Quarterly investment briefing
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First Actuarial LLP

Discussion topic – annuities as an investment

In this quarter's investment briefing Ryan Templeton from our investment team speaks to Rob Skelton (who leads our investment research) and Phil Kelly (from our buy-out team) about annuities as a potential investment.

Ryan: Can you start by explaining why annuities are being discussed in an investment briefing? I thought annuities were what you bought when you wound up a pension scheme.

Phil: Good question! If you buy annuity policies in the names of your members, as you would to wind up a scheme, then the annuity policies become an investment of the members and not the scheme. However, if you bought them in the name of the trustees then they are an investment of the scheme in just the same way as a bond or equity fund. You should get some investment advice if you're thinking of buying them.

Rob: From an investment perspective we treat annuities as a matching asset with similar characteristics to gilts or bonds. They provide a secure income stream that can be used to meet the benefit payments of the scheme. Annuities just tend to do it better than gilts or corporate bonds.

Ryan: You say they do a better job of matching liabilities than bonds. Why?

Phil: Each annuity that a scheme buys will relate to a specific scheme member. Your scheme will pay pension payments to the member and will receive the same amount back from the insurer as regular income. In this way the cashflows are exactly matched. Longevity risk is also removed because the annuity payments will continue for the entire life of the member. The annuity will also cover any benefits payable to the member's spouse after the member dies.

Rob: In contrast, a portfolio of bonds will pay income that broadly matches the payments due to your members. However, the match won't be perfect. For a start, bonds won't keep on paying even if your pensioners live longer than you expect. That's what Phil means by removing longevity risk.

The income from bonds will also tend to be lumpy in nature as bonds typically pay coupons every 6 months. You'd be very lucky to get a portfolio of bonds that met your income requirement exactly each month.

Ryan: What about pensions that have increases in payment. Do annuities allow for that?

Phil: Your scheme can buy annuities which have the same characteristics as the payments to your pensioners. For example, annual inflation-linked increases subject to a floor or cap. However, some types of increases tend to be more keenly priced than others. CPI linked benefits in particular are expensive.

Rob: That's probably because an insurer has trouble hedging the risk of paying CPI linked benefits. RPI inflation is easier to hedge because assets such as inflation linked gilts, that make payments linked to RPI inflation, can be readily purchased. Similarly, caps and floors on pension increases tend to be costly as, the insurer has to purchase complex instruments to hedge its position. The cost of these instruments would be built into the premium.

Ryan: So annuities should do a better job at matching liabilities than bonds, but are they secure?

Rob: The strict requirements under Solvency II for insurers means they must hold large reserves. As a result, for each £100 of annuity policy bought, the insurer must hold more than £100 of assets. In turn, these assets are largely invested in low risk securities such as gilts and corporate bonds. Therefore, annuities are considered to offer similar security to that of gilts or high quality bonds.

Phil: It's also worth bearing in mind that in the unlikely event of a bulk annuity insurer becoming insolvent, the trustees would ordinarily be covered by the Financial Services Compensation Scheme (FSCS). Annuities are classed as long term insurance contracts by the FSCS and the compensation would cover all of the annuity payments. So we consider them to be very secure.

Ryan: What about expected returns?

Rob: Just like a bond, the return you'll get on an annuity is driven by the price you pay for it. So over to Phil on this one.

Phil: Unfortunately, it's not as easy as looking up the price on Google. The only way to be sure of the price is to get actual quotations from the insurers. That requires a lot of work to be carried out by both the trustees (and their advisers) and insurers as the insurers will need to know full details of the scheme's benefits, along with complete membership data, before they can crunch the numbers and come up with a price.

The price will also depend on the level of competition. Generally speaking, larger schemes are more attractive to the insurers and so these schemes will see more attractive pricing. Smaller schemes (particularly sub £20m schemes) may find that only one or two insurers are willing to quote and therefore the pricing in these cases will generally be less attractive.

At the moment we're seeing the keenest pricing value for pensioners where we estimate that annuities are being priced on a discount rate of around gilts plus 0.3% pa.

Rob: I would see that as offering a return of gilts plus 0.3% pa, somewhere between gilts and investment grade corporate bonds.

Ryan: So compared with gilts, annuities offer higher returns, similar security, better matching ***and*** longevity protection? Why don't all pension schemes sell their gilts and corporates and buy annuities?

Phil: There are some barriers, particularly for smaller schemes where the lack of competition can mean that buying a bulk annuity is more difficult. There's also the danger that if annuities are purchased in respect of a large proportion of the members, the remaining membership is too small for an insurer to be interested in the future. This can lead to difficulties if you want to wind up the scheme.

Buying a bulk annuity can also have a negative impact on a company's balance sheet. This is because the value placed on the annuity policy for accounting purposes is often less than what you would have paid for it.

Rob: Adding to that, there is also the attraction of all the other things you could do with a gilt or corporate bond portfolio. For instance, leveraged LDI funds allow some of the attractive qualities of gilts and corporate bonds to be retained (i.e. protection against future high inflation / low interest rates) whilst freeing up capital to invest for long term growth, something many pension schemes desperately need.

Ryan: OK, so do you see much interest in purchasing annuities?

Phil: For the right schemes, particularly those with a high allocation to bonds, a strong funding position and a low return objective (e.g. a gilts plus 1% discount rate) annuities can be appealing. We're seeing particular interest in purchasing annuities in respect of high liability pensioners where pricing is usually more attractive. For such members, the use of medical underwriting can improve pricing further.

Small print

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