

<b>Balanced Retirement</b>	<b>Burrows &amp; Cummins</b>
<a href="#">The case for annuities and drawdown</a> Billy Burrows June 2010	8 Duncannon Street, London, WC2N 4JF Tel: 0207 484 5366 <a href="http://www.burrowscummins.co.uk">www.burrowscummins.co.uk</a>

## **The case for Annuities and the case for Pension Drawdown**

### **Introduction**

Those retiring with above average sized pension funds are faced with a choice between purchasing an annuity or investing in a pension drawdown plan. For most this decision will probably be one of the most complex personal financial decisions that they will ever make but most people do not have the necessary expertise and experience to be able to make the right decisions.

In order to make the right decisions, it is important that your retirement planning objectives are clearly set out and the relevant risks and choice of options are properly understood. Without a proper understanding of these issues, there is a significant risk that decisions made today may be regretted at a later date.

Retirement planning does not have to be so black and white; an annuity or drawdown. In many cases it might be better to consider a combination of annuities and drawdown. One approach is to start off in drawdown and then gradually purchase annuities at regular intervals. This is called Phased Retirement.

### **Phased Retirement**

Phased Retirement recognises the changing nature of an individual's financial objectives and their risk tolerance in the transition from work, through the early years of retirement and into later retirement.

Experience has shown that those who take a balanced approach to retirement by investing in a combination of annuities and drawdown are often in a better financial position than those who have invested mainly in drawdown.

### **Balanced Retirement**

Annuities and drawdown are at opposite ends of the risk spectrum. Annuities being seen as a safe investment, with no flexibility, whereas drawdown provides flexibility and choice over income levels and investment but is much higher risk. For many, the main attraction of drawdown is the lump sum death benefit (less 35% tax).

Balanced Retirement recognises that there is a strong case for both annuities and drawdown. Although many investors have the perception that annuities are poor value, experience has shown that annuities provide excellent value for money and should form the foundation for pension income.

### **The case for Annuities**

Annuities are the only policy which can guarantee a high level of income for the rest of the annuitant's life, however long that may be. For this reason they have central role to play in retirement income planning.

There are two main criticisms leveled at annuities. Firstly the income from an annuity is low and so annuities are poor value. Secondly on death, annuity payments cease and the capita is lost. Both of these criticisms can be easily refuted. Annuity rates provide a high level of guaranteed income because they are invested in long dated gilts and other fixed interest investments such as corporate bonds and property. These yields reflect the general economic and financial climate, in particular the outlook for inflation and interest rates. A private investor is simply unable to achieve the same level of guaranteed income for life by investing their pensions themselves without being exposed to significant risks.

While it is true that annuities cease on death, it is not the full picture. Many annuities are set up on a joint life basis, which means that income continues to the surviving spouse on the death of the annuitant. Joint life annuities therefore provide a valuable death benefit in the form of continuing income for as long as one of the married couple is still alive.

For many, the problem is not dying too early, but living longer than expected, often with the need for a high level of income in later years. As discussed below, annuities are based on the concept of mortality cross subsidy and therefore provide valuable protection against outliving your assets.

In summary annuities have the following advantages:

- Income for life, no matter how long that is
- High level of guaranteed income
- Joint life annuity option
- Peace of mind and security
- Investment linked annuities and flexible annuities are available

### **The case for Drawdown**

The case for pension drawdown focuses on the need for income flexibility, investment control, and choice of death benefits.

Drawdown provides flexibility over the level of income payments, control of the investment strategy and choice of death benefits. For many the most important advantage of drawdown is the option for a lump sum death benefit after allowing for a 35% tax charge.

At first sight this appears as a huge advantage over an annuity, but on closer inspection the advantage is not so clear cut because the death benefit is only possible because of the absence of the mortality cross subsidy.

The other main advantage of drawdown is the ability to take control of the investment strategy.

Most drawdown plans are invested in Self Invested Personal Pensions (SIPPs) which allow the pension fund to be invested in a wide range of investments. With the appropriate investment strategy it may be possible to achieve a higher level of future income compared to an annuity, but there are significant risks with drawdown.

The advantages of drawdown are:

- Income flexibility - income can be varied between certain limits each year
- Investment control - option to invest in collectives or directly in equities
- Lump sum death benefit - on death the balance of the fund can be paid as a lump sum less 35% tax
- Tax planning opportunities - income levels can be adjusted so as to be tax efficient
- Option for phased or balanced retirement

### **Retirement Planning Objectives**

At first sight it might seem straightforward to set out an individual's key retirement objectives. When asked about their retirement objectives, many people will say:

- I want to ensure that I have enough income to enjoy a certain standard of living for the rest of my life
- When I die I want to ensure that my partner and family are financially secure
- I want to have control and flexibility over my income and investment choices
- I want peace of mind and security and not to be exposed to excessive risk

The problem is that there is no one policy, annuity or drawdown that can achieve all of these objectives. As the table below shows, each objective can be met in a number of different ways.

<b><u>Objective</u></b>	<b><u>Annuities</u></b>	<b><u>Drawdown</u></b>
I want to get the highest possible income now	A level annuity provides the maximum income but there is on inflation proofing	Taking the maximum income from drawdown is regarded as a high risk option
I want to ensure that I have enough income to enjoy a certain standard of living for the rest of my life	An inflation-proofed annuity is the only policy that can guarantee to maintain a certain standard of living	There is always the risk that future income levels from drawdown will fall if investment returns are lower than expected
When I die I want to ensure that my partner and family are financially secure	Joint life annuities can be set up to provide income for surviving dependants following the death of the annuitant	The main advantage of drawdown is the option to pay a lump sum (less 35% tax)

## Objective

## Annuities

## Drawdown

I want to have control and flexibility over my income and investment choices	Standard annuities do not allow flexibility. However there are flexible annuities	Drawdown provides income flexibility, control over investments and choice of death benefits
I want peace of mind and security and not to be exposed to excessive risk	Annuities do provide peace of mind and security with no risk.	It is important not to underestimate the risks associated with drawdown
I want value for money and a financial who can advise me properly	This requires a specialist adviser who understands the dynamics of the annuity market as well as the complexities of drawdown	

Balance retirement recognises that the main objectives, income requirements and risk tolerance change with age, and the only effective way to meet these changing objectives is by having a combination of annuity and drawdown polices.

### **Balanced Retirement in Practice**

There are essentially two ways to manage a balanced retirement strategy. Those with a number of different self employed, personal pensions or company pensions can balance their retirement options by arranging annuities with some policies and drawdown with other policies. The exact strategy will depend on individual circumstances.

However the most efficient way is to invest in a Self Invested Personal Pension (SIPP). This is because this provides the maximum flexibility and control in a cost efficient way.

### **Conclusion**

Balanced retirement advocates a dynamic combination of annuities and drawdown because this is the best way for many people to achieve their retirement objectives.

There is no one solution as each individual will have different circumstances but based on a proper understanding of the relevant risk, a balanced portfolio of drawdown annuities can significantly reduce the risks associated with pension drawdown.

Even though there is talk that the government will make it easier not to buy annuities after age 75, I believe that prudent individuals should still invest part of their pension funds in annuities because experience has shown that those who defer buy annuities often regret it. Not only is there a significant risk of losing out in terms of income but in later years, drawdown becomes a much higher risk strategy.