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Demystifying with-profit annuities

What is a with-profit annuity?

A with-profit annuity provides a guaranteed income for life with increases dependent on the performance of the underlying investment. Although the bonus formula depends on market returns, the application of smoothing significantly reduces the effects of market volatility, generating stable returns for investors. Decisions about the increases are partly subjective, as they allow discretion of how

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net investment return required to provide a level pension. The lower the discount rate, the more it costs to purchase a given initial level of pension, but the higher the expected future increases in pension. Once a bonus has been declared, the purchase rate is deducted from the bonus to determine the increase, e.g. given a declared bonus of 10% and a 3% purchase rate, the pension increase will be 7%.

to distribute profits from, for example, mortality experience. Such decisions are, however, well regulated and made by experts and actuaries in the industry.

What is a purchase rate?

The purchase or discount rate is the

What is the philosophy for declaring bonuses?

The aim with bonus declarations is to declare a bonus as high as possible without jeopardising the financial stability and security of the with-profit annuity portfolio. This will be in line with the stated bonus formula and subject to underlying fund performance and adjustments based on the mortality experience of the pool.

What are the risks covered by a with-profit annuity?

In a with-profit annuity, the longevity and investment risks of an individual is carried by the insurance company. Pensioners receive a guaranteed monthly income for as long as they are alive. For joint life pensions, the surviving spouse will receive a pension for as long as they are alive, even after the death of the main pensioner. Even if the underlying portfolio returns are negative, your income cannot decrease, although poor returns would limit the increases.

Who should invest in a with-profit annuity?

Investors in a with-profit annuity want some investment exposure to the market returns of a balanced fund. These investors are willing to take a bit of risk to earn some upside potential, but also seek the security of a guaranteed pension for as long as they live.

Three questions to ask your annuity provider

Comparing with-profit annuities from different providers is a difficult and complicated exercise. To help you make a decision, here are three important questions you should ask your with-profit annuity provider before buying an annuity product:

1. Are my funds being placed with a company I can trust to survive for the rest of my life?

Get information about the company's financial stability, the solvency ratio of the insurer and reports by investment analysts.

2. How are the increases calculated?

With-profit annuity products designed in the 90s were often referred to as 'black boxes' due to the discretion of the providers to determine the increases; despite this, such decisions are made by experts in the field (actuaries). Current product providers should be able to give you details on how increases are calculated, as well as any discretionary adjustments that may apply.

3. What is the long-term track record of the provider and what is the expectation of the level and stability of bonuses?

Realistic returns and sustainable and stable increases over the long term should be a feature before opting into a with-profit annuity. Looking at recent increases, and the impact of the economic conditions on future increases, will give an understanding of the sensitivity to market conditions.