TO DEFER, OR NOT TO DEFER ANNUITISATION

Many international studies conclude that it is better to annuitise at, or early in retirement. These findings are further supported by other surveys where most participants rank the need to have the certainty that their income in retirement will last for life as the most important consideration.

However, in practice we often find the opposite where the majority of individuals choose to defer annuitisation or not to annuitise at all. Why do people do the opposite to what they articulate as being important, and what is deemed optimal in retirement?

This note will focus on the following possible reasons: human behaviour, the misperception of relative value, and the misperception of the drivers of the price of a life annuity.

Human behaviour

Arguably the biggest factor contributing to this conundrum is that humans have the inherent desire to defer big decisions. Unfortunately this inclination to defer makes fertile ground for opposing arguments to take root, looking for reasons to support the desire to defer. It is therefore easy to see how common misperceptions can lead to decision-making that is contrary to their main objective, often leading to poor long-term outcomes in retirement.

We aim to demonstrate that deferring annuitisation comes at a cost, therefore countering the arguments that are often presented in favour of deferred annuitisation.

Misperception of value

Belief that high annuity rates at older ages represent better value

All else equal, it is true that annuity rates are higher for older ages. The common mistake is to interpret the higher annuity rate at older ages as better value for money. For example, many people incorrectly assume it is better value to buy an annuity at age 70 with an annuity rate of 10% versus buying at age 65 where the rate is 8,5%.

The reality is that it is not cheaper to buy an annuity at older ages, in fact the opposite is true. It becomes more expensive.

To understand why, one needs to make sure you compare apples with apples. The annuity rate at age 65 is more expensive simply because it allows for 5 years' worth of additional annuity payments, which is not included in the annuity rate from age 70 onwards.

If you correctly compare the price of the payments from age 70 onwards (which is not easy for the man on street to do as it requires detailed understanding of annuity pricing) you will find that the decision to defer annuitisation from 65 to 70 is between 10%-15% more expensive, all else equal!

So if you want to secure an income for life, it is better value for money to do that sooner, rather than later.

Clarifying Example
If the annuity rate is 10% for a 70-year-old male, and 8.5% for a 65-year-old male, one assumes 10% is better than 8,5%. However, this does not compare like-for-like as the annuity rate for the 65-year-old is expected to pay five years more income.

Misconception of drivers of price

Belief that current record-low short term interest rates make guaranteed annuities unattractive

It is true that the price of annuities improves when "interest rates" are high, all else equal. It is also true that we currently have the lowest short term interest rates in history due to the impact of COVID-19. However, people incorrectly conclude that due to the low short term interest rate, annuity prices are high and that it makes sense to wait for these interest rates to increase.

The truth is that life annuity rates are not sensitive to **short term** "interest rates".

What matters in pricing life annuities is the level of **long term** interest rates. In South Africa, the long term interest rates have increased from pre-COVID levels and despite coming down from its peak in March 2020, annuity rates are still attractive (also see Rethink Conventional Wisdom). So, when you buy an annuity now, you already benefit from these higher interest rates. It therefore does not make sense to defer the decision to annuitise based on your view of short term interest rate movements.

To defer or not to defer – that is the question

Historically, the inability to adjust income from a life annuity and the inherent desire to defer big financial decisions and the common misperceptions of price and value are some of the reasons why many South African retirees opt for a living annuity, or defer annuitisation.

So while it makes sense to annuitise earlier, it does not mean that clients must commit solely to a guaranteed life annuity.

At Just, we believe that partial annuitisation in a blended living annuity is the optimal solution. Research shows that by securing your essential expenses with a guaranteed income inside a living annuity, blended annuities provide a sustainable income for life and allow for the balance to be invested more aggressively to leave a higher expected capital legacy on death – all in a single product. And it is not an all or nothing decision. Blending allows annuitants to structure a suitable combination over time, balancing the various trade-offs by switching additional tranches into the life annuity component when required.

Need more information?

Please let us know if you would like to discuss the above in more detail, or to request a quote:

Email: sales@justsa.co.za
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