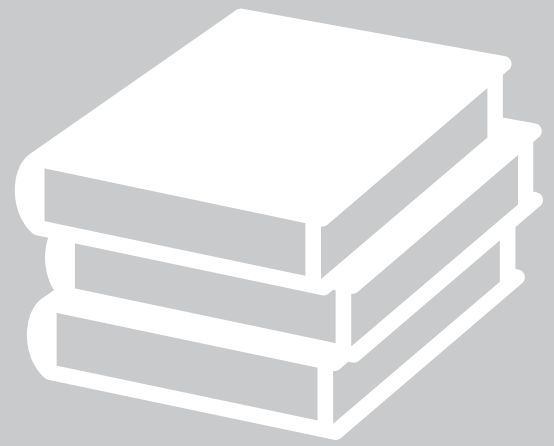


Challenger Retirement Income Research



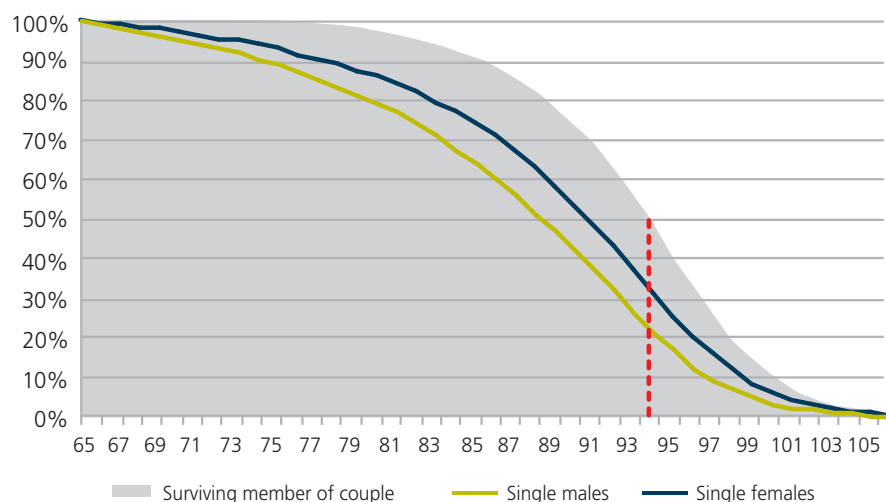
The value of a flexible annuity

The resurgence in the Australian lifetime annuity market in recent years involved adding flexibility and liquidity to a traditional annuity. The value of this flexibility can be seen in outcomes for retirement income and residual estate capital that would not otherwise be available with a traditional annuity. This paper sets out a framework for the use of a flexible annuity and guidance to advisers on how to value it appropriately.

Income for life

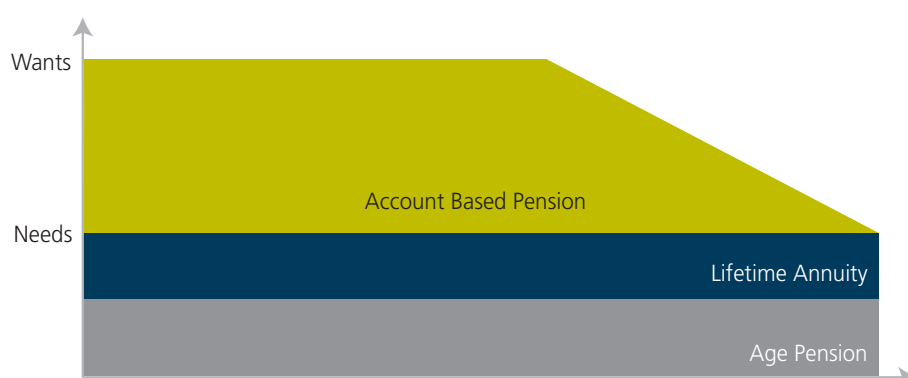
A lifetime annuity provides a retiree with income for life. This income will be secure and regular and is ideally suited to providing the cash flows to cover retiree spending needs above the Age Pension. Without an annuity, many retirees will lack the peace of mind that they desire. Everyone is aware that people are living longer. For a 65-year-old couple today, there is a better than 50% chance of one of them being alive at age 93. Figure 1 provides the survival rates for males, females and the last surviving member of a couple.

Figure 1: Survival rates for Australian 65-year-olds



The potential for a retirement income stream needing to last for up to 30 years creates a tension for new retirees; one that must be balanced. On one hand, a long time in retirement requires some investment in high returning assets for higher potential long term returns. On the other, retirees seek a source of secure cash flows to fund their spending in retirement. A good retirement income plan will have both. The role of an annuity is to provide a layer of secure income to enable a retiree, or even a retired couple, to always meet their retirement spending needs. Money for other desired spending (or wants) can be sourced from non-guaranteed market sources as seen in Figure 2.

Figure 2: Income layering



A defensive asset in retirement

Any good investment portfolio involves a mix of growth and defensive assets to align with the risk preferences of the investor. In a retirement income portfolio, the annuity should be seen as supplementing the growth assets, not replacing (or competing with) them. Advisers need to compare the annuity to a defensive asset like a government bond, rather than think of it as replacing the whole portfolio. That's not the role of the lifetime annuity.

Annuity rates are not directly comparable with bond yields though. Some of the annuity payment reflects the return of invested capital. A simple way to compare the values is to calculate an internal rate of return (IRR) on the regular payments to certain age levels. A lifetime annuity would still have some value to the survivor (in terms of future payments) but we will return to this later.

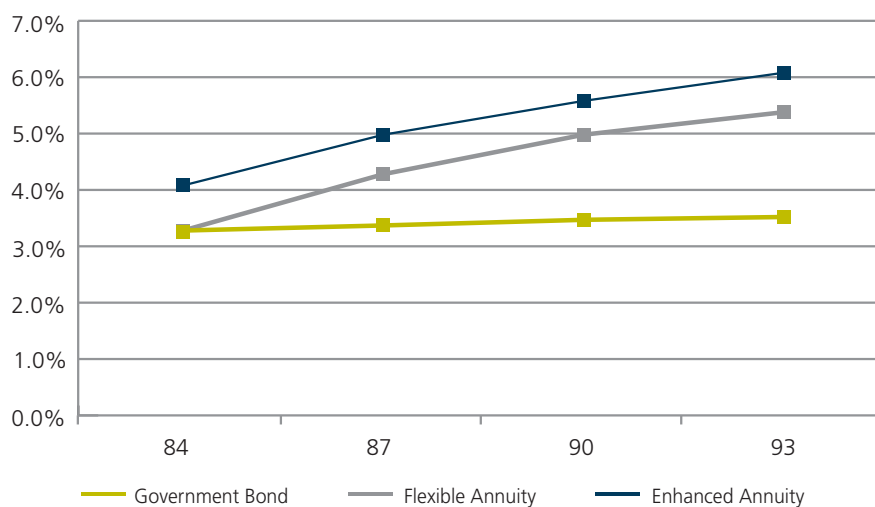
Let's start with a traditional lifetime annuity: the Challenger enhanced income option. As at 23 October 2017, this had a payment rate of \$5,762 (indexed) for a 65-year-old male, representing the income payment in the first year that increase in line with CPI on a \$100,000 investment. The rate for no indexation was \$7,416. In comparison, the yield on a 20-year Australian government bond is 3.27% as at 23 October 2017. In order to understand the gap, consider the IRR of the enhanced lifetime annuity. To age 87, male life expectancy, it has an IRR of 5.0%pa, which rises to 6.1% by age 93. This a large margin above the bond, so the lifetime annuity can really lift income in retirement.

The need for flexibility

Some retirees need more than just a higher income stream. Conditioned by a lifetime of saving capital, they are concerned about the potential loss of capital if they don't make it to their life expectancy. The modern flexible annuity has been designed to deliver this. For a small reduction in income, a flexible annuity will provide some access to capital for an extended period, and even provides 100% of the original investment as a death benefit in the early years.

Figure 3 illustrates the lower IRR that will be received from a flexible annuity compared to the enhanced annuity. It also highlights that for the majority of retirees who survive to near life expectancy or longer, a flexible lifetime annuity still provides better income through retirement than other defensive assets such as government bonds. For a retiree who lives to life expectancy (or just beyond), the average increase in return for replacing government bonds with an annuity is around +1.50% pa. This is a significant increment over current bond yields and will boost the total returns on the retiree's portfolio.

Figure 3: IRRs on Government bonds and lifetime annuities



A better estate balance

The key to a flexible lifetime annuity is that it provides peace of mind on two fronts:

1. Income so that essential needs can be met for life;
2. The ability to leave any unused capital to the retiree's estate.

The first point is obvious from the nature of the annuity, but the second point requires some explanation. By generating secure income for the retiree, the lifetime annuity enables a retiree to keep their growth assets invested. While most retirees will spend down their capital in retirement, using the income layering approach with a lifetime annuity helps to preserve capital for longer. This protects a retiree's portfolio against the risks of poor returns at the start of retirement, sometimes called sequencing risk. The outcome is best illustrated through a case study.

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

Jeremy Cooper
Chairman, Retirement Income
02 9994 7178
jcooper@challenger.com.au

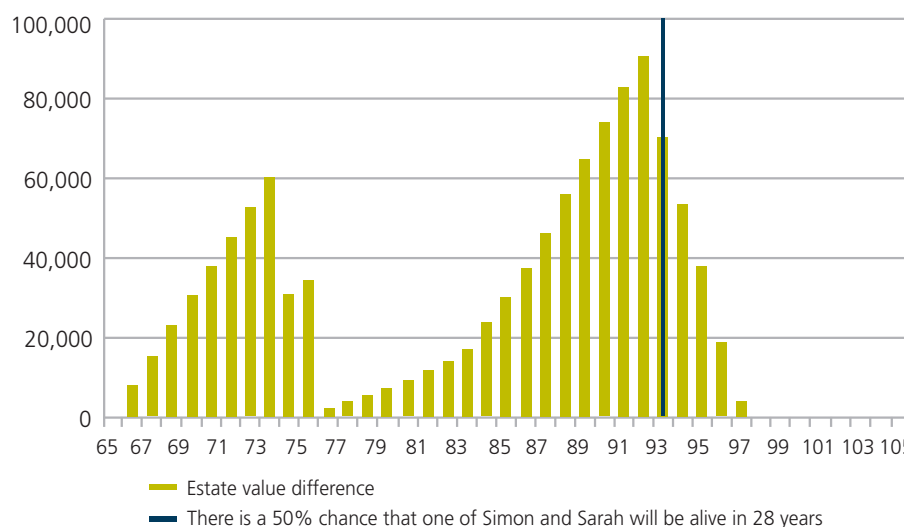
Aaron Minney
Head of Retirement Income
Research
02 9994 7107
aminney@challenger.com.au

Amara Haqqani
Senior Manager, Retirement
Income Policy
02 9994 7177
ahaqqani@challenger.com.au

A simple case study

Sarah and Simon a newly-retired couple, have no outstanding mortgage on their home and a total of \$600,000 in super to support their income in retirement. They also have \$60,000 in personal assets and cash outside super. Using the Challenger Retirement Illustrator, we can highlight the impact of having a balanced allocation in an account-based-pension against having the same growth and defensive split, but with 30% of the 50% of defensive assets in a flexible lifetime annuity.

Figure 4: Estate differential with a flexible annuity



The result can be seen in Figure 4. This highlights the difference between a residual estate balance with a flexible annuity against the residual estate balance without an annuity. In both cases, the total spending is the same, matching the ASFA comfortable standard of \$60,000 a year. The combination of the death benefits and access to capital means that in this example, there are no ages at death where the estate balance for Simon and Sarah would be lower with the flexible annuity than with the account-based-pension only. Under different retiree circumstances there may be some years of a slightly lower balance, but the key is trading off some of the additional income generated by the annuity for higher death benefits in the early years of retirement.

Conclusion

Using a flexible lifetime annuity as part of an overall retirement income portfolio can be very beneficial for your retiree clients. It can increase their peace of mind that they will have the income they need for life, as well as allowing their estate to use any capital not needed for the retiree's own spending.

Challenger Limited
Level 2
5 Martin Place
Sydney NSW 2000
Australia

www.challenger.com.au

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