



A Framework for Evaluating Retirement Income Products

Philip Mowbray
Philip.Mowbray@barrhibb.com

Limitations in Traditional Retirement Product Sales and Advice Tools

In our previous Market Insight report, "A Framework for Communicating Value and Risk of Retirement Income Products", we considered the challenges faced by product manufacturers and distributors in measuring and communicating risk and value in different types of retirement product.

As highlighted in this previous report, 'at retirement' customers are exposed to a complex combination of market risk, interest rate risk and mortality risk. We believe that traditional risk measures such as volatility, and communication tools such as deterministic illustrations and critical yield measures, have not been effective in explaining risk and value in different retirement products. Customers have been poorly placed to make well-informed decisions as to which retirement product or investment strategy best meets their own retirement needs.

This lack of effective tools for communication and advice process is also a significant barrier for providers and distributors seeking to sell more sophisticated retirement products with features such as guarantees designed to mitigate the risks. Traditional deterministic approaches have been unable to differentiate between the different options available to the customer.

In the previous report, we presented an analytic framework based on stochastic projections that allows us to evaluate a number of risk measures across a range of retirement products, in relation to the customer's retirement objectives. These risk measures can be effective in assessing and comparing the income and capital benefits associated with different retirement income products or strategies. Unlike conventional measures such as volatility or critical yield, the risk measures output from this analytic framework relate directly to the individual customer's own retirement needs.

We used a retirement planning case study to demonstrate how these 'customer-focused' risk measures could be effective in helping a customer an advisor evaluate a range of different retirement products and strategies. This analytic approach also highlighted the potential role for retirement products with long-term income guarantees; often referred to in the UK as 'Third Way'.

In this second report, we will illustrate how this analytic framework can be used by advisors to evaluate some of the Third Way products in the UK marketplace, and to understand which of these likely best meet their customer's retirement objectives.

Particular Challenges for Third Way Retirement Products

In developing guaranteed income drawdown products for the UK market, product manufacturers have introduced a number of product design innovations to mitigate the impact of more restrictive UK pension legislation. This has resulted in more complex propositions than in other markets such as the US. As a consequence, even where advisers have decided that 'Third Way is the right way', they are faced with a complex array of products offering different features.

What sources of information do advisers and their clients have in order to evaluate these different products?

- Key features documents.
- Product marketing literature. This may include descriptions of product benefits, scenario illustrations which show how the product would perform under particular market outcomes, together with a range of sales tools to help advisers explain the product to customers.
- Product survey reports produced by third parties, providing details and comparisons of the features of the different products available within the market.

Importantly, none of these existing sources of information will tell the adviser whether the products will meet a particular customer's retirement needs.

These traditional tools do not help the adviser make a well informed decision as to which of the products will be most appropriate for a given customer.

For example, although this information might state that one product has an income guarantee step-up cap of 10%, compared to another product with no cap, it is very difficult to know whether this difference in product design will impact on the ability of the products to meet a particular customer's requirements for income and death benefits.

In the following section, we demonstrate how the analytic framework developed in the previous report can be used to measure risks and benefits for a sample of specific 'Third Way' retirement products. We will show how the outputs from this framework can be used by financial advisers to make properly informed decisions as to which retirement products or strategies best meet an individual customer's retirement objectives.

Case Study: Using the Analytic Framework to Evaluate a Selection of UK Third Way Products

Let's refer again to the simple practical case study we used in the earlier report. Our retirement customer, Mr Sprightly, is a healthy 60 year-old male with a retirement fund of £1 million, an income target of £50,000. He would also like to be able to leave cash to his children if he dies early in retirement.

We have used our analytic framework to produce projections based on a number of different Third Way products on offer in the UK. As a benchmark, we have also produced a projection for a typical USP drawdown product. For each of the different products, we have projected income and death benefit outcomes and used these to compute a set of risk measures relating directly to Mr Sprightly's retirement objectives.

Exhibit 1 presents a summary of these risk measures, relating to the projected income and death benefits available to Mr Sprightly at ages 75 and 85. The average values reflect the expected growth in income and death benefits, whilst the Lower 95% values reflect the potential downside (ie. the 1 in 20 'worst case' outcomes):

Exhibit 1

Comparison of a Sample of Existing UK 'Living Benefit' Products (end-December 2008)

Risk Measure		Standard USP Drawdown (60% Equity)	AEGON Inc For Life (30%)	AEGON Inc For Life (60%)	Lincoln i2Live Drawdown (35%)	Lincoln i2Live Drawdown (70%)	MetLife Retirement Portfolio (35%)	MetLife Retirement Portfolio (60%)
Age 75	Average income level (£k pa)	£73k	£55k	£63k	£57k	£66k	£53k	£57k
	Lower 95% income level (£k pa)	£32k	£50k	£50k	£39k	£39k	£48k	£48k
	Probability of meeting £50k income target	80%	100%	100%	65%	62%	46% ¹	53%
	Median death benefits, gross (£k)	£707k	£656k	£706k	£657k	£679k	£713k	£681k
	Lower 95% death benefits, gross (£k)	£284k	£302k	£97k	£392k	£157k	£277k	£9k
Age 85	Average income level (£k pa)	£57k	£55k	£64k	£54k	£68k	£55k	£64k
	Lower 95% income level (£k pa)	£16k	£50k	£50k	£39k	£39k	£48k	£48k

¹ Although this probability is less than 100%, the MetLife Retirement Portfolio product has a 100% chance of an income greater than £48,000.

Even from the limited information in Exhibit 1, we can draw some important points:

- In the 1 in 20 'worst case' outcome, the income level produced by the standard drawdown product falls to £32k at age 75 and to £16k at age 85; very much below Mr Sprightly's target of £50k per annum.
- The various products offer significantly different income and death benefit profiles.
- The characteristics of all the products vary at different points through the retirement lifecycle. Whilst some generate higher income in the short term (eg. Drawdown), some deliver more secure income profiles later in retirement (eg. AEGON, MetLife). Some offer a combination of income growth potential and security (eg. Lincoln).

The variations in income and death benefits shown in Exhibit 1 are the result of differences in the design of the structure of the income and death benefit guarantees. Both the initial guarantee level and the rules determining the income growth during retirement vary significantly across the different products. In this respect, each of the providers has incorporated different design innovations in order to differentiate their own product offering.

These results suggest that in order to make an informed choice as to which product may be most suitable, the advisor should be clear about their customer's specific requirements for income and death benefits.

The sensitivity of the product selection decision to the customer's specific objectives is highlighted in Exhibits 2(a) and 2(b) below. In Exhibit 2(a) we compare the expected (average) level of income and death benefits generated by the different products at age 75; products appearing to the right of Exhibit 2(a) offer higher expected income growth. In Exhibit 2(b) we consider what the income and death benefits would look like for Mr Sprightly in adverse or 'worst case' conditions.

Exhibit 2(a)

Expected Income Level vs. Expected Death Benefit (Age 75)

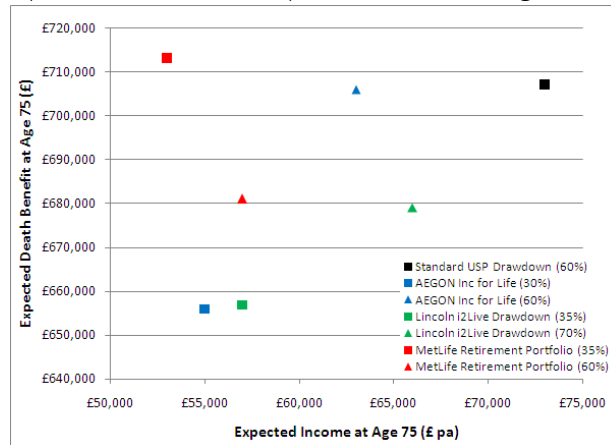
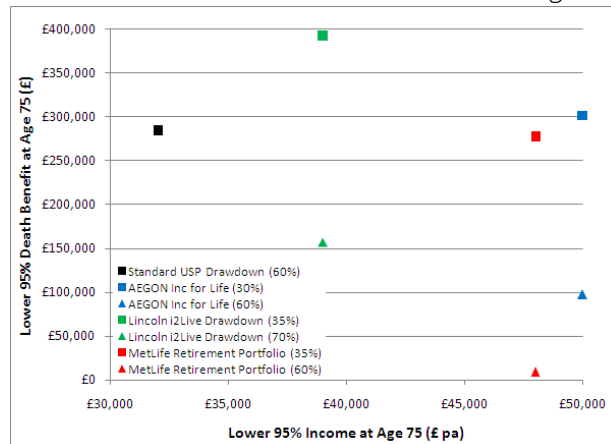


Exhibit 2(b)

Lower 95% Income Level vs. Lower 95% Death Benefit (Age 75)



As we would expect, the products appear in quite different positions on the two charts. Products which offer the greatest potential for income growth, appearing to the right in Exhibit 2(a), tend to offer more limited downside protection in terms of either income or death benefits, appearing to the lower-left of Exhibit 2(b).

In general, the higher equity versions of the different products tend to produce higher expected levels of income growth, and higher expected levels of death benefit. The lower equity versions of the products tend to offer limited income growth potential, but with less variability and potential downside in the level of residual death benefits.

All the Third Way products considered here will meet Mr Sprightly's income target with a reasonable probability. However, if he is to select the most appropriate product, he will need to be clear as to which of his retirement objectives are most important to him:

- If Mr Sprightly is particularly concerned with maximising potential income growth during retirement, subject to an underlying guarantee, then the AEGON and Lincoln products with higher equity allocations have amongst the highest expected income and death benefit levels at age 75. The trade-off is that the lower 95% death benefit values are lower than most of the other products.

- Conversely, if he is most concerned with the risk of falling income levels, then the lower equity allocation versions of the AEGON and MetLife products provide more robust protection in relation to both income and death benefits than most of the other products.
- Finally, if despite his reasonable health, Mr Sprightly's main concern is the level of death benefits available to leave to his children, then the lower equity versions of the Lincoln and MetLife products, which deliver more limited income growth, offer higher expected death benefits and more effective death benefit protection to age 75.

Traditional advice tools such as deterministic product projections or critical yield analysis would not have helped Mr Sprightly or his financial advisor decide which of the products best matched his retirement needs. In fact, these tools would not have differentiated between any of the products we have considered in this report.

So long as Mr Sprightly can prioritise these retirement objectives, his financial advisor can use the outputs presented in this report to identify the most appropriate product.

Summary:

Using an Analytic Framework to Evaluate Retirement Product Options

The various Third Way products in the UK 'at retirement' market appear to be targeted at different customer needs or preferences. A product or strategy which performs well on one risk measure is likely to compare less favourably using another risk measure. Product manufacturers have introduced unique design innovations in order to differentiate their own products. The existing UK market for Third Way products appears to be very much a case of 'horses for courses'. This is likely to continue as new propositions enter the market.

The challenge for the retirement customer is to be clear about his or her own retirement objectives, in terms of future income needs and preference for death benefits. This will enable financial advisors to ensure the correct criteria are used to evaluate different retirement products.

Advisors will need to develop an approach to retirement advice that incorporates the needs of the individual customer into the selection of appropriate products or strategies.

Traditional tools such as deterministic projections or critical yield analyses have not been effective tools for advisors.

The type of information provided by stochastic framework presented in this report will support advisors make informed decisions as to the appropriateness of different retirement products for individual customers.

Applying the Framework to Support the Design of Retirement Portfolios

Retirement customers are faced with an increasingly diverse range of different retirement products: conventional annuities, investment-linked annuities (including with-profit annuities), income drawdown, together with the Third Way products we have considered in this Insight report.

In our next Insight report "Retirement Portfolio Planning: Designing Retirement Solutions to Meet Customer Objectives", we will present evidence to show that retirement customers' objectives are often best served by allocating their retirement savings to more than one type of retirement product. We will show how the same analytic framework that has allowed us to evaluate individual products can also be used to help advisors design retirement portfolios which best meet their customer's retirement objectives.

Contact Us

Head Office

Barrie & Hibbert Ltd
7 Exchange Crescent
Conference Square
Edinburgh
EH3 8RD

Tel: 0131 625 0203
Fax: 0131 625 0215

Please contact info@barrhibb.com

North America Enquiries

Barrie & Hibbert Inc.
40 Wall Street, 28th Floor
New York,
NY 10005

Tel: 646-512-5750
Fax: 646-512-5756

Please contact us@barrhibb.com

EMEA Enquiries

Barrie & Hibbert Ltd
41 Lothbury
London
EC2R 7HG

Tel: 0203 170 6145
Fax: 0131 625 0215

Please contact emea@barrhibb.com

Asia Pacific Enquiries

Barrie & Hibbert Asia Ltd
Level 39, One Exchange Square
8 Connaught Place
Central Hong Kong

Tel: +852-3101 7561
Fax: +852-3101 7530

Please contact asiapac@barrhibb.com

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