

# Pensions: I say tomaeto ...

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The UK and America are “separated by a common language”. It would seem that the separation is a little more. The two countries are heading in opposite directions on pension annuities right now.

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## Annuities in the UK

Pensions and annuities in the UK are under pressure. Occupational pension schemes are in deficit. In some cases the pension scheme deficit is larger than the market value of the sponsor. Their corporate sponsors are weakened by the economic downturn.

In the insurance sector, the new EU capital rules, Solvency II, as they stand are set to increase the capital needs of annuity writers which will push annuity rates down. This combined with the large concentrations of longevity risk in the major annuity writers in the UK and low interest rates, means that annuity pricing in the UK is unattractive.

In many ways the UK is searching for an alternative form of retirement income to the classic annuity.

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## Pensions in the USA

In the USA retirements savings products tend to follow fashions. In recent years the variable annuity product has gained considerable favour with sales sky rocketing.

A variable annuity is an index linked product, with many of the indices being equity based – eg S&P500, Dow, etc... The policy holders are isolated from the stock market fluctuations to some extent by guarantees embedded in the policy. These guarantees extend to a guaranteed minimum withdrawal benefit (GMWB), a guaranteed minimum income benefit (GMIB) and a guaranteed minimum

accumulation benefit (GMAB). Anyone who has spent much time around derivatives markets will identify these as long dated and complex options.

Variable annuity business is one factor behind the near death experience of a few of the major writers in the USA. The regulatory capital requirements for variable annuity business have now been strengthened as a result. This has prompted President Obama to announce that the US should switch towards retiree annuities – a more fixed annuity type of business. However, the UK experience would suggest that these products are not particularly suitable. In addition in the USA, annuities tend to be fixed term and so the annuitant is totally exposed to longevity – one of the major risks. BRAVE Partners finds it tough to see how a fixed term, fixed annuity provides for retirees in the USA.

## Common language

The common theme in the USA and UK is that the current standard investment products and vehicles appear to be failing. In many ways these can be seen as outdated technology. Both countries seem to be wrestling with: “What next?”

- Longevity. A bond has a fixed maturity. A pension does not, it lasts until the pensioner dies.
- Inflation. CPI inflation can be hedged and this is the inflation component of a classic occupational pension plan. However, unless pensioners are to be consigned to drop behind the mainstream standard of living then they really need to receive wage inflation increases. Long term wage inflation runs at about 1.5% above goods inflation. This reflects productivity gains.

“Younger retirees need some equity investments to grow assets for later retirement”

Christopher Cloke-Browne  
Managing Partner  
BRAVE Partners LLP

## Rebuilding pensions

Conventional wisdom states that pensioners should be wholly invested in bonds. The argument goes that an annuity is “bond-like” because the payments are fixed. This is partially true, but there are many factors about a pensioner that mean that the payments should not be fixed. To summarise a few:

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There is arguably a need for pensioners to have some investment exposure to equities. The facts are that when retirement, annuities and pensions were first introduced, pensioner life expectancies were short. A friend of the BRAVE partners is a senior figure in HR at one of the of the blue chip companies. She mentioned that when that company introduced their UK occupational pension scheme, they expected pensioners to live for two years post retirement.

Younger retirees need some equity investments to grow assets for later retirement.

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- The USA and UK seem to be struggling to find the right investments for retirement.
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