

# Challenger

## Retirement Income Research

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## Valuing income for life

While it is easy to appreciate that no-one lives forever, people are not always clear on how to value a stream of payments that continue as long as you live.

### The traditional lifetime annuity

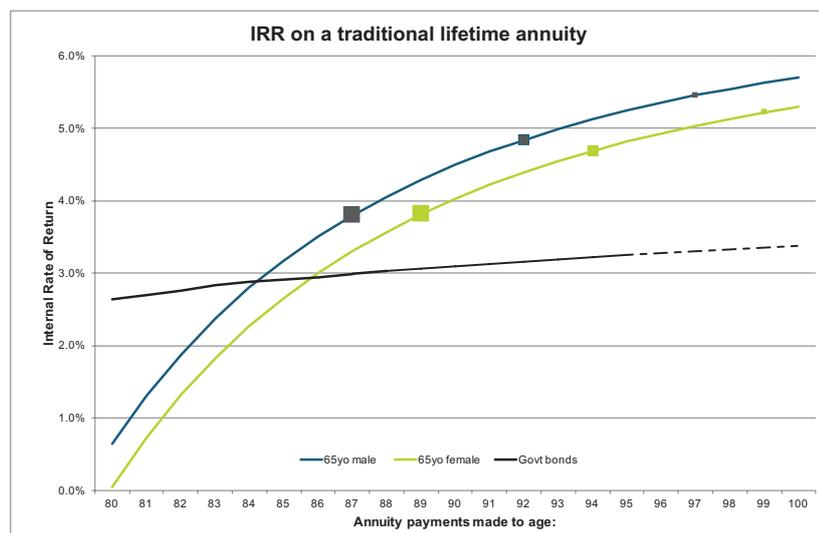
A traditional lifetime annuity is a secure guaranteed product supported by capital from a life insurer. It provides regular payments to the retiree as long as they are alive. The payments can be indexed to match inflation, but for an easy comparison this paper considers fixed annuity payments. As at 31 October 2016, the payment rates per \$100,000 for a 65-year-old were [\$6,598] for males and [\$6,276] for females. The female rate is lower because they will live longer on average.

### The value of the lifetime cash flows

Payments from a traditional annuity involve a partial return of capital and there is no terminal residual capital. It is therefore necessary to convert the payment rate to an internal rate of return (IRR) in order to compare it to other investments, such as government bonds. The Australian Government has now issued a 30-year bond, so the comparison as seen in the chart below is relevant across retirement.

A traditional lifetime annuity does not provide a high IRR when payments stop well short of life expectancy. Annuities these days have additional features to provide increased flexibility and death benefits which can improve this payoff.

### Internal Rates of Return for different length of life



Source: RBA, Challenger rates as at 31 October 2016. Life expectancy based on ALT 2010-12, with 25-year improvement factors from the Australian Government Actuary.

The payments from the lifetime annuity are high enough that even without a return of capital, the IRR is better than a government bond for most people. The large squares in the chart highlight the points of life expectancy for 65-year-olds. The smaller squares at five and ten years beyond life expectancy highlight the higher returns for those who live longer than average.

The information in this paper has been compiled by the Challenger Retirement Income Research team.

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## **An annuity is more than an investment, it's also insurance**

Some benefits to the retiree from a lifetime annuity cannot be measured with the investment framing of the IRR. Economists would refer to this as additional 'utility'.

### **Peace of mind**

Many people worry if their income will last for life. While the Age Pension is there as a safety net, this is inadequate for most and holders of annuities typically have greater peace of mind. Retirees, who have greater levels of risk aversion, can sleep better at night knowing they will always have secure income for their essential needs.

### **Confidence to invest other assets**

With the backstop provided by the annuity, retirees can invest the majority of their savings to maximise returns because they no longer need to be earmarked for income needs. When the annuity provides the necessary safety for the portfolio, retirees can use long term strategies more confidently to generate higher returns.

### **Flexibility**

Annuities today can be tailored to meet different needs. They have evolved from providing a single defined benefit and can incorporate:

- Death benefits
- Liquidity options to access capital
- Inflation protection through indexation
- Options to pay a surviving spouse

### **Tailored outcome**

A lifetime annuity, while offering exactly the same payout rate, will have a different ex post utility between any two purchasers. The annuity promises to make payments tailored to the individual lifespan of the annuitant – the length of which is unknowable at the time of purchase.

### **Efficient capital consumption**

Many Australian retirees will receive a partial Age Pension because of the means testing arrangements. Most of these people will consume a large part, if not all, of their capital during their retirement. A traditional lifetime annuity does this in an efficient manner so that, in conjunction with the means testing, pensioners can receive income from the annuity as its residual capital declines and also receive a higher Age Pension. This can mean significant dollars to pensioners relying on some Age Pension.

### **Summary**

Purely on the numbers, lifetime annuities provide a better return than government bonds for most retirees (who will survive into their 80s). They are a safe investment and provide an even better return for longer-living retirees. There are additional benefits, particularly when investing only a portion of a retiree's savings.

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