



Institute of Actuaries of Australia

**Super Policy
Forum**

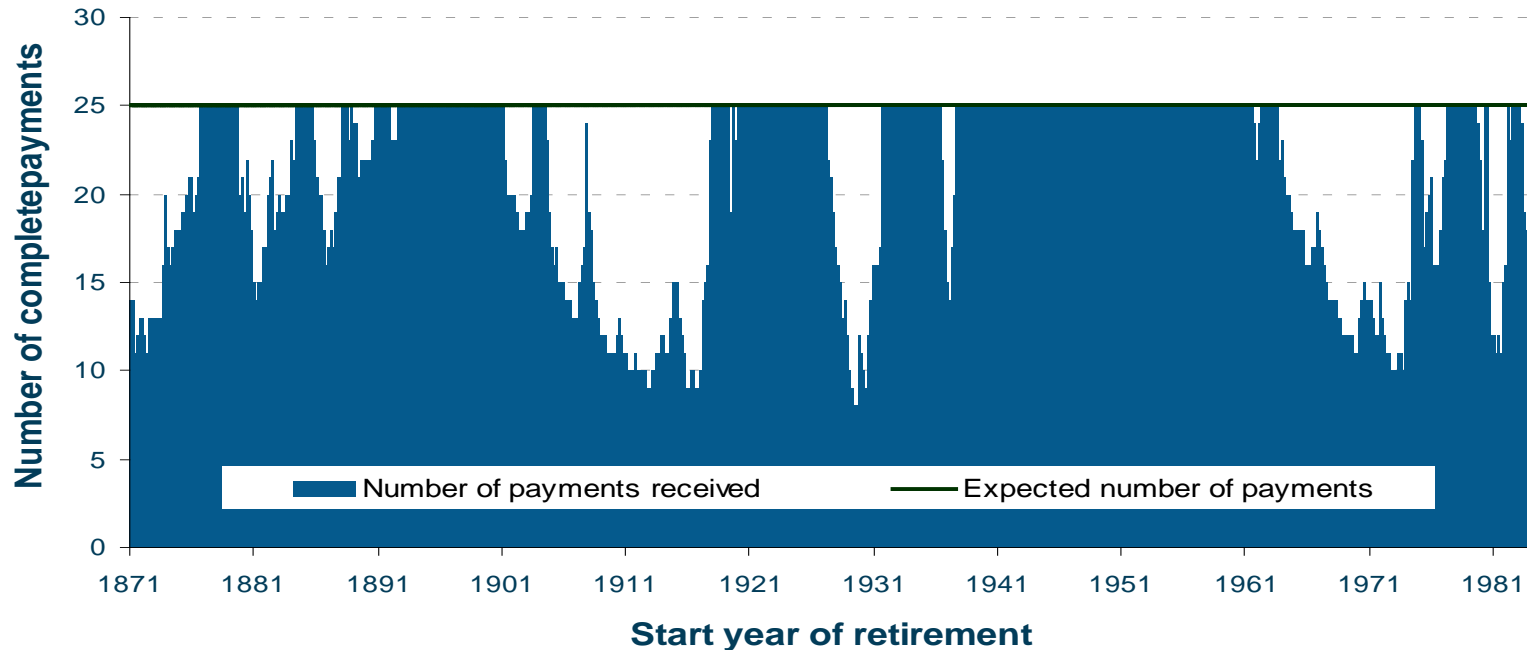
Annuities in Retirement Portfolio Construction

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Agenda

- **Risk and risk premium**
- **Impact of fees**
- **The case for annuities**
 - **Portfolio construction**
 - **Public policy**

Market risk and early depletion



- If you create a “risk budget” and “spend” it on higher income over a life expectancy plan:
 - You probably won't make it to your life expectancy
 - There is a >10% chance you will only make it half way

10/30/60 Revisited



1. Source: The Russell 10/30/60 Retirement Rule

2. Source: Rice Warner Superannuation Fees Report 2008

Portfolio construction case for annuities

Asset Allocation			Pr (Inadequacy)	Remaining account balance at age 90 (\$)		
Growth	Defensive	Strategy		Worst	Median	Best
0%	100%	Non-Annuity	67%	-180,359	-103,035	-2,698
		Annuity	0%	-115,676	28,296	254,911
30%	70%	Non-Annuity	57%	-157,853	-51,762	96,277
		Annuity	0%	-98,456	78,148	362,986
50%	50%	Non-Annuity	50%	-160,139	-18,006	204,226
		Annuity	0%	-102,315	96,905	462,624
70%	30%	Non-Annuity	42%	-167,867	18,682	348,781
		Annuity	4%	-121,776	98,179	563,188
90%	10%	Non-Annuity	36%	-183,093	55,496	594,990
		Annuity	32%	-163,898	84,891	691,012

Assumptions: Initial Balance \$500,000; Target income \$37,621 pa; Adequate income \$19,450 pa; High Fees

Pricing of Lifetime Guaranteed Annuities

Annuitant	Life Expectancy	*Annuity Payment	
		Fixed Term	Lifetime Annual
60 year old male	31 years	\$3,945	\$4,153
60 year old female	37 years	\$3,765	\$3,904
65 year old male	26 years	\$4,209	\$4,522
65 year old female	30 years	\$3,985	\$4,152

*Based on initial investment of \$50k and does not include age pension entitlement

Covering longevity risk is less expensive than providing a fixed term equal to life expectancy (if you live past 81 years)

Public policy case for annuities

- **Choice mantra rings hollow**
 - Very few people actually choose
 - Our retirees take too much equity risk
- **Annuitisation will raise retirement incomes**
- **Annuitisation will lower aged pension costs**
- **Australia is uniquely laissez-faire in permitting lump sums and in low use of annuities**
- **Universal uptake materially improves pricing by removing adverse selection**

Summary

- **Growth asset portfolios are inappropriately risky in retirement**
- **Extra return from growth assets is largely eaten up by fees**
- **Simple annuities provide the return without the risk**
- **Annuities make sense for portfolio construction and public policy**
- **Australia is the outlier**

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