SPRING 2013

retirement academy

Annuities at a tipping point

THE CASE FOR INVESTMENT-LINKED ANNUITIES

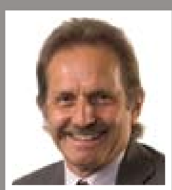
Supported by our sponsors:

mgmadvantage

Retirement has more potential with PRUDENTIAL

Contents

Billy Burrows has been advising clients on annuity and drawdown options for over 20 years and is one of the UK's best known annuity experts. Billy is a director of Better Retirement and Retirement Academy.



Professor John Maule is a leading authority on behavioural economics. John is Emeritus Professor at Leeds University Business School and an associate at Linstock Communications.

From Prudential

I recently made a presentation at the annual Personal Finance Society conference where I invited feedback from professional advisers about the key considerations, questions and concerns for clients in the run up to, and at retirement.

The issues covered mean this report should be on the reading list of all advisers. Whether it's what to do about record-low annuity rates, how to deal with both inflation and investment risk and even how to manage longevity risk - the issues covered highlight the dilemmas being faced by retirees.

For many clients and their advisers, the question should not be "do you want to take any risk?" but rather "what risks are you more comfortable taking?" Advisers should ensure that their clients are, at the very least, aware of the risks and concerns highlighted above. Given the current maelstrom of very low yields, increasing longevity, the implementation of the RDR and the ABI Code of Conduct, many advisers are reviewing their retirement advice processes at the moment.

With so many people reaching retirement over the next few years, it is even more critical than usual that the financial services industry makes sure it is giving retiring clients the best possible solution for their needs and aspirations. For many, the days of just considering a conventional annuity or income drawdown should be behind us.

Vince Smith-Hughes
Head of Business Development

Retirement has more potential with
PRUDENTIAL

From MGM Advantage

Retirement has changed beyond all recognition. Not only have we seen annuity rates plummeting by 20% in the past three years, but many people are retiring with more complex financial circumstances and their needs are not being met by conventional annuity options.

Fortunately, there are genuine alternatives to conventional annuities, which address many of the problems currently facing those looking to convert their pensions into income.

Too often we see investors choosing the simple and perceived safety of a lifetime annuity without recognising, or perhaps appreciating, that the level income they purchase at the start of their retirement years reduces in real terms each and every year.

With low interest rates and continued uncertainty around the future, it is more important than ever that advisers and their clients consider all of the available retirement income options, especially investment-linked annuities.

Which is why we are associated with this report, which aims to shed more light on one of the most important areas of financial planning. We want to encourage people to seek advice and ensure they consider all of the options available at the point of taking a retirement income.

I hope you enjoy reading it.

Aston Goodey
Director of Sales and Marketing

mgmadvantage

Executive Summary

The annuity market is facing a tipping point. Conventional annuity rates have fallen to such an extent that it is time to question whether they should be the automatic default option for those with above average pension funds, especially as there is a range of alternative products which are steadily growing in popularity. With conventional annuity rates at an all-time low, more needs to be done to address the barriers preventing financial advisers and customers from considering the full range of retirement income options.

Initiatives to promote the open market option (OMO), including the ABI's new Code of Conduct, are gaining traction. However, it is not just about encouraging the 450,000 people a year who exchange lifetime savings for an annuity to shop around different providers. It is also critical to shop around for different products.

This is especially true for Middle Britain, which stands to lose most from sticking with conventional products. Already squeezed by higher taxes, higher expenditure and lower interest rates, those with above average pension pots (£50,000 plus) may be ill-served by the most popular annuity and drawdown options. In 2012, about 15,000 people purchased investment-linked annuities totalling over £1 billion, which represents about 8% of the total annuity market. In contrast, 92% of annuities puchased are conventional guaranteed annuities totalling over £13 billion. We estimate that sales of investment-linked annuities will grow significantly in the coming years as the market share increases.

Many professional advisers and their clients appear to remain polarised between conventional annuities – which pay guaranteed incomes – and pension drawdown, which is more flexible. Such an approach ignores the important range of options in the middle.

One of the problems of retirement income planning is that advisers and their clients take long-term decisions based on short-term criteria, for instance, which policy pays the most income at the outset. But with ever longer retirements and the impact of inflation, what seemed a good choice at the outset can seem less so 20 years later. Newer products like investment-linked annuities can help overcome this problem by paying investors a relatively high starting income with the potential for future growth and flexibility.

With the help of Professor John Maule, a leading authority on behavioural economics, this paper explores why advisers and their clients haven't, until now, taken as much interest in investment-linked annuities as they perhaps should. This includes:

- The misplaced notion that they are complex
- The perception that they are too risky
- Behavioural and social bias which perpetuates the status quo

Together, we have also identified several tools and techniques to address some of the barriers to investing in alternatives to conventional annuities, including:

- Better communication techniques e.g. the onion method
- Better understanding of risk e.g. explaining the risk paradox
- More structured decision-making processes e.g. the nudge approach

The following document takes a close look at the current annuity market, explaining why conventional products shouldn't be the default for Middle Britain. It describes and compares a range of alternative products – including investment-linked annuities, fixed-term income policies and pension drawdown. The paper concludes by looking at the future of retirement income planning and how we can begin to influence both client and adviser behaviour.

Part 1: The state of the current annuity market

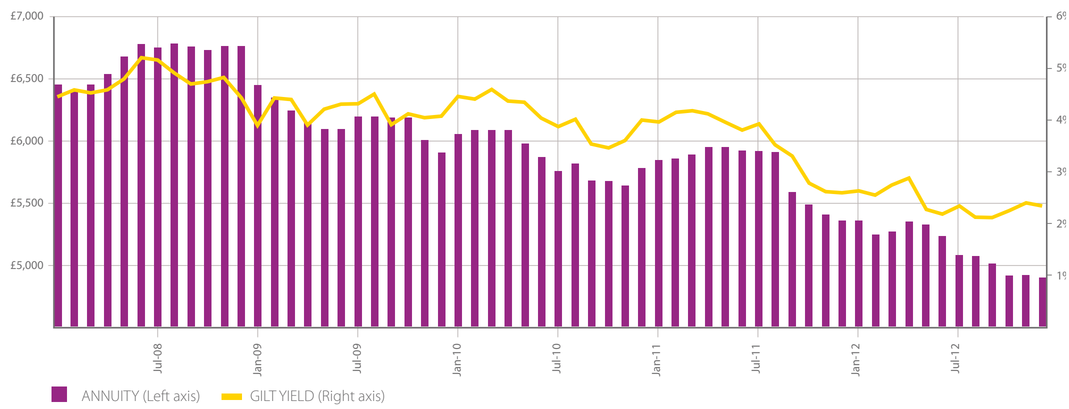
Jane Austen wrote in Sense and Sensibility: "An annuity is a very serious business; it comes over and over every year, and there is no getting rid of it". Today, annuities are an even more important business. The total market is now over £12 billion a year. Annuities are important because they are bought by the vast majority of people who retire with personal or company money. Those lucky enough to have a company final salary pension scheme, sometimes called defined benefit, don't have to worry about annuities because their pension is paid directly by the scheme.

Annuities were rarely out of the headlines in 2012 as they fell to the lowest levels ever. In December 2012, the industry started complying with a ruling from the European Court that prevents life assurance companies from pricing annuities according to gender, which means that men and women now get the same rates despite women outliving men in most cases.

Annuities at rock bottom

Annuity rates have fallen almost continuously over the last 20 years and are now at the lowest levels ever. There are two reasons why annuity rates are so low:

- The yield on fixed interest investments such as gilts and corporate bonds, which are used to price annuities, have fallen to the lowest level since records began in 1703
- People are living longer so their pension pots need to provide an income for a greater number of years



Annuity rates have fallen to such a low level that many believe they have reached a tipping point where we can no longer automatically assume that an annuity is the best way for those with above average pension funds to convert their hard earned pension pots into income.

Value for money

Economists use complicated formulas to calculate the value from annuities, but we can use less complex techniques. There are two easy ways to work it out:

- The payback period
- The underlying interest rate

Payback period

The payback period is the number of years it takes to get the original capital paid back. Any payments after this period represent interest or profit on the original sum invested.

The table shows the income from a single life annuity and illustrates the payback time.

Date	Annuity*	Gilt Yield	Payback time (yrs)
01/03/2005	£7,014	4.79%	14.3
01/03/2006	£6,921	4.11%	14.4
01/03/2007	£7,031	4.67%	14.2
01/03/2008	£7,284	4.51%	14.7
01/03/2009	£7,123	4.38%	14.0
01/03/2010	£6,844	4.50%	14.6
01/03/2011	£6,672	4.05%	15.0
01/03/2012	£6,144	2.75%	16.3
01/03/2013	£5,589	2.47%	17.9

* Single life annuity, male aged 65, £ 100,000 purchase price, guaranteed 5 years and level payments.

The table shows that as annuity income falls, it is taking longer and longer for investors to get their original capital back and, consequently, it will be longer before they start to earn a profit on their original investment.

Most people underestimate their life expectancy by between two and three years which means that they also tend to underestimate the value for money of annuities. The average life expectancy for a man aged 65 is between 23 and 25 years. Therefore, using the example above, an annuity purchased today will be paid on average between six and eight years after the original capital has been paid. We can use this to calculate the underlying interest rate.

Underlying interest rate

At the beginning of 2013 the yield on 15 year gilts, which is used as the benchmark for pricing annuities, was 2.3%. However, in practice insurance companies use a higher interest rate to calculate annuity rates because they invest in high yielding investments such as corporate bonds. This means that the underlying interest rate for an annuity is between 2% and 3%, depending on how long the annuity is paid for.

Put another way, those investing in annuities at the moment are giving their capital to insurance companies, only to get back their original capital plus a small amount of interest.

At a time of low interest rates and relatively low inflation this might seem like a decent return, but if interest rates and inflation increases in the future this will not be such an attractive investment.

It is also important to consider the return after allowing for inflation. Inflation as measured by the retail price index (RPI) is currently about 3%, which means that many are actually getting a negative return on their annuity income.

Annuities will continue to be the default option for those with below-average pension funds

The average pension fund at retirement is around £30,000 and, in most cases, an annuity is the best way to convert these funds into pension income, as the main priority is a straightforward policy that pays a guaranteed and secure income.

It may not be obvious but insurance companies try their best to be fair and use several techniques to give their customers the best possible value from their annuity. These include:

- Offering special terms for those in poor health and those who may have a below-average life expectancy. These are called enhanced annuities
- Pricing annuities on where you live by using postcodes. The principle is that those living in poorer parts of the country may not live as long as those in more affluent areas
- Making it easier to shop around for the best annuity by using the OMO

This means that conventional annuities will remain the option of choice for those with average sized pension funds.

Individuals who have a lifestyle or medical condition that may reduce their normal life expectancy may be able to get a higher starting income by applying for an enhanced annuity. The three most common criteria are:

- **Smoking, being overweight and drinking excessive alcohol**
- **Take prescription medication**
- **Having been to hospital recently because of a medical condition**

The amount of enhancement depends on individual circumstances but could be as high as 40%.

Squeezed Middle Britain

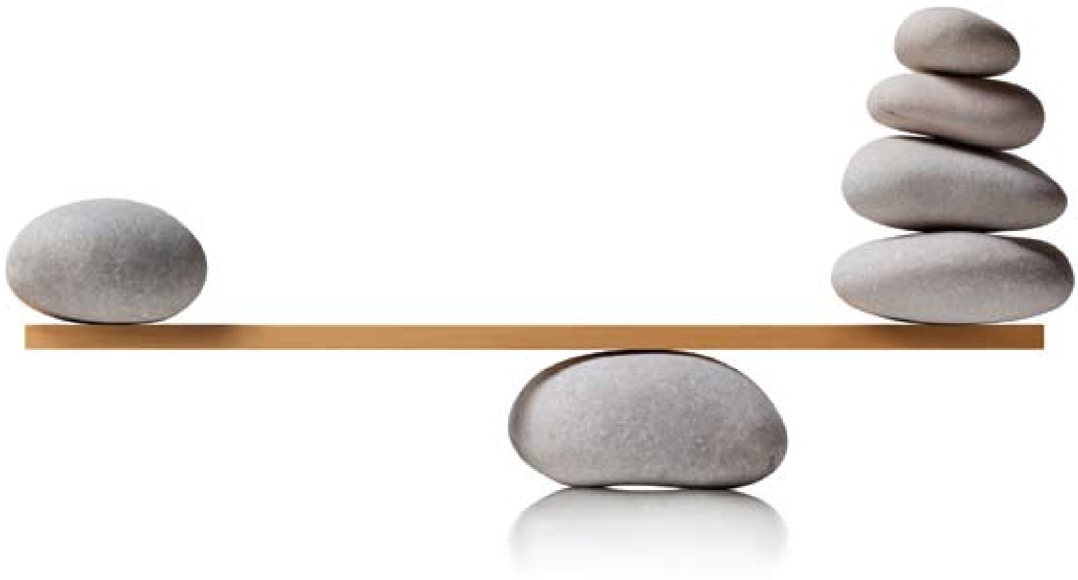
However, conventional annuities may not meet the needs of those with above-sized pension funds because they often need to take a longer view of their retirement incomes, and need more flexibility to deal with their more complex financial situations.

This Middle Britain group often find themselves squeezed by higher taxes and higher bills. Now they are being squeezed by annuities, especially as those living in more affluent postcodes get lower annuities.

Those with larger pension funds may be able to secure more suitable longer-term income and get the flexibility that they need by considering some of the alternatives to conventional annuities. We will consider them in the next section.

Key points

- The majority of people retiring purchase conventional annuities
- The income from annuities and their value for money has fallen significantly over recent years
- There have been positive developments in the annuity market such as increased availability of enhanced annuities and investment-linked options
- Conventional annuities are still the option of choice for those with smaller funds
- Middle Britain investors have more complex financial situations and therefore conventional annuities may not meet their needs
- It is time to question whether guaranteed annuities should be the automatic default for those with above average pension pots

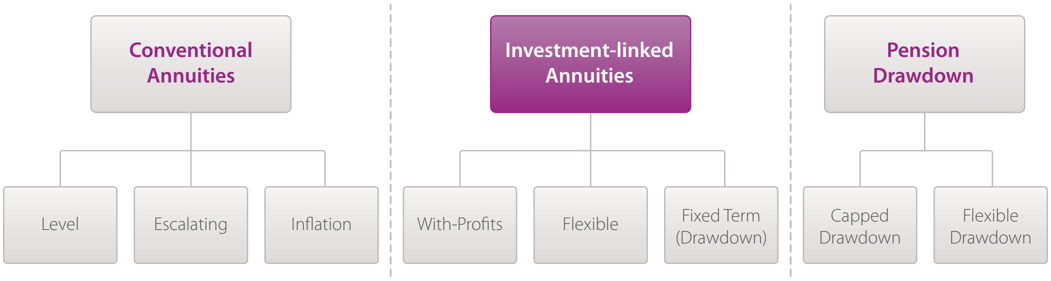


Part 2 – The alternatives

Conventional annuities pay a guaranteed income for life, but they offer very little flexibility. Other types of annuities offer the flexibility to change income and investment options, and instead of paying a completely guaranteed income they can offer an element of guaranteed income with the potential for some income growth.

There are three alternatives to guaranteed annuities:

- Investment-linked annuities
- Fixed-term income plans
- Pension drawdown policies



Investment-linked annuities

An investment-linked annuity is similar to a conventional annuity in that it pays an income for life. However, instead of paying a guaranteed income as a result of being invested in gilts and fixed interest securities, investment-linked annuities are invested in a wide range of investments, thereby providing the potential for future income growth.

The most obvious difference is that the income from a guaranteed annuity will not change (or increase by a known amount each year) whereas the income from an investment-linked annuity will increase or decrease at regular intervals depending on investment returns.

Most investment-linked annuities have a guaranteed minimum income level, below which the annuity payments will not fall.

Guaranteed annuities have no flexibility. Once set up they cannot be changed, whereas there is flexibility to change the income and investment options for investment-linked annuities.

Investment-linked annuities have many of the same characteristics as conventional annuities in that they can be single or joint life, have a guaranteed payment period and have a choice of payment options. Also, those in poor health may qualify for an enhanced investment-linked annuity.

Good examples of investment-linked annuities are the Income Choice Annuity from Prudential and the Flexible Income Annuity from MGM Advantage. Prudential's Income Choice Annuity is invested in its with-profits fund whereas MGM Advantage's Flexible Income Annuity is invested in unit linked funds.

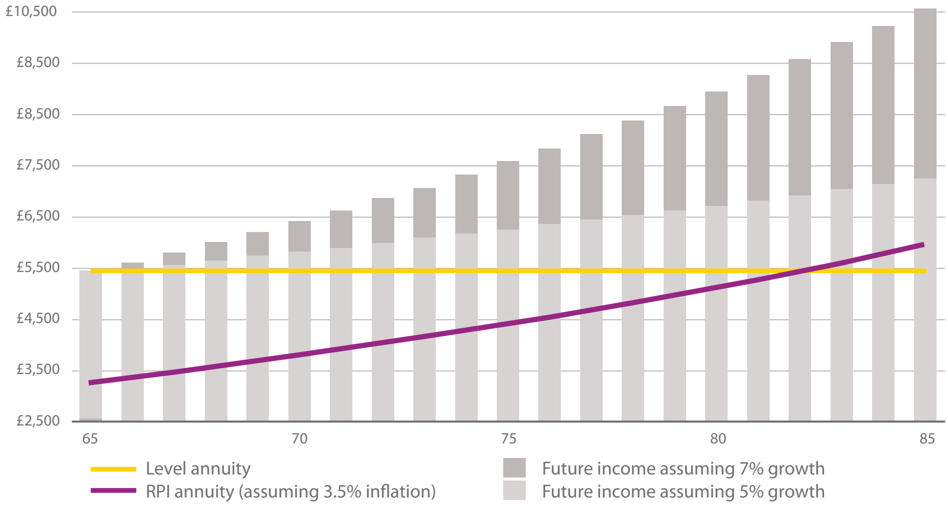
Both types of annuity work in broadly the same way. At the outset, the investor chooses a level of income between the minimum and maximum limits set by the insurance company and determined by legislation. In order for this level of income to be maintained each year, the underlying pension fund will need to grow at a certain rate. This is called the *Required Return**. At regular intervals, the annuity income is recalculated and the actual returns achieved by the funds selected are compared with the *Required Return*. If the Actual Returns are higher than the *Required Return* the annuity income will increase, but if the Actual Returns are lower than the *Required Return* the income will reduce.

**Prudential and MGM Advantage use different terminology to explain these terms and use different underlying calculations. See section 5 for details about where to get more information.*

The graphics show how projected bonuses impact on income from an investment-linked annuity.

Prudential's Income Choice Annuity (ICA)†

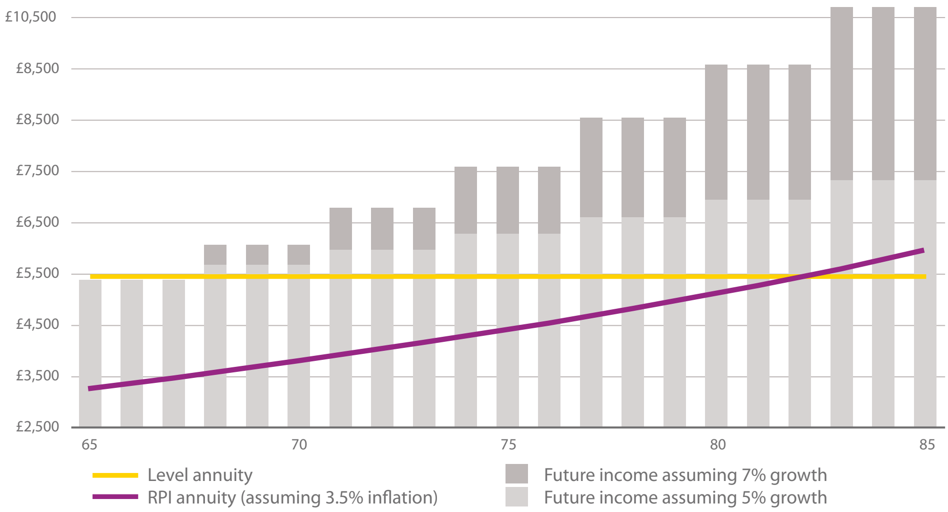
Required Smooth Return = 3.5%



The future income projections for ICA are for illustrative purposes only and assume gross returns of 5% and 7% per annum without any allowance for charges or deductions. The projections shown on a Prudential illustration will be lower as they include deductions and charges.

MGM Advantage's Flexible Income Annuity (FIA)†

Required Fund Performance = 3.5%



The future income projections for FIA are for illustrative purposes only and assume returns of 5% and 7% per annum after charges as shown on MGM Advantage's annuity illustrations.

† Gross annuity payments, £ 100,000, single life, age 65, with 5 year guarantee and monthly payments

The rationale for investment-linked annuities

As we have explained, an annuity is the only financial product that can guarantee an income for the rest of the policyholder's life. The average life expectancy for a 65 year old annuitant who is in good health is about 25 years, which means that an annuity is a long-term policy.

When considering how best to secure a long-term income stream it is important to consider what may happen in the future, and how this may impact an individual's income requirements. The future is full of surprises, and most individuals will have to deal with many unknowns including not knowing:

- how long they will live
- what will happen to interest rates
- how inflation will erode their spending power
- if investing in the stock market provides higher returns than investing in bonds

A conventional annuity may be the best way to deal with some of these unknowns, for instance by providing valuable insurance against outliving your pension and by providing a guaranteed income. But they are not designed to deal with many of the other unknowns such as inflation, unless the expensive inflation-linked option is selected.

Investment-linked annuities provide the potential for future income growth which will help offset the effects of inflation. Also, if interest rates were to increase in the future, some investment-linked annuities have an option to invest in a guaranteed annuity on the open market.

The rationale for investment-linked annuities is that they combine many of the features of a conventional annuity, for instance income for life, with the advantages of investing in the stock market which provides the potential for longer-term income growth, and will help protect against the effects of inflation.

There are, of course, some disadvantages to investment-linked annuities, in particular, the risk that future income can fall in value if investment returns are lower than expected..

Investment-linked annuities – advantages and disadvantages

Advantages	Disadvantages
Potential for future income growth which will help to offset the effects of inflation	Future annuity payments may be lower than expected if investment returns are lower than predicted
Income for life (mortality cross subsidy)	Increases in future life expectancy can be passed on to the policyholder through changes in bonuses
Income flexibility – Typically income can be changed at any time or at the anniversary of the contract	If too much income is taken in the early years it may result in lower income in the future
Minimum Income Guarantee – income will not fall below an agreed minimum, no matter what happens to the stock market	If income falls to the minimum income level there is no guarantee that it will return to the previously high level

Aviva and LV= also offer with-profits annuities and London & Colonial has an investment-linked annuity.

Fixed-term annuities

A fixed-term income plan pays a guaranteed income for a specified term – normally five or ten years – and at the end of the term, a guaranteed maturity amount is paid. This must be used to invest in another pension income policy such as a lifetime annuity, another fixed-term plan or pension drawdown.

Most fixed-term income plans have an option to transfer to another policy, e.g. annuity, if the policyholder's circumstances change before the end of the term.

They aim to combine some of the advantages of a guaranteed annuity with some of the advantages of drawdown. They offer the advantage of a guaranteed income, albeit for a fixed-term, and the flexibility to buy a different policy in the future if personal or financial circumstances change.

Technically a fixed-term income plan is an option under a drawdown plan and is therefore subject to the same income limits and death benefit rules. This means that the maximum income is the same as the Government Actuary's Department (GAD) limits and 55% tax is paid on any lump sum death benefits.

Pension drawdown

Drawdown allows investors to make income withdrawals direct from their pension funds, instead of buying an annuity. There are two types of drawdown: capped and flexible drawdown.

Capped drawdown

Capped drawdown is available to everybody who has a registered pension plan and the rules specify how much income can be taken, where the funds can be invested and what happens on death.

The maximum income that can be paid from a capped drawdown is determined by GAD tables. The maximum income in any one year is roughly equal to a 120% of a single life annuity, but there is no minimum income requirement. The maximum income limits are set for the next three years, at which time they are re-calculated based on the current GAD rates.

One of the main attractions of drawdown is that when the policyholder dies, there is a choice of death benefits:

Lump sum death benefit: A surviving spouse or dependant may take the remaining pension fund as a capital sum, less a 55% tax charge. The lump sum payment will normally be free of IHT (inheritance tax).

Continued drawdown: A surviving spouse or dependant may continue to make income withdrawals and this will be taxed as income.

Annuity purchase: A single life annuity can be purchased for the spouse or dependant without a guarantee period or value protection.

Flexible drawdown

Flexible drawdown is similar to capped, but those who can show they have more than £20,000 per annum of secured pension income will not be subject the maximum income rules and will be allowed to take unlimited amounts of income from their pension funds. However, all income will be taxed at their marginal rate. There are no income reviews for flexible drawdown.

Summary

	Conventional Annuities	Investment-linked Annuities	Fixed-term Income Policies	Pension Drawdown
Overview	Guaranteed income for life	Income for life with potential for income growth	Fixed income with guaranteed fund value at maturity	Pension fund remains invested and income taken
Income	Payments can be level or increasing in line with inflation or 3% p.a.	Will rise or fall each year depending on required return and actual returns	Maximum income is 120% of annuity GAD tables. No minimum and limits reviewed every three years	
Death benefits	Income can be guaranteed for up to 10 years and/or joint life annuity income. Another option is value protection (capital invested less all income paid) and any lump sum payment will be taxed at 55%		**Lump sum:** remaining capital sum, less a 55% tax charge **Continued drawdown:** continue making income withdrawals **Annuity purchase:** a single life annuity without a guarantee period	
Investments	No choice	With-profits or unit-linked	No choice	Wide range of investments
Risks	Income payments guaranteed but risk inflation will erode value of income	Value of income will fall if future returns are lower than predicted	The maturity value may provide income at lower level	Value of drawdown fund and income may fall in value
Advantages	Guaranteed income for life	Potential for income growth and flexibility	Flexibility to invest in different annuity or drawdown policy	Income flexibility, investment control and choice of death benefits

Source: ©Retirement Academy 2013 www.retirement-academy.co.uk Spring 2013

Who are these options suitable for?

Investment-linked annuities, fixed-term and drawdown are suitable for those who have above averaged sized pension funds and who are attracted by the flexibility and potential for a higher income in the future. However, it is important that people understand all the relevant risks.

These options are not normally suitable for those who cannot afford to take the risk on their standard of living falling in future, if their pension income fell in value.

Investment-linked annuities may meet the needs of a wide range of investors, especially those facing the following circumstances:

- Concerned about low annuity rates but want still want an income for life
- Want an income that may increase in the future to help offset the effects of inflation without locking into an inflation linked annuity
- Have multiple policies, some of which may be invested in an investment-linked annuity
- Considering an alternative to pension drawdown
- Do not want to put all of their eggs into one basket
- People looking to maximise their initial income at retirement

Anybody who is considering an investment-linked annuity must understand all the risks and should ensure that they discuss the key issues with their financial adviser. According to annuity experts Better Retirement, there are three golden rules when advising on annuities and drawdown:

1. Ensure that there is sufficient secure income from other sources so that if the income from an investment-linked policy falls in value, the investor will not be short of income, or ensure they can survive on the minimum income guarantee
2. Understand the relevant risks, including the client's capacity for loss
3. Make sure all the relevant options have been considered and evaluated

Key points

- Investment-linked annuities provide potential for future income growth
- Fixed-term pays a guaranteed income for a fixed term and pays a guaranteed maturity value which must be used to invest in an annuity or drawdown plan
- Drawdown offers income flexibility, investment control and a choice of death benefits
- Alternatives to conventional annuities may be suitable for a wide range of investors

Part 3 – Why don't more advisers and their clients consider investment-linked annuities?

The total annuity market in the UK is £13 billion. Only £1 billion is currently invested in investment-linked annuities, which means they have less than an 8% share of the market. We have worked with Professor John Maule, an expert in psychology and decision-making from Leeds University Business School, to explore why take up is not higher. Professor Maule believes that new insights from behavioural economics help to explain why financial advisers and their clients often fail to consider investment-linked annuities.

In this section, we focus on just three key factors informing annuity decisions, explaining what they mean and how we can begin to address individual and social barriers.

Key Barriers	Adviser perspective	Client perspective
1. Too complex	• Lack of product knowledge	Too complex and confusing
2. Too risky	• Poor understanding of advice issues	Seen as being too risky despite potential upside
3. Negative social influence	• Product bias across peer group	Poor level of social acceptance

1. Too Complex

The Issue

Research shows that many people have limited thinking capacity. They are 'cognitive misers', minimising the amount of complex thinking they do. These limitations mean that they do not consider all the relevant information when making a decision.

Instead, people use a broad range of short-cuts in thinking, called 'heuristics'. These short-cuts involve processing less information, often in a much simpler way than experts. For example, in situations that people have experienced before, they often simply choose what they did last time if it was thought to be reasonably successful. A second example is default thinking where people shy away from making a decision at all, by simply sticking with what they are given or what is usually provided.

Implications

People use these simpler forms of thinking even though they often lead to poor decision-making. These forms of thinking have the potential to explain why advisers and clients regularly overlook investment-linked annuities in situations where they are a viable best option.

Both groups may be drawn to guaranteed annuities simply because that's what they've always done. The need to simplify will lead them to overlook crucial changes in financial markets and longevity that, properly considered, may tip the balance towards different products. Also, guaranteed annuities may be seen as the default by the majority of people who wish to minimise their thinking.

Recommendations

It is important to identify the short-cuts in thinking used by advisers and their clients and ways of helping them to overcome the biases that occur from using them. This will help advisers and their clients to gain a better understanding of the issues and especially the alternative annuity options.

This may involve developing better ways of communicating the key issues and developing a more structured information/advice process. For example, one of the problems with the current annuity decision-making process is that most people make long-term decisions on very short-term criteria e.g. who is paying the highest income at any given moment. By encouraging investors to think longer-term about their income requirements, they should be able to understand the limitations of guaranteed annuities and the advantages of investment-linked solutions.

In practice: The Onion Approach

Better Retirement, a specialist annuity adviser, uses the 'Onion Approach' to help clients make better annuity decisions. Just as an outer layer of the onion is often flaky, so too are clients' understandings of their longer-term aims and options. The first step is usually to discuss their income goals, explain how an annuity works and note how inflation may erode their purchasing power. The next layer looks at current annuity rates, noting that there may be benefits to not locking into low rates. The next level involves an explanation of the actual mechanics of different products followed by the risks.

Billy Burrows: *"I have had many clients who start out by saying that 'I know exactly what I want' only to change their minds later, once they have peeled away the layers and considered all of the options."*

2. Too Risky

The Issue

People are generally risk averse. They have a strong preference for options where the outcomes are thought to be certain, over those associated with risk. Research indicates that people will only choose a risky option over one with a smaller but certain outcome when the actual value of the risky option is more than two and a half times better. In addition, people are myopic in the sense that they focus on a very small part of the relevant information when assessing risk.

Risk aversion and myopia combine together to cause the 'risk paradox' where people strongly prefer an option which is deemed safe in the short-term over a risky option which has better long-term outcomes. This leads people to focus on the safety associated with fixed annuities and to overlook any longer-term threats such as inflation that can be better managed by investment-linked annuities.

Implications

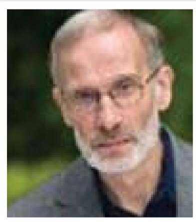
Risk aversion means that clients need to perceive considerable benefit when switching from a 'safe' to a 'risky' option. This is likely to have a negative impact on choices between guaranteed and investment-linked annuities. However, there is a broad range of framing factors that can modify these attitudes to risk. For example, presenting information in ways that encourage people to frame in terms of the losses from not changing rather than gains from actually changing should increase people's preference for flexible annuities.

Recommendations

Advisers and their clients need help in understanding and evaluating the risks associated with all the relevant options. One option is to discuss the risk paradox. Many clients think they are taking no risk by investing in a guaranteed level annuity, but in fact they are exposed to the risk that inflation will erode the spending power of their pension and that they are locking into low annuity rates. The paradox is that by taking some risk with their annuities, they may reduce the risk that their pension income will not meet their future expectations.

Another option is to present the future returns from annuities in real terms i.e. after adjusting for inflation. This would mean that the level annuity is, in fact, reducing as inflation reduces the spending power. Only an index-linked annuity would show a level line and an investment-linked annuity would show a range of options depending on future investment returns.

In Practice: Case Study



Martin is a freelance journalist, 67 years of age, single and has several money purchase pension plans from his previous employment. Describing himself as someone who did not want to take undue risk and concerned about the effects of future inflation, he discussed the options including investment-linked and drawdown with Better Retirement.

After considering his long-term income requirements and risks that could affect his future income it was agreed that Martin's priorities were to secure sufficient income to maintain his future standard of living while also having flexibility and some investment in the stock market.

Better Retirement recommended a combination of guaranteed and investment-linked annuities. One annuity would increase by 3% per annum to meet his everyday living expenses, and the other annuity would be investment-linked with a required smooth return of 3% enabling Martin to benefit from any future income growth whilst providing flexibility to change his Income or to purchase another type of annuity if future circumstances change.

In Martin's words: *"Initially I thought I would invest in conventional annuities because I am a cautious type, but after understanding all the risks I face during the rest of my retirement I decided that a combination of annuities, including investment-linked, would be more prudent in the long term."*

3. Social Bias

Issue

The previous two sections focus on individual thinking processes. However, there are also social processes that influence people's choices. Social amplification theory explains how the social context amplifies or mitigates attitudes to risk.

The key social influences that determine attitudes include what people read in the papers, what influential others say and the level of trust they have in those managing the risk. Characteristics of the threat itself are also important, with threats associated with a lack of personal control and unfamiliarity further increasing perceptions of risk. Amplified risks are particularly unattractive and will lead both clients and advisers to reject potentially suitable product options.

Implications

People managing and communicating financial risk should not simply rely on their own actuarial assessments and just present 'the numbers' to clients and advisers. They need to take account of how potential amplifiers may affect risk assessments and the likely effect this will have on both advisers and clients. Alliances with influential groups, transparent media campaigns and communications materials that downplay the lack of control and unfamiliar aspects of risk can help to promote informed decision-making.

Recommendations

It is critical to identify the key information sources – both formal and informal – that will have an influence over annuity decisions. At its core, we need to encourage key influencers to challenge conventional thinking on pension annuities. In a positive development, increasing numbers of advisers, and growing numbers of consumers, recognise that conventional annuities may no longer be the natural 'risk free' default. Major advisory firms, product providers and influential groups must do more to communicate the message that alternative options are worthy of consideration and are socially acceptable. As ever, the perceived trustworthiness of the individual or group is critical.

In Practice: The Retirement Academy

The Retirement Academy helps insurance companies and professional advisers understand more about the key issues in the retirement market. They provide a number of master classes to help professional advisers deliver a better advice service to their clients. Tim Eadon, previously CEO of the Personal Finance Society, points to the Retirement Academy's three pillars of advice:

- More informed explanations of the key issues and options
- Clearer presentation of the relevant options
- Superior decision-making process, including decision aids

Tim Eadon explained: *"By taking clients through a more structured decision-making process, advisers are better equipped to overcome many of the behavioural biases that act as barriers to understanding the full range of annuity and drawdown options."*

Part 4 – The future of retirement income planning

Conventional annuities account for over 80% of sales of annuity and drawdown policies but this situation must change in the future. It is not that there is anything fundamentally wrong with conventional annuities, but the world into which people are retiring now is vastly differently from the world which annuities were initially intended for. Annuities are ideal for those who want certainty, but in an increasingly uncertain world certainty also means inflexibility.

There are three forces that may influence the direction of the annuity and drawdown markets in the coming years:

- The new distribution rules which will impact on sales and advice of annuities
- The future trend in annuity rates and equity prices
- Changes in adviser and client behaviour – Annuity Portfolios

The new distribution rules

New rules came into force on 31st December 2012 which has changed the way in which financial advisers engage with their clients and charge for their services. The objectives of the new rules are to improve the standards of financial advice to individual clients by ensuring:

- consumers are offered transparent and fair charging systems for the advice they receive
- consumers are clear about the services they receive
- consumers receive advice from highly respected professionals.

The new rules, collectively known as the RDR (Retail Distribution Review), were designed by The Financial Conduct Authority's predecessor, the Financial Services Authority (FSA) in order to provide more transparency to adviser charges, and to ensure advisers are better qualified. The most widely published aspect of RDR is the ban on commission for advised sales which has been replaced by customer agreed fees.

The industry is well placed to deal with the intended consequences of RDR and the new rules should result in better outcomes for those clients that take advice. However the industry may not be so well placed to deal with some of the unintended consequences, not least the perception of some that advice has become increasingly complex and expensive, and that choosing products without advisers would be more prudent.

The new RDR rules do not apply where no advice is given and therefore commission will still be paid on non-advised annuity sales. There is no requirement for sales people who sell annuities without advice to have professional qualifications.

There is general agreement that investment-linked annuities require advice but there may be circumstances in which they can be sold without advice. Therefore if a significant number of Middle Britain clients are attracted to non-advised annuity brokers who cannot advise on the alternatives to conventional annuities, there will be a significant risk that clients will not get the most suitable outcomes.

We are positive about the outlook for financial advice because investing in annuities is one of the biggest and most important decisions that many people will make, and they owe it to themselves to get all the help and advice they need in order to make the right decisions.

The future trend in annuity rates and equity prices

The future outlook for annuities and investments is very uncertain and those approaching retirement will have to grapple with a number of important issues. Inflation will probably continue to be a worry, and interest rates are unlikely to increase significantly for some time.

2013 may be a better year for annuities as rates may slowly increase above the current low levels. There are number of reasons to be cautiously optimistic about conventional annuity rates, however the Sword of Damocles still hangs over the annuity market in the form of Solvency II and increased life expectancy.

Changes in adviser and client behaviour – Annuity Portfolios

If the outlook is still uncertain, those with above average sized pension funds may wish to consider investing in more than one type of annuity or drawdown in order to achieve a balance between secure income and the flexibility of investment-linked options.

Conventional annuities meet the needs for those who need certainty, but they do not meet the needs of those who need flexibility. At a time when the income from guaranteed annuities represents little more than return of the original capital, investment-linked annuities and drawdown offer viable alternatives.

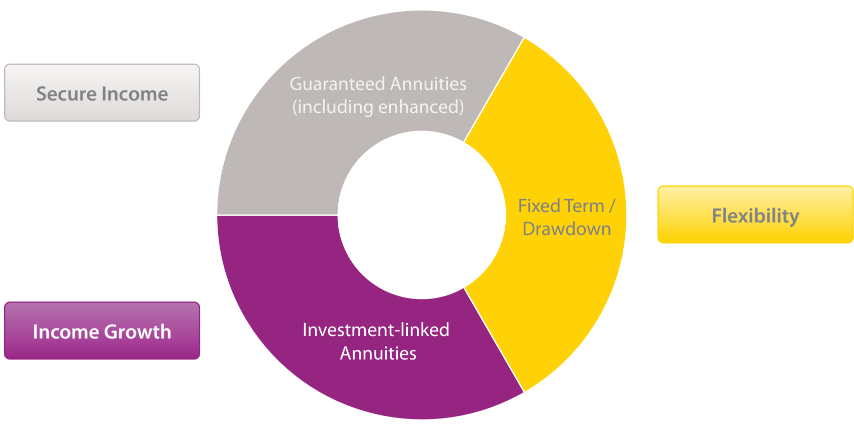
Those needing more flexibility at retirement should look at the approach taken in other areas of financial planning. For example one of the basic rules of investing is not to put all the eggs in one basket, and spread the risk over several investments.

There is no reason why this maxim cannot be followed when arranging annuities and drawdown. There are a number of ways in which a portfolio of annuities can be arranged. One of the most popular is to have a combination of guaranteed annuities and investment-linked annuities. A variation on this might be to combine annuities and drawdown. For those who want the maximum flexibility, a form of phased retirement may be the solution.

In order to decide on the right combination of different annuity and drawdown options, advisers and their clients should consider the following questions:

- What are the income requirements, now and in the future?
- What is the attitude to risk and capacity for loss?
- How much flexibility is needed?
- What is their preference for death benefits?

In most cases these questions cannot be answered without help and advice from a specialist annuity and drawdown adviser. A good adviser will explain all of the suitable options and explain the relevant risks.



Above: The key elements of an annuity portfolio: Secure income, Income growth and Flexibility

Conclusion

The conventional annuity is still the way to obtain the highest *guaranteed* income for life, but it does not meet the needs of everyone, especially those with above average pension pots. Many of today's pensioners require more flexibility to meet the demands of a longer and more varied retirement.

Alternative options such as investment-linked annuities can produce better outcomes for many pensioners by combining the peace of mind of an income for life with the potential for future income growth and flexibility. However these policies are not without risk, and it is important that investors fully understand all the risks associated with these options.

Insights from behavioural economics provide techniques to encourage clients and advisers to consider the full range of options and develop a better grasp of the key issues. Especially the need to encourage investors to think about their longer-term objectives and to understand the relevant risks.

The market for investment linked annuities is expected to grow from its present level of £1bn, as the number of people that are looking at alternatives to conventional annuities increases.

The new distribution rules will undoubtedly have a major impact on the direction of the annuity and drawdown markets in the coming years. Qualified advisers must now consider the full range of retirement income options in order to demonstrate that they are treating customers fairly. They will need to explain all the key issues – from longevity through to a proper assessment of risk and reward.

However, there is a danger that those customers who follow the non-advised route may not be given the opportunity to consider investment-linked annuities. There is general agreement that investment-linked annuities require advice, but there are circumstances in which they can be sold without advice providing there is a robust process in place that explains the risks and ensures the policy is suitable for the client.

Finally, there is a growing trend towards the portfolio annuity which may be a combination of guaranteed and investment-linked annuities. A client's overall risk may be reduced by investing in more than one type of annuity or drawdown product in order to achieve a balance between secure income and flexibility.

Key points

- Annuities are at a tipping point because rates are at the lowest levels ever
- Conventional annuities are still the product of choice for smaller pension pots
- Those with above average pension pots should consider investment-linked annuities
- Middle-Britain investors can benefit from potential for income growth and flexibility to meet their long term objectives
- Insights from behavioural economics can be used to show how the market for investment-linked annuities can be expanded

Part 5 – More information

Useful websites:

Prudential – for individual clients	www.pru.co.uk
Prudential – for Professional Advisers	www.pruadviser.co.uk
MGM Advantage – for individual clients	www.mgmadvantage.co.uk
MGM Advantage – for Professional Advisers	www.mgmadviser.com
Better Retirement	www.brgl.co.uk
Retirement Academy	www.retirement-academy.co.uk
Linstock Communications	www.linstockcommunications.com
Unbiased (find an advisor)	www.unbiased.co.uk
Money Advice Service	www.moneyadviceservice.org.uk
The Pensions Advisory Service (TPAS)	www.pensionsadvisoryservice.org.uk

Contact numbers:

Prudential – General enquiries	0800 000 000
MGM Advantage – General enquiries	0845 608 6171

Linstock provides communications advice to organisations in the financial and professional services sector. Its team works hard to apply the latest thinking, including emerging theories in behavioural economics.