Lonsec

The role of annuities in retirement portfolios

Lonsec Retire - Investment Perspectives

09 | 2019

Contents

"How much can I spend?" 2
Some of the common issues facing retirees 2
The government response 3
What is an annuity? 3
Main benefits and risks of annuities 4
Social security and the ATO 5
How Annuities could fit within a broader portfolio 6
Case study 7
Summary 11

“How much can I spend?”

This question lies at the heart of so many conversations between a retiree and their adviser. Although not explicitly stated, this simple question ties in to so many other related concerns – Can I spend enough to be comfortable? Will I run out of money? What are my options if my health deteriorates? What about bequests?

All these questions boil down to one thing – a craving for certainty. While this is understandable from a retiree perspective, the key challenge for the financial advice industry is how much certainty can we provide in answering these questions, and how do we manage expectations?

With many changes taking place in the retirement products space and the baby boomer cohort starting to retire in greater numbers, it is an opportune time to consider how annuities may form part of a solution to address the issues many face in retirement.

Some of the common issues facing retirees

As people transition from the accumulation phase of investment into retirement, their investment objectives also change. In the accumulation phase the primary investment objective of most individuals is to maximise wealth for retirement, whereas in the drawdown phase a primary objective for most retirees is to generate a level of income commensurate with lifestyle goals.

Goals in retirement are complex and multi-layered, though generally speaking there is a focus on replacing pre-retirement earnings with a post-retirement income stream, maintaining a certain lifestyle standard, leaving some money for the next generation or allocating capital for ‘lifestyle’ spending eg, holidays, caravan etc.

However, there are many other issues which have become increasingly relevant in retirement, notably:

1. Sequencing risk – income streams can be severely impacted by the timing of negative investment returns. This is particularly relevant where losses occur close to retirement age as underlying investment portfolios do not have the benefit of time to recover losses.
2. Longevity risk- the risk of outliving your savings. This risk has become increasingly important as life expectancies have increased, something which is expected to continue.
3. Market risk – most retiree nest eggs will be exposed to market movements, just as in accumulation. In most instances investors will need to take on market risk to maximise chances of meeting long-term investment goals. However, significant market events, such as the global financial crisis can materially reduce retiree savings.
4. Inflation risk – the purchasing power of income streams can be eroded over the longer term by inflation. Real returns are critical in retirement as retirees need income to at least keep pace with inflation.
5. Interest rate risk – the risk that interest rates fall, reducing a retiree’s income from term deposits and other cash-like products in the short term. In the long term, it increases the present value of future expenses or liabilities. Unhedged interest rate risk is one of the largest drivers of changes in a retiree’s funded status.

Within the construct of income being a retiree’s primary objective, the probability of outliving savings is an all too real threat. Over recent years in Australia, the focus of the federal government and industry bodies has been on managing retirement portfolios for longevity risk.

The government response

A burgeoning retiree population, alongside a desire to reduce dependence on government-funded pensions, has seen an increased focus on retirement products. The government response thus far has centred on removing barriers to lifetime products (including legislating for the development of "Innovative Superannuation Income Streams" and new Social Security means test treatment of lifetime income streams). The government has also progressed (but not yet implemented) its Retirement Income Framework, including proposals for a Retirement Income Covenant (requiring super fund trustees formulate, review regularly and give effect to a retirement income strategy) and simplified and standardised disclosure for retirement products amongst other elements.

One of the ways longevity risk can be managed is through a guaranteed income stream. For some, the Australian age pension will provide this support, however, for many this does not guarantee enough income to support their lifestyle. In this case, additional guaranteed income solutions will be sought.

Term deposits and annuities are probably the most well-known products that provide a guaranteed payment that is known at the time of investment. Not only are the payments on these investments determined at the outset but they are either offered by banks or life insurance companies, which are regulated by APRA.

Many annuity providers exited the Australian market some years ago when legislative changes made annuities less attractive to investors by removing the asset test exemption from the age pension means test. Instead, many financial institutions preferred to go down the path of wealth management, in a pre-GFC world when banks could generate higher ROEs on their lending books. This posed less potential risk to the balance sheet with lower set up costs. However, with the increasing demand for retirement income solutions we have seen notable interest from potential annuity issuers in coming back to the Australian market.

With the evolving environment, product providers have progressively looked to introduce new features to traditional annuities to meet different investor needs, as well as capital protected products and other retirement products.

What is an annuity?

An annuity is a contract between an investor and insurance company, whereby the investor makes a lump sum contribution in exchange for a series of guaranteed payments. Capital is either returned at the end of the period or paid out over the life of the annuity as part of each payment term.

The main types of annuities are:

Term annuities:

- A term annuity is a life insurance contract that provides a series of regular income payments for an agreed period in return for the payment of a lump-sum of money at the start of the period.
- The product offers to provide a guaranteed minimum income for a fixed term, irrespective of how investment markets perform.
- Can interact with the Social Security Means Test differently to other financial assets as term annuities for longer than 5 years are not subject to deeming, but use deduction amounts in the means tests.
- Attractive to investors (particularly retirees) looking for protection against market risks.

Lifetime annuities (including deferred lifetime annuities):

- A lifetime annuity is a life insurance contract that provides a series of regular income payments for the remaining lifetime of the investor (or a nominated reversionary annuitant) in return for the payment of a lump-sum of money.
- The product offers to provide a guaranteed income for life, irrespective of how investment markets perform or how long the annuitant lives.
- Payments from lifetime annuities are enhanced by mortality credits as the pooled nature of the product provides payments to all survivors.
- Most annuities sold today include a death benefit for several years after purchase as well as the potential to access the capital for a period of time based on life expectancy.
- Lifetime annuities are not subject to deeming for the age pension means test. There can be advantages to some investors due to the run-down of capital
- Can be attractive to investors (particularly retirees) looking for protection against market risks (falls in investment values and reduction in income) and longevity risks (outliving retirement savings) as well as estate planning.
- A deferred annuity is a lifetime annuity set to commence at a certain point in time in the future.

Variable annuities:

- Variable annuities offer to pay a minimum level of income for an agreed period or for life. The initial investment is placed into specific investment funds chosen by the investor and this account balance may vary depending upon the performance of the underlying investments, fees and additions and withdrawals.
- The guaranteed minimum income has the potential to increase over time if the underlying investment funds perform very strongly.
- The distinguishing feature is the lifetime nature of the product and like lifetime annuities, address longevity risk for retirees.
- Available in the Australian market as guaranteed lifetime income/insurance products, currently offered by MLC.

Main benefits and risks of annuities

Benefits

- Annuities provide a guaranteed payment, established at the time of purchase and paid over an investor's lifetime. Thus, annuities are not subject to extreme market events that can have a negative impact on the sustainability of a retiree's account balance.
- Annuity payments are contractual obligations of life insurance companies. Capital is pooled in statutory funds and monitored by APRA, providing additional comfort annuity providers will be able to meet these obligations. For further information, see Lonsec Product Reviews.
- Investors can select inflation indexed annuities which preserve income stream purchasing power.
- Recent innovation has improved liquidity with many annuities offering capital withdrawal periods.
- Guaranteed death benefits for beneficiaries.
- Potential social security benefits.

Risks

- Opportunity cost – By locking away part of their savings, retirees forgo the opportunity to potentially earn better returns in the future. This regret can be supressed when bigger fears come to the forefront, such as the large losses experienced during the GFC which drove many into cash and term deposits. In this instance, many investors were driven by loss aversion and dread risk (after one very bad experience, a person becomes overly fearful of similar experiences, even if they are statistically rare) but regret avoidance never disappears entirely. For this reason, it is unlikely that investing 100% of their savings in an annuity is suitable for a retiree.
- Liquidity risk – capital is not always able to be accessed, depending on the type of annuity. New features provide greater flexibility but involve trade-offs.
- Credit risk – annuitants are exposed to the creditworthiness of the statutory fund of the insurer and must be comfortable the insurer can meet its obligations when they fall due over an investor's lifetime (and beyond if the investor has a reversionary beneficiary). The capital adequacy of insurance companies is monitored by APRA.
- Transparency – fees are not usually quoted as an explicit cost. Instead, annuity providers earn a spread between the return on assets and the guaranteed income stream paid to investors (similar to the way a bank does not explicitly charge a fee for a term deposit). This makes it difficult to compare fees with other retirement products (such as account-based pensions or guaranteed products) where separate investment management, guarantee and platform administration fees are explicitly charged.

Social security and the ATO

In July 2017, the federal government changed the law to encourage retirees into guaranteed income products and the design and innovation of such products. From this point, the government extended the tax exemption on earnings in retirement from just superannuation pensions to other retirement products including deferred lifetime annuities.

Annuities may also provide additional Social Security and Aged Care benefits. This will be dependent on the structure of the annuity (e.g. term or lifetime) and whether a retiree is affected by either the Income or Assets Tests administered by Centrelink. While quite a complex area, the most relevant considerations are summarised below:

- Term (term annuities only) – annuities with terms of six years or more (or less than 6 years where equal to life expectancy) are classified as long-term income streams, so deduction amounts may be applied for the Income and Asset Tests. Annuities with a shorter term than this are treated as short term income stream and therefore a financial investment subject to deeming.
- New means test assessment of lifetime annuities commenced on or after 1 July 2019 – where a lifetime annuity commences on or after 1 July 2019 and meets the rules of Innovative Superannuation Income Streams just 60% of payments will be assessed as income under the income test (for deferred lifetime annuities income will only be assessed from when payments commence) and just 60% of any investment amount will be counted as an asset under the assets test until age 84 (or for a minimum of five years) and just 30% assessed as an asset thereafter. This assessment can mean for assets or income tested clients an immediate increase in Age Pension entitlement following an investment in a lifetime annuity.

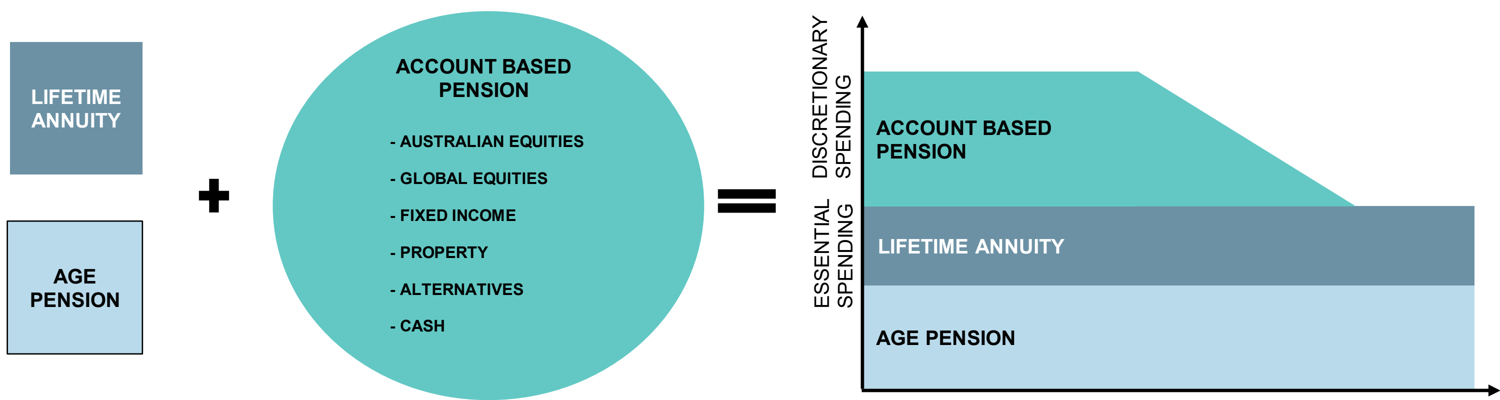
- **Aged care means test** – certain annuities can reduce the assessable assets and income for the aged care means test.

Lonsec recommends careful consideration be given to all tax and social security implications or benefits prior to the purchasing of any retirement income product.

How annuities could fit within a broader portfolio

Unlike many retirement income solutions, annuities offer a guaranteed level of income to investors and some types of annuities are able to mitigate longevity risk by guaranteeing an income for life.

The chart below illustrates how an annuity can work with the age pension to help a retiree meet their essential spending objective.



In Lonsec's experience, it can be difficult to prescribe a suitable exposure to annuities at a model portfolio level given the multiple assumptions needed eg. the incremental benefit of including an annuity may be low for small investment balances as these retirees will most likely be dependent on the age pension to manage longevity risk and meet essential spending needs. Conversely, the need to guarantee an income stream may be low for high net worth retirees given the ability to self-fund their retirement objectives.

That said, retirees looking to secure part of their income stream, or in conjunction with the age pension boost the amount of guaranteed income during retirement, annuities may be an attractive proposition. Additionally, Lonsec notes that there is a mass market of retirees for whom annuities may be appropriate, typically those with retirement savings of between $400,000 to $1,000,000 (for couples who own their own home) or between $250,000 to $750,000 (for singles who own their own home). This range is a guide only and based on the Age Pension income and assets test thresholds and the ASFA numbers for a comfortable retirement lifestyle of approximately $43,000 for a single person and $61,000 for a couple. Lonsec notes optimal annuity allocations will be dependent on a number of factors including access to Centrelink benefits, liquidity needs, life expectancy and estate preferences. Lonsec strongly advises retirees considering investing in annuities to seek advice from a financial adviser.

Lonsec does not have a preferred means to best accommodate an allocation to annuities within a diversified investment portfolio but notes there are two commonly held schools of thought. The first is

to allocate from the defensive assets within a portfolio and the second is to 'carve-out' a separate allocation for the annuity and retain the existing asset class weightings over a smaller asset base.

Given the similarities with traditional defensive assets, shorter dated and term annuities with 100% residual capital value (RCV) can be classified as fixed interest and funded from the defensive part of a diversified investment portfolio.

The following provides a basic example of how a 30% annuity allocation can be included in a diversified retirement portfolio of $550,000.

No Annuity Allocation	%	$
Australian Equities	25	137,500
Global Equities	25	137,500
Property & Infrastructure	10	55,000
Fixed Interest	35	192,500
Cash	5	27,500
Total Portfolio	100	550,000

Annuity Allocation from Defensive Assets	%	$
Australian Equities	25	137,500
Global Equities	25	137,500
Property & Infrastructure	10	55,000
Fixed Interest	5	27,550
Cash	5	27,500
Annuity	30	165,000
Total Portfolio	100	550,000

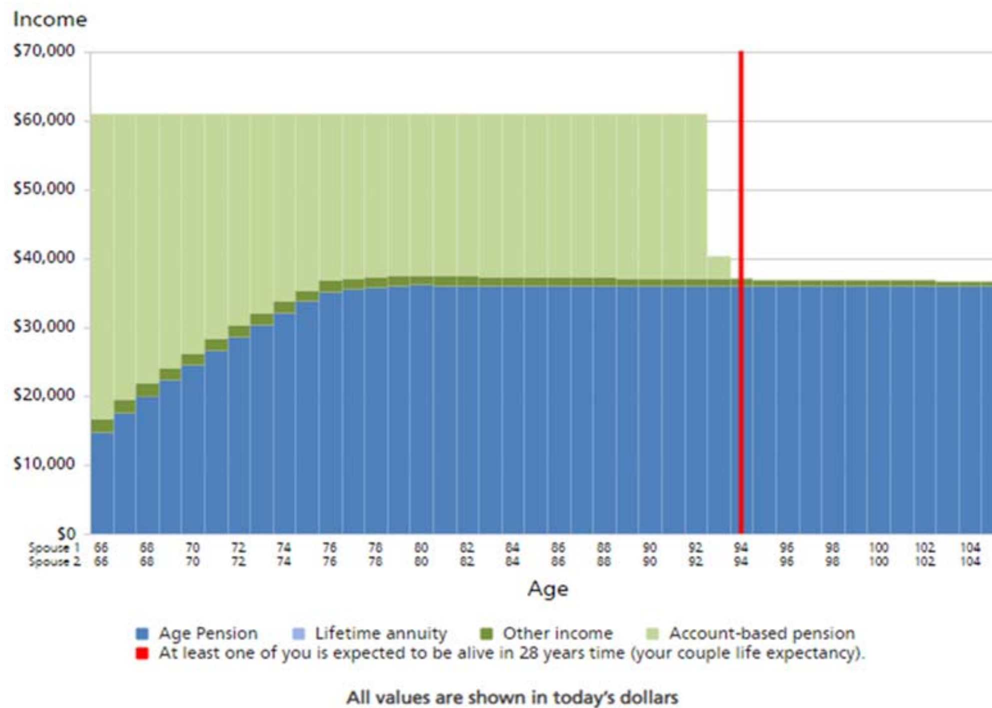
30% 'Carve-Out' to Annuities	%	$
Australian Equities	25	96,250
Global Equities	25	96,250
Property & Infrastructure	10	38,500
Fixed Interest	35	134,750
Cash	5	19,250
Total Portfolio ex Annuity	100	385,000
Annuity		165,000
Total Portfolio with Annuity		550,000

Case study

To demonstrate the potential benefits of incorporating an annuity as part of a retiree's total portfolio, consider the following case study:

- Couple, homeowners both aged 66 (current Age Pension age)
- $300,000 each held in super
- $50,000 in term deposits
- $20,000 in personal assets
- 50/50 defensive growth risk profile
- Aiming to achieve a desired level of annual income of $61,061 p.a. (equal to the AFSA Comfortable level of annual income at March 2019) but requiring annual income above the maximum level of Age Pension to meet essential living expenses in the event that their retirement assets are depleted.
- Estimated life expectancy of 93 (for one member of this couple)

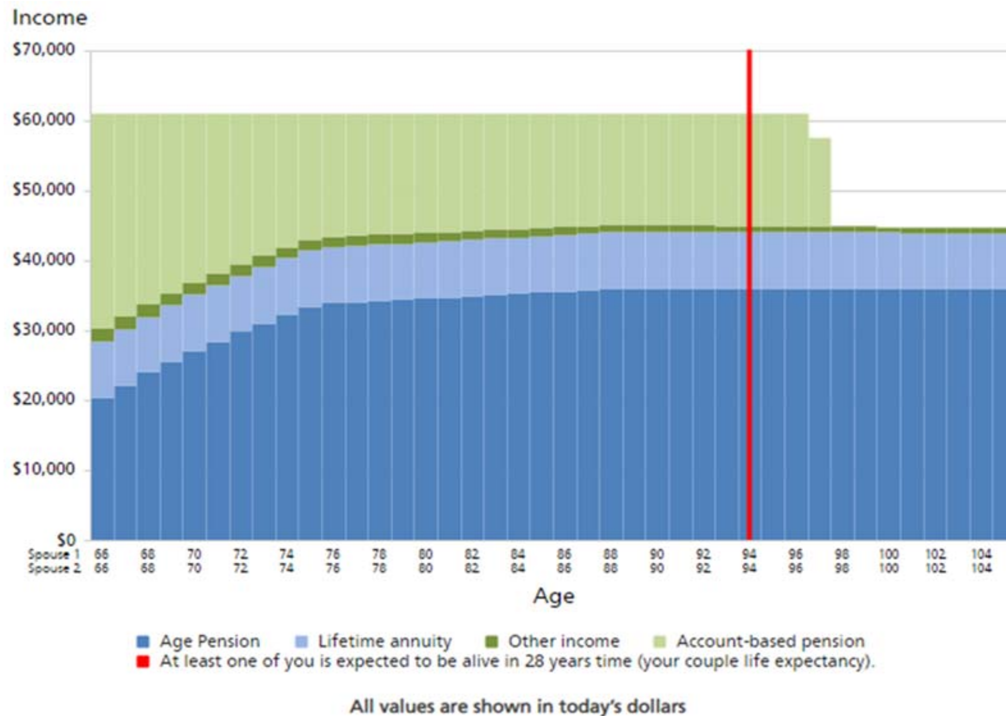
Investment returns sourced from Willis Towers Watson: 3.7% p.a. for defensive assets before investment fees of 0.6% p.a. and platform fee of 0.5% p.a. Returns of 7.7% p.a. for growth assets before investment fees of 0.8% p.a. and platform fee of 0.5% p.a. CPI of 2.5% p.a. Cash and term deposits return 4% p.a. Centrelink rates and thresholds as at 1 July 2019.



Simulations from Challenger Retirement Illustrator.

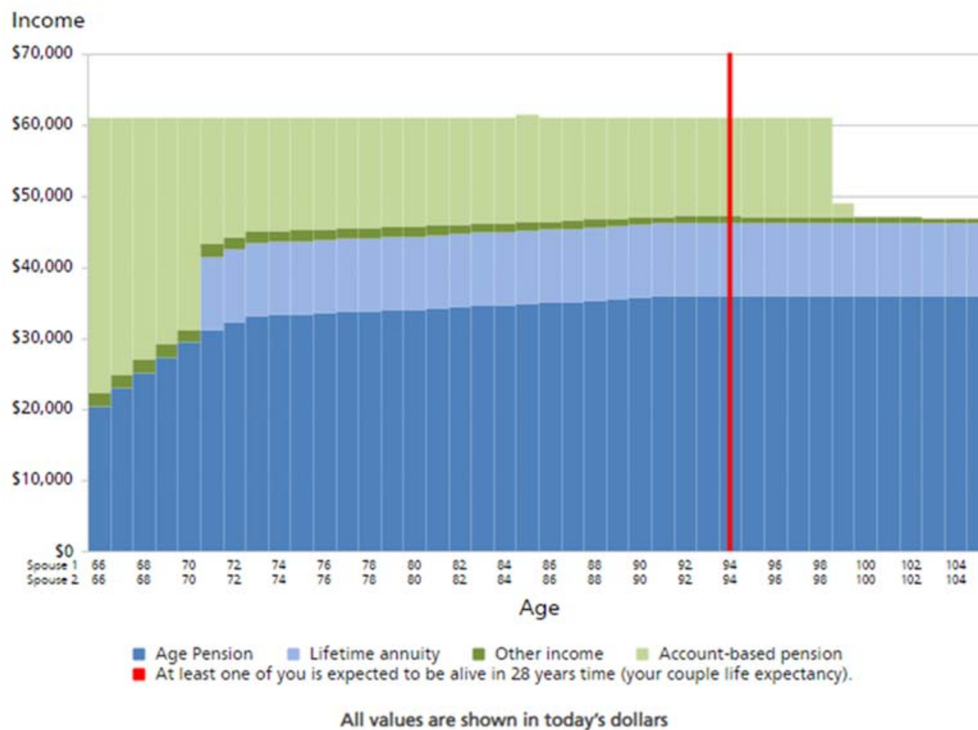
The first chart shows the couple's retirement income objective being funded by an account-based pension (50/50 growth / defensive split) along with any age pension entitlements. In this scenario, the couple receives $61,061 each year (indexed by CPI) until their investment portfolio is depleted at age 93, short of their life expectancy of 94.

The second chart shows the same couple with their retirement income objective again funded by an account-based pension and any age pension entitlements, however there is also a 30% allocation to lifetime annuities. Under this scenario, the couple effectively extend the longevity of their savings beyond their life expectancy. Importantly, at the point where investment assets are depleted, the couple is not solely dependent on the age pension alone, with income supplemented by the annuity sufficient to meet their essential spending requirements.



Simulations from Challenger Retirement Illustrator.

The third chart shows the same couple with their retirement income objective again funded by an account-based pension and any age pension entitlements, however there is also a 30% allocation to deferred lifetime annuities (in this instance illustrated using a five-year deferral; period). Under this scenario, the couple also effectively extend the longevity of their savings beyond their life expectancy. Also, at the point where investment assets are depleted, the couple is not solely dependent on the age pension alone, with income supplemented by the higher annuity payments (deferred annuity payments are higher for equivalent investment amounts) sufficient to meet their higher essential spending requirements.



Simulations from Challenger Retirement Illustrator.

The simple case study shows how an annuity can work as part of a diversified portfolio in ensuring the couple's income objectives are met throughout their estimated life expectancy.

Investors should note there are some limitations to this analysis. Importantly, the annuity has been classified as a defensive asset because the payments are contractually guaranteed. These payments provide a higher return than other the defensive assets in the case study because the annuities are backed by a range of defensive and growth assets, as well as accruing mortality credits. Therefore, inclusion of the annuity generates higher returns compared to a portfolio invested in traditional defensive assets only.

Summary

Annuities are well placed to satisfy the income needs of retirees, particularly those who:

- are concerned about outliving their retirement savings.
- are concerned about their income from savings not keeping pace with inflation (if indexation is selected).
- are seeking income stream certainty.
- do not wish to rely solely on income from their allocated account-based pensions.

Investment needs of retirees vary greatly and suitability of investment products will largely depend on whether they fulfil specific lifestyle goals. There is naturally a trade-off between certainty of income, rates of return, access to capital and cost when assessing which product features are best suited to each retiree's unique circumstances. Overall, Lonsec believes there can be potential benefits from incorporating an annuity into a retiree's portfolio structure.

IMPORTANT NOTICE: This document is published by Lonsec Investment Solutions Pty Ltd ACN 608 837 583, a Corporate Authorised Representative (CAR 1236821) (LIS) of Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445 (Lonsec Research). LIS creates the model portfolios it distributes using the investment research provided by Lonsec Research but LIS has not had any involvement in the investment research process for Lonsec Research. LIS and Lonsec Research are owned by Lonsec Holdings Pty Ltd ACN: 151 235 406. Please read the following before making any investment decision about any financial product mentioned in this document.

Disclosure at the date of publication: Lonsec Research receives a fee from the relevant fund manager or product issuer(s) for researching financial products (using objective criteria) which may be referred to in this document. Lonsec Research may also receive a fee from the fund manager or product issuer(s) for subscribing to research content and other Lonsec Research services. LIS receives a fee for providing the model portfolios to financial services organisations and professionals. LIS' and Lonsec Research's fees are not linked to the financial product rating(s) outcome or the inclusion of the financial product(s) in model portfolios. LIS and Lonsec Research and their representatives and/or their associates may hold any financial product(s) referred to in this document, but details of these holdings are not known to the Lonsec Research analyst(s).

Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is limited to general advice and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of his or her financial circumstances or should seek independent financial advice on its appropriateness. If the financial advice relates to the acquisition or possible acquisition of a particular financial product, the reader should obtain and consider the Investment Statement or the Product Disclosure Statement for each financial product before making any decision about whether to acquire the financial product.

Disclaimer: LIS provides this document for the exclusive use of its clients. It is not intended for use by a retail client or a member of the public and should not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by LIS. The information contained in this document is current as at the date of publication. Financial conclusions, ratings and advice are reasonably held at the time of publication but subject to change without notice. LIS assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, LIS and Lonsec Research, their directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.

Copyright © 2019 Lonsec Investment Solutions Pty Ltd ACN: 608 837 583 (LIS). This report may also contain third party supplied material that is subject to copyright. The same restrictions that apply to LIS copyrighted material, apply to such third party content.