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A new way to overcome longevity risk

Until now there have been very few cost effective options to overcome the risk of retirees outliving their savings, annuities have provided one way, but they can be expensive and inflexible. Mercer's new **LifetimePlus** longevity product aims to address these short-comings.

On average Australians can expect more than 20 years in retirement and for many of us that period will be longer. Retirement planning wouldn't be so hard if we knew exactly how long our retirement was going to last, but of course, we don't. Uncontrollable triggers can derail even the best laid plans for many. A lack of longevity defence means many Australians will simply outlive our savings.

According to Mercer's research, nearly 50% of Australians aged 50-80 years are concerned about longevity risk and most don't have a strategy to combat it. Half of the population underestimate their life expectancy by more than two years.

"Our research shows Australian retirees are likely to outlive their savings by more than five years on average and one in four will outlive their savings by 11 years," explains Guy Thorburn, leader of Mercer's retirement business in the Pacific.

"As many as 10% of the population will live even longer and may be forced to rely solely on the age pension for 15 years or more."

Traditionally, there are three ways of protecting against longevity risk:

1. Rely on the Age Pension: Some people have little choice but to use their savings to pay off the mortgage and other debts and then live frugally off the age pension.

2. Self-insure: Others will try to manage the risk themselves, rolling their superannuation balance into an account-based pension and draw an income. Crucially, this approach means that the risk of out-living their savings remains with them and therefore they tend to drawdown their balance cautiously.

3. Hand the risk to a life company: The third option is to hand over the risk of outliving your savings to a life company via an annuity. This type of product gives certainty that there will be a level of income forever, but that certainty comes at a cost.

Figure 1.

The quote

Australian retirees are likely to outlive their savings by more than five years on average.
Guy Thorburn

Now Mercer has come up with a fourth way. Dubbed 'Mercer LifetimePlus', the product creates a 'pool of lives' and pays out an income until death.

Open to members of participating superannuation funds, individual investments are put into a mutual pool, and that money is invested in a mixture of defensive assets, including term deposits, rolling deposits and an absolute return fund.

The product pays out in three different ways: Every three months the member receives his or her investment earnings in interest – the strategy targets cash plus 1%, after fees.

When the member is older than 75 and has been invested for 15 years there's also a capital repayment where 2.5% of what was invested is paid across to the retiree's cash account each year. That amount then provides liquidity to increase income in later years, which means that after 20 years of these payments you will have received half your money back, plus the investment earnings plus the living bonuses.

Finally, the member will then start receiving a 'living bonus', which is paid out of the funds left by members who have died or withdrawn from the product. The share they receive depends on age, gender, how long they've been invested in the product and the amount they invested.

"The living bonus delivers the guts of the longevity protection," Thorburn says.

According to the retirement product expert, the main advantages of Mercer LifetimePlus over a traditional annuity are threefold.

"It's accessible, it's cost-effective and it's transparent," he says.

"It's accessible because it sits within an account based pension, that's unique. You can do it all within the one account based pension.

"It's cost effective because members are sharing the longevity risk amongst themselves, there's no premium being paid across to another entity. That means investors can expect better outcomes through their retirement in terms of what they have to spend.

"And it's completely transparent in that it is an investment option with a clear headline fee of 40 basis points. You can't always see how much annuities are costing you."

With Mercer LifetimePlus, financial planners and their clients have a genuine alternative to other forms of longevity protection currently available on the market.

Mercer anticipates that retirees would allocate around 25% of their account based pension into Mercer LifetimePlus. By way of example, a customer who invests $100,000 from a $400,000 super balance could expect up to $10,000 pa above the age pension after in their older years.

This is consistent with the findings of the Financial System Inquiry, which reported in November 2014 that "managing longevity risk through effective pooling could significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement.

"Faced with the question of how to fund potentially 35 years with no income can be a sobering experience. The message is take control as soon as possible.

"The benefit of LifetimePlus in the end is that by incorporating cost-effective longevity protection, retirees can really make their superannuation balances work a lot harder and get a better standard of living in retirement, which is what we all want," Thorburn syas. **FS**