Funds on FRIDAY

glacier by Sanlam

1 June 2007 COMPILED BY GLACIER RESEARCH VOLUME 449

Annuity Products – what are they and how can you use them?

Who is Kirshan Reddy?

Kirshan is an Actuarial Consultant at Sanlam Life. His role entails the valuation of Sanlam's annuity business as well as calculating and monitoring the profitability of the business. He is currently completing his Actuarial studies and is close to qualifying as an Actuary.

This week Kirshan Reddy from Sanlam Life's Actuarial Valuations writes about the current annuity environment

You've finally reach the day when you can put your feet up and retire after having saved each valuable cent while working for as long as you can remember. You've had to decide on where to invest, when to invest, how much to invest and all this to ensure you "have enough for retirement". Having reached this time in your life, you probably believe that you're ready to enjoy all your hard work and that the worst is over, unfortunately, your investment planning doesn't stop here – you've just reached the halfway stage.

Once you retire, you face the following critical risks:

- ***Long life risk:*** the risk of living longer than expected and therefore running out of money during your lifetime.
- ***Inflation risk:*** the risk that the amount of money you receive does not increase enough to keep up with the increase in prices of goods and services.
- ***Dependant life risk:*** risk of your dependants not having sufficient income to continue with their lifestyles upon your death.
- ***Investment risk:*** risk of poor returns on your assets after retirement that reduces your ability to withdraw income to meet your needs and includes the risk that your investments are depleted during your lifetime.

Financial planning after retirement is extremely important and vital for the type of life you intend to live after realising you will not be receiving a fixed income from employment. You will receive the benefits from your retirement policies and other sources and be required to use this money to compensate you for the rest of your life. There are primarily two different ways in which this can be achieved. Firstly, you can disinvest the monies that you require when you need it and secondly, you can purchase an annuity product from any life insurer.

The first method allows you the freedom to take as much money as you require at any time that you want to, but has the risk that you may run out of money during your lifetime. An annuity product is an insurance product that provides you with a specified amount of income for the rest of your life. This method therefore removes the risk of running out of money during your lifetime, but does not give you the freedom to withdraw any amount of money that you require. Fortunately, you have tools that can allow you to balance these two factors, but will eventually be based on your individual risk profile and preferences.

There are a number of annuity products in the market that are designed to address these risks and can meet your individual risk profile and preference viz. guaranteed annuities and living annuities.

Guaranteed annuities

Guaranteed annuities offer you an income for life in return for a single premium. You have the guarantee of a stream of future income for life therefore never having to worry about running out of income during your lifetime. The insurer carries the investment risk of ensuring they have sufficient funds to pay you for the rest of your life. This feature is a strong attraction in trying to manage your long life and investment risk. Two other features that make this product attractive are:

The information contained in this document has been recorded and arrived by Sanlam Personal Portfolios in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients. Sanlam Personal Portfolios (Pty) Ltd accordingly accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use of, or reliance, in any manner, on the information provided in this document.

- ***Joint-life annuity option:*** you can choose to receive this annuity as part of a joint-life annuity. This form of annuity provides income to your spouse or children upon your death and therefore also provides a form of death benefit, but paid in regular amounts. This helps manage your dependant life risk.
- ***Guaranteed Term annuity option:*** you can choose to receive this annuity for a fixed minimum period, irrespective of whether you survive that period. This therefore allows income to be generated for a minimum period to benefit your family if something happens to you before this minimum period expires. When you survive this minimum period, the payment is then made to you for the rest of your life. Again, this feature gives you an added control of your dependant life risk.

The above features show the benefits of managing long life risk and also to provide a protection benefit to your family members. However, another important issue that comes up with this product is the form of the payment that you want to receive for the rest of your life. These can currently come in 4 forms:

- ***Level annuity:*** you shall receive a fixed and level payment for the rest of your life. This is the cheapest form of annuity product because there are no changes to your payment stream and it is guaranteed for the remainder of your life. This form does not give you protection from inflation risk because over time, the prices of goods and services increase but your income remains constant.
- ***Fixed increases annuity:*** you shall receive payments which increase annually at a fixed percentage chosen by you at the start. This form of annuity allows you to choose the percentage at which your payments can increase and therefore allows you some inflation protection. You will encounter inflation risk, if the rate of inflation is higher than the fixed increase that you chose at the start.
- ***Inflation-linked annuity:*** you shall receive payments which increase annually at the rate of inflation in the economy. This therefore reduces inflation risk considerably. Most annuities of this type offer a minimum increase of 0% so your annuity will not decrease if deflation occurs.
- ***Discretionary growth annuity:*** you shall receive a guaranteed minimum payment that increases annually at a growth rate decided by the insurer. This growth rate is based on returns earned by investing your single premium in attempting to offer you growth in your income each year. You still face inflation risk if the growth declared by the insurer on your income is less than the rate of inflation applicable at that time. Your growth is also dependant on the underlying assets that are used to generate this growth on your income.

The above descriptions highlight the different ways in which your inflation risk is managed but also indicates the various forms of income that you can choose from to meet your individual preferences.
In summary, guaranteed annuities offer you an income (in various forms) for the rest of your life (or your spouse's/children's lives) for a possible minimum guaranteed period. It allows you to control your long life risk and inflation risk as well as providing protection benefits for your family upon your death. The main disadvantage of this product is that there is very little flexibility when it comes to the income that you want to receive after you've purchased this product because as your circumstances change, you cannot change your benefits. Another important restriction on this product is that you are not allowed to surrender your policy unless you provide proof of transferring to another insurer or provide proof of good health to the insurer.

Living annuities

Living annuities provide you with an income based on a percentage of your underlying capital. On retirement, you invest your capital and choose your own funds in which you want the money invested. Each month you will then receive a percentage (usually between 5% and 20%) of this underlying capital in the form of income. You have the choice (on a yearly basis) of deciding what percentage of this capital you want to receive. This provides you with the flexibility of deciding your level of income and allows you to monitor your underlying investments.

However, you carry the investment risk of the returns on the underlying capital being insufficient to cover this income that is paid to you. You also carry the long life risk that this underlying capital gets depleted during your lifetime if the percentage of income that you choose outweighs the return and then you use up all the capital invested.

In comparison to the guaranteed annuities described above, the critical difference is that you carry the investment and long life risks under a living annuity. The other risks can somewhat be managed the same way as the guaranteed annuities as explained below.

Living annuities are also known as investment linked annuities and can also offer a joint-life feature where the remaining income is paid to your dependants upon your death. This therefore helps you manage your dependant life risk.

The income you receive is based on the underlying capital of your investments. Therefore, you can manage your inflation risk if the income you receive increases in line with inflation. One way in which this scenario can occur is if your underlying capital is suitably invested and is able to earn returns in excess of inflation and in excess of your

percentage income therefore your income increases as the capital underlying your investments increase. However, there is no guarantee that this will happen so you are still exposed to inflation risk under a living annuity.

Financial planning

Given the above information you should be more aware of the risks that you face when you retire and you will have to weigh these risks against each other and with your individual risk appetite. Based on the amount of capital that you have to invest on retirement, there are various combinations of the above products that can be designed to meet your needs.

Having a diversified investment portfolio before retirement is just as important as after retirement. You must ensure that you invest your retirement benefits in a suitable manner to minimise the risks that you face after retirement, but to ensure you still receive a reasonable return on your assets.

For example, you can use a proportion of your benefits from your retirement savings to purchase a living annuity after having researched the various funds in which you want to invest. Then use the remaining proportion to purchase a joint-life, guaranteed annuity with a minimum guaranteed period and possibly with inflationary growth. This combination helps manage the four main risks outlined earlier and allow you the flexibility of drawing income according to the investment performance of your assets after retirement. In this 'portfolio' you can manage your risks and allow for enhanced investment return and flexibility from the living annuity.

All the above sounds pretty simple to do, but the main concern that you will have is the cost of these benefits. You want to minimise your risks after retirement, but each of these options has an associated cost. For example, inflation-linked guaranteed annuities cost more than level guaranteed annuities. You also want to ensure that over your lifetime, you would have received at least the single premium that you are paying for the annuity product. With these complications, your investment decision becomes slightly more difficult and therefore an individual solution is required to meet your actual risk profile and preferences upon retirement.

Your choice of products will be based on what you have at your disposal upon retirement. Therefore, important decisions that you must make now is how to accumulate wealth until you retire so that you can afford to minimise your risks and be able to continue living the lifestyle that you want to when you retire.

Conclusion

We trust that you consider your 'portfolio of annuity products' before retirement to identify the costs of these products at various insurers. It will also give you an idea of what you must accumulate until retirement to be able to receive an expected level of income. This can be arranged with your financial advisor and the closer you are to retirement, the quicker you should be planning for this day.

Glacier Research would like to thank Krishan for contributing to this edition of Funds on Friday