Gordon Midgley Memorial Debate:

‘Drawdown Will Eventually Replace Annuities’, April 16, 2008

For the Motion: Billy Burrows

Hello, my name is Billy Burrows and I am here to propose the motion, - **Drawdown Will Eventually Replace Annuities’**

My many years of experience in advising Individual and Corporate clients about annuities and drawdown, advising insurance companies about product development and speaking with government and the regulators leaves me in no doubt that drawdown will continue to replace drawdown as the preferred option for many **Middle Britain** investors

That is providing clients get the correct advice and the industry continues developing innovative new products like variable annuities.

In one sense annuities and drawdown are opposite sides of the same retirement income coin.

On the annuity side, income is guaranteed for life, come what may, and therefore they provide peace of mind and security - but this comes at a price – investors are locked into current gilt yields and there is no flexibility to change the annuity options if circumstances change in the future.

On the other side of the coin is drawdown, where investors give up the annuity guarantee in order to have more choice, including:

- Income flexibility
- Control of investment
- Choice of death benefits

So how does an individual decide whether to buy an annuity or drawdown? The answer is by carefully weighing up the advantages and disadvantages of each option.

We can cut to the chase: - There are two reasons why many investors prefer drawdown to annuities:

1. Drawdown can provide a lump sum death benefit whereas when annuitant dies, the annuity income stops – however don't forget many annuities are joint life annuities so income only stops on the death of the 2nd annuitant.
2. Many investors think that can invest in a way that will provide superior returns compared to an annuity – that is investing in equities is better than investing in bonds

These two charges against annuities were most eloquently articulated by Lord Grantley speaking in a House of Lords debate on pensions in October 1997 when he said: "In my view, there are two overwhelming reasons why people should not invest in annuities under any circumstances.

The first is that investing in annuities is contrary to the interests of a family . . . in that they are worth nothing when the investor dies.

The second reason is simply that annuities are a lousy form of investment."

I challenge my friend who is opposing the motion to argue against this. What he can say to defend annuities against these criticisms?

Retirement Income Market

I now want to take a wider view of the Retirement Income Market

Central to my argument is the point that in the past the relatively un-sophisticated nature of the retirement market favoured annuity purchase, but as the market matures and becomes more sophisticated, the balance of advantage will increasing tip towards to drawdown.

In order to nail this point home, I must quickly examine the changing position of the key stakeholders in what I call the "retirement income decision making process" – these are

- ✓ The individual investor
- ✓ Product providers
- ✓ Financial advisers
- ✓ Government and the regulators

The investor

Investors are a diverse bunch of people. Some with small pensions, some with large pensions but they all share some common characteristics and they face many of the same risks including:

- ✓ Living longer than expected and running out of income
- ✓ Dying sooner than expected and leaving their family without an inheritance
- ✓ The risk that inflation will reduce the spending power of their pension
- ✓ Investment returns being lower than expected
- ✓ A change in personal circumstances – health, death of partner

Put it another way - without putting words into their mouths, most clients would agree that their retirement income objectives are:

To provide a sustainable income in real terms,

as long as they or their partner are alive,
without taking undue risk
but having as much flexibility as possible.

So how can this objective be achieved?
sustainable income in real terms

Annuities provide income for life, but unless the very expensive Inflation Linked option is taken the income is not sustainable and there is no flexibility.

Many people take out level pensions and I don't need to tell you that is far from a no risk option. Inflation is like sin – every government denounces it but they all practice it.

Some people may argue that with-profits annuities can provide a sustainable income because they are invested in real assets – although I agree with this in principle, they are still annuities and fail the flexibility test.

To be clear, drawdown cannot guarantee to provide a sustainable income in real terms – but because drawdown will inevitably be invested partly in equities, and over the longer term equities should provide a good hedge against inflation – so providing investors are prudent their income should at least keep up with inflation

as long as they or their partner are alive,

This used to be the uniqueness of an annuity – the new variable annuities will guarantee income for life

without taking undue risk

What is undue risk?

It is misleading to believe that annuities are risk free – for example inflation risk, risk of early death

Yes drawdown is risky but new investment management techniques and more sophisticated advice does much to reduce the risk and the new style variable annuities can significantly reduce investment risk

as much flexibility as possible.

Annuities are inflexible – period

There is nothing more flexible than drawdown - well there is and it is called Phased Retirement which is another form of drawdown

This analysis shows that drawdown is the only product that can meet the objectives of Middle Britain investors

Put it another way - If this room was filled with Middle Britain investors of retirement age (instead of distinguished members of the financial services industry) and I asked for their views on annuities, they would say something like:

“We don’t like the idea of annuities because the rates are poor and if we die early the insurance company pockets all the money”
Equally they might say:
“We like the idea of drawdown because it provides flexibility but we are concerned about the risks and the costs”

My reply to this is; “If you can invest in a product that provides a guaranteed income for life whilst offering flexibility of the drawdown but without many of the risks, would you be interested.”

This is of course the variable annuity concept. I will discuss this in more detail later.

Product Providers

In the context of the annuity /drawdown debate there are two important issues for providers. – Supply and Demand

On the supply side there is a shortage of suitable assets to back annuities. I have so far deliberately avoided complex technical issues, but if we look at the “value for money from annuities” we will find that annuities are still good value for money but the shortage of suitable long dated fixed interest investments into which annuities are invested means that there is less yield to pay back to customers. Combine this with the effects of enhanced annuities – and you can see how the income payouts for Middle Britain annuities is being squeezed downwards. Nowhere is this more evident than in the market for inflation-linked annuities.

Contrast this to the ever increased supply of suitable investments for drawdown and more sophisticated investment management techniques.

On the demand side, there is an ever increasing demand for annuities and this is fuelled by the move to company DC pensions. At present these are mostly small sized funds but as time goes on these funds will increase and value. I predict that one of the biggest challenges to DC schemes in the future will be how they deal with members who have above average pension pots and want advice on the more flexible options including drawdown.

If and when these members get the right advice, more will invest in drawdown and other alternatives to standard annuities.

This is a good point to throw into the pot another observation from the Billy Burrows school of annuities – Individuals with their own personal pension pots are emotionally tied to their pensions – after all they have invested their own hard earned income - Consequently there is a relatively high number of them who invest in drawdown.

By and large those with company pension company are less emotionally attached – it is the company's money – Consequently many do what the scheme advisers tell them.

However one the consequences of the increase in money purchase schemes is that investors are connecting with their pensions in much the same way as their personal pension contemporaries – the result is more directors and senior managers want to mange their pensions in retirement and so drawdown becomes a more a viable option.

Finally I get to what I think is the most important reason why product providers will wean customers away from annuities – product development

Insurance companies have tried to design innovative annuities but unfortunately these annuities have not taken the market by storm. There are many reasons for this including the complexity caused by the regulations and absence of lump sum death benefits.

This should be contrasted to the more recent product development in the area of variable annuities.

Put simply, it has proved impossible to make an annuity look like a drawdown, but now it seems that it is possible to make a drawdown look like an annuity.

Variable annuities or as I prefer to call them “Guaranteed Drawdown” products come in different shapes and sizes but that all have the following characteristics:

- ✓ An option for a guaranteed income for life
- ✓ Some type of guarantee income – typically income will not fall below a certain level
- ✓ A wide range if investments and some of the future investment gain can be locked in – this provides scope for a growing income
- ✓ The cost of the guarantee is expressed as an additional management charge
- ✓ The policies are Unsecured Pensions so investors have the full flexibility of drawdown until age 75

In this way investors can benefit from an annuity style income but with the advantages of drawdown.

There is a price to pay to for the lifetime income guarantee and annual management charges differ from company to company but typically range from 0.75% per annum to 1.5% per annum.

It seems to be that the opponents of variable of annuities are not denying the obvious advantages of an annuity / drawdown hybrid – they focus their attention on costs. Everything has a cost and is down to the advisers and investor to decide whether the additional costs of variable annuities represent value for money. Ask me later about my man from Grimsby!

My argument that **Drawdown Will Eventually Replace Annuities,** does not entirely depend on variable annuities becoming widely accepted because investment techniques for pure drawdown are becoming more sophisticated and drawdown plans are already becoming more popular. I strongly believe that the advent of variable annuities will accelerate the move towards wider acceptance of drawdown.

Professional Advisers and Government and the Regulators

I would like to round up my opening remarks by looking at the world of retirement from the point of view of:

- ✓ **Professional Advisers**
- ✓ **Government**
- ✓ **and the Regulators**

The Regulator is asking how Professional Advisers will discuss all of the new options with their clients, explain all of the risks and recommend the most appropriate policies.

In response, advisers are developing more sophisticated “decision making process” that seek to match a client’s retirement objectives and risk profile to a wider range of retirement income products. In fact I am currently working a project designing a decision making process that will enable IFAs provide better advice to their clients, consider a wider range of products, and analyse risk in a more sophisticated manner – all in a way that is fully complaint and will be profitable for advisers.

Lets be clear- better and more sophisticated advice will result in more clients investing in a wider range of products with drawdown playing a prominent role– remember my comments about the risks facing individuals approaching retirement.

I do wonder about Government, but who am I to criticise the Government?

In my own mission to eliminate double speak I wonder how we have got to the position where the Government says: “we want to encourage innovation in retirement income products” but the rules restrict any meaningful product innovation. Let me give you two examples:

- Value Protection is only available to age 75
  - If there was one thing that would have made annuities more appealing to the man in the street it is money-back annuities but the age 75 restriction makes this option practically worthless
- Drawdown ends at age 75 when Alternatively Secured Pension takes over
  - What a mess – I appreciate the Government and Revenue’s argument that a pension should be used for the purpose for which it was intended – i.e. pension income, but it should not be too difficult to allow investors to continue in drawdown past age 75 whilst satisfying the requirement for pension income rather than inheritance planning. For example, I have long argued that the rules for “minimum income distributions for 401 K’s in the US provide a useful model.

I suggest that in the end the politicians will listen to the voters (and perhaps people like you and me), especially as more voters aspire to be Middle Britain’s and as pensions becomes an important election issue.

Conclusion

In conclusion Mr Chairman, I argue that there is no “golden bullet” that will suddenly turn UK investors away from annuities to drawdown, rather I argue that you if consider all the different forces at work in the retirement income market you must conclude that over time, more and more investors will invest in pension drawdown products. Annuities will still be important but will increasing find their role limited to those with smaller funds and older investors.

I urge you to support the motion

Thank you

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Additional comment – not used in debate

Let’s look at the problem from another angle. I have observed over the years that many people make important decisions about annuities whilst trying to reconcile opposing messages from two different sides of their brains.

One side of the brain is the rational side that says “don’t be stupid – you need to invest an annuity because it’s guaranteed and safe”

The other side of the brain, the emotional side says ”annuities are for whimps – you can do better by investing your own money and keeping control of your pension”

I am fond of saying that those who understand financial risk – investment managers / bankers / actuaries take very little at retirement, whilst those who do not understand financial risk – politicians / people in the media and marketing / architects take more risk than is probably good for them.

I guess that you could say that the first group pays more attention to the rational side of their brains, but I prefer to think that the first group act without much emotion whilst the second group act with too much emotion.

This might seem as an argument against drawdown, but I am going to go on to argue that annuities are not as risk free as one thinks and drawdown need not be as risky as one thinks. I also believe that the very real advantages of drawdown far outweigh the advantages of annuities and as times goes on the drawdown advantage will increase.