



Would you rather be financially secure now

or when you're dead?

Copyright © 2020 Combined Pensioners & Superannuants Association of NSW Inc.
www.cpsa.org.au
cpsa@cpsa.org.au
1800 451 488

**Level 3, 17-21 Macquarie Street,
Parramatta NSW 2150**

DISCLAIMERS

Would you rather be financially secure now or when you're dead? is not intended as and does not provide financial advice of either a specific or general nature. It is purely intended to demonstrate the factors involved in funding a typical retirement period of twenty-two years.

The calculations of amounts presented in tables and the text of *Would you rather be financially secure now or when you're dead?* are based on a number of assumptions that do not meet actuarial standards. Specifically:

1. It is assumed that no income tax is payable in the scenarios presented in this booklet.
2. It is assumed that the rate of inflation is constant and unchanging at 2 per cent a year over a retirement period of twenty-two years and beyond.
3. It is assumed that Age Pension indexation is based on the annual rate of inflation of 2 per cent and that indexation occurs once a year only. The starting point for indexation in *Would you rather be financially secure now or when you're dead?* are the Age Pension rates valid from 20 September 2019.
4. It is assumed that the amount of the Age Pension income free area is indexed at the same time as the Age Pension, i.e. once a year and at a rate of 2 per cent.
5. It is assumed that the amounts to which the lower deeming rate applies are indexed once a year in line with the rate of inflation of 2 per cent.
6. It is assumed that deeming rates of 1 per cent and 3 per cent apply and that at the start of indexation the amount to which the lower deeming rate applies is \$51,800 for single Age Pensioners and \$86,200 for partnered Age Pensioners combined.
7. It is assumed that the lower asset limits for the Age Pension are indexed at the rate of inflation of 2 per cent and were those for home owners, \$263,250 for singles and \$394,500 for partnered combined.
8. It is assumed that the higher asset limits for the Age Pension are indexed at the rate of inflation of 2 per cent and were those for home owners, \$574,500 for singles and \$863,500 for partnered combined.
9. It is assumed that during the course of a twenty-year retirement period and beyond the annual nominal rate of return is 5 per cent.
10. It is assumed that (a) the purchasing power of retirement income; and (b) indexed annuities as shown in various Tables can be calculated with reference to the assumptions listed above.

As a result, the rounded estimated dollar amounts presented in *Would you rather be financially secure now or when you're dead?* are almost certainly not accurate. However, the relationships between these estimated dollar amounts are likely to be valid and reflect real-world retirement income results.

Would you rather be financially secure now

or when you're dead?





“Mate”, he said, “we’re down to our last million.

“We’re getting 1.2 per cent on our term deposits. That’s \$12,000 a year.

“That’s less than the pension!”

The call to CPSA was from an 85-year old self-funded retiree in distress.

He said he didn’t know what they were going to live on.

Their money was in term deposits and the interest from those came to about \$12,000 a year.

And it’s true: \$12,000 is less than the full rate couple’s pension, which is \$37,000 a year.

But then again, this retiree had a million dollars in the bank!

Hundreds of thousands of full rate pensioners would swap their pension for a million dollars in a flash.

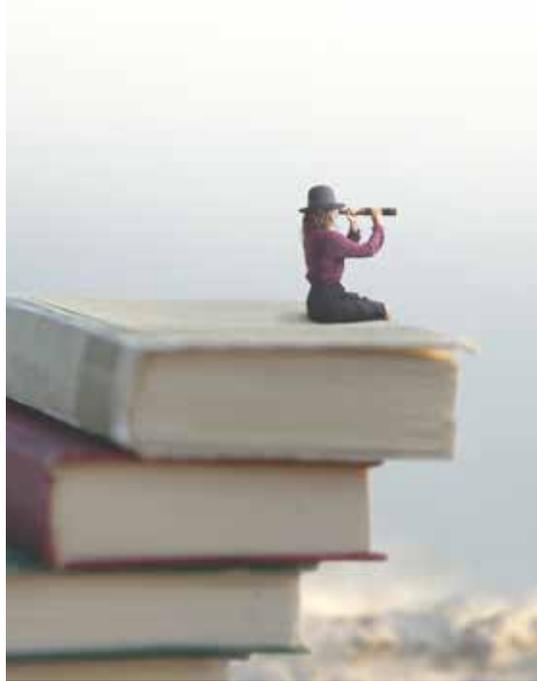
They would start using that last million dollars.

And they wouldn’t wait until they had turned 85 either.

And that’s what this booklet is about.

Many retirees who have built up their savings over many years believe that capital must not be touched.

After all, one of the golden rules of investing is to preserve your capital no matter what.



Psychologically, it can be hard giving up sticking to that rule.

It’s a rule you’ve followed all your life.

Not following it can cause great personal anxiety.

But unless you’re very, very wealthy, it will be very hard not to draw down on your capital to live well in retirement.

This is true particularly now that term deposits rates are so low.

Not touching your capital almost certainly means that you will be financially secure when you’re dead but very poor as you live out your retirement.



This booklet looks at your options to draw down on your capital while not running out of money before you die.

It will discuss four scenarios, four ways of using your capital in retirement and it will compare those four scenarios. Then you be the judge. Or rather, you be the judge after seeking professional financial advice to make sure that what you do is best for you.

The four scenarios are about different ways of using your capital to fund your retirement. The first examines what happens when you don't touch your capital at all. You use your capital to generate an investment return and use that return to spend.

The second takes a similar approach but tries to deal with inflation. Inflation reduces the purchasing power of your capital. Even though your capital returns the same amount in dollars, those dollars are also worth less each year.



The third scenario grapples with what happens if you accept you have to dig into your capital each year to fund your retirement. Obviously you want to spend the same each year, but how many years is 'each year'? You don't know when you will die. The financial industry for this is: longevity risk, the risk you will outlive your savings.

The fourth scenario addresses longevity risk by making people pool their retirement savings. In this way, an indexed income can be guaranteed for as long as you live.

For each one of the four scenarios, there are also questions to consider about whether you can, want or need to set any capital aside for replacement of a car, roof, a once-in-a-lifetime trip or anything else that is one-off and costs a lot of money. Perhaps you want to think about your estate, so that you can leave something behind for your family, friends, pets or ... CPSA!

To answer the question which of these four scenarios (or any other scenario not covered in this publication) is best for you, you need to overcome the almost universal urge of retirees to avoid seeing a financial planner.

Don't do this on your own! See a financial planner!

The image is a vertical composition of two photographs. The left half shows a dirt road winding through a rural landscape with utility poles and trees. The right half is a close-up of a large, textured tree trunk. The text is overlaid on the right side.

**LIVING ON
RETURNS,
NOT TOUCHING
CAPITAL**

***‘They’re adamant
they won’t touch
their capital, which
is there to produce
investment returns’***

Not everyone has a million dollars when they retire. Most of us don't.

So let's look at a couple of pension age and about to retire with a sizeable but more realistic \$500,000 in savings combined. They also own their own home.

For argument's sake, let's say they both have a life expectancy of another 22 years.

They are adamant that they won't touch their capital of \$500,000 throughout their retirement, which is there to produce investment returns.

\$500,000 is over the lower asset limit of \$394,500 for the Age Pension.¹

Based on a long-term average rate of investment return of 5 per cent, this couple could expect an income from their savings of \$25,000 per year.

They could also expect to receive a part pension of just over \$28,000 per year.

All up, they would have an income of \$53,000 per year.

But for how long?

The pension part of this couple's income is indexed twice a year.

However, the other part of their income of \$25,000 is not indexed at all.

So, while the purchasing power of their part Age Pension is maintained through indexation, the purchasing power of their other income is not.

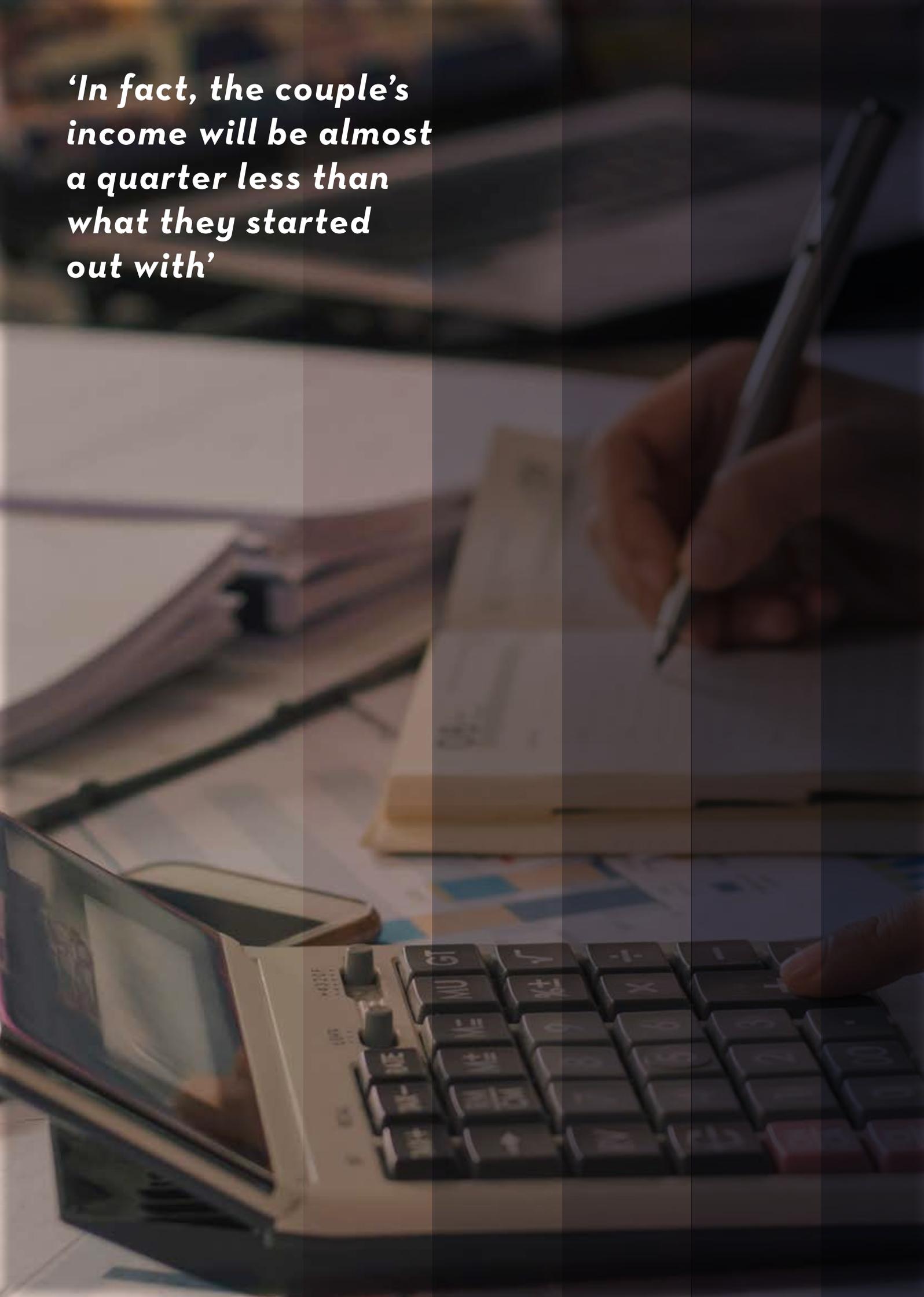
At the end of their retirement, after twenty-two years, that \$25,000 will be worth 35 per cent less in today's dollars: \$16,000.

TABLE 1

Retirement Year	Investment Income	Purchasing power of investment income
1	\$25,000	\$25,000
5	\$25,000	\$23,000
10	\$25,000	\$21,000
15	\$25,000	\$19,000
22	\$25,000	\$16,000

1. In December 2019.

'In fact, the couple's income will be almost a quarter less than what they started out with'



Their savings of \$500,000 will also decline in real value by 35 per cent to \$327,000 in today's dollars.

TABLE 2

Retirement Year	Savings	Purchasing power of savings
1	\$500,000	\$500,000
5	\$500,000	\$461,000
10	\$500,000	\$417,000
15	\$500,000	\$377,000
22	\$500,000	\$327,000

In fact, in today's dollars, the couple's entire income after twenty-two years will have just over \$41,500 in purchasing power a year. That's almost a quarter (22.7 per cent) less than the \$53,000 in purchasing power they started out with.

TABLE 3

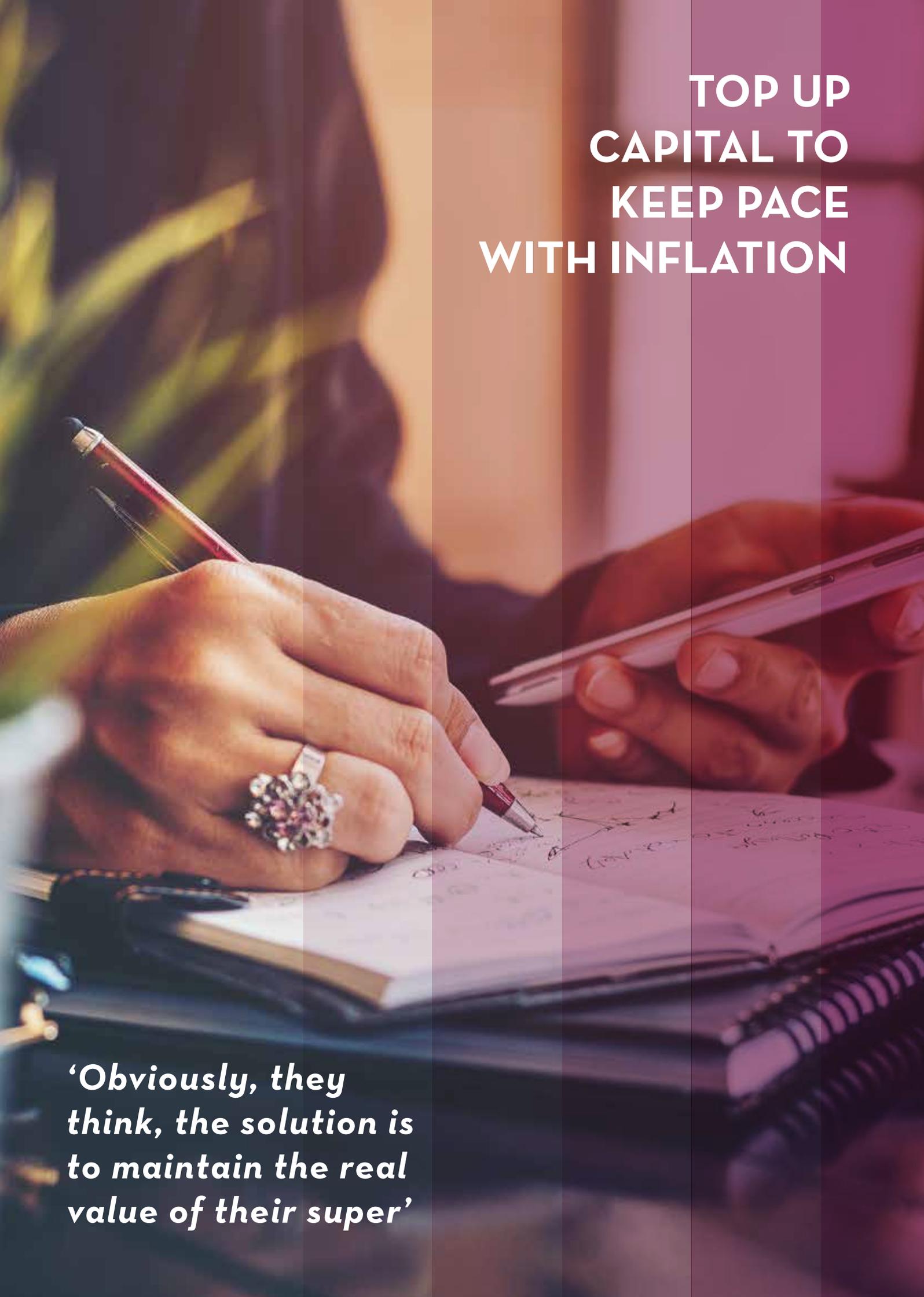
Retirement Year	Retirement income (Age Pension and other income)	Purchasing power of retirement income
1	\$53,000	\$53,000
5	\$55,500	\$51,500
10	\$59,000	\$49,000
15	\$62,500	\$47,000
22	\$68,000	\$41,500

By maintaining their capital of \$500,000 at the level it was when they began their retirement so that their retirement income and their quality of life would be assured, they have achieved the opposite:

1. Their savings have been reduced by 35 per cent in real value.
2. The income from their savings have also declined by 35 per cent in real value.
3. Their overall income, comprising their investment income and their part Age Pension, has declined by 22.7 per cent in real value.



On learning this, the couple understandably wants to look at doing something else.

A close-up photograph of a person's hands. The left hand, adorned with a large, ornate ring, holds a red pen and is writing on a spiral-bound notebook. The right hand holds a white smartphone. The background is softly blurred, showing a person in a dark jacket with yellow stripes. The image has a vertical gradient overlay, transitioning from a warm orange on the left to a deep purple on the right.

**TOP UP
CAPITAL TO
KEEP PACE
WITH INFLATION**

‘Obviously, they think, the solution is to maintain the real value of their super’

The couple decides that it is clearly not enough

to simply maintain their savings at \$500,000 throughout their retirement.

Obviously, they think, the solution is to maintain the real value of their superannuation savings.

They decide to each year top up their savings at the rate of inflation of 2 per cent.

That way, the investment returns will be higher and this will ensure that the real value of their retirement income is maintained as well.

Let's see how that pans out.

To start with, part of their investment income can now not be spent. Part of it goes into the bank to top up their savings.

After the first retirement year, this means only \$15,000 of the \$25,000 generated by their savings is available to be spent. \$10,000 stays in the bank to top-up and maintain the real value of those savings.

As a result, their investment income does go up every year, keeping pace with inflation.

TABLE 4

Retirement Year	Savings	Total investment income	Investment income minus top-up of savings
1	\$500,000	\$25,000	\$15,000
5	\$541,000	\$27,000	\$16,000
10	\$597,000	\$30,000	\$18,000
15	\$660,000	\$33,000	\$20,000
22	\$758,000	\$38,000	\$23,000

Their Age Pension also goes up every year. Combining the investment income minus top-up of savings and their Age Pension income, they are able to maintain an income of \$43,500 annually for 22 years. This income maintains its purchasing power throughout that period, as shown in Table 5 below.

TABLE 5

Retirement Year	Investment income after topping up superannuation savings	Annual part Age Pension income	Total retirement income	Purchasing power in today's dollars of total retirement income
1	\$15,000	\$28,000	\$43,500	\$43,500
5	\$16,000	\$30,500	\$46,500	\$43,500
10	\$18,000	\$34,000	\$52,000	\$43,500
15	\$20,000	\$37,500	\$57,500	\$43,500
22	\$23,000	\$43,000	\$66,000	\$43,500

‘Under both scenarios, there’s a huge amount left at the end of 22 years’



In the previous scenario, where they simply maintained their savings at \$500,000 throughout their retirement, they started out with \$50,000 in purchasing power annually and ended up with \$41,500 in purchasing power annually after 22 years.

In this scenario, they start out with \$43,500 in purchasing power and maintain this throughout their retirement, for 22 years.

TABLE 6

Retirement Year	Purchasing power of retirement income	
	Scenario 1	Scenario 2
1	\$50,000	\$43,500
5	\$48,000	\$43,500
10	\$46,000	\$43,500
15	\$44,000	\$43,500
22	\$41,500	\$43,500

It turns out that Scenario 1 is a little bit better than Scenario 2, because the average purchasing power under scenario 2 is \$45,500, \$2,000 more than under scenario 3.

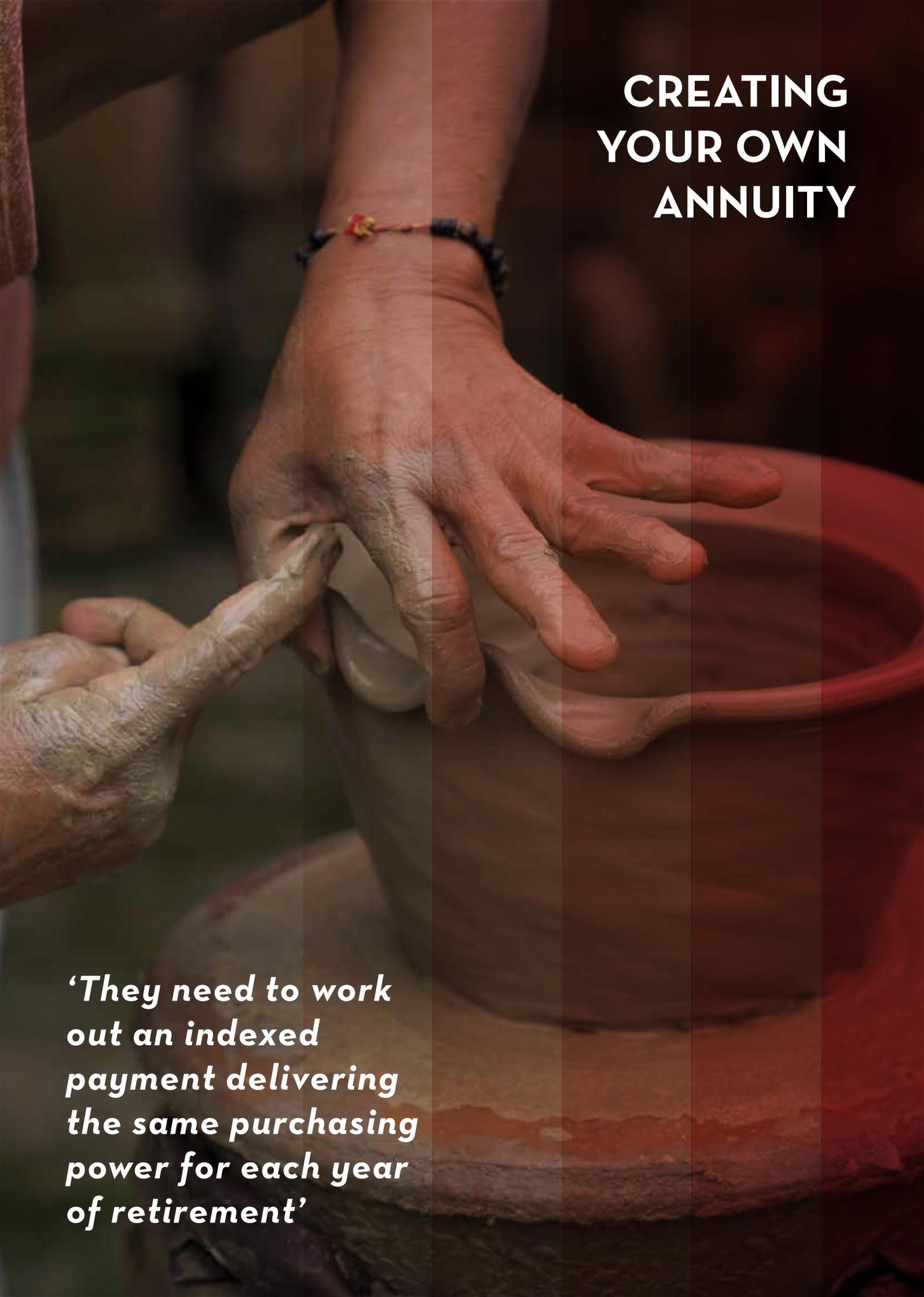
However, under both scenarios there is a huge amount of money left at the end of 22 years and the end of retirement.

In Scenario 1, there's \$500,000 left over with a purchasing value in today's dollars of \$327,000.

In Scenario 2, there's \$756,000 at the end of 22 years, with a purchasing value in today's dollars of \$500,000.

The couple decides to investigate ways of dipping into all that money without ending up broke before they die.





CREATING YOUR OWN ANNUITY

'They need to work out an indexed payment delivering the same purchasing power for each year of retirement'

Can they do this?

Yes, they can.

By gradually using up their savings, their capital over a 22-year period. By taking out exactly what's needed to maintain the purchasing power of their annual income over those 22 years.

They need to work out an indexed payment delivering the same purchasing power for each of the twenty-two years of retirement.

With \$500,000 in initial savings and assuming a 5 per cent rate of return including 2 per cent inflation, the initial amount will be \$31,750 gradually going up to \$48,000 in the last year due to inflation.

TABLE 7

Retirement Year	Retirement savings	Indexed annuity	Part pension payment	Total retirement income	Purchasing power of total retirement income (today's dollars)
1	\$500,000	\$31,750	\$28,000	\$60,000	\$60,000
5	\$467,000	\$34,250	\$30,500	\$64,750	\$60,000
10	\$399,000	\$38,000	\$34,000	\$72,000	\$60,000
15	\$291,000	\$42,000	\$37,500	\$79,500	\$60,000
End 22	\$ -	\$48,000	\$43,000	\$81,000	\$60,000

The problem is that they can do that for maybe twenty-two years, but what if they live longer?

The money would be gone. There's just the Age Pension left. That Age Pension would amount to \$56,500 in the twenty-third year but have purchasing power in today's dollars of \$36,000. That's down \$24,000 from the previous year, a drop of 40 per cent.

TABLE 8

Retirement Year	Age Pension payment	Purchasing power of Age Pension
23	\$56,500	\$36,000
25	\$58,750	\$36,000
30	\$65,000	\$36,000

What our couple were attempting by eating into their capital for top-ups of their investment income was creating an annuity for themselves. To be precise, they were creating an annuity indexed for inflation.

The problem was that they simply could only create an annuity for a fixed term.

They could not create an annuity for their lifetime.

Isn't there a way to do that?



LIFETIME ANNUITY

*'It's insurance
against running
out of money'*

Yes, there is.

There is a way for this couple not to run out of money before they die.

But it requires a whole lot of like-minded couples to bring this about.

For argument's sake, let's say there are three couples who each have saved \$500,000 by the time they retire. Each couple has a life expectancy of 22 years. They decide to pool their money in one bank account.

Again for argument's sake, let's say one couple (couple A) dies together after exactly 22 years, exactly as expected.

Another couple (couple B) dies together after 15 years, seven years earlier than expected.

The last couple (couple C) dies together after 29 years, seven years later than expected.

They all get \$60,000 a year purchasing power in today's dollars for their lifetime.

They are all financially secure while alive (and not while they are dead) because they pooled their resources.

Couple A got back what they put in.

Couple C got back more than they put in.

Couple B got back less than they put in.

This is what is called a lifetime annuity. It is insurance against running out of money.

It obviously takes more than just three couples for a lifetime annuity scheme to work. But given a sufficient number of couples (and singles), the law of averages ensures that everybody who is participating gets an indexed income for life.

Companies marketing lifetime annuities use official actuarial life expectancy tables to work out the amount you are required to pay.

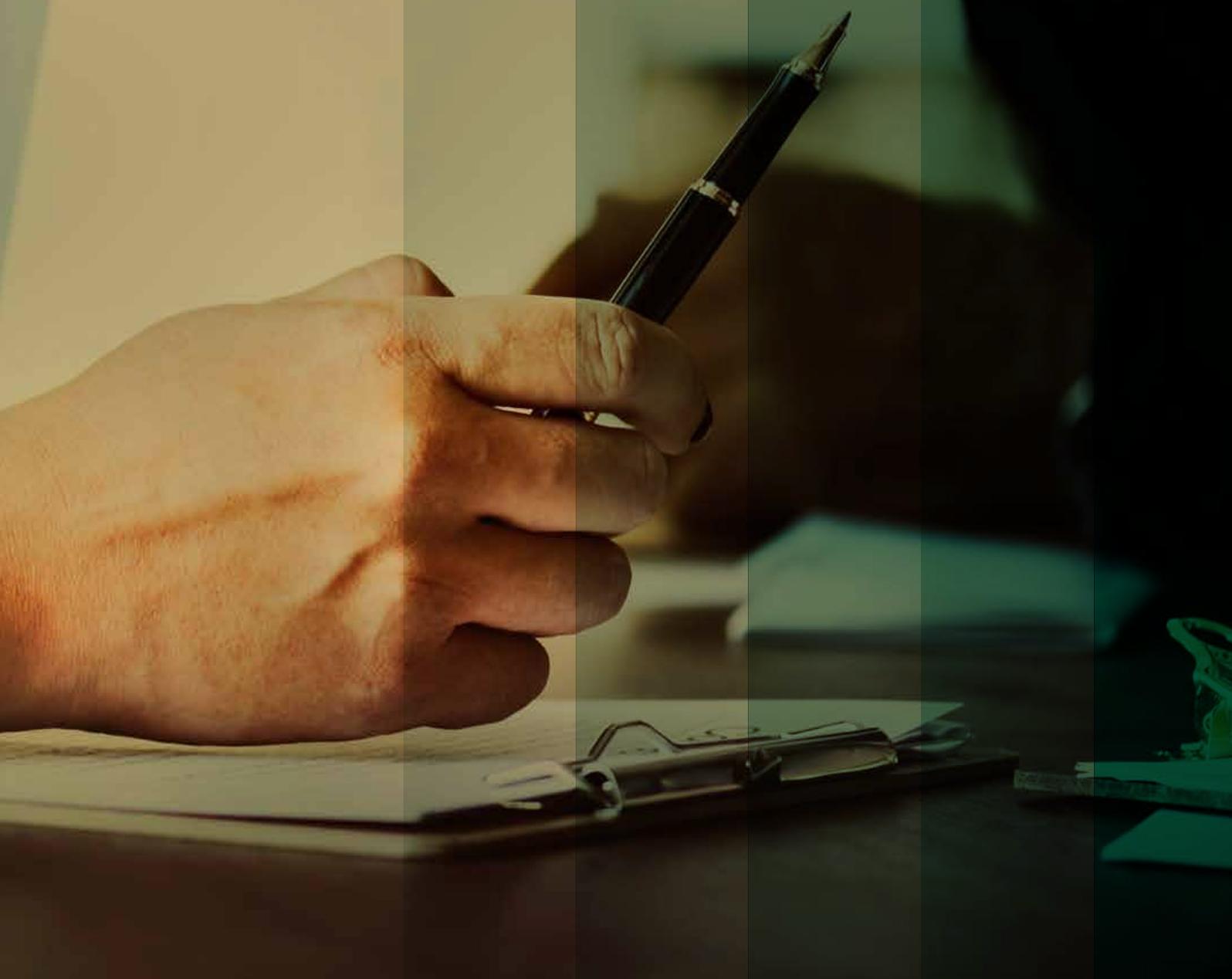
Of course, insurance comes at a cost.

While there tend to be no fees and charges (or premiums) for indexed lifetime annuities, the annuity payments may not be what you expect them to be.

According to the online calculator for indexed lifetime annuities sold by a company called Challenger, a couple at age 67 with \$500,000 to spend on an annuity could expect, in their first retirement year, payments totalling \$11,192 for the male and \$10,582 for the female.

Yes, the male gets more but it's no sex discrimination. It's just that women have a longer average life expectancy and therefore lower annual pay-outs.

***‘There’s nothing
like self interest
to motivate an
investment banker’***



It pays to be male and in a same-sex relationship, where a couple could expect a combined annual payment of \$22,384, representing a return of 4.47 per cent annually on an initial \$500,000.

That beats current term deposit rates hands down.

While you get from a lifetime annuity pretty much what you can get from a do-it-yourself annuity (but only for a limited number of years!), there is one break you can only get if you buy a lifetime annuity.

Centrelink will only count 60 per cent of the purchase price of your lifetime annuity in the pension asset test.

Once you turn 84, Centrelink will only count 30 per cent.

This break means about \$7,000 in extra purchasing power annually for a couple investing \$500,000 in a lifetime annuity.

While the purchasing power of the indexed lifetime annuity stays the same, the much lighter means testing of the purchase price of this lifetime annuity for the Age Pension results in a significant increase in the fortnightly pension payment.

A lifetime annuity is a secure investment that pays a regular income for life in return for a lump sum investment, regardless of how long you live or how investment markets perform.

TABLE 9

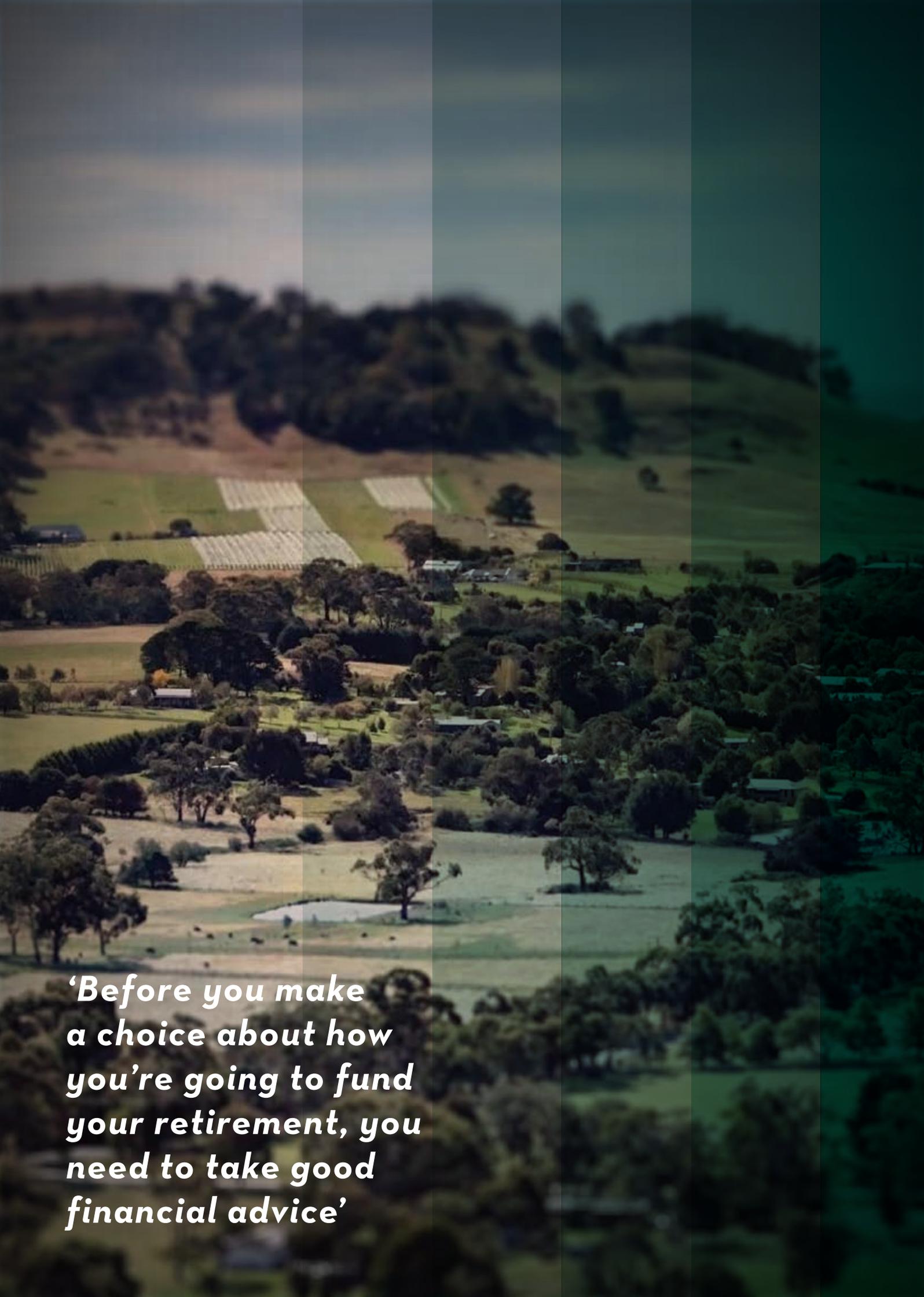
Retirement Year	Indexed annuity	Part Pension payment with Centrelink 60% break	Part Pension payment without Centrelink break	Purchasing power of total retirement income (today's dollars) with 60% Centrelink break	Purchasing power of total retirement income (today's dollars) without Centrelink break
1	\$31,750	\$35,000	\$28,000	\$66,750	\$60,000
5	\$34,250	\$35,000	\$30,500	\$66,750	\$60,000
10	\$38,000	\$35,000	\$34,000	\$66,750	\$60,000
15	\$42,000	\$34,500	\$37,500	\$66,750	\$60,000
22	\$48,000	\$34,000	\$43,000	\$66,750	\$60,000

Our couple's \$500,000 goes into a secure fund along with money from other annuity investors. This fund is known as the 'statutory fund', and all regular payments to annuity investors are paid from this fund.

The Australian Prudential Regulation Authority (APRA) requires institutions to put their own money into the statutory fund to make sure it's in their interest that the statutory fund performs well.

There's nothing like self-interest to motivate an investment banker.

APRA monitors the statutory fund's investments to ensure that it can pay investors as agreed. If at any time the statutory fund does not achieve investment returns that are sufficient, institutions must cover the shortfall.

An aerial photograph of a rural landscape. In the upper left, a large solar farm is visible, consisting of numerous rows of photovoltaic panels. The surrounding area is a mix of green fields, scattered trees, and a few buildings. A small pond is located in the lower middle section. The background shows rolling hills under a clear sky. The image has a vertical gradient overlay, transitioning from a light blue-grey at the top to a dark teal at the bottom.

***'Before you make
a choice about how
you're going to fund
your retirement, you
need to take good
financial advice'***

APRA can also require institutions to invest more of their own money into the statutory fund or require them to change the statutory fund's investments.

A lifetime annuity can be any size, generally starting from \$10,000, and it can be part of a larger portfolio.

Generally, a lifetime annuity has a long period during which it can still be cancelled by the investor, who gets a lump sum withdrawal payment in that case.

A lifetime annuity also pays your estate a guaranteed death benefit if you die before your life expectancy has run out.

Annuity investors pay no fees. Institutions that sell lifetime annuities simply invest the money annuity investors give them. If they achieve investment returns that are above the amount required to pay annuity investors their monthly income, they keep the excess amount. This is how annuity institutions make a profit. If they make a loss, they are still legally bound to pay annuity investors their monthly income.

Annuities are about income certainty, so they are likely to give you lower returns than more risky investments where you may receive higher returns but you can also incur losses.

Lifetime annuity payments are indexed according to inflation annually, not unlike the Age Pension, and are guaranteed regardless of how long you live. Note that if the CPI is a negative in any year, your payment would get reduced accordingly, whereas the Age Pension would not get reduced: it just wouldn't go up.

A lifetime annuity operates with what's called a 'withdrawal period'. This period is defined as the start date of a lifetime annuity and the life expectancy of the person or couple who have taken out the annuity. During the 'withdrawal period', it is generally possible to terminate the annuity and receive a lump sum refund of a proportion of the initial money invested. Once the 'withdrawal period' has expired, the investor continues to be paid their monthly income (indexed annually), but the annuity can no longer be terminated.

In Australia, Challenger has a virtual monopoly on lifetime annuities, but this may change. Superannuation funds are increasingly finding that their members want retirement income streams after having made contributions during their working life.

However, before you make a choice about how you are going to go about funding your retirement, you need to take good financial advice.

This booklet is not suggesting that, now that you understand how lifetime annuities work, you go out and get yourself or yourselves one. These types of decisions should not be made without getting good advice to make sure that you get what is actually in your best interest.



CPSA

**COMBINED PENSIONERS &
SUPERANNUANTS ASSOCIATION**

www.cpsa.org.au

©2020

CPSA receives funding support from the NSW Department of Communities & Justice, NSW Health and the Australian Government Department of Health.