Summary
- Prior to the introduction of the pension freedoms, most people had to buy an annuity, but that has since changed.
- Annuity sales have declined, while drawdown sales have increased.
- However, there are pros and cons to both products and it depends on a person's personal circumstances.
- There may also be a hybrid option, where people can use both products.

Annuity vs drawdown

Almost three years since the introduction of the pension freedoms, Natalie Tuck asks if there is a clear winner in a face-off between annuities and drawdown

When George Osborne proclaimed "no caps, no drawdown limits…no one will have to buy an annuity," in his 2014 Budget, he sent the pensions world into a frenzy, turning the decumulation phase on its head.

Freedom and choice

The pension freedoms came into effect the following year in April 2015, allowing anyone over the age of 55 to have full flexible access to their pensions; annuities were no longer the only choice, people could also buy a Lamborghini, or so said the Pensions Minister at the time.

Steve Webb's infamous comments were the talk of many in the early days of pension freedoms, but waiting at the sideline was the option of drawdown. Prior to the reforms, the rules around drawdown were very strict but the product is now an important player in the decumulation stage.

The Financial Conduct Authority's (FCA) most recent data reveals a market increase of 4 per cent between October 2016 and March 2017. In contrast, the FCA's data on annuities revealed that sales fell by 16 per cent in the same quarter.

There are pros and cons to both; the advantage of an annuity, says Better Retirement's retirement director Billy Burrows is that it pays a guaranteed income for life but there is no flexibility. "The benefits of drawdown are income flexibility, control over investments and choice to leave death benefits, but that comes with risk," he adds.

Out of fashion

The idea of an annuity is simply, "a mortgage in reverse", says Burrows, but since the introduction of the freedoms the product has suffered. As demand for annuities falls, providers have left the market. Last month, Retirement Advantage's departure from the market marked the eighth company to stop selling annuities since 2014.

Naturally this sparks concerns over competition, with rates already low. Burrows believes that with less competition, there could be slightly lower rates, but is not too concerned, as a bigger part of annuity pricing is based on current yields and projected life expectancy.

Furthermore, Hargreaves Lansdown head of policy Tom McPhail notes that those who have quit the market since 2014 only accounted for around 20 per cent of market share, "so competition hasn't been adversely affected as might be supposed".

"Given the collapse in demand for annuities since pension freedom was announced in 2014, it is hardly a surprise we have seen so many companies leave the market," McPhail says.

It's not all bad news, however, with industry experts predicting an upsurge in annuities in several years' time. "Recent research by Hargreaves Lansdown indicates we may see an upsurge in annuity demand around 10 years from now as the baby-boomers move into later retirement," McPhail notes.

This same thought is shared by other experts, such as the Personal Finance Society chief executive Keith Richards: "If you ask a typical consumer what they want from a retirement income product, they almost always describe an annuity type situation, so they may come back into vogue, if and when gilt yields post a sustainable increase. It's all about the numbers."

It is the numbers that are the big issue for annuities. Data published in September 2017 by Moneyfacts revealed annuity rates have fallen by around 10 per cent over the last two years, meaning that retirees opting for an annuity today are likely to receive thousands of pounds less than previously over a typical 20-year retirement.

With rates so low, are annuities fit for purpose? According to the experts the answer is yes. Richards argues that the lower rates are due to a rise in life expectancies, and does not equate to a fall in value for money, rather it represents a spreading of value over a longer period. Burrows too believes annuities are still good value, as they pay back your sum of money over your life expectancy. "The problem is the rate of interest they are using is probably about 2 per cent."

However, more recent data from Moneyfacts suggests that 2017 has seen standard annuity rates recover slightly, with a 1.66 per cent increase based on a £50,000 pot for a 65 year old. That coupled with the expected increase in demand may bring the humble annuity back in vogue.

The risky choice

There is no doubt in the popularity of drawdown, the FCA's statistics telling all, but is it a sustainable option? Research by AJ Bell published in December 2017 found almost half of savers are making unsustainable withdrawals from their pensions. The study found that 44 per cent of people are withdrawing over 10 per cent of their pension savings each year.

Taking out more than 10 per cent annually with the average savings pot will only last savers a maximum of 12 years, according to the research. In comparison, AJ Bell highlights that a lower 6 per cent annual withdrawal for the average £118,000 pot would last the retiree 26 years.

It is also clear from the research that the younger a person is, the more likely they are to underestimate how long their pension will need to last for. Over half, 51 per cent, of 55 to 59 year olds anticipated that their pension income will need to last for 20 years or less. However, data from the Office for National Statistics suggests men in this age group are predicted to live for another 24 to 27 years and women are expected to live for another 26 to 30 years.

People opting for drawdown are clearly overestimating how much they can withdraw from their pots based on their own longevity projections. The average rule of thumb is a drawdown rate of 3.5 per cent if capital is to be preserved, says JLT Employee Benefits head of technical John Wilson. "Drawdown is no different to having money in your own bank account. If you take too much out and you have a low rate of return, you'll run out of money," Burrows says.

Unlike annuities, when a person enters into drawdown they will need to review their investments regularly. Wilson says that the frequency of reviews depends on the nature of the investments held.

"For example, a large fund invested in stable investments with a low regular income being withdrawn, where the product automatically manages liquidity, may only need an annual review. However, if the investments held are volatile, withdrawals are at a high and frequent rate and investments need to be encashed regularly to create liquidity, quarterly or even monthly reviews may be required," he says.

With drawdown there is also a sequence of return risk that concerns the order in which returns from investments occur, rather than the average over time. Cass Business School professor of asset management Andrew Clare has previously warned that "outcomes can be very devastating for some people and it's really a matter of luck whether it affects you or not".

Despite this risk, drawdowns are popular because yields are very low so annuities, especially at younger ages, don't appear attractive, says Burrows. "Drawdown appears attractive, because the markets appear buoyant, but depending on how things pan out, it may be the case that we see interest rates slowly increase and we see increasing concerns about the global economy overheating, so if rates go up and the markets look less attractive, it will change the relative merits of annuities versus drawdown."

Hybrid

With risks to both, and varying needs throughout retirement, is there a way to use a combination? Wilson certainly believes that a combination approach could be the "optimum solution" for many defined contribution savers.

This a thought shared by Richards who too believes a combination could be an "ideal solution". He says that in the case of drawdown and annuities, a typical solution might include using an annuity to cover essential spending and using drawdown on top to fund more variable/unpredictable needs. Another option is choosing drawdown in the early part of retirement and moving to an annuity later on it retirement.

There is still a risk to this approach, however, as Burrows highlights that people could spend most of their money in the drawdown stage and then have very little to purchase an annuity with. As for the future, anyone who knows will be a very rich individual, says Richards.

Written by Natalie Tuck