

Soon-to-be-retirees face biggest financial decision of their lives

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Tens of thousands of South Africans who retired at the end of 2009 now face one of the most important financial decisions of their lives – what to do with their retirement savings accumulated throughout their working careers. This decision will have a significant impact on whether they are able to maintain their standard of living during their golden years.

Faced with variety of products to choose from, pensioners typically take one of two views:

- Choose a high level of initial income and accept a decline in buying power as one ages; or
- Choose a low level of initial income but with expected increases, to help maintain their lifestyle well into their 90's.

Once retired, pensioners may find that they have very different needs than originally assumed at retirement. For example, a pensioner may have chosen a high level of initial income and accepted a decline in buying power as they age. After several years they would discover that they have insufficient income should they live to 90. This could be a large problem for a healthy 78 year old pensioner facing decreasing levels of income both in rand terms and compared to inflation.

A better understanding of the products offered at retirement would lead to pensioners understanding how the different products meet different needs. This would lead to better financial planning decisions being made by pensioners at retirement.

AFTER-RETIREMENT INCOME PRODUCTS

There are currently a wide range of annuity products in the market that provide after-retirement income, namely:

- **Level annuities**
Level annuities provide level payments for the life time of the pensioner. Payments are guaranteed never to decrease, but there are also no future increases.
- **Inflation-Linked Annuities**
Inflation-Linked Annuities provide pension payments for life, guaranteed to increase in line with inflation.
- **With-profit annuities**
A with-profit annuity provides regular pension payments for life as well as the opportunity to participate in the investment profits via an annual bonus increase. Any investment return in excess of the pricing interest rate is available for increases. The payments from a with-profit annuity are guaranteed never to decrease, and any increases granted via the annual bonus, are also guaranteed for life.
- **Living annuities**
A living annuity is a market-linked investment, which

allows the pensioner to draw an income from their portfolio. The income that can be drawn is selected by the pensioner and is limited to between 2.5% and 17.5% of their portfolio value. One can think of it as a bank account from which income can be drawn thereby reducing the amount left in the portfolio. Selecting a higher income percentage, will lead to higher amounts being withdrawn from the portfolio and will thus reduce the portfolio value available for further income withdrawals. The underlying portfolio moves in line with the underlying investments, so any increase or decrease in the investments will lead to an increase or decrease in the portfolio value. Any increase or decrease in the portfolio value will be reflected on the annual policy anniversary, as income is selected as a proportion of portfolio value.

Level, Inflation-linked and With-profit annuities all have the advantage of guaranteeing that payments will never "run out" and will be paid for life, whereas the Living annuity does not guarantee payments for life. However level annuities could be extremely detrimental to a person who lives to be well over 80 due to the lack of inflation protection. The situation could be worse for females who, on average, are expected to live longer than males, as inflation erodes the buying power of their pension for a longer time period. A with-profit annuity or an inflation-linked annuity may be preferred as they provide increases,

however, they come with the disadvantage of providing lower income levels during early retirement.

In conclusion, there are a variety of annuities available for pensioners to purchase when they retire. Each annuity has advantages and disadvantages and it is

important to be cognisant of the risks in each product. Trustees can play a great role in this by educating members and ensuring access to appropriate products. It is thus very important that the annuities are well understood by the pensioner (and well explained by their broker)

and a decision is made whilst considering both short term and long term income needs.

SUMMARY

Below is a table summarizing the advantages and disadvantages of the different products available to purchase at retirement.

	Advantages	Disadvantages
Level Annuity	<ul style="list-style-type: none"> ■ Guaranteed payment for life ■ Payments guaranteed to never decrease ■ High level of starting pension for a given price, or alternatively, a low price for a given level of pension (compared to other types of annuities) 	<ul style="list-style-type: none"> ■ Pension payments cease on death, unless dependant annuities or guaranteed periods of payment are chosen. These options reduce the initial starting pension. ■ Offers no protection against the effects of inflation on the pension
Inflation-Linked Annuity	<ul style="list-style-type: none"> ■ Guaranteed payment for life ■ Receive a pension that is guaranteed to move in line with inflation ■ Payments guaranteed to never reduce buying power 	<ul style="list-style-type: none"> ■ Pension payments cease on death, unless dependant annuities or guaranteed periods of payment are chosen. These options reduce the initial starting pension. ■ Low starting pension compared to other annuities
With-Profit Annuity	<ul style="list-style-type: none"> ■ Guaranteed payment for life ■ Payments guaranteed to never decrease ■ Annual increases, once declared, become part of the basic pension for life and can never be removed ■ Increases expected allow pension to keep up with inflation (at least in part) - depends on pricing interest rate ■ Past increases well above inflation only for the top categories, below inflation for many pensioners. 	<ul style="list-style-type: none"> ■ Pension payments cease on death, unless dependant annuities or guaranteed periods of payment are chosen. These options reduce the initial starting pension. ■ Increases not guaranteed ■ Increases may not keep up with inflation
Living Annuity	<ul style="list-style-type: none"> ■ Flexible income selection (2.5% to 17.5% available to withdraw each year) ■ Capital preservation is offered via balance of portfolio paid to dependants on death 	<ul style="list-style-type: none"> ■ Underlying portfolio value affected by market price movements, which could negatively affect income levels ■ Payments not guaranteed to never decrease ■ Payments not guaranteed for life