

## Annuity Rates – At their highest for 4 years

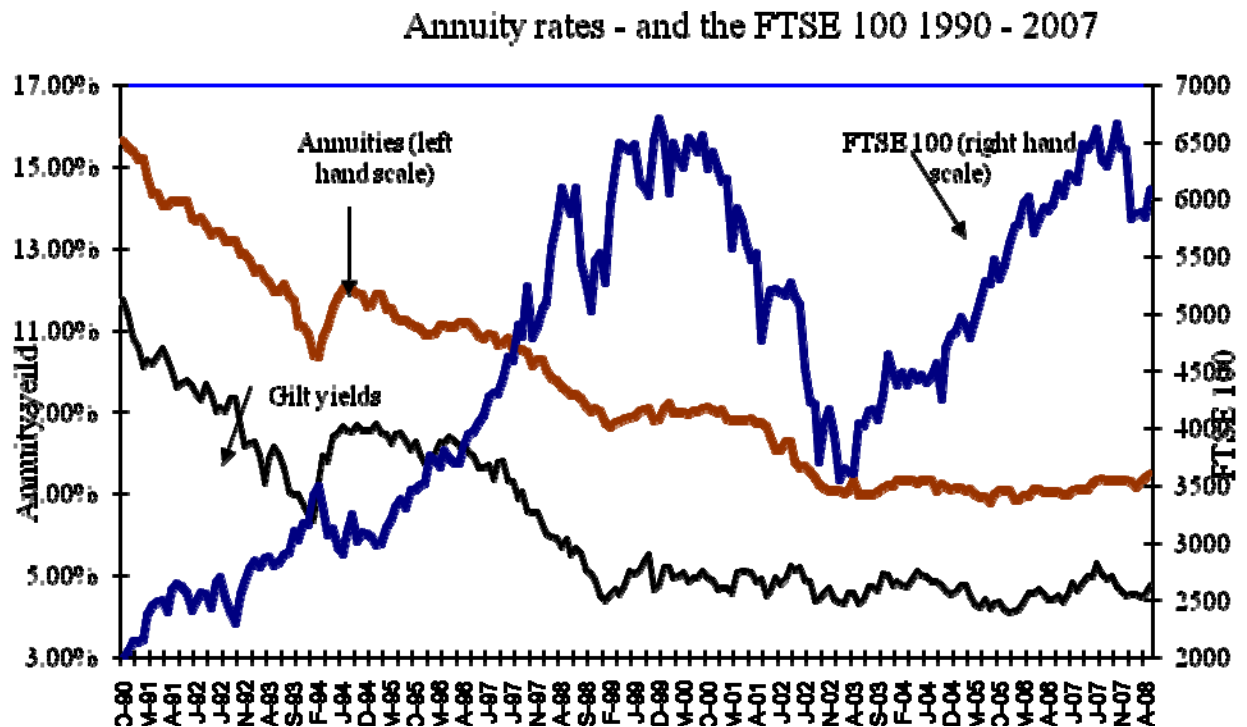
Annuity rates have fallen by over 50% in the last two decades. In 1990 the single life annuity rate for a man aged 65 was over 15.5%, but today it is below 7.5%. Although there have been brief periods when rates have increased, the trend has been consistently downwards.

The good news is the trend in falling annuity rates may be about to be reversed meaning investors will get more income from their annuities. However the bad news is that the outlook for global stock markets is uncertain, so the same investors may have less in their pension fund with which to buy their annuity than they had expected.

Nevertheless with the recent increases in annuity rates combined with a rally in equity prices, it now appears to be a good time to consider buying an annuity.

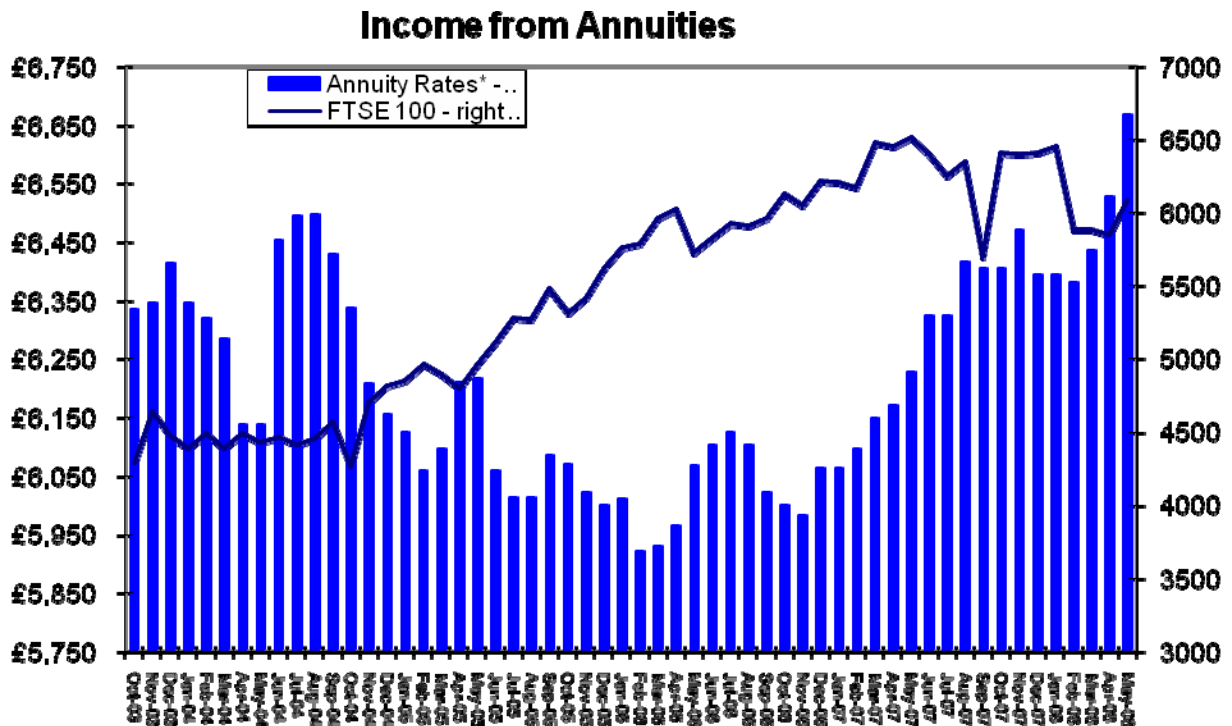
At present a £ 100,000 annuity for a man aged 65 and a female aged 60 (joint life, 2/3rds widow's pension and level payments) pays a gross income of £6,668 per annum. This is the highest annuities have been since August 2004 when the same annuity was paying £ 6,500. In the intervening period this annuity fell as low as £ 5,921 in February 2006.

Chart 1



The charts plot annuities on the left hand axis and the FTSE 100 index on the right hand axis and shows how annuities and the stock market have risen and fallen over time. Chart 1 compares annuities against the FTSE 100 and long dated gilt yields since 1993 whereas chart 2 shows the movements since October 2003.

Chart 2



Those with a keen eye will notice that although annuity rates and gilt yields move in parallel, the gap between annuities and yields is narrowing. This reflects how the effect of longer life expectancy has resulted in life companies reducing rates. This suggests that even if yields stay at current levels we can expect annuity rates to fall even further as insurance companies adjust their mortality tables. I suspect that even if research showed life expectancy had peaked *and was even declining*, few insurance companies would reverse their policy of factoring in ever increasing life expectancy.

The increase in annuity rates means that those retiring today will get nearly £ 700 per annum more than those who retired in 2006 and even in the short time since Christmas annuity income has risen by nearly £ 300 per annum for every £100,000 invested.

This is obviously very good news for those approaching retirement but it is important to remember that annuities do not rise or fall in a vacuum, and is important to consider the impact of rises or falls in the value of pension funds.

Put simply, if annuity rates improve but the value of the pension fund that will buy the annuity falls by a higher percentage, the end result is a lower income not higher.

The reverse is true. If the value of the pension fund rises by more than annuity rates fall the result is higher income.

There are times when both annuity rates and the stock market rise or fall together. A period when annuities and the stock market fall together is known as a double whammy. We saw this in September 2007 and at the beginning of 2008.

At present both annuities and the stock market are going up and although the values of pension funds that are invested in equities have not regained all of the losses sustained earlier in the year values are up and it might make sense for investors to lock into these gains and secure their incomes by purchasing an annuities.

Investors and their advisers should ask themselves what caused annuity rates to fall during the last 20 years and why annuity rates are now rising. Annuities are priced in relation to the yield on long dated gilts and corporate bonds and also with reference to life expectancy tables. Yields have been falling in value for a number of reasons but the main factors are supply and demand, increased life expectancy and the outlook for inflation. The demand for bonds has been strong as large investors including pension funds have increased their holding of fixed interest investments and at times of uncertainty in stock markets there is often a flight to quality which results in a switch away from equities to bonds. There seems no let up in the increased demand for fixed interest investments and the increasing demand for annuities will only make the matter worse.

The supply and demand problem provides a neat argument for the development of the market in with-profits annuities. If bond yields, hence annuities, are driven down by an excess of demand over supply, then the value for money from annuities will decline over time. Therefore the only way that investors will be able to get better value for money from their annuities is if they invest in assets other than bonds and they share some of the mortality risk with the annuity provider. A with-profits annuity invests in real assets including equities and property and the mortality risk is shared because the provider can pass the effect of longer life expectancy to the investor by reducing bonuses. It is important that anyone contemplating a with-profits annuity understands all of the risks.

*The increase in life expectancy may be slowing down, but continued improvements in medical science suggests that despite the younger generations' "happy go lucky" lifestyles people will be living longer in the future.* Furthermore the increased sale of enhanced annuity rates means that the mortality cross subsidy from standard annuities is reducing because those with below life expectancy are being removed from the annuity pool.

The third reason for the huge reduction in annuity rates is inflation. In 1990 annual inflation was nearly 10 % per annum, and today it is around 4%. If inflation is high investors look for a higher return from bonds to compensate for inflation. Those who bought in annuities in the early 90's will have benefited from falling inflation. The same may not be true for those buying annuities today. If inflation continues to increase the

purchasing power of annuities will be eroded. There are concerns that the official index for inflation (RPI is still used for annuities) does not reflect pensioners' real inflation. "What is the point of paying the high price of an index linked annuity if it does not keep up with personal inflation" asked one of my clients recently. Given the choice, more and more investors are choosing level annuities in preference to escalating annuities. This is hardly surprising when the difference between the starting incomes can be as high as 30%. I fear that the low take up of escalating annuities will cause problems in the future if the cost of living for pensioners continues to increase so rapidly.

In conclusion, purchasing an annuity can be a complex exercise because it is important not only to select the right options but it is also important to get the timing right. Unfortunately many people have little control over the timing of their annuity purchase because when they retire they need a pension, but most people can maximise their income at retirement by following a few simple rules:

- Consider investing in safer investments such as fixed interest in the run up to retirement
  - This safeguards against a sudden fall in equity prices as happened in early 2008
- Don't fall into the trap of putting off an annuity purchase in the hope that rates will improve
  - There is an opportunity cost in deferring an annuity purchase as income forgone in the deferral period is rarely made up by higher payments in the future
- If you have a large enough pension fund consider purchasing your annuities in stages
  - Phasing your annuity purchase may improve your overall annuity income and provides more flexibility
- Don't ignore the effects of inflation, it will not go away

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