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News Release

DC members - Ignore inflation at your peril

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According to a recent parliamentary publication[1] 95% of individuals are forgoing inflation protection for their retirement income by opting for fixed rather than inflation-linked annuities. This leaves them open to inflation risk: if there were to be a substantial rise in inflation, the real value of their retirement benefits could be severely eroded.

Mark Humphreys, Head of UK Strategic Solutions, comments:
"The past two decades have seen low and declining inflation in the UK, and many people find it hard to envisage a return to a higher inflation environment like that of the 70s and 80s. However, there are a number of factors – including the high and rising levels of government debt and Quantitative Easing - which could drive a rise in inflation in the medium term. With the vast majority of DC members lacking any inflation protection for their annuity income, the consequences of this could be severe."

Behavioural biases may cause the widespread selection of fixed over inflation-linked annuities by DC members upon retirement. These include the tendency of individuals to prefer present over future consumption and the inclination to place too much weight on the recent past when building expectations for the future.

However, inflation-linked annuities also seem to be expensive relative to fixed annuities. In the modelling undertaken by the Schroders UK Strategic Solutions team, the 'payback period' of inflation-linked annuities exceeded the expected lifespan[2] of our example member unless inflation was between 5 and 6% (significantly higher than market estimates of breakeven inflation of 3.46% over the

[1] From a UK parliamentary publication on Quantitative Easing, November 2012
http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/writev/qe/m05.htm
[2] In England, the remaining life expectancy of a 65-year old man is 18.0 years. ONS (2011), UK Interim Life Tables, 2008-2010.

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same period)[3]. The solution to the problem is therefore not as simple as persuading members to purchase inflation-protected annuities.

Payback period for an inflation-linked annuity under different inflation assumptions

Inflation Assumption	Payback Period	Age at 'payback'
1%	n/a	n/a
2%	39	104
3%	32	97
4%	24	89
5%	**20**	**85**
6%	**16**	**81**
7%	14	79
8%	13	78
9%	11	76
10%	10	75

Based on fixed and inflation-linked annuity rates for a 65 year old* with a pension pot of £100,000
Source: find.co.uk annuity calculator, as at 4th February 2013. *Annuity rates are gender neutral, following the EU Gender Directive ruling, effective from 21st December 2012.

Delaying annuitisation for as long as possible is one alternative. As well as reducing the number of years for which members are fully unprotected from inflation risk, delayed annuitisation also provides benefits in the form of optionality, as pensioners could hold out for favourable annuity rates before making their purchase. However, there is a danger that interest rates could continue to decline and annuity rates to worsen, so optionality may not always produce a positive outcome.

With the abolition of compulsory annuitisation, members may also have the option to avoid annuitisation entirely and to invest instead in an inflation-linked income fund (possibly with some form of principal protection). However, the availability of suitable income funds is limited, and – in any case – strict minimum guaranteed income requirements (currently £20,000 a year) mean that the majority of DC members do not qualify for the flexible drawdowns they would need to follow this route[4].

Many pensioners are therefore left with no alternative but to annuitise at unfavourable rates, usually without adequate inflation protection. The absence of a feasible solution to the problem highlights the need for regulatory change in the DC space (in particular a relaxation of the minimum income

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[3] Based on annuity rates as at 4th February 2013 and 18 year breakeven inflation as at 1st February 2013 (from the Bank of England implied inflation curve)
[4] Individuals not meeting the minimum guaranteed income requirements can only withdraw money from their pension pot within strictly specified annual limits. Because they are unable to move their pension pot into a fund with greater inflation protection, avoiding annuitisation is not necessarily a solution.

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requirement rules) and for the development of new funds with suitable characteristics to provide DC members with a retirement income (i.e. high income, inflation-linked, principal protection).

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