LCP on point

Is there a right time to buy an annuity?

November 2021

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Introduction

Until 2015, people with a Defined Contribution (DC) pension pot had three main options when it came to taking a pension.

Those with the smallest pots could cash them out, whilst those with the largest pots could draw down on them gradually, provided they satisfied certain stringent conditions. But for the vast majority of people there was really only one choice – to take their pension pot, access up to a quarter in the form of a tax-free lump sum, and use the rest of the pot to buy an income for life in the form of an annuity.

According to figures from the Association of British Insurers (ABI), in 2012 over 90% of DC assets which were accessed were used to buy an annuity[1].

Whilst an annuity may be the right answer for some people, annuities were becoming increasingly unpopular with those who were compelled to buy them. There were three main reasons for this:

a. The market for annuities was not working well, with too few people exercising their 'open market option' which allowed them to shop around for a better annuity rate beyond their current pension provider; cost-effective advice on annuities was also in short supply

b. In particular, the take-up of "enhanced" annuities for those in poor health was relatively low, meaning that such individuals often received poor value for money

c. Ultra-low interest rates combined with a steady rise in life expectancies meant that headline annuity rates reached record low levels and were perceived to offer poor value, especially where people were compelled to lock in to prevailing annuity rates for the rest of their life;

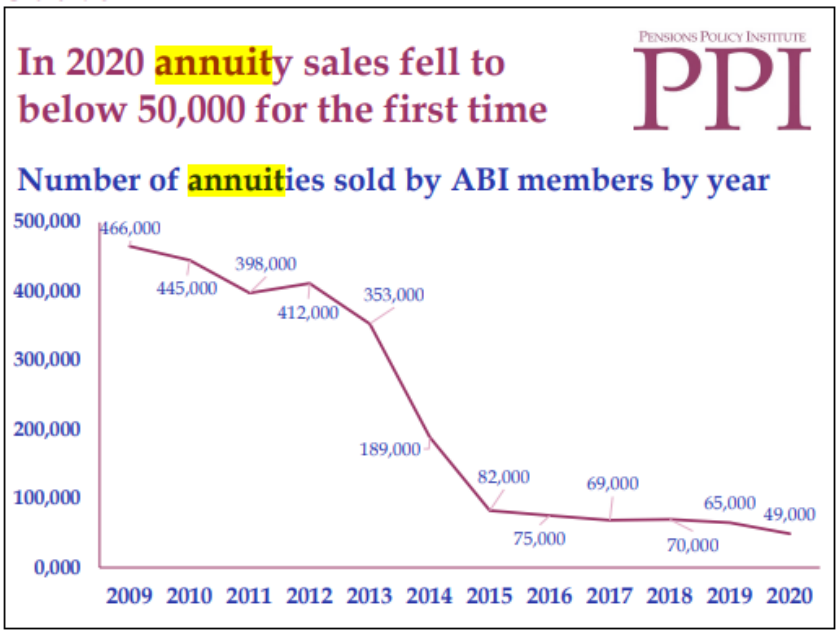
In response to this, in the 2014 Budget the Chancellor, George Osborne, announced that the rules on accessing pensions would be relaxed in a reform known as Pension Freedom and Choice or 'pension freedoms' for short.

In essence, from April 2015 the government made it far easier to access DC funds without buying an annuity. Whilst buying an annuity remained an option, those aged 55 or over could now cash out the whole of their pension pot if they wished to do so, whilst those who wanted to take their money in smaller chunks could access new and more flexible forms of pension drawdown.

The behavioural change which followed demonstrates just how unpopular annuities had become. The rule change presaged a dramatic collapse in annuity sales as shown in the following chart from the Pension Policy Institute's 'DC Future' report, published in 2021. The decline was especially sharp among smaller annuities now that individuals could cash out their pension pot in full if they wished.

[1] See: 'The DC Future Book', Pensions Policy Institute, 2021. The DC Future Book | Pensions Policy Institute

Chart 1. Annuity sales 2009-2020



Even before the introduction of 'pension freedoms', the popularity of annuities had already been in decline, with demand dropping by around one quarter between 2009 and 2013. But from the year before the Budget announcement to the year after, three quarters of the market was wiped out, and volumes have continued to drift down since then.

Annuities have not suddenly become 'bad' products. Having the certainty of an income for life, with the option of protection against inflation and a payment for a surviving spouse, is in many ways an attractive way of using pension savings. But the product was clearly very unattractive to those in their late 50s or early 60s who obviously valued the greater flexibility now on offer.

The question which this paper seeks to address is whether the attractiveness of an annuity changes as you go through retirement.

In simple terms, a product which might not look good value to someone coming up to retirement could look very different to someone ten or twenty years into retirement. And, because pension freedoms are relatively new, we simply don't know yet whether those who have enjoyed the freedoms since 2015 who were in their late 50s and early 60s will still feel the same way about these flexibilities in their 70s and 80s.

As we discuss in this paper, one reason for thinking that attitudes to annuities might change through retirement arises from the fact that mortality risk increases as an investor gets older. This means that the relative uncertainty of how long you may actually live *increases* as you get older.

This is a crucial concept and we will explain how life expectancy uncertainty increases as we get older below. However, if we accept that it does for now, this means that managing a drawdown pot to make sure that you don't run out of money (on the one hand) or end up living excessively frugally to avoid the risk of running out (on the other hand) becomes steadily more difficult as you get older.

The paper is structured as follows:

- First, we explore how life expectancy uncertainty increases as we get older and (hence) why purchasing an annuity to remove mortality risk might start to represent better value for money as you get older;
- Second, we set out the basics of our approach to modelling the retirement process to assess at what point during retirement (if at all) buying an annuity could be expected to produce better outcomes for an individual;
- Third, we present a 'base case' result using a set of assumptions about people's attitudes, about how much money they want to take out using drawdown, how they invest their drawdown pot and so forth; we find that, based on these assumptions, there might be a 'crossover' age at which the individual would do better to switch to buying an annuity rather than staying with drawdown;
- Fourth, we test how robust our finding is by varying the assumptions we have made and looking at alternative strategies such as partial annuitisation at retirement followed by full annuitisation later in life.

In the light of this analysis we then offer some thoughts on potential policy implications.

We would stress at the outset that we see this paper very much as the start of a conversation rather than a definitive 'final answer'. We would welcome feedback on our methods and assumptions and ideas for refining the approach we have taken.

1

01 *Why might an annuity look like better value as you get older?*

As shown in Chart 1 above, sales of annuities have been reducing for many years, but the real slump in sales happened when those who had not yet retired and annuitised were given the freedom to access their pension pot in a different way using income drawdown.

By definition, the majority of these people who are now opting for income drawdown rather than an annuity purchase would be in their late fifties or in their sixties, as we can expect that most people older than this would have already retired and been compelled to purchase an annuity before the rules changed.

All this tells us is that annuities are currently not a popular option for those at, or around, retirement age. What we do not yet know is whether those same people who have opted for income drawdown now will take a different view as they get older and are still managing a pension pot into their 70s, 80s and beyond and where an annuity purchase may become a relatively more attractive option in later life.

In fact, there is good reason to think that moving away from income drawdown and purchasing an annuity might become more attractive as you get older. This relates to the fact that the relative uncertainty of how long you may live increases as you get older.

The following charts illustrate this point.

Chart 2 shows, for a man aged 60 and a man aged 80, the chance of living to certain ages, expressed as a proportion of their average life expectancy. By definition, 50% of people live to the average (median) age, but the distribution of outcomes away from the average is quite different for the 60 year-old compared to the 80 year-old, especially when it comes to living longer than expected. For example, as shown in Chart 2, the 60 year-old man has almost no chance of living double the average, whereas the 80 year-old man has to consider this a realistic possibility. A similar pattern applies to women as shown in Chart 3.

Chart 2. Probability of living longer or shorter than average – man aged a) 60 and b) 80

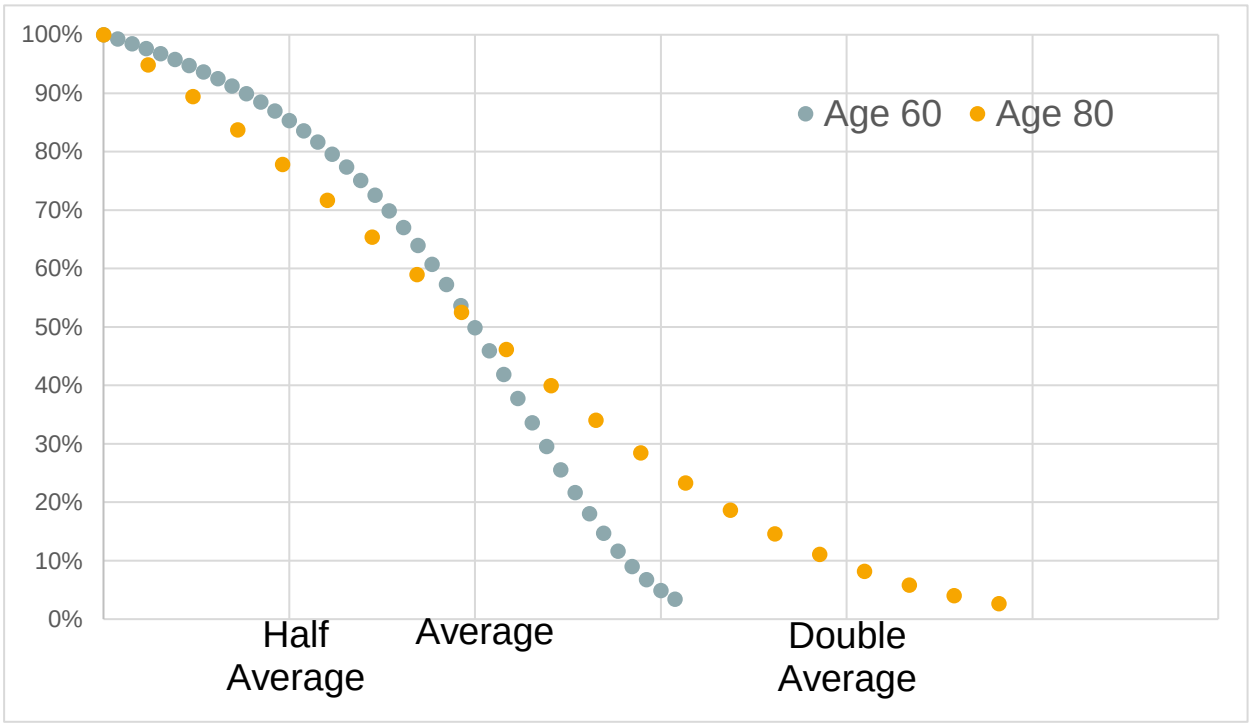
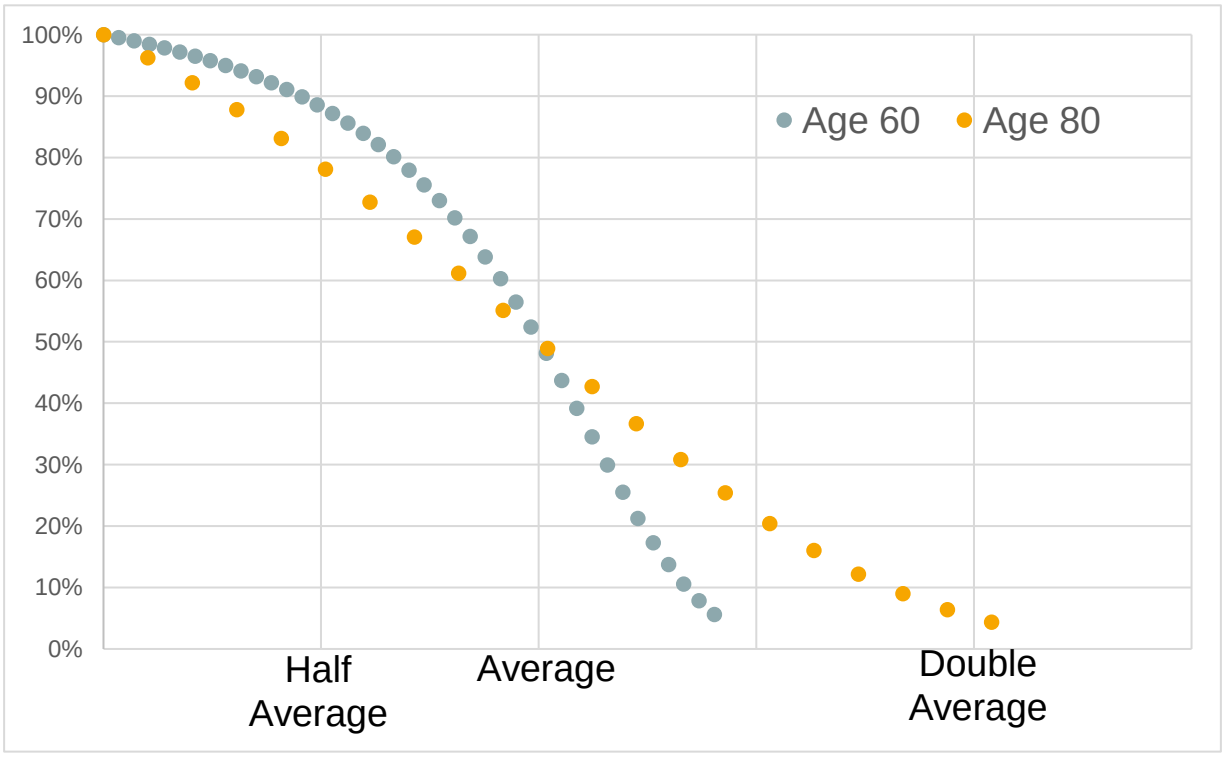


Chart 3. Probability of living longer or shorter than average – woman aged a) 60 and b) 80



Source: Authors' calculations based on ONS data for period life expectancies

The Box shows a numerical example of this phenomenon.

Living longer than expected – why the risk grows as you get older

Consider the case of a man currently aged 60. On average he will live a further 26 years, to age 86. What are the chances of him living *double* the expected period? To do this he would have to live to the age of 112, and, as shown in Chart 2, this means the answer is 'virtually nil'.

Now consider a man aged 80. On average he can expect to live nearly nine more years, to just under 89. What are his chances of living *double* the expected period? To achieve this milestone he would need to celebrate his 98th birthday. Whilst this is unusual, ONS data suggests there is roughly a 6% chance of him living to this age.

In short, even if you have a good idea how long you might live on average, the chance of your individual outcome being significantly different from that rises as you get older.

Applying this approach to the challenge of managing a pot of money, it becomes clear why things get more difficult as you get older. Leaving aside any desire to leave a bequest, in an ideal world you would presumably want to spend your money at a steady rate so that you spend the final pound on the day you die. If you spend more slowly than this then you might have an unnecessarily frugal retirement. If you spend more quickly than this then you could run out of money prematurely.

However, as we have now seen, as you get older, the risk increases that your individual outcome will differ significantly from the average. In particular, as you get older you become much more likely to live 150% or 200% longer than expected. If you are worried about this risk you might decide to draw on your pot more slowly to protect against this risk. But this means a lower standard of living, and if you end up living the average amount of time you will end up with an unspent balance.

Buying an annuity, which is guaranteed to last as long as you live, removes this longevity risk. **And, given that the relative uncertainty around how long you will live rises with age, the attractiveness of an annuity will also rise with age.**

In the next section we describe a model which will try to assess whether this increasing attractiveness is enough to encourage some people to switch into an annuity later in retirement.

02 Our model[2]

In order to assess the 'optimal' strategy for an individual we need to know what they are trying to achieve. An economist would talk about 'maximising their utility', which is another way of saying we need to know what will make them happiest.

Our model assumes that there are three things that people value with regard to their retirement finances:

- 'Upside' – we assume that people will be happier if their annual income in retirement goes up rather than goes down;
- 'Avoiding downside' – we assume that people will be very unhappy if their annual income falls in retirement;
- 'Bequests' – we assume that people may attach some value to having an unspent balance when they die which can be left as an inheritance to their heirs.

None of these three statements is particularly controversial, but the challenge is in deciding *how* important each of these considerations is to the saver with a pension pot who is planning for retirement.

For example, you could use all of your pot to buy an annuity at retirement. On the plus side, this would remove all 'downside' risk. But on the minus side it would probably also mean that there was nothing left for your heirs after you died. Whether or not an annuity was a good idea in this context might depend on the *relative* importance you attach to these different goals.

For the purposes of our analysis we assign a relative 'score' to these three objectives – achieving an upside through higher income, avoiding a downside of falling income and leaving a bequest.

Whilst there is no 'right answer' to the relative importance of these three factors, academic research, based in part on experiments where people are asked to express their preferences between different options, suggest the following would be a good starting point:

- Individuals are more unhappy when they lose one pound than they are happy when they gain a pound; this phenomenon is known as 'loss aversion', and there is plenty of academic evidence that people's preferences are not symmetrical when it comes to gains and losses – in short, losses really hurt;
- Individuals place more weight on money now than on a potential bequest to their heirs of equivalent value; in part this may be because they won't be around to see their heirs enjoy their inheritance but also because of 'discounting' – money now means pleasure now,

[2] In this chapter we describe our model in non-technical language as far as possible. A more formal and technical explanation of how the model works is available on request.

whereas the prospect of leaving a bequest is to some extent a deferred and uncertain satisfaction some time in the future;

For the purposes of our model, we will benchmark alternative retirement strategies against the guaranteed annuity income that an investor could purchase at retirement and use this as a key reference point.

To keep things simple, £100 of actual or notional annuity income is assumed to give £100 of utility in our computer model of retirement.

However, using income drawdown (rather than buying an annuity) usually offers investors the opportunity to withdraw an amount greater than the guaranteed annuity over time and each £100 of extra income from drawdown (***above*** a comparable guaranteed annuity income) is assumed to give us £50 worth of additional utility[3].

Conversely, using income drawdown also runs the risk of running out of money due to poor investment performance or due to living beyond your average life expectancy (or a combination of these two factors) and so we assume that each £100 of "lost income" from drawdown (ie income from drawdown that is ***below*** a comparable guaranteed annuity income) – will reduce our utility by £200.

Finally, on death we have assumed that each £100 we leave as a bequest gives us a utility of £10.

How this works in practice, can be explained by a simplified example:

Consider scenario 1 with pensioner A who retires at age 60 with a pot of £100,000 and who purchases a single life, non-increasing annuity of £4,000 and then goes on to live for 25 years whereupon they die at the age of 85. The total income received from the annuity is £100,000 and each £100 of guaranteed annuity income gives us a utility of £100 so our total utility for pensioner A under scenario 1 is £100,000. Another way of putting this is that we get £100,000 worth of happiness in retirement thanks to the annuity purchase.

Now consider the same scenario 1 but with pensioner B who has the same age 60, the same pot of £100,000 and who also lives for 25 years but using income drawdown. We assume that they enjoy an income of £5,000 per year and thanks to good investment returns they also leave a pot of £50,000 to their heirs as an inheritance. We can calculate the utility of pensioner B under scenario 1 as follows:

[3] Economists refer to this as 'diminishing marginal utility' – each extra pound gives less additional satisfaction than the pound before.

Pensioner B, scenario 1	Actual amount	Utility amount
The annuity that could have been purchased at retirement (but was not)	£4,000 per year for 25 years = £100,000	£100,000
Extra income actually achieved thanks to income drawdown	£1,000 per year for 25 years = £25,000 in total	£12,500 (each £100 of extra income gives us £50 worth of additional utility)
Bequest upon death	£50,000	£5,000 (each £100 we leave as a bequest gives us a utility of £10)
TOTAL for Pensioner B		£117,500 total utility

So, our total utility for pensioner B under scenario 1 is £117,500 which means that pensioner B had £117,500 worth of happiness in retirement thanks to the income drawdown strategy. The combination of additional income plus leaving a bequest meant that Pensioner B is around 18% happier than Pensioner A.

We can repeat this process of calculating the utility for pensioner A and pensioner B many thousands of times for a wide range of scenarios with a range of different investment returns over time and also allowing for the uncertainty of how long the pensioner lives.

For example, consider scenario 2 where our Pensioner B is not so lucky and suffers poor investment returns. We again assume a retirement age of 60, and a starting retirement pot the same at £100,000. For the purposes of this example we also again assume that the pensioner lives for 25 years under scenario 2. Under scenario 2, pensioner A will have the same utility as scenario 1 because they will buy the same annuity at retirement.

Let us also assume that under Scenario 2 using income drawdown our Pensioner B will enjoy an income of £5,000 for 20 years and then run out of money due to poor investment returns and so have no income (from this source) for the last 5 years and no cash to leave as a bequest on death. We can calculate the utility of pensioner B under scenario 2 as follows:

Pensioner B, scenario 2	Actual amount	Utility amount
The annuity that could have been purchased at retirement (but was not)	£4,000 per year for ***20*** years = £80,000	£80,000
Extra income actually achieved thanks to income drawdown	£1,000 per year for ***20*** years = £20,000	£10,000 (each £100 of extra income gives us £50 worth of additional utility)
Lost income for final 5 years	£4,000 per year for 5 years being the annuity we could have purchased =£20,000 in total	*Minus £40,000* (each £100 of lost income will reduce our utility by £200)
No cash for a bequest		*Nil*
TOTAL for Pensioner C		£50,000 total utility

So, our total utility for pensioner B is £50,000 which means that pensioner B had only £50,000 worth of happiness in retirement thanks to the failed income drawdown strategy. In other words, the 5 year period of having no income meant that Pensioner B is only half as happy over their retirement as Pensioner A.

This method of calculating the "utility" associated with a range of different outcomes allows us to quantify and compare many thousands of scenarios.

The actual units for utility are not important, but it is the relative size of these three numbers (+50/-200/+10) which helps to quantify and summarise the values and preferences of the individual. We experiment later in the paper with different weights for these different factors.

In all our scenarios in the rest of the paper we consider an individual who:

- Is aged 60, five years above the first point at which individuals can currently start to draw on their pension
- Has a Defined Contribution pension pot which they can either use to buy an annuity or can put in a 'drawdown' account where it is invested and from which they draw a regular sum.

We then attempt to compare their happiness using the utility numbers under two scenarios:

a) Baseline for comparison – annuity purchase at 60

If they buy an annuity, we assume that they would buy one without inflation protection (which is in line with the decision made by most annuity purchasers). For a 60 year-old, we assume an annuity rate of 3.87%, so a £100,000 pot will generate £3,870 per year of income in retirement[4].

[4] We understand that achieved annuity rates at age 60 are currently slightly over 4%. However, there is likely to be some 'selection bias' in the market with those most likely to benefit from an annuity being more likely to take one out. By contrast, our assumed average annuity rate is averaged across the whole population.

b) Alternative strategy – income drawdown

We assume that the reason someone goes into drawdown is to make their money work harder, generate more investment returns and enjoy a higher standard of living than they could get if they buy an annuity. We therefore assume for our base case:

- The individual will take regular withdrawals at 130% of the annuity they could have bought; on a £100,000 pot this would imply an income of £5,028 per year for a 60 year old;
- That they invest in a mix of higher risk assets (mostly equities) and lower risk assets (mostly bonds); in the base case we assume a 55% equities / 45% bonds split, but we will also test higher levels of equity investment.
- We assume:
  - A long-term return of 1.2% per year on bonds;
  - Long-term inflation at 3.3%
  - For drawdown, a total expense ratio on the drawdown product at 0.9% per annum including all administration, platform, custody and investment management fees.

Whether the annuity strategy or the drawdown strategy will make the individual happier will depend on a range of factors, and in particular on how the drawdown investments perform and also on how long they live.

We therefore test our results against a wide range of around 2000 potential scenarios to assess both the average outcome and the range of potential outcomes.

Having set up our model we then calculate for an individual aged 60 how their expected happiness in drawdown compares with their happiness from buying an annuity. A figure of more than 100% means they are happier in drawdown and under 100% means they are happier with an annuity.

Having established a relative percentage happiness score at age 60, we then repeat the analysis for the same individual at age 61, age 62 and so forth. Each time we express their happiness in drawdown as a percentage of their happiness with an annuity. If the figure is always over 100% then they should stay in drawdown throughout. But if there is a 'crossover' point when the figure goes under 100%, we expect they will be happier if they switch into an annuity.

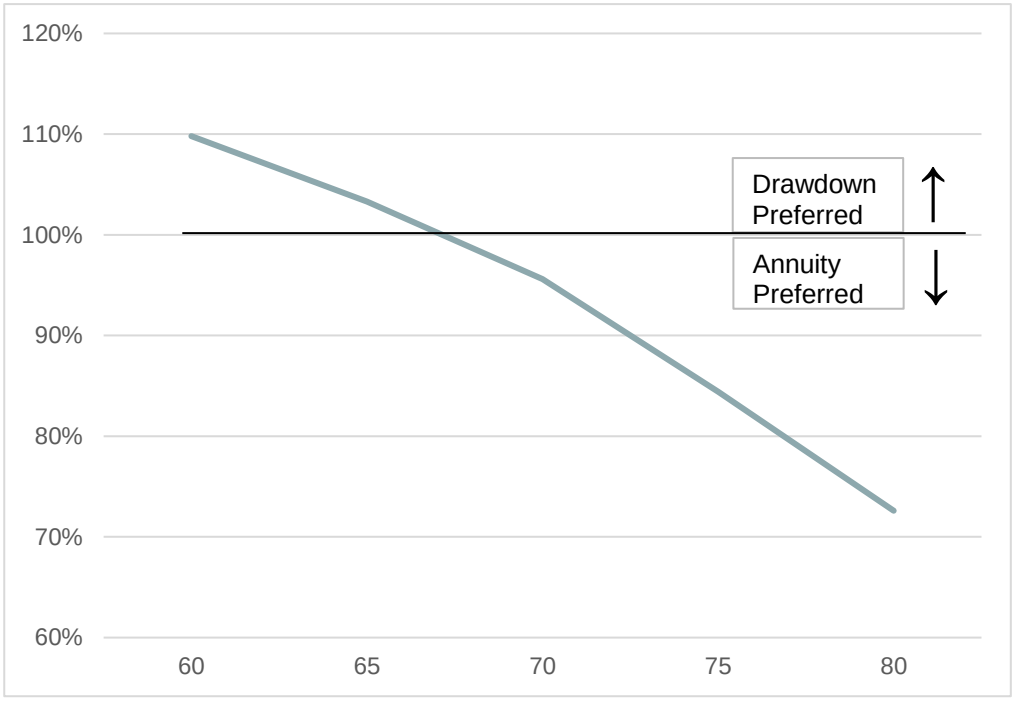
In the next section we present the results from a 'base run' of this model.

03 The model in action – our base scenario

As described above, the purpose of our model is to compare the happiness someone would be expected to get by going into drawdown with the happiness they would get by buying an annuity. A score of over 100% means they do better in drawdown, and a score of under 100% means they would be happier buying an annuity. We compare happiness at age 60, then again at age 61, then again at age 62 and so on, so that we can check whether the balance between the two options shifts through retirement.

Chart 4 shows the results of our analysis for the same individual at age 60, 65, 70, 75 and 80, comparing the happiness from being in drawdown against the happiness from buying an annuity[5].

Chart 4. Base scenario – Relative attractiveness of drawdown over annuity



[5] We stop our analysis at age 80 because of the general lack of availability of annuities for those above this age.

Two very important points emerge from this analysis:

- At age sixty, this individual can expect to be happier in drawdown than by buying an annuity. Interestingly, aside from those who cash out smaller pots, this has been the most popular choice for most people at or around retirement since the introduction of 'pension freedoms';
- As the investor gets older, the relative attraction of drawdown decreases. This is primarily because relative life expectancy becomes more uncertain as you get older, and this increases the attractiveness of an annuity. Crucially, at some point during retirement – in this case around age 67 – there is a crossover point where the individual would expect to be happier if they switched to an annuity.

Naturally, a result of this sort is likely to be sensitive to the assumptions made and it is important to test how far different assumptions would change the result.

In the sections which follow, we therefore test the sensitivity of this result to:

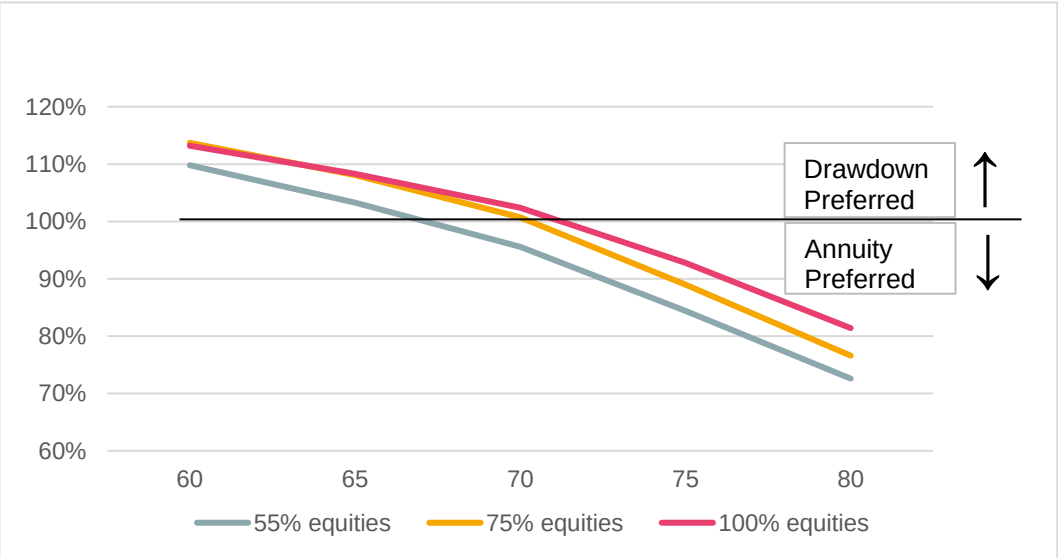
- The level of investment risk taken in the drawdown product;
- How rapidly you want to take an income from your drawdown pot
- Whether the annuity bought is flat or inflation-linked
- How much you worry about 'downside risk'
- How much you prize leaving an inheritance

Finally, we examine a fundamentally different strategy, where the individual part-annuitises immediately and invests the balance in a drawdown account.

a) Variation 1 – Taking more risk in drawdown

In our base model we assume that the saver going into drawdown will invest 55% of their fund in equities and 45% in bonds. But if they are going into drawdown in order to 'make their money work harder', then this could be regarded as a relatively cautious strategy. We therefore first test whether our conclusion about switching to drawdown at around age 67 is affected if the saver takes more risk. Specifically, we test the results if they invest 75% in equities and separately if they invest 100% in equities. The results are shown in Chart 5.

Chart 5. Variation 1 – Relative attractiveness of drawdown with a) 55% equity share, b) 75% equity share and c) 100% equity share



As with our base case, the relative attractiveness of drawdown declines over time relative to purchasing an annuity, but the 'crossover' point where switching to an annuity might be more attractive varies considerably according to the level of investment risk being taken in the drawdown product.

Interestingly, our model predicts that increasing your allocation to equities also increases your average utility rate. This could be due to a combination of factors:

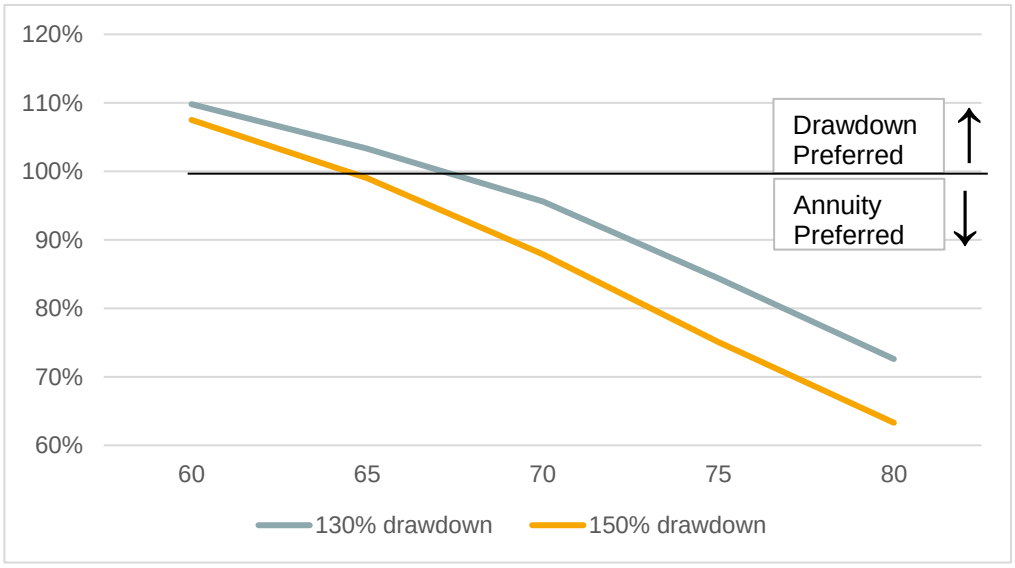
- low expectations for interest rates may make bonds unattractive
- the very long time horizons in retirement make equity risk more appropriate with a 60 year old expected to live nearly 30 years on average
- the fact that equity risk could be acting as a "hedge" against the risk of living to a very old age.

In the 100% equity portfolio, the 'crossover' point for switching to an annuity is in the early 70s rather than late 60s where the drawdown product is only 55% invested in equities.

b) Variation 2. More aggressive rates of drawdown

In our base case we have assumed that the individual is aiming for a higher regular income than they could get from an annuity and that they choose to take 130% of the amount from their drawdown pot that they could get if they had bought an annuity. However, there is no particular reason to think that 130% is the optimal approach so we next test how our results would look if the individual drew down at a more 'aggressive' rate of 150% of the annuity income they could have had instead. The results are shown in Chart 6.

Chart 6. Variation 2 – the impact of faster rates of drawdown

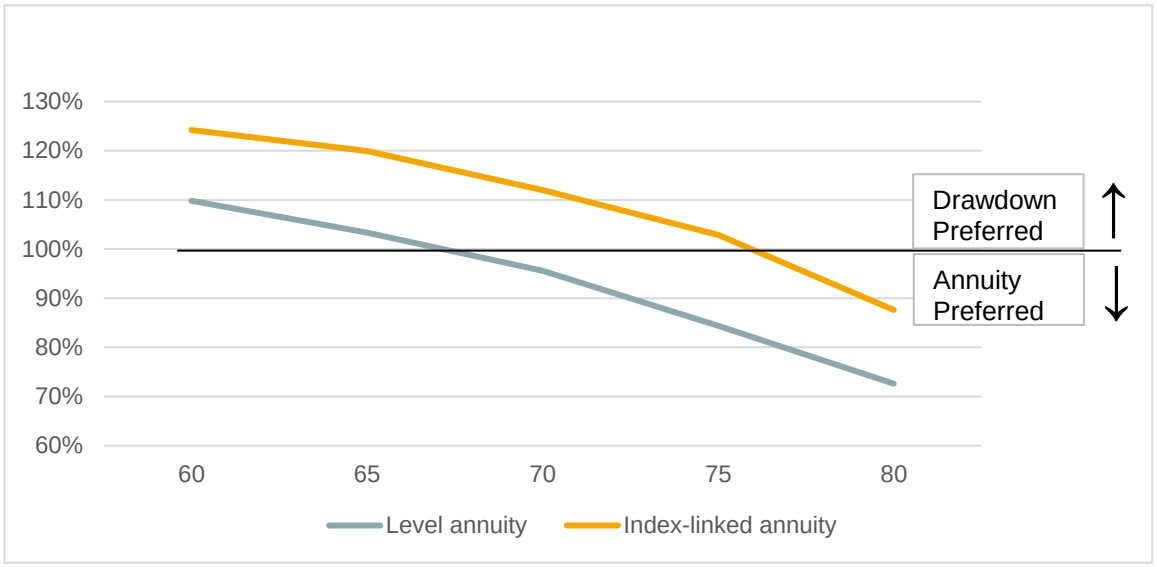


As shown in Chart 6, at all ages the individual is likely to be less happy if they choose to take money out of their drawdown account at 150% of the equivalent annuity rather than 130%. The chart also shows that the 'crossover' point at which switching to an annuity looks more attractive comes earlier in this version. The saver can only keep going at this relatively rapid rate of drawdown for around five years before it makes sense to swich to an annuity. But we estimate that they would be happier overall if they took money out more slowly and switched to an annuity slightly later.

c) Variation 3. – how does drawdown compare with an index-linked annuity?

So far we have compared going into drawdown with buying a level annuity – one which does not change even as prices rise. But index-linked annuities are available and so we test in this section whether buying an index-linked annuity looks more or less favourable against drawdown than buying a level annuity.

Chart 6. Variation 3 – benchmarking against an index-linked annuity v benchmarking against a level annuity

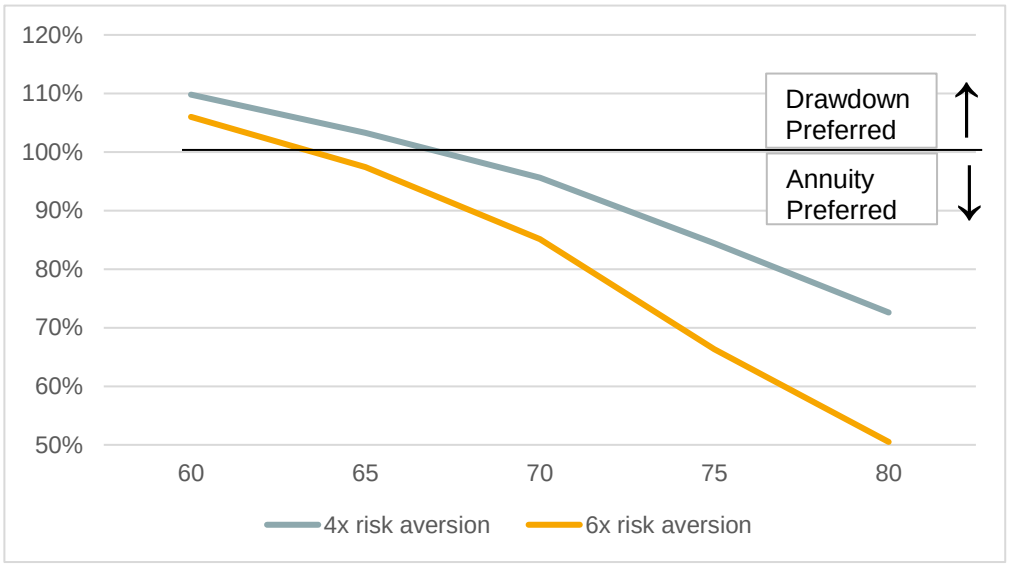


As Chart 6 shows, there is a big difference in how attractive drawdown looks depending on whether it is compared with a level annuity or an index-linked annuity. According to our model, drawdown looks *much* more attractive when benchmarked against an index-linked annuity, and the individual should probably only think about switching to such an annuity beyond the age of 75 if an index-linked annuity is the alternative. At all ages, the level annuity gives drawdown more of a run for its money than an index-linked annuity. This tends to suggest that index-linked annuities are likely to be relatively poor value for money for an individual with the sorts of preferences we have assumed.

a. Variation 4 – What if you care a lot about 'downside risk'?

In our base model, we assume that losing one pound reduces your happiness by four times as much as gaining a pound would increase it (an extra £100 gives £50 of utility but a loss of £100 gives a £200 loss in utility). But there may be some people who feel more strongly than this and (for example) would be six times as unhappy to lose a pound as they would be happy to gain a pound. So we next test how far this stronger 'risk aversion' affects our results.

Chart 7. Variation 4 – Impact of greater risk aversion



For people who are very 'risk averse', being in drawdown at any age is less attractive than for people who are only mildly concerned about the risk of their investments going down in value. For the more risk averse population (the red line in the chart), spending any time in drawdown is of limited value, providing an uplift of just 6% in our happiness score compared with buying an annuity at once, but by age 65 this score has already turned negative compared with an annuity. If someone who has a strong aversion to loss stays nevertheless stays in drawdown for some reason (perhaps because nothing prompts them to reconsider their options) we find that by age 80 they are going to be only half as happy staying as they are compared with switching to an annuity.

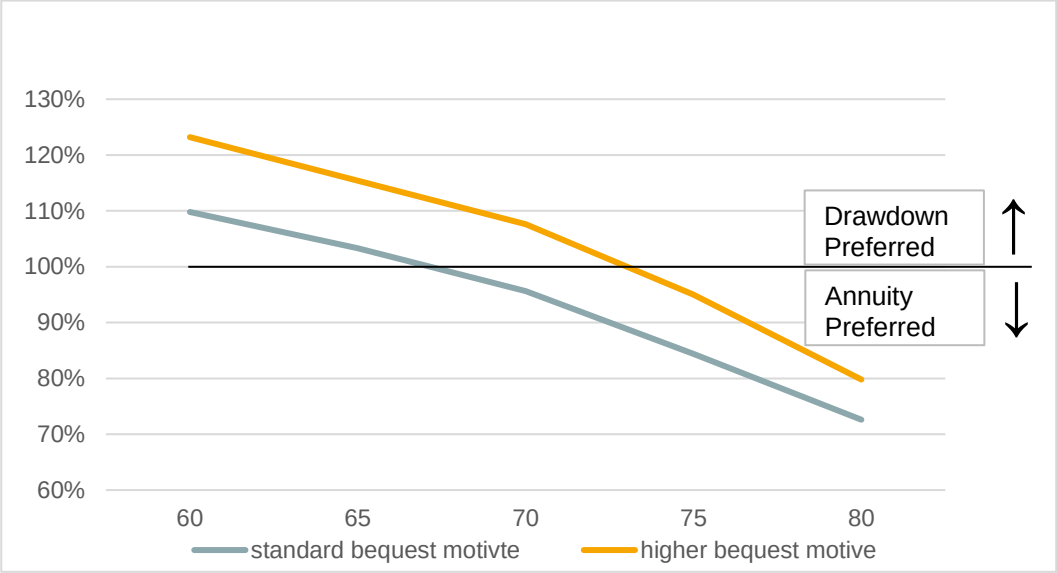
d) Variation 5 – What if you care more about leaving a bequest?

In our base case, having an extra £100 of income for yourself is benchmarked as being worth £50 in drawdown. However, £100 left as an inheritance is valued at just £10.

Whilst most people attach a lot of value to money today, there is such a thing as a 'bequest motive' and some people will attach more value than others to increasing the chance of having money left when they die.

To test how this attitude would affect our results we compare our base model with one in which the satisfaction from having an extra £100 left as an inheritance is scored at £25, rather than scored at £10 in the base case. Chart 8 shows the results.

Chart 8. Variation 5 – what if you value bequests more highly?



In this chart, moving to a world where people place 2.5x the weight on having money left as in our base case (a 'higher' bequest motive) has a significant impact on the relative attractiveness of drawdown over annuity. As the chart shows, for those who are especially keen to have money to pass on, locking into an annuity early on in retirement looks particularly unattractive, as might be expected. But perhaps more surprisingly, there is still a crossover point where annuities start to look more appealing. In our base case the crossover is at age 67, but even those who care more about bequests might still be more happy overall if they consider switching to an annuity in their early 70s. Although they give up on having funds left to bequeath if they switch to an annuity[6] this is more than offset by the extra security they get from knowing that their income will last as long as they do.

[6] For now, we are looking at an annuity with no 'guarantee'. Modern annuities are more likely to come with some form of guaranteed payout and this may alter the balance for those with a strong bequest motive.

04 *A 'hybrid' approach to the use of annuities in retirement*

So far, we have assumed that an individual will put all of their pension pot into drawdown at the start of their retirement but might switch all of it into an annuity at some point later in retirement.

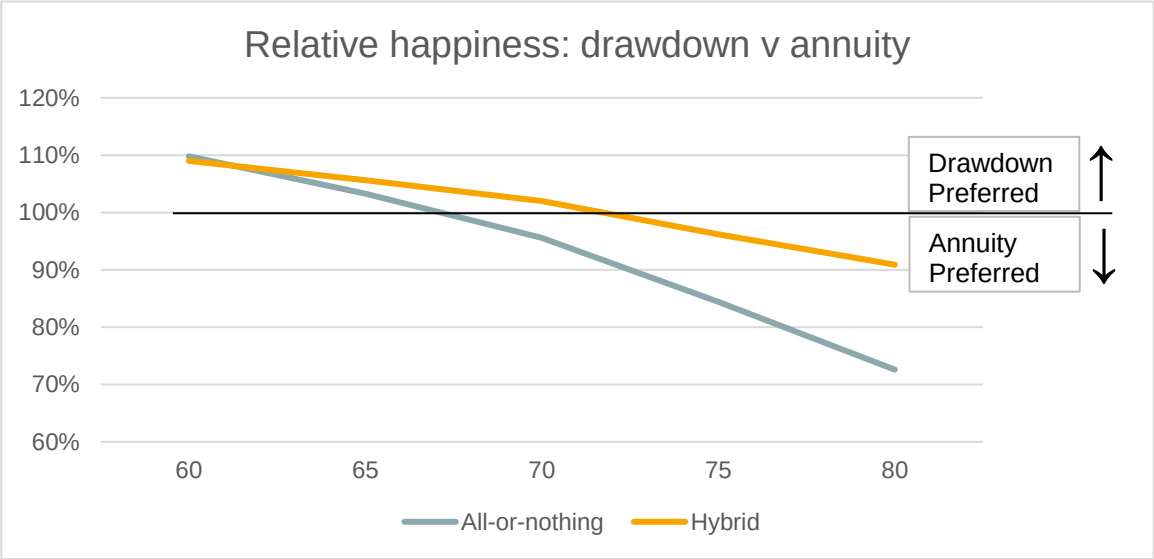
This is obviously a rather extreme assumption and in this section we look at a different approach to managing your money in retirement.

In our base case, the saver puts all of their money into drawdown but 45% of the funds are invested in the relatively low-risk, low-return form of bonds. There is an argument that the saver might as well take all the low-return part of this portfolio and use it to buy an annuity which secures a guaranteed core income for life, and then invest the balance wholly in equities[7]. They should then review the situation through their retirement and potentially switch the balance of their funds into an annuity at a later stage if this would maximise their happiness.

To compare the two approaches, we have tested of a 'hybrid' approach (partially annuitising at retirement) with the all-or-nothing core model presented earlier.

The results are shown in Chart 8.

Chart 8. How does a 'hybrid' strategy fare compared with the all-or-nothing approach?



[7] See for example this article by Adrian Boulding: Go against the pack and consider an annuity (dthomas.co.uk)

The blue line in the chart is our usual base case, where the saver is 100% in drawdown at retirement and finds by around age 67 that they would be happier if they switched 100% into an annuity at this point. The red line assumes that 45% is immediately invested in an annuity with the balance in drawdown, wholly invested in equities. Two key findings are:

- Compared with just buying an annuity at retirement, the 'hybrid' approach produces much higher levels of happiness, especially at older ages, than starting wholly in drawdown;
- Even for those who partially annuitise at retirement, there is still a point during retirement where it may make sense to annuitise the rest; in this case, the cross over point is in the early 70s rather than late 60s.

05 Discussion and policy implications

When pension freedoms were originally implemented, the focus was very much on giving people at or around retirement more choice over what they did with their Defined Contribution pension pot. Savers responded in large numbers by moving away from buying an annuity at retirement and instead either cashing out (particularly for small pots) or by moving into drawdown.

This is obviously a rather extreme assumption and in this section we look at a different approach to managing your money in retirement.

However, for the reasons shown in Section 1, an annuity which might appear to be relatively poor value at retirement age could look much more attractive in later retirement. Indeed, a key finding of our research is that in a world of 'loss aversion', across a very wide range of assumptions, there is almost always a 'crossover point' during retirement at which moving out of drawdown into an annuity may be the optimal strategy.

What we do not yet know (because pension freedoms have only been in operation for a few years) is whether those who have so far chosen to go into drawdown will stay in drawdown through their lives – and potentially suffer 'reduced happiness' as a result – or whether they will switch to an annuity later in life.

There are some reasons to think that people might be more willing to consider an annuity later in retirement:

- The saver's willingness – and ability – to spend time managing their drawdown pot and monitoring investment performance may decline over time;
- The attractiveness of an annuity may become more apparent as the individual is faced with managing a pot which may need to last anything from a few years to more than a decade;

On the other hand, there may be reasons why individuals might *not* switch, even if our modelling suggests that they could be happier by doing so:

- Inertia is a powerful force in retirement just as it is in workplace pensions; having set up a drawdown account and got used to dealing with it, it may feel easier to stay with the familiar;
- Annuities may still be perceived to be poor value, and options may be limited for those who want to buy an annuity in later retirement.

All of this raises the question as to the process by which an individual may be prompted to review what they are doing with their money in retirement. Whereas the government has established 'PensionWise' to provide guidance to those at retirement, there is no equivalent 'nudge' for older retirees to review their strategy.

If it is felt that savers are at risk of seriously suboptimal outcomes because of the lack of review, options could include:

- Mandatory annuitisation at a certain age such as 75; given that most of our charts suggest that most people would be happier if they switched at this point (or earlier), this could have its advantages; but in a world of 'pension freedoms' introducing some form of default annuitisation later in retirement would certainly be controversial;

- A softer version of the above suggestion, would be where products are developed which start out in drawdown but are designed to switch to an annuity automatically at a later stage, with the exact age depending on the saver's preferences; the switch to an annuity would happen 'by default' without further action by the saver, but they would retain the right to change their mind before that date;

- Instituting a 'mid-retirement' review[8], along the lines of the 'mid-life MOT' which is currently being trialled; drawdown providers could, for example, be required to nudge savers at some point during retirement towards reconsidering whether they are in the right product; such nudges would need to be carefully designed to overcome the risk of inertia, but if a 'mid-retirement' review became an established social norm there is more chance of it prompting a retiree to consider if they need to change their investments.

One of our most powerful findings is that even though drawdown (or part-drawdown, part-annuity) will almost always produce better outcomes for those early in retirement, there is consistently a crossover point at which a switch to an annuity may be preferable. This finding seems to be robust to a wide range of alternative assumptions about investment strategy in drawdown, rate of drawdown withdrawal or even attitudes to bequests. If this is the case then the search must now be on for ways to make sure individuals give serious consideration to the option of an annuity not just (and not mainly) at retirement, but throughout their retirement. This is work which seems barely to have begun and must involve a concerted effort by government, regulators, product providers and advisers. Without it, Pension Freedoms will remain unfinished business.

[8] We are grateful to Sarah Lueshi of the Pensions Policy Institute who coined this phrase.

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