Discovery

Life annuity policies with capital protection

An analysis by Discovery Invest Technical Marketing

Suppressed returns in local markets over the past few years has led to the resurgence in popularity of retirement income products that guarantee an income for life plus capital protection. These products are often colloquially referred to as 'back-to-back' policies, and they are not a recent innovation. The basic structure of the product is that the client pays a lump sum, and in return, the insurer provides an income for life with a guarantee of the initial capital paid back on death.

Let's analyse these products in a bit more detail and determine when they may or may not be appropriate.

WHAT IS THE CLIENT BUYING?

When a client buys one of these policies, they are buying a life annuity and life cover. The life annuity usually has flexibility in terms of yearly income increase and spouse reversion on the death of the main insured person, but the life cover is usually a fixed '0/0' structure. In other words, there is 0% yearly premium increase and 0% yearly benefit increase. The monthly life cover premium is deducted from the annuity income.

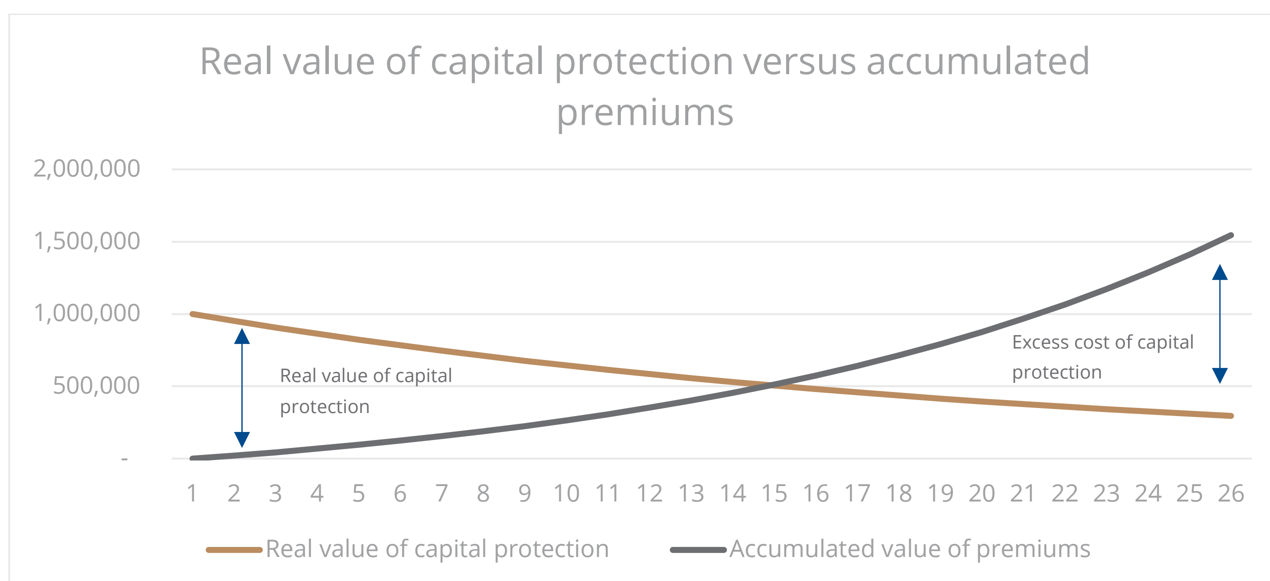
In practice, the insurer takes the lump sum from the client, buys long-term secure assets, and uses the interest from this to pay the income. The capital is then secured to pay to the client's beneficiaries when the client dies. So, the life insurance component is not typical life insurance where a death reserve is funded from the ongoing premiums. This is how the insurer can offer the 'life cover' free of underwriting.

The important question to ask is this: How valuable is the 'life cover' component, compared to a standard life annuity or a living annuity?

THE TRUE VALUE OF THE STRUCTURE

Capital protection provides peace of mind to provide for dependants and leave an inheritance to beneficiaries. However, it's important to consider the impact of inflation over time, individual life expectancy, and the lack of flexibility to assess its true value.

It's important to note that inflation quickly erodes the real value of the life cover over time. Then consider that the premiums for the capital protection add up as time goes on. As illustrated below, after just 5 years, the capital protection minus accumulated premiums paid is worth 27% less than the starting capital protection in real terms (taking into account inflation). In 10 years, it's worth 72% less. After 15 years, the cost of the premiums exceeds the real value of the capital protection.



Assumptions: inflation of 5%, flat R1 million life cover benefit, flat life cover premium for life for a 65-year-old male based on the average of three main provider quotes, 8% accumulation rate. Please note that the above is for illustrative purposes only and results are not guaranteed. There are risks involved in buying or selling a financial product based on a forecast, illustration, hypothetical data, or projection.

Then consider that the average life expectancy of a 65-year-old client with a life annuity is around 20 years. Healthier clients live even longer: the average life expectancy of a 65-year-old with Diamond Vitality status is 25 years, with a 40% chance of living past age 100. This means the average client is expected to live past the inflection point where the capital protection costs more than it provides in real terms. In addition, the value of the capital protection will be worth just 35% of its original value in real terms at the average life expectancy.

Given the amount of time that the average client will spend in retirement, the client must then consider the importance of income flexibility. Over the span of 20 to 30 years, it is almost certain that a client's income needs will change. For example, medical expenses will likely rise by more than inflation and increase as a person ages, which means these expenses will form a larger and larger percentage of a client's total expenditure. Also, there is the risk of unexpected expenses. If a structure like a life annuity

with capital protection is selected, clients will not have the flexibility to adjust their income if the need arises.

This means that the client is locked into a product with high premiums. In return, they get cover that quickly depreciates, with no way of exiting the agreement when the value proposition reverses. Also, although the income is secure for the term of the retirement, the lack of income flexibility may be sorely felt in the later years of retirement.

CHOOSING THE RIGHT PRODUCT STRUCTURE

It's clear from above that retirement, in most cases, is a long-term endeavour. Therefore, it's important to have a strategy that not only provides income sustainably but also a level of flexibility in income to accommodate life events and rising medical expenses.

Living annuities can provide flexibility in terms of income and access to markets over the long term, which can create capital growth. The latter point is worth emphasising, because growth assets like equity and property are expected to outperform other assets over the long term. Notably, the range of historical outcomes of these asset classes narrow significantly as the investment term increases.

In fact, our research on past performance indicates that for investment periods of longer than 6 years, the minimum historical return achieved in equities outweighed the maximum cash returns over the same periods[1]. This means that for a long-term investment like retirement, clients who can sustainably draw down from a living annuity are almost certainly better off in a portfolio with a healthy allocation to risky assets, rather than in a conservative strategy or a life annuity. Even if markets look poor or volatile at the point of retirement, it is not a good strategy to make a long-term investment decision based on recent market movements. The data indicates that in the long term, more aggressive investments will outperform less aggressive ones.

Life annuities generally provide a yearly real income (increasing with inflation)[2] of around 4% to 8% of the initial capital amount. This income depends on interest rates at the time and specifics like the yearly income increase, spouse reversion and guarantee term selections. With life expectancies rising globally, income sustainability is important in retirement.

It is often the case that clients who require higher drawdowns in the range of 4% to 8% and who don't want to take on extra market risk will rather look at life annuities. This may be a reasonable choice, provided the client is in very good health. However, a client in poor to decent health who is not expected to live very long into retirement may still be better off in a living annuity, where residual capital will be left on death to beneficiaries.

The above analysis shows that when considering the life annuity with capital protection, this product structure is only appropriate for clients who need guaranteed income and want a death benefit. Even then, given that the real value of the life cover versus the premiums erodes quickly, the client may still be better off with a living annuity or just a standard life annuity.

[1] Based on research conducted by Discovery Invest Technical Marketing on over 20 years of long-term rolling investment returns as at 31 December 2019.

[2] For this, we are ignoring flat income, but as shown earlier, it should be clear that a flat income's real value erodes quickly over time due to inflation. In fact, after just 15 years, the inflation-adjusted income would be worth 50% less. In a life annuity, a flat income is almost always a bad decision, unless income sustainability is not necessary for the client.

CONCLUSION

When considering retirement structures, it's important to consider the impact of inflation, the actual cost of what's being purchased and life expectancy statistics. What initially seems like a great deal may in fact be a poor deal over the long term.

A decision on retirement income structure should consider long-term sustainability of income, but must also consider the long-term nature of retirement and statistics on the growth of assets and the importance of income flexibility. Therefore, in most cases, a living annuity is likely the best option for a client. Life annuities can become an option if the client is in good health, requires a higher drawdown and is not willing to take on any meaningful investment risk.

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