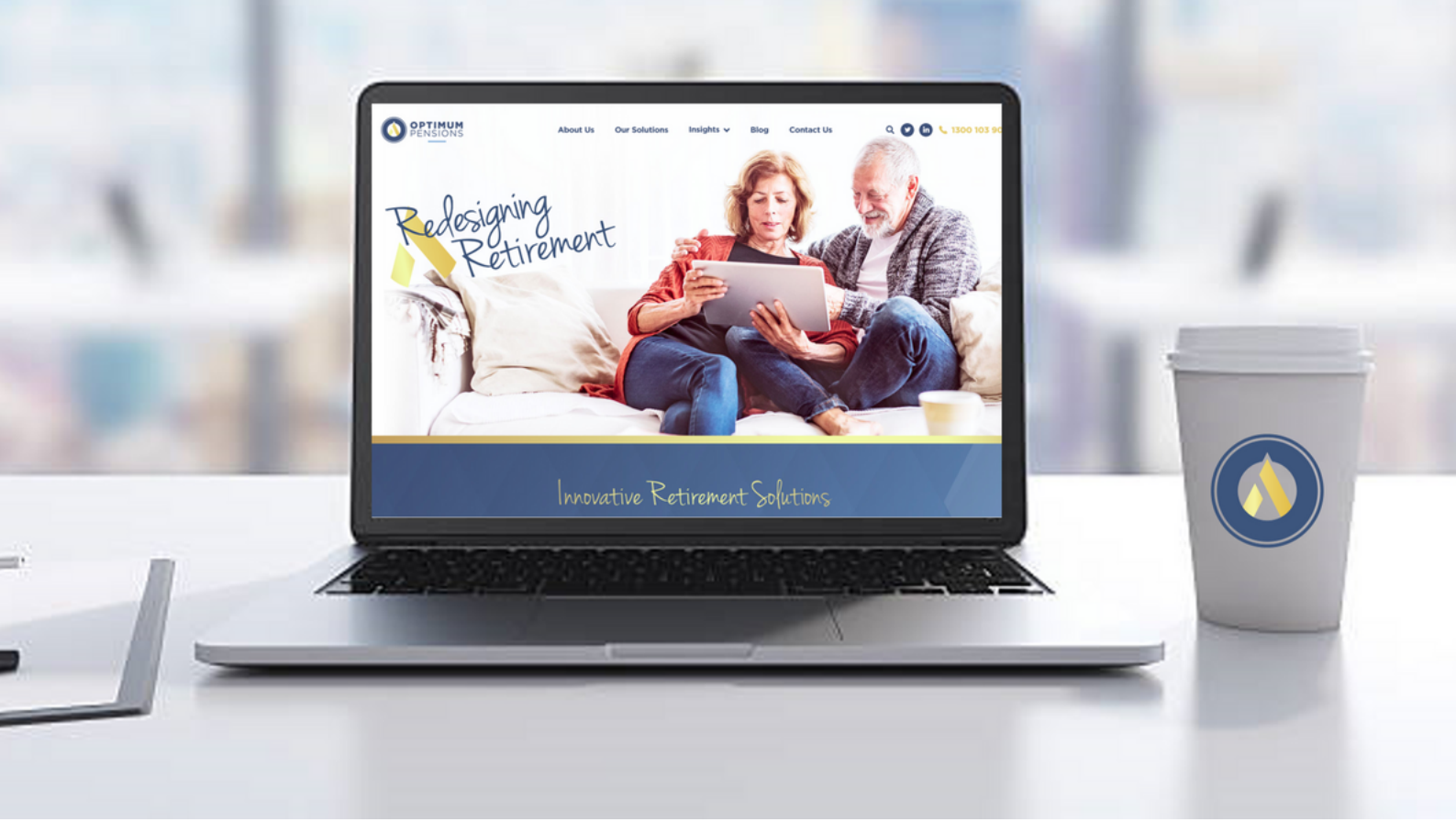
END NOTES

[1] The figure is approximately 30% if a discount is applied.

[2]Assumptions for the ABP: 1000 males aged 65 with $300,000 in an ABP drawing income in line with the minimum percentages at each age. 6.5% gross return less 0.6% fees. The die in line with the Australian Life Tables (with 25 year improvement rates). Incomes are paid at the start of the year, death bens paid at the end of the year.

[3] Assumptions for the investment-linked product.Benefit design and rates are based on Generation Life's LifeIncome product with 2.5% LifeBooster. 6.5% gross return less 1.1% fees. The 1000 males are assumed to die in line with the Australian Life Tables (with 25 year improvement rates). Incomes are paid at the start of the year, death bens paid at the end of the year.

[4] Annuities and Retirement Happiness – Towers Watson's Insider, September 2012, Launched in 1992 by the University of Michigan, the Health, and Retirement Study (HRS) is a longitudinal panel study of retirement. The study, upon which the Towers Watson analysis is based, surveys approximately 26,000 Americans over age 50 every other year on retirement issues, such as wealth, income, job history, health, and cognition.



FOR MORE INFORMATION

Any questions or comments regarding this document should be directed to:

PETER ROWE
GENERAL MANAGER, OPTIMUM PENSIONS

+614 0774 7802
peter@optimumpensions.com.au

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