

wealth management specialists

Guide to Annuities

Level or Escalating?

You need to weigh up whether you think you will live long enough to benefit from the protection against inflation offered by an increasing annuity. Your income requirements may reduce as you become less active in older life and so a level annuity may work well for you in a low inflation economy, but should inflation dramatically increase you may find the purchasing power of your annuity reducing rapidly. We have developed a special forecasting tool which shows the difference between the income from both level and increasing annuities and calculates how long you would have to live before the increasing option is providing better value.

Level Annuities

A level annuity pays the same income each year for the rest of your life. The main drawback with a level annuity is that what you can buy with the income falls as prices rise through inflation

Level annuities pay a higher starting income compared to increasing annuities. Think carefully about the effect of inflation. Could you really cope with having no increases at all in your annuity income during your retirement, which could last 30-40 years?

Escalating Annuities

To protect your income from rising prices, you can choose an annuity that is designed to increase each year. There are two main choices:

1. Escalating annuities - your income is guaranteed to increase at a fixed rate each year, commonly 3% or 5%.
2. Inflation-linked annuities - your income is adjusted each year to reflect changes in the Retail Prices Index (RPI) - the main measure of inflation used by the government. So, if inflation is 3% one year, then your income goes up 3%. If inflation is 10% next year then your income goes up by 10%. However, your income is not guaranteed to increase each year - if the RPI did not rise, nor would your income.

With an escalating annuity, the starting income is a lot lower than you would get from a level annuity. For example, for a man aged 65, the starting income from a 5% escalating annuity might be two-thirds or less of the amount from a level annuity. It could take more than 10 years for the escalating income to catch up, and nearly 20 years before the total that you would have received from the escalating annuity exceeded the total from a level annuity.

Annuities with a guarantee period

If you die soon after taking out an annuity, it will not have paid out much. To guard against this, you can choose an annuity with a guarantee period.

These sorts of annuity commonly guarantee to pay out at least five or ten years' worth of income, even if you die within this period. On your death, the income may continue to be paid for the rest of the guarantee period, or it may be paid as a lump sum to your estate (and inheritance tax might be due on it)

If anyone is financially dependent on you, do not look on a guarantee period as a substitute for a joint-life last survivor annuity. If you live to the end of the guarantee period, the survivors will get nothing.

Annuities if you have a partner

A single-life annuity pays out only during your own lifetime. A joint-life last survivor annuity pays out until the second person of a couple dies.

On the first death, some annuities carry on paying the same amount to the survivor. With others, the amount is reduced - for example, by a third or a half. You choose at the outset how much income you want the survivor to get.

With some pension schemes, it is the law that you must opt for an annuity that provides a pension for your widow or widower equal to half the income you were getting. Your provider can tell you if this applies to your plan or scheme.

Value Protection - a new benefit should you die before age 75

People are often concerned they may not see the full value from their annuity if they pass away in the early years - value protection means this eventuality is taken care of.

- A lump sum can be paid out in the event of death before age 75 but you are also safe in the knowledge that income will be paid out for life, even if that is longer than you had planned for financially.
- You can choose to protect up to 100% of the value of your pension fund. Adding value protection will reduce your pension income and you need to be sure that you can still meet your needs.

There are only a handful of providers offering this type of plan, so contact us for advice in the first instance.

Investment Linked Annuities

These offer the chance of a higher income in the future, but at the expense of taking extra risk.

These plans link to real assets such as fixed interest and equities, but you need to be comfortable with linking your income in retirement to the volatility of the stockmarket. They are therefore more risky than conventional annuities.

With-Profit Annuities

These link your income directly to the performance of the insurance company's with-profits fund. Typically, your income is made up of two parts:

1. a minimum starting income - this is usually set at a low level but, unless investment conditions are very bad, you will usually get at least this much income. Some with-profits annuities guarantee it.
2. bonuses - The insurance company usually announces bonuses each year. Bonuses can be 'reversionary' (usually announced once a year and guaranteed to pay out for the duration of your annuity) and 'special' - these only pay out a year or so until the next bonus announcement. The amount of any bonus depends on many factors, the most important of which is stockmarket performance. Some insurance companies may guarantee a bonus rate, for example 3% a year. Sometimes you can choose the guaranteed rate, but the higher the guarantee, the lower your starting income.

There are few companies offering with profits annuities now and their popularity has diminished following the introduction of Unsecured Pension.

Unit Linked Annuities

Your income in retirement will be linked directly to the value of an underlying fund of investments. Generally, you can choose the types of fund, for example:

- medium risk managed fund where the fund manager selects a broad range of different shares and other investments - spreading your money widely reduces risk;

- higher risk fund where a fund manager selects shares and other investments in a particular country - Japan, say - or sector, such as smaller companies or technology companies. Because your money is less widely spread, the risk is higher;
- tracker fund (usually medium risk) which tracks the performance of a particular stockmarket index like the FTSE-100 (top 100 UK companies by market value). Usually, these have lower charges than managed funds.

Again, these have diminished in popularity since the introduction of Unsecured Pension

Purchased Life Annuities

You may wish to use your tax-free cash or any other funds that you have built up to purchase this type of annuity. This is similar to a pension fund annuity, (also known as a compulsory purchase annuity), but is taxed more favourably and should therefore provide more income £ for £. Remember though, once you have purchased your annuity you cannot normally convert it back to cash.

Please note, this guide is not intended to make any recommendations whatsoever regarding the individual suitability of any products