

Managing longevity risk

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Longevity risk is one of the biggest risks facing retirees. It refers to the risk of outliving your savings. Longevity issues arise as people enter retirement, generally with a fixed amount of money to fund their retirement years (either in the form of a lump sum or pensions), but with no idea of how long they will live and, therefore, no idea how long their money needs to last.

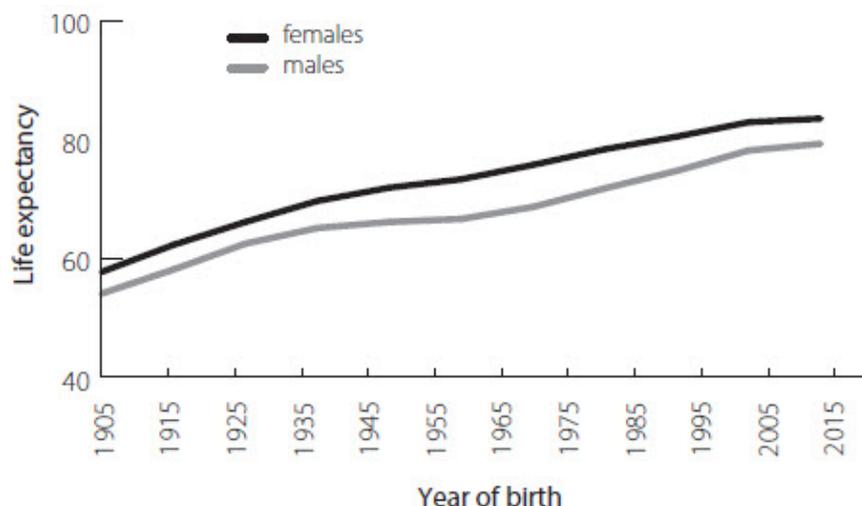
For those who do not receive lifetime pensions, longevity risk is a function of two unknowns:

- how long a person will live and
- how investment markets will perform over that time.

According to the Australian Bureau of Statistics (ABS), over the last 50 years the life expectancy of a new-born boy increased from 66.1 years (when born in the period 1946-48) to 80.1 years (when born in the period 2011-13). Similarly, the life expectancy of a new-born girl increased from 70.6 to 84.3 years during the same period (see graph below). The increase in life expectancy at birth is due to declining death rates at all ages. Advances in medical treatments and drugs, as well as a reduction in some risk factors, have contributed to people living longer.

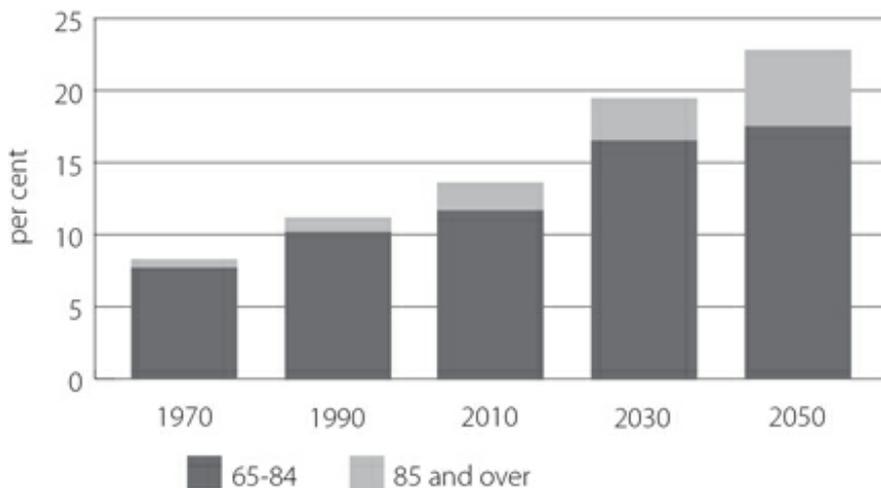
Although women continue to have a greater life expectancy than men of the same age, the improvement in life expectancy for men over this period has been slightly greater than that of women.

Life expectancy at birth



Source: Australian Institute of Health and Welfare, Australian trends in life expectancy

The proportion of the population age 65 and over is growing



It's important to understand that life expectancies are based on historical averages; it doesn't mean that the 65-year-old male should expect to live until age 80. What it means is that he has a 50 per cent chance that he will live beyond age 80, and a 50 per cent chance that he will die earlier.

How do you manage longevity risk

There are very few products in the Australian market that specifically manage longevity risk.

Account-based pensions are the most popular type of income stream product. Purchased with superannuation monies, an account-based pension provides an income source during retirement years. As account-based pensions are linked to the market, your investment, and therefore the income payments you receive, will be affected by market fluctuations.

The risk borne by the investor is that the income drawn from an account-based pension is not guaranteed to last their lifetime; it depends on the initial capital invested and the return from the underlying investments. Longevity risk can, however, be managed to a certain degree by setting and adjusting the underlying investments, asset allocation and the level of income drawn each year from the pension.

A product that does protect against longevity risk is a lifetime annuity or pension. Unlike account-based pensions, a lifetime annuity is not exposed to market returns, so does not suffer as a result of a downturn in the market, and it provides a guaranteed income stream for life. Despite the certainty, however, these are unpopular because the rate of return is locked in at the time of purchase. Not only that but access to funds is restricted, so there is a corresponding loss of flexibility. Since the changes to superannuation in 2007, the value of these annuity investments has been included as an asset under Centrelink's assets test.

One concept prevalent overseas is that of deferred annuities (a form of longevity insurance), which can be purchased on retirement. In this case, you must have accumulated sufficient funds from other sources (such as an account-based pension) to support you until you reach your life expectancy age. Once you reach your life expectancy age, the deferred annuity begins paying income and continues to do so for the rest of your life. These types of products generally work by pooling longevity risk. Members of the pool, as a group, retain investment risk and the aggregate longevity risk (ie the risk that, on average, all members live longer or shorter than the assumed life expectancy). This differs from an account-based pension, where a person assumes all of these risks, or a lifetime annuity, where the provider assumes all of the risks.

Safety nets

There are a number of retirement safety nets available if you should run out of income or suffer a reduction in the value of your income or assets. The most obvious is the age pension, which is essentially a means-tested Government-backed safety net for retirees who are not able to fully provide for themselves in retirement.

The second major safety net available to many Australians is the equity in their home, which can be drawn on later in retirement and can form an important part of a retirement income plan. However, care should be taken that this safety net is not overused because the equity could potentially be drawn down very quickly, which could leave you in a difficult position.

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