

## Annuities – a difficult choice

April 2009

**For those looking to take income from any money purchase pension, several factors have contributed to a significant decline in what income they can expect to generate.**

Exceptionally low long term interest rates, declines in stockmarket-based investments, increasing life expectancy and falling inflation are all having an impact. In this note we look at what's happened to level and index-linked annuities and the differences between maximum annuities and pension fund income withdrawal. We also comment on the suitability of recently launched annuity alternatives which provide guaranteed income and offer some investment upside.

### **A level or an index-linked annuity – what a difference a year makes**

Annuity rates have fallen substantially over the past year. For a 65 year old male with 10-year income guarantee, the top level annuity rate is now 5.82% compared to 7.77% last May (a drop of 25%), while the best index-linked rate (from a different provider) is now 3.78%, compared to 4.75% last May (a drop of just over 20%). The difference between the starting rate for an RPI-linked annuity compared with a level annuity has narrowed slightly, with an index-linked annuity now 36% lower than a conventional level annuity compared with 39% lower in May 2008 (all annuity rates sourced from the FSA website's annuity comparison tables).

The gap between index-linked and conventional annuities depends upon two principal factors. One is life expectancy - the greater the purchaser's life expectancy, the bigger the initial difference in income. For example, the gap for a man aged 55 is about 45%. Thus one effect of improving longevity is that, all other things being equal, over time the gap will widen.

The other crucial factor is the difference between the nominal yield on the fixed rate securities used to back level annuities (usually corporate bonds) and the real (i.e. inflation-adjusted) yield available from index-linked securities (which are almost entirely government bonds).

The credit crunch-driven rise in corporate bond yields last year pushed up level annuity rates and as those yields fall back, so do annuity rates. However, index-linked gilt real yields have moved in the opposite direction. The average real return on 15 year+ index-linked gilts is now around 1.12% compared with 0.85% last May and 1.45% at the start of June 2007.

Whether an index-linked annuity is worth buying depends on two imponderables:

- How long the investor lives, and
- The expected price inflation over their lifetime.

One way to judge the market's long term inflation assumption is to look at the difference between conventional and index-linked long gilt yields. This throws up a theoretical long term inflation figure of around 1.8%, compared with 3.8% last May, indicating a more benign outlook for inflation.

However, even at 1.8% inflation, a 65 year old male will have to wait until his 89th birthday before his index-linked annuity overhauls its level counterpart. For total payments (in monetary terms) to be equal he will have to wait until he is 112 and in inflation-adjusted terms until he is 116.

**CA 06.04.09 AR**

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If inflation matches the government's implicit target of 2.5% for the RPI, then the crossover point comes in to age 83 and the break-even total payment point is age 99 in monetary terms and 101 in inflation-adjusted terms.

With the latest RPI rate at zero the possibility of deflation has raised its head. If we do experience negative inflation in the short term, this could see those with existing index-linked annuities experience a fall in their income, although the medium term outlook is most likely positive inflation, particularly given the fiscal stimulus currently underway.

Many retirees have rightly been concerned about mitigating the risk of rising inflation in the medium term and thus have been tempted to consider index-linked annuities. On current rates, a would-be purchaser needs to be very long-living or very pessimistic about future inflation to justify giving up the much higher starting amount from a level annuity. If one adds in the potential for income to fall in the event of short term deflation, it all points to index-linked annuities not being very good value for most investors. If an index-linked annuity is still desired then it is probably good advice to only secure one with a small proportion of one's pension fund.

### **Annuity rates v drawdown**

An alternative to buying an annuity (whether level or index-linked) is to take unsecured pension income directly from the fund (known as drawdown). The income withdrawal rates are governed by rates published by the Government Actuary's Department (GAD) and are based on gilt yields. We thought that quantitative easing (QE) would have a negative impact on pension income drawdown rates for March and with the interest rate on which such withdrawals are calculated now down to 3.25% (from 4% last month), we've been proved right.

The Bank of England's gilts purchases are in the 5- to 25-year maturity range. While that was allegedly chosen to avoid the ultra-long stock favoured by UK pension schemes, the range is centred on the 15-year maturity which sets the benchmark yield for income drawdown. Quite how dramatic the impact of the Bank's move has been is shown by how the 15-year gilt yield has moved recently. On Wednesday 4 March, the day before the Old Lady announced her QE plans, the FTSE Actuaries' 15-year Gilt Index yield was 4.26%. Seven working days later on Friday 13 March – the date used to set drawdown yields for the next month – the corresponding figure was 3.42%, which was just enough to force rounding down for drawdown calculation purposes to 3.25%. There has been a similar, but smaller drop in corporate bond yields: the iBoxx £ Corporates AA 15+ yield declined from 6.71% to 6.16% over the same period. Since these are used by insurers to back conventional annuities, that has pushed down annuity rates.

The net result is that the normal gap between maximum drawdown and conventional annuity reverses at age 50:

Age	Maximum drawdown rate as percentage of annuity rate	
	Male	Female
50	98.0	98.1
55	102.6	99.5
60	103.1	101.8
65	106.0	103.1
70	111.0	106.2



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*Based on 3.25% drawdown interest rate and FSA rate tables for a nil guarantee annuity for a purchase price of £120,000.*

As pension 'simplification' reaches its third anniversary, it could be time for HMRC to revisit the basis for the drawdown tables.

### **A half way house solution**

For those seeking security of income and capital in the short term, with the possibility of participation in future investment growth from risky assets like equities, a number of providers have launched new innovative retirement income products.

These are likely to be attractive to those who are more reliant on their pension fund to fund their retirement income and want to improve the potential benefits and thus can't accept either the constraints of a level annuity, the risks of an index-linked annuity producing less than a level annuity or the risk that stockmarkets continue to fall. These plans come at a cost, but that might well be a price worth paying for some individuals. We'll be producing a detailed review of how these new products work later this year. In the meantime investors would do well to remember that well known truism in the context of retirement income, 'You can't have your cake and eat it!'

Contacts	Telephone	Email
Jason Butler	07973 951107	<a href="mailto:jasonbutler@bloomsburyfp.co.uk">jasonbutler@bloomsburyfp.co.uk</a>
Carolyn Gowen	07775 712969	<a href="mailto:carolyng@bloomsburyfp.co.uk">carolyng@bloomsburyfp.co.uk</a>
Robert Lockie	07951 725880	<a href="mailto:robertl@bloomsburyfp.co.uk">robertl@bloomsburyfp.co.uk</a>

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