PERSONAL FINANCE

Living annuities must be used correctly

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To start with a bald statement: there is nothing fundamentally wrong with using an investment-linked living annuity (illa) to provide a pension. The costs do need to be reduced, but illas are an essential pension-paying option.

The problem with illas lies with how they have been used incorrectly by annuitants, often on the basis of poor advice from financial advisers who, without any qualifications in asset management, have nevertheless provided advice on investments. The fees charged by these advisers also contribute to the costs that, National Treasury says, reduce an illa pension by about 20 percent.

Despite these drawbacks, illas are an essential option in times of low interest rates.

Traditional guaranteed annuities, which are bought from life assurance companies, are based on prevailing long-term interest rates, your age and your gender.

The older you are, the higher the pension you will be paid, because the life assurance company does not expect that you will live as long as someone who is younger.

Women are expected to live longer than men, so they receive a lower monthly pension, but on average over time the same as earlier-dying men.

The key problem is interest rates. If interest rates are low when you retire, the low rate will be reflected in your pension, because the life assurance company will use mainly long-term bonds as the underlying asset to pay your pension, locking you into that low rate. If interest rates are high when you retire, you will receive a much higher pension, then and into the future.

So currently, if you are under the age of 70, a traditional guaranteed annuity may be an unwise decision.

Last week, Personal Finance published details of two pieces of research that showed that many, if not most, pensioners with illas face the probability of running out of money before they die, particularly if they live for longer than average.

It is absolutely essential that the investments underlying an illa are made by people who know what they are about. And it is just as important that the pension you draw down as a percentage of your annual capital is kept at five percent or less.

The five-percent rule is based on various pieces of research undertaken in recent years.

If you draw more than five percent a year, there is a very good chance that you will run out of money. The only exceptions are if you retire later in life or if you expect a shorter lifespan, such as suffering from a life-shortening medical condition.

The research we published last week, showing how precarious the situation is for many illa pensioners, resulted in some rather silly financial advisers claiming on various websites that Personal Finance had got it wrong and that we were scaring retirees off illas.

What nonsense. We reported on research that shows that, on average, illa pensioners are drawing down too much as a pension, and the situation is getting worse every year.

We could not get it wrong, simply because it was not our research. The research came from financial services industry organisation the Association for Savings & Investment SA (Asisa) and the country's biggest retirement fund services provider, Alexander Forbes. And there is no reason to assume that either of them got it wrong – both have a sound track record on research.

Perhaps some of those silly financial advisers provided inappropriate advice and now they have unhappy clients.

Overall, the Asisa figures do not look that bad, with the average drawdown rate at seven percent – two percentage points more than the target of five percent.

Asisa was pleased that, on average, the drawdown figure was not greater than seven percent – it had been concerned that the situation could be worse.

The problem with percentages is the number of people who are above the average. For every person below the average, there is another one who is above the average.

What is of concern is that the average pensioner over the age of 75 is receiving a monthly illa pension of R1 640, and 21.3 percent in this age group are drawing down a pension at 17.5 percent or greater, meaning they could outlive their capital.

This means that something went very wrong in the early years of their retirement. Their investment choices were a mess and/or they drew down too large a percentage of their retirement savings.

The research is an apt and timely reminder that great care must be taken with living annuities. If you get it wrong at the start of your retirement, you will pay a significant penalty later on.

Peter Dempsey, Asisa deputy chief executive, correctly warned last week that no pension can make up for a shortfall in retirement savings – and particularly not an illa.

Incidentally, all illa pensioners should consider switching to a guaranteed annuity in their seventies, because, even if interest rates are low, a guaranteed pension becomes a lot more favourable and can better an illa, particularly because of the guarantees.