

FEATURE



With-profits annuity rates can go up or down, but can pay off in the long run for committed investors

INVESTMENT-LINKED ANNUITIES Despite taking a huge hit from the drop in equity prices, investment-linked annuities are still a valid choice for the long-term investor

Long distance returns



BILLY BURROWS

Annuities that invest in the stock market or with-profits funds, commonly known as investment-linked annuities, have been available for some time. Commercial Union and Provident Mutual were among the first to offer a form of unit-linked annuity, but it was not until Equitable Life launched its with-profits annuity (WPA) in 1987 that these products became widely accepted. The next milestone was when Prudential entered the WPA market in 1991. This was quickly followed by Scottish Widows and Norwich Union, and by 2000 the WPA providers included Standard Life, Scottish Mutual and Sun Life.

The dramatic fall in equity prices in 2001, and the subsequent bad publicity surrounding with-profit funds in general, halted the demand for WPAs. Subsequently a number of insurance companies, including Standard Life, pulled out of this market. Today there are only four companies providing WPAs: Legal & General, LV, Prudential and Norwich Union. Prudential is by far the most dominant provider.

In 2008, more than £11.5bn of pension annuities were purchased, of which £11bn were fixed and retail prices index annuities, and £500m were investment-linked annuities – of which the majority are with-profit annuities. In addition, £3.2bn was invested in pension drawdown. The

figures for WPA sales show that WPAs are a small, but important percentage of overall annuity sales.

What is a with-profits annuity?

WPAs are invested in a with-profits fund, which means annuitants share in the future investment gains or losses of the fund. This is in contrast to standard non-profit annuities, where the income is guaranteed but there is no investment growth.

WPAs have the normal annuity options available, eg single or joint life and choice of guaranteed periods and payment frequencies, but the big difference compared to standard (non-profit) annuities is that every year the annuity income is recalculated to take account of the actual bonuses paid to the companies. Income in future years can be higher or lower than previous years.

Income choice annuity

Prudential is set to inject new energy into the WPA with the launch of a new type of WPA policy called the 'income choice annuity'. It allows investors to choose the starting level of income between a maximum and minimum amount. This can be reviewed annually and potentially changed every two years.

It also has a guaranteed secure level of income, a minimum below which the annuity cannot fall, no matter what happens in the financial markets.

The starting annuity payments are not guaranteed, but future income payments will rise or fall in subse-

quent years depending on future bonuses paid by Prudential.

How does income choice work?

There are two important concepts to understand:

- required smoothed return (RSR);
- declared smoothed return (DSR).

The RSR is effectively the anticipated bonus rate (ABR) used in other WPAs. Once an investor has selected the income level they would like, the RSR for the income to remain at that level will be disclosed. It is important at this stage that the investor is comfortable with the level of risk being taken. The lower the RSR, the less risk of income falling, and the higher the potential for growth. The higher the RSR, the higher the risk of income falling and the less potential there is for growth.

The DSR is the actual bonus added to the annuity at the end of each year. If the DSR bonus is higher than the RSR, the annuity income will increase, whereas if it is lower the annuity income will fall. Table one explains in more detail, showing the starting income for a range of annuity options.

In this example, the annuity with an RSR of 4.5% pays a similar starting income to a level annuity. At the end of year one, the annuity income is recalculated using the actual smoothed return or DSR. This may be higher or lower than the RSR, as shown in table two.

The pros and cons of WPAs

The rationale for any investment-linked annuity is that annuities are a long-term investment and so should be invested in long-term assets such as global equities and property, which aim to provide an effective hedge against inflation and potential for income growth.

Most people need an income that has the potential to grow to meet their ever-increasing expenditure and life expectancy, but find the cost of inflation-linked annuities too expensive. Providing investors understand and accept the additional risks, investment-linked annuities allow investors to choose the level of starting income and benefit from future growth if returns are higher than anticipated.

What are the advantages?

- It combines the advantages of an income for life with the potential advantages of investing in the stock

TABLE ONE: STARTING INCOME FOR ANNUITIES

Annuity type*	Gross income
Income choice – 6% (RSR)	£7,472
Level annuity	£6,384
Income choice – 4.5% (RSR)	£6,384
Income choice – 1% (RSR)	£4,041
Inflation-linked annuity	£3,851

*£100k single life annuity for a man aged 60

TABLE TWO: RSR/DSR CALCULATIONS

Year one income	£6,384 a year – RSR 4.5%		
Year two income	DSR of 5%		
	£6,384 x	1.05 (DSR) 1.045 (RSR)	= £6,414
	DSR of 4%		
	£6,384 x	1.05 (DSR) 1.045 (RSR)	= £6,353

market;

- With-profit funds smooth investment returns, ironing out investment peaks and troughs;
- In certain circumstances they are a good alternative to pension draw-down;
- They provide the potential of a growing income, with the security and peace of mind associated with standard annuities.

What are the risks?

- Future annuity payments will fall in value if future bonuses are lower than the chosen ABR or RSR;
- Future bonuses may fall as well as rise;
- The real value (allowing for inflation) of annuity payments will fall if inflation is higher than any increases to the WPA;
- Increases in future life expectancy can be passed on to the policyholder through reductions in future bonuses.

What does the future hold?

I believe there is a bright future for investment-linked annuities and in particular those with reduced volatility. My starting point is to examine what most pensioners want from their annuities. For many the objective is a sustainable income, in real terms, for the rest of their and their partner's lives, without taking undue risk.

It is easy to see that the standard level annuity, and many of the alternatives, do not meet these objectives.

Level annuities maximise income at the outset, but inflation will erode the real value over time. Inflation is

the real enemy for anybody relying on a fixed income and it is a foolish investor who ignores this. The only secure way to protect against inflation is with an index-linked annuity, but these start about 35% lower than level annuities and take a long time to catch up.

Although there is no guarantee, a properly run with-profits fund should provide an effective hedge against inflation over the longer term. While it is unrealistic to expect a WPA with a high ABR or RSR to keep pace with inflation, a WPA with a lower starting income is better placed.

Most of the alternatives to level annuities, especially pension draw-down, involve investment in equity-based funds. As recent events have demonstrated, volatile markets can be very cruel to older investors. Although with-profits funds are often criticised for their lack of transparency, complexity, and disappointing returns from some of the weaker funds, there is a strong argument that annuities could be the last bastion of with-profits. A properly run with-profits fund with an effective smoothing policy should deliver less volatile and more consistent returns compared with an equity-based fund. Smoothed returns more closely match the risk profile of retired investors.

A typical WPA investor realises that an annuity is a long-term investment and therefore it is sensible to have an annuity invested in real assets in order to have the potential for income growth. The same investor will also be concerned about taking undue risk and will take steps to reduce their inflation, investment and longevity risk. They may decide to invest in more than one type of annuity, for instance a combination of fixed and investment-linked annuities.

At present, too many investors and their advisers are asking the wrong questions. Instead of asking how much income they want, they should ask what type of income do they want? An income guaranteed to have less spending power in the future, an income that is taken from a pension drawdown plan and requires constant management, or an income for life with the potential for growth and reduced volatility?

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