Legal & General

The Economics of the Coming Retirement Spaceship

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The Economics of the Coming Retirement Spaceship

Open and Closed Systems

I was reading an economics paper recently on open and closed systems, and felt that it could help us understand better the financial issues that pensioners face in retirement, and which professional financial advice could help them cope with.

So what are open and closed systems?

An open system is one which sits within and interacts with a wider environment. We used to regard our earth as an open system – until the last century there was always a frontier, a limit to the known world of human habitation, beyond which people had not yet gone.

And up until very recently we have behaved as if our existence on earth could draw on an inexhaustible supply of natural resources, and had unlimited reservoirs to store our outputs or throw away the pollution we create.

It's that sort of interaction with an infinite external environment that characterises an open system.

In contrast, a closed system is finite, bounded and cut off from the external world. Anything that is output by part of a closed system can be regarded as an input to anther part of the same system. Natural resources are recognised to be finite, and we have to manage with what's already contained within the closed system.

Since mankind succeeded in exploring the whole earth, we have begun to realise that in many ways our earth is a closed system, and the current growth of environmental concerns is testament to that.

There are profound implications for economists in switching thinking from open system mode to closed system mode.

Within an open system, production is encouraged and consumption is regarded as a good thing. We measure our success as Gross Domestic Product, the market value of the goods and services produced within our country.

In his final Budget in 2007, our Chancellor Gordon Brown acclaimed his record of growing consumption as a wonderful thing "*Mr Deputy Speaker, I can report that after 10 years of sustained growth, Britain's economic growth will continue into its 59th quarter - the forecast end of the cycle - and then into its 60th and 61st quarter and beyond.*"

By contrast, in a closed system, throughput is no longer regarded as desirable. Instead we need to encourage the maintenance of capital stock. Consumption ceases to be a goal in itself, but a necessary part of maintaining our stock. In turn, we welcome

technological changes that enable the maintenance of a given capital stock with less throughput. Future Chancellors will need to re-think their success criteria.

In our world of finance, increased environmental awareness is prompting a growth of ethical investing. Today, £8.9billion is invested in ethical funds, with three quarters of a million people holding at least part of their savings in ethical accounts.

This sector has grown at 19% per year for each of the last ten years, which is a phenomenal sustained rate of growth.

Investing to save the planet used to be a pretty risky affair, as it meant investing in small companies that had yet to make a profit. But now legislation and government subsidies have driven a huge growth in what we might call climate change companies, and there are plenty of large and profitable companies for fund managers to choose from.

Consumers can now choose from around 100 ethical funds, and you do need to read the prospectus closely to understand the ethical criteria they are following. Some will focus more on social issues, others on environmental. Within, say, environmental, the strictness of the criteria they follow will vary from light green to dark green. It's interesting to note that some will exclude the nuclear industry on the grounds of its potential to create abominable pollution, as happened at Chernobyl, whilst others will embrace nuclear power as one of our most important non-carbon energy sources.

As the ethical fund industry has come of age, it has been able to demonstrate that not only is ethical investing good for your conscience, it can also be good for your performance. A Mercers report commissioned by the United Nations last year showed that responsible investing rarely damages the profitability of investment portfolios. Mercers analysed 20 different academic studies from around the world and found that responsible investing carries no performance penalty. Back here in the UK, a recent Life and Pensions Moneyfacts survey showed the average ethical fund outperforming the average non-ethical fund over one and three years.

Retirement is like a closed system

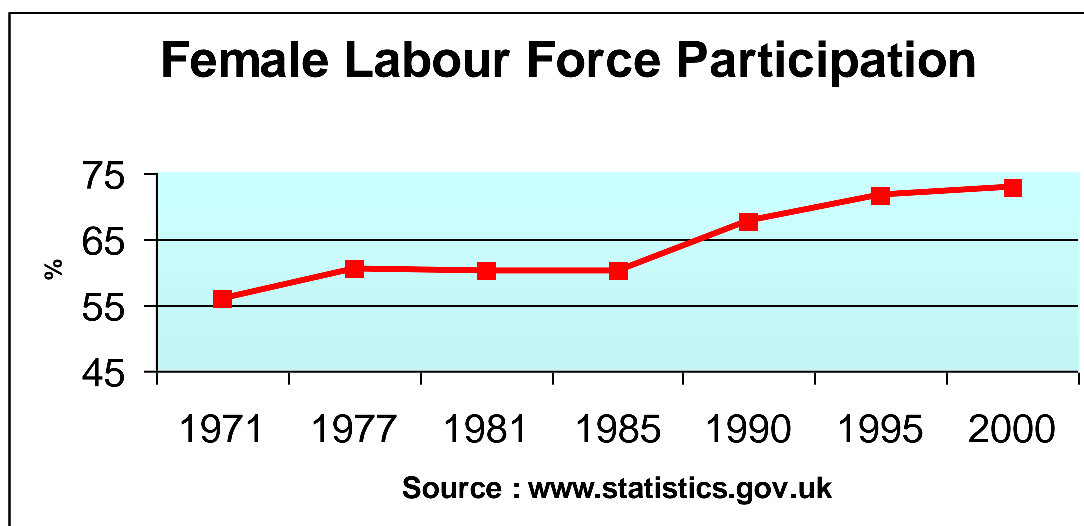
Retirement, which is the focus of this piece, is in many ways a closed system. It marks the end of paid employment, so there will be no more wages to replenish the pensioner's asset base. No doubt quite a contrast to one's 20's and 30's, when paid employment stretched ahead like an almost endless stream of income.

At this age, the pensioner is also unlikely to add to the stock of children, which was the Victorian way of ensuring support in old age. (If you produced enough children, then surely one of them would be prepared to look after you in your dotage.) I say "unlikely", as there are of course famous instances of late fatherhood, such as Pablo Picasso who produced four children by three women, the last one at age 68. Going even better than that was Charlie Chaplin who married four times, producing eleven children, the last one when he was aged 73.

And lastly, the age of inheritance has also probably passed for pensioners. Figures from the English Longitudinal Study of Ageing show that you are up to six times as likely to receive an inheritance in your fifties as you are in your seventies – by then the generation likely to leave you a bequest will probably have passed on.

And retirement is more closed than it used to be. Going back to that Victorian ideal, Children today are less able to help an aged parent than they used to be. For starters, they are probably heavily in debt themselves. The average student debt for a new graduate is now £17,500 and will rise again next year as tuition fees bite harder. The average mortgage for a first time buyer is now £131,000

Women, who have traditionally borne the brunt of caring for elderly relatives are more likely to have a career themselves. In 1971, only just over 55% of women were in work, today that figure has risen to almost 75%.



Distance is also an increasing problem in the delivery of inter-generational care, as families become more geographically disperse. This has been driven by increases in car and home ownership. For example, 74% of households today own a car, compared to 51% in 1971, and this has enabled more people to move further from their place of upbringing.

So pensioners are much more likely to be on their own in future. This is worrying indeed, as The Royal Commission for Long Term Care, set up by Tony Blair's Government to analyse the current state and future needs of long term care in the UK, found that amongst pensioners needing care help in their own home, over 80% relied on informal care provided voluntarily, mostly by women, most often by the daughter or daughter in law.

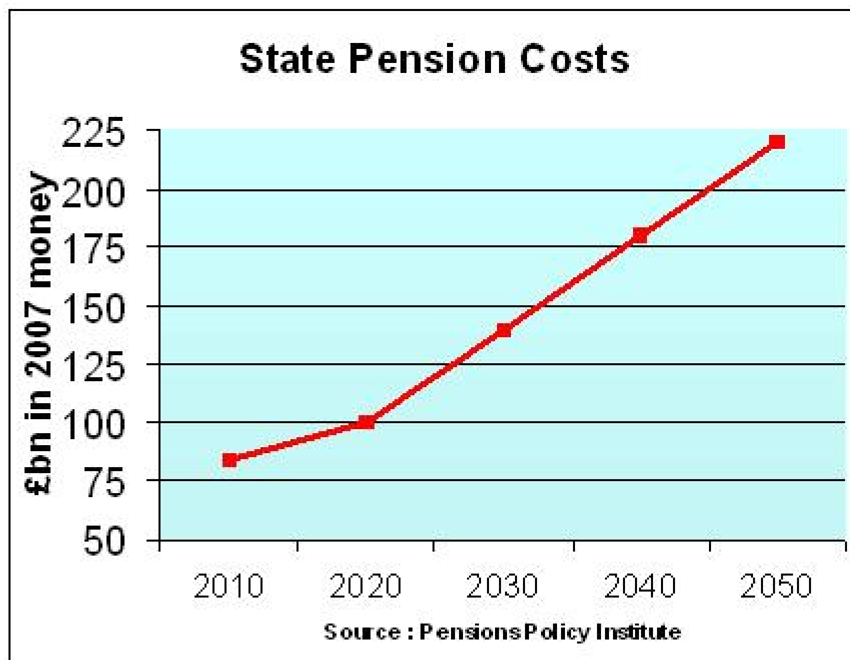
And if your family aren't going to help, don't expect the State to help you either.

The demographics work against the next generation of pensioners. The so called "baby boom" generation, that bulge in the population statistics borne between 1945 and 1965 (between the bomb and the pill if you want an easy way of remembering it) are going to create an additional 7 million over 65 year olds. By 2040, the support ratio, measured as the number of pensioners to the number of workers, will have deteriorated from 1 : $3^1/_2$ today to 1: 2 .

Not only will there be more people claiming the State Pension, but legislation already enacted in the Pensions Act 2007 has made it more generous. Annual increases in the Basic State Pension are to be improved from price inflation to the higher earnings inflation at some point within the next three years. And for those retiring from 2010, only 30 years of working or caring will be needed to qualify for a full pension, instead of the current 44 years for men and 39 years for women.

These changes, plus the greater number of women now working, mean that the proportion of women who qualify for a full Basic State Pension will increase from 30% today, to 70% of those retiring in 2010 and on to 90% by the year 2025.

The Pensions Policy Institute has costed these improvements, and calculated that the bill the taxpayer has to foot will increase from £84 billion in 2010 to £220 billion in 2050, both numbers measured in 2007 money.



And just in case those figures are not sufficiently mind boggling to persuade you that the State won't have left over money to support future pensioners, it's worth touching on the Health Crisis.

Although the Health Crisis is not talked about as much as the Pensions Crisis, it is driven by exactly the same demographics. It was scoped in another major Government Review, "Securing Our Future Health – Taking a Long term View", carried out by Derek Wanless in 2002. Wanless identified that by 2033 the country will need another 62,000 doctors and 108,000 nurses to cope with the ageing population. Sadly, what the Government seem to have done since then is to make a succession of nurses redundant.

We'll start to look for solutions in a minute, but to complete the bleak picture, the economy is in no position to afford all these extra pensioner costs. During his ten years as Chancellor, Gordon Brown built a "borrow and spend" economy. During his reign, Britain's manufacturing sector shrank from 21% of GDP to 13% of GDP, with 3.5 million manufacturing employees switching to the service sector. And in the service sector, the key is to keep spending up so that the money keeps circulating!

Our spending is financed by debt. According to figures from CreditAction, The UK's personal debt increases by £1million every five minutes. The average household now pays £3,800 of interest every year, and that's up £343 on last year.

The so called "credit crunch" is bringing an end to this easy debt. Whilst many portray the credit crunch as some kind of glitch in the banking system, triggered by dodgy mortgages in the USA, the reality for us is that those parts of the rest of the world that have a balance of payments surplus are becoming increasingly reluctant to lend their money back to the British people.

And with good reason. One person over here is being declared insolvent or bankrupt every four minutes. Debt recovery agencies are now chasing £21 billion of overdue loans. The Citizens Advice Bureau are expecting to deal with 6,600 debt problems today.

Whilst our debt will rise by £300 million today, we will have to make interest payments of £258 million today. Our service sector driven economy, kept afloat for years on a wave of debt fuelled spending has a bleak future when most of the debt we raise now is just to cover interest payments – so not much left over for spending.

It is interesting to see how the Government have reacted to this slowdown. The mini-Budget of 13th May, ostensibly a response to the 10p tax debacle, gave all basic rate taxpayers an extra £120 in their pay packet to spend this year. A giveaway that has been costed by the Institute for Fiscal Studies at £5.5 billion. It has been funded by Government borrowing. The advice for drunks is that if they are feeling hungover they should take a few more sips, and it looks like the Chancellor is trying that to stave off our debt hangover.

Frankly the numbers do not add up, and future pensioners would be wise to anticipate that Government promises of how much care and support they will get may be reneged on or devalued.

How can Pensioners Manage their Closed System ?

So, if retiring from work is a little like climbing into your spaceship and blasting off into a space where you will be financially on your own, how can we help pensioners to manage themselves in a closed system?

The important thing is to recognise that managing a closed system is all about maintaining the current stock.

The first thing to look at is the current stock of savings. It will be necessary to look at the whole savings position, not just the pension plan. So in addition to their State and private pensions, we need to take a view of ISAs, and non tax favoured savings too. Looking at the aggregate position will enable us to survey the total stock, and set in place an appropriate asset allocation for the portfolio as a whole.

Housing is an important form of saving too, and I will return to that later. It needs to be brought into the picture, both to record its value now and formulate plans for its future.

Human welfare is also an important part of the stock to be maintained. This is part of shifting the mentality from consumption to maintenance. There are obvious applications for preventative medicine and a good exercise / keep fit routine. Even eating can be seen differently – if we view being well fed as a good thing, rather than seeing eating per se as a good thing, we are more likely to maintain a good diet. Meals can be enjoyable, but their primary purpose is to restore the state of being well fed.

I am meeting more and more financial advisers who now draw up long term projections for their pensioner clients. This really can help them see beyond how they are going to manage their money this year and look on to how they are going to manage their finances for the rest of their lives.

Of course we don't know how long that will be, and one adviser I admire enormously told me recently that he now projects all his clients assuming they will live to 100.

We do know that people are living longer than they used to. According to the DWP's Pensions White Paper of 2006, if we look back to 1950, then a man retiring at age 65 could expect to live until age 74. A man retiring at age 65 today can expect to live until age 85. And projecting further mortality improvement, as medicines and technologies progress, by 2050 a man retiring at age 65 will expect to live until age 89.

I'm delighted to say that there is also clear evidence that these extra years should also be healthy years. The improvements in longevity we have been witnessing are matched by improvements in pensioner fitness. The Living In Britain Survey, a major longitudinal study, has shown that in the period 1980 to 2001, the proportion of 85 year olds able to walk outdoors unaided has increased from 52% to 59%. And the proportion of 85 year olds still able to climb stairs has increased from 69% to 76%.

Demographers call this phenomenon “compression of morbidity” – more of us are living into old age and the sickly period at the end that we’d all rather not think about is being squashed into the just last few years of life. We need to factor this back into those long term projections I’m encouraging financial advisers to make. An active pensioner will need money for travel and hobbies, and the active period is increasing. Between the active period and the sickly period there may well be a passive stage to life, where pensioner expenditure is low because they have ceased to go out very much. A life of daytime television viewing is very low cost – even the licence is free to over 75 year olds.

Now, living longer and living healthier has not happened to us by chance. It’s happened because we are spending more on our healthcare. Just look at an international comparison, between Sweden that spends 9% of GDP of healthcare, and Russia that spends only half of this sum, at just 4.5% of GDP, according to figures from the OECD.

And yes, the Swedes are living longer. The likelihood of a 42 year Swede living another 30 years is 75%, whereas it’s only 36% for a Russian.

And yes, the Swedes are living healthier too. Having got to age 72, 87% of Swedes are free of disability, but only 47% of Russians are.

These figures are borne out in their national leaders too – Boris Yeltsin the famous Russian leader lived to age 76, but suffered from years of heart disease. Following his 1996 re-election he was forced to have a quintuple heart by-pass, and his activity was much restricted thereafter. Indeed at was at age 72, where as I’ve said the majority of Russians are disabled, that Boris Yeltsin was so disabled that his scheduled meeting with the Irish Premier Albert Reynolds at Dublin airport was called off when Yeltsin couldn’t get off the plane. There was speculation that vodka may have played a part.

Compared to these two countries, the UK spends 7.8% of GDP on healthcare. That’s not far off the Swedish level, but for pensioners that can afford it, I recommend budgeting for more healthcare expenditure.

Despite all the political rhetoric, the main way that the NHS regulates it’s expenditure is still through a system of queueing. Pop down to your local NHS hospital and you will see that the wards are stuffed full of old dears, as it’s the retired population that need most hospital treatment. With another 9 million over 65 year olds on their way, those queues are only going to get longer.

Pensioners can jump the NHS queue by going privately. Typically, a new knee costs between £9,000 and £10,000, a new hip costs between £12,000 and £16,000, a coronary angioplasty costs between £6,000 and £8,000 and (men only) having your prostate sorted costs between £2,000 and £9,500.

Incidentally, I was struck by the wide range of costs for the prostate job and asked my medical friends why this is so. Apparently there are various treatments and it depends on how much functionality you want left afterwards.

But seriously, the important point here is that pensioners may wish to produce lump sums of money at short notice to pay hospital bills. You cannot do this with a pension – that just generates a stream of income – you need savings plans as well that can be encashed to produce lump sums.

This is relevant earlier in life, when people in their 40's and 50's are saving for retirement. It's important to maintain a balance between pension and non-pension savings. By all means take full advantage of any employer pension contributions on offer, which frequently involve matching employee contributions, but don't lock all your savings into pensions.

When pension contributions are described as getting tax relief, that is only part of the story. Setting aside the tax free lump sum on retirement, what pensions get is actually tax deferral, not tax relief. Yes, you contribute free of tax, and yes your funds roll up free of tax, but when you draw the pension in retirement you will pay tax on both those contributions and any investment growth they earned.

Whether tax deferral works in your favour or not hinges on the tax rate when you paid into the pension and the tax rate when you draw it out.

This can work splendidly well for someone who is a higher rate taxpayer during their career but only a basic rate taxpayer in retirement. They will have avoided paying tax at 40% and replaced it with a later tax charge at only 20%.

But the same individual could come badly unstuck if they are a higher rate taxpayer in retirement too, and if the higher rate of tax has increased by then. Speaking historically, the current higher rate of 40% is actually quite low. When Geoffrey Howe was Chancellor, he set the higher rate of income tax at 60%. And before him, Denis Healey had set it at 83%, in his determination to "squeeze the rich until the pips squeak".

Whether or not making individual contributions to a pension plan, and by so doing deferring tax, will turn out to have been a wise move will depend upon the direction of future tax rates. The portents are not good.

The Pensions Commission, chaired by Adair Turner calculated the cost of paying for our ageing population through taxation. If their costs were all raised as income tax, then I calculate that income tax would have to rise by 16%.

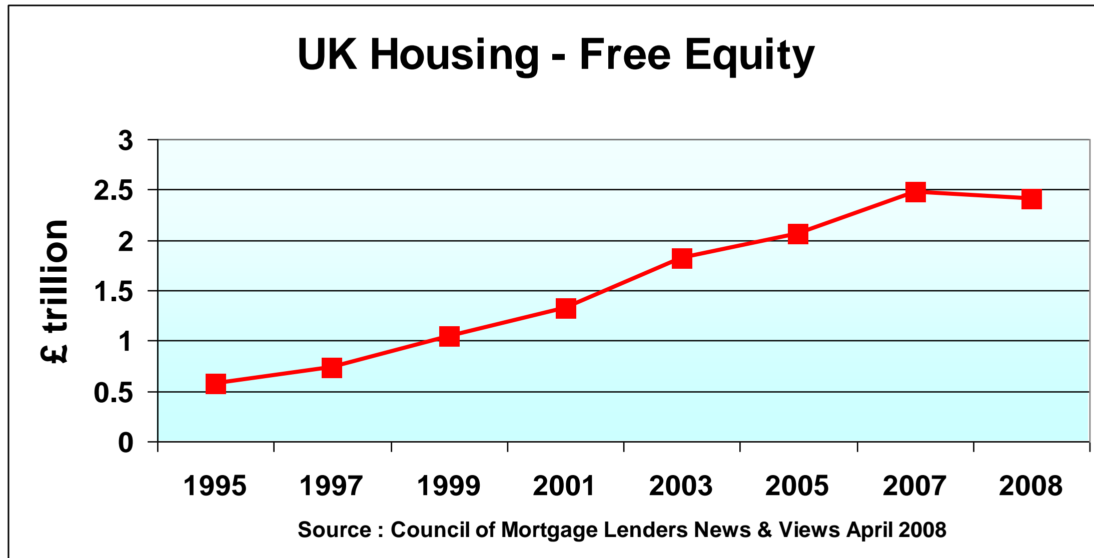
The Liberal Democrat party have until just two years ago advocated a higher rate of tax of tax of 50% on incomes over £100,000.

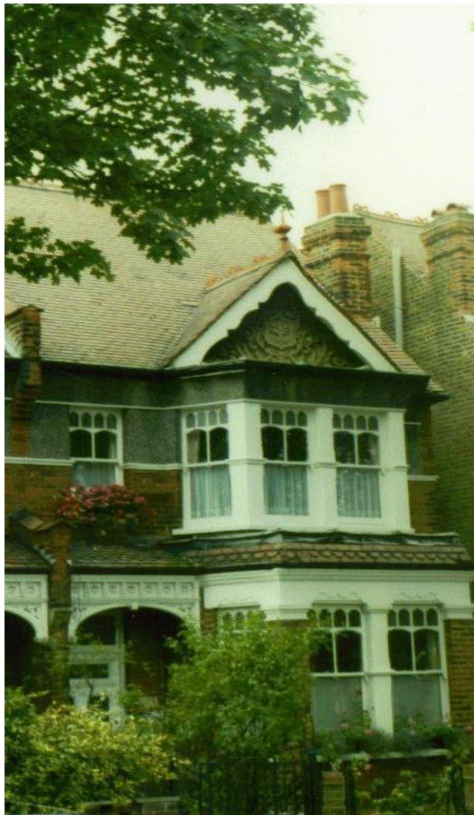
Frank Field, one of the more visionary figures in the Labour Party called at this year's Allen Lane Foundation Lecture that "the super-rich should pay higher taxes unless they donate to charity".

We should not get carried away with thinking that pensions are tax efficient and so the only vehicle to save for retirement in.

Housing

Despite the current talk of a correction in the housing market, the growth of free equity amongst owners of homes in the UK has been a phenomenal success story.





Since 1995, the excess of the value of homes above mortgages secured against them has rocketed to almost $2^1/_2$ trillion pounds according to research by the Council of Mortgage lenders.

But don't think that pensioners having valuable equity tied up in housing is a new thing. This picture is of "Ilium", my great great grandfather's former house in Chiswick. When he died, his will instructed that the house be sold and the equity used to establish a row of almshouses in Sittingbourne for the poor.

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Having already covered the Pension Crisis and the Health Crisis I'd like to complete the trilogy by explaining that we have a housing crisis in Britain too.

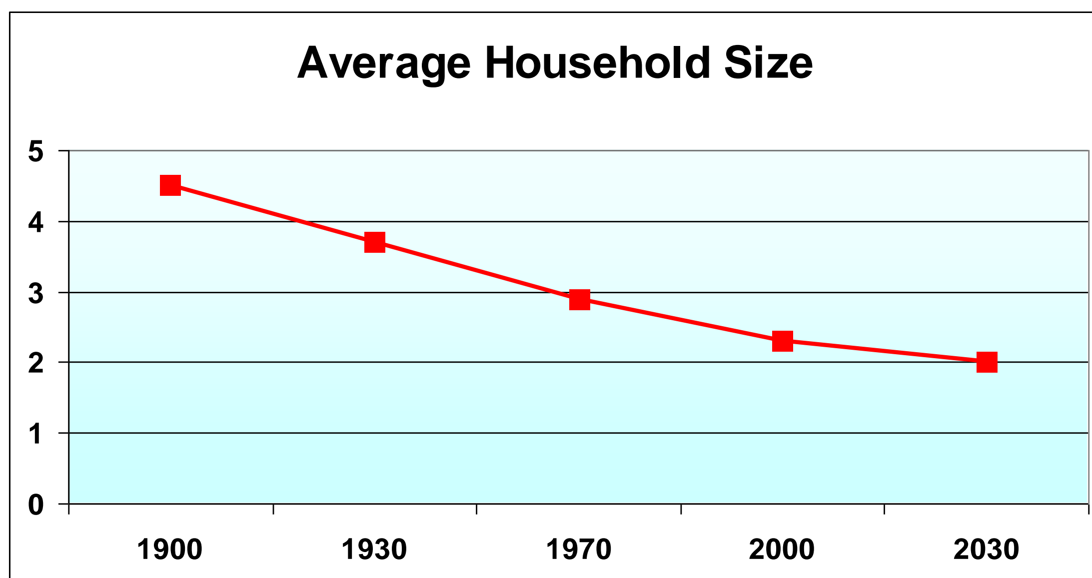
At the hub of the problem is the fact that some people have houses and some don't. Government know we need more, and plan to build another three million homes by 2020. Whether these plans will become a reality remains to be seen, as construction firms are currently scaling back their activity.

Even if we do get another three million homes, many will be built in the wrong place such as on floodplains and many will be the wrong size. The majority of new homes now being built are one and two bedroom apartments. These are not built for living in, but built for selling to people who want to be landlords and get rich quick on Buy to Let.

Turning to housing and pensioners, and a recent study on Older People's Housing by the International Longevity Centre found that 56% of pensioner households have two or more spare bedrooms. These people are what, in the jargon, we call "house-blockers". Radical opinion makers have called for house-blockers to be forcibly evicted from their properties, to make way for homeless families.

Such force should not be necessary, as downsizing can be an attractive option for older people. It presents an opportunity to release funds for controlled expenditure, and should be a core proponent of the pensioner's long term financial plans.

Just stop and look at the long term pattern of average household size, which I've compiled from various publications by the Office of the Deputy Prime Minister, the Living in Britain Survey and the London School of Economics.



If you are a pensioner living in a large house built in the early 1900's, then just remember that it dates from an era when families had more children, when grandparents often lived in too, and when the household probably accommodated at least one servant too. It was designed for times when the average household size was double what it was now.

You might be well advised to sell up large houses now, while there is still demand. In years to come, nobody may want the large old houses, and they will be sold at knock down prices to re-developers who will be complaining about how much it costs to demolish them and dispose of the rubble in an environmentally friendly way.

Another way for pensioners to free up cash from their house is equity release. The Daily Mail is a newspaper that takes seriously its mantle of looking after the older reader, and has published a Daily Mail Guide to Equity Release. In it, respected financial journalist Charlotte Beugge writes "there has never been a better time to take out an equity release plan".

The guide shows illustrative amounts of capital that can be released. It suggests that a lifetime mortgage on a £250,000 house could release £112,500 if taken out at age 80, £87,500 if taken out at age 70 but only £62,500 if taken out at age 60. That would release only 25% of the equity.

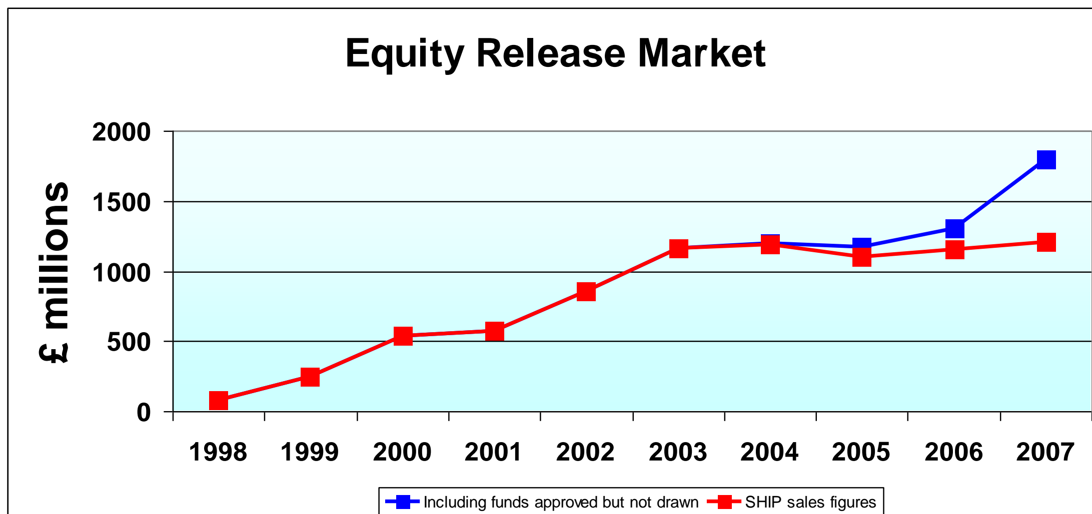
Not only do I think downsizing is better at releasing capital than equity release, I see no reason why pensioners shouldn't do both! Why not trade down to a smaller house first, and then use equity release as well?

A 70 year old in a large house worth £500,000 could trade down to a bungalow for £250,000 and then take a lifetime equity release mortgage against the bungalow. This combined approach could release over $^{2}/_{3}$rds of their equity for consumption.

The equity release market has been a success story over the last ten years. According to the industry trade body SHIP, around 30,000 pensioners every year take up this opportunity, releasing over a £1 billion for expenditure that can maintain their lifestyle.

At first sight the sales graphs suggest that equity release may now have plateau-ed, with the SHIP figures showing sales levelling off since 2003. But these figures disguise another fundamental change in this market, which is the move to so called drawdown mortgages.

With a drawdown plan, the pensioner is granted approval for a major loan against their property, but only draws the funds down in tranches as when they are ready to spend each slice of funds. This depresses the SHIP sales figures which only record the funds actually drawn down, although the reality is that the pensioner may have now built those future tranches of equity release into their personal lifetime financial projection. I have re-worked the SHIP figures to take account of mortgages authorised but not yet drawn down, and my calculations show that this market is still rocketing ahead.



The signs are that the equity release market still has a long way further to go.

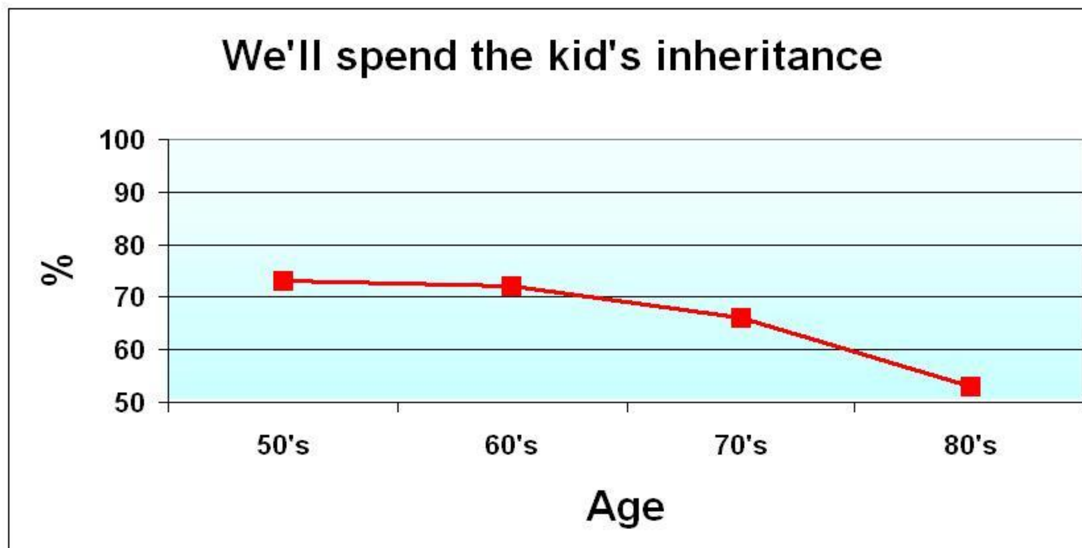
Actuaries Say Spend It Faster

Actuaries are usually the harbingers of doom in the pensions industry, warning of inadequate levels of saving and increasingly dire deficits within employers sponsored pension schemes. But on 10th March 2006, the Actuarial Profession put out a press release urging pensioners to spend more money in retirement.

What the actuaries had noted was that although in many ways retirement is like a closed system, with no new inputs of cash or help in prospect, in one essential way it is different – it has an end date. And being experts in financial projections, the actuaries had spotted that pensioners need to be spending more of their savings in retirement, or otherwise they will die without having enjoyed the fruits of their lifetime savings.

They are not the first to note this. St Paul's Epistle to Timothy, often read at funerals, reminds us "for we brought nothing into this world, and it is certain we can carry nothing out".

And the actuaries seem to have caught the changing mood of the nation here. A major study by the Joseph Rowntree Foundation – Attitudes to Inheritance – reports that "two thirds of those with potential to leave a bequest say they will enjoy life and not worry too much about doing so". This study also revealed an age shift here, with pensioners in their fifties and sixties keener to spend the kid's inheritance than the older generation now in their seventies and eighties.



Source : Joseph Rowntree Foundation - Attitudes to Inheritance

People with this attitude often proudly proclaim that they are “skiers”, standing for spending the kid’s inheritance.

One of the things that prompted the actuaries into this somewhat out of character exuberance was the pattern of increasing inheritance tax payments in the UK. The official figures from Her Majesty’s Revenue and Customs show that inheritance tax in 2002/3 totalled £2.3 billion, but by 2007/8 had shot up to £3.8 billion, a 65% rise in just 5 years.

Even taking into account the new transferable nil rate band between husbands and wives, that was pulled like a rabbit from the hat by the Chancellor last October just before the General Election that Gordon Brown never called, IHT receipts for 2008/9 are still forecast at £3.2 billion, still 40% ahead of the 2002 tax take.

As a nation, we now pay more inheritance tax than we do beer duty, or wine duty, or air passenger duty or insurance premium tax.

For many years we have paid more inheritance tax than capital gains tax. But the Treasury forecast that these two will now swap over, following the abolition of taper relief and indexation relief on capital gains for individuals. Fortunately life assurers retained their indexation relief, enabling them to benefit customers with life assurance based investments such as bonds.

Not everybody is a confirmed skier yet, and many will want to give something to the generation that follows them. The patterns of bequest were analysed earlier this year in a research piece by the International Longevity Centre drawing on data from the British Household Panel Survey. Here it was found that the mean age for receiving an inheritance is now 50. That’s after education, training and career building have taken

place. It's also after house purchase and after family formation (well, apart from the Charlie Chaplins amongst us).

What's more, the mean age of inheritance is still moving upwards, increasing at the rate of ½ a year every year.

Perhaps a better idea is to give money away earlier, so that your intended recipient benefits from it at an age where it will make a difference. This too seems to be catching on.

The same International Longevity Centre research piece also looked at inter-vivo transfers, gifts between two living people. Around half a million people a year receive an inter-vivo transfer, with the numbers having increased by 25% over the last five years. Amongst professional and managerial classes, the mean size of transfer is modest at £2,000 but this has actually doubled over the last five years, suggesting an increasing trend.

I believe people are beginning to realise that if you want to give money away rather than spend it, then using a bequest is often lousy timing. I was struck by a recent comment in USA Today's Investment Column (28/5/08) that *"a bequest is not the best way to give money to people – you have to die to trigger the benefit"*.

This brings us back to the importance of financial advisers helping people to take a complete picture of their money position, and projecting that picture forwards year by year until death. Now gifts can be factored into that projection, at times when they will really make a difference to the recipient.

Provided the picture really is complete, taking into account all of the individual's assets, many clients will be genuinely surprised at how much they need to give away in order to bring their inheritance tax liability down to a manageable size.

Helping Pensioners Spend More With Confidence

I've been making the case that comprehensive financial projections will help pensioners to spend more with confidence, but do we also have the right financial products available to achieve this.

Help is at hand, with a new generation of products coming from America, called variable annuities, or third way annuities. These products combine the freedom of being able to choose your own fund managers and asset allocation with the security normally seen in guaranteed products with no investment upside potential. Offering a range of guarantees, they can provide security against either living to long or stockmarket turbulence, and are much more flexible than standard annuities.

They can be purchased in a variety of tax wrappers – inside or outside a pension, UK domiciled or written in an offshore tax haven.

Variable annuities have proved very popular overseas. In the US $1.5 trillion dollars are now invested in variable annuities. In Japan, over $14 trillion yen are now

invested in variable annuities, but don't get too excited by that number as the yen is a pretty small unit of currency. In sterling terms, one yen is about one third of a groat. That's about half a penny in our decimal currency.

Penetration in Europe has been slow so far, with Germany leading the way with the top insurer there claiming to have sold 150,000 policies now.

But there are concerns over this new wonder product. The marketing of it can be aimed at pensioner's feelings of insecurity, even when that insecurity is unjustified. There is a lovely picture in the customer brochure one major provider of a pair of carpet slippers sat neatly in the glass bowl of a food blender, just conjuring up an image of your comfortable retirement between cut to pieces if someone or some event turned the blender on.

In America there have been allegations of mis-selling of variable annuities, with expensive guarantees being sold to consumers who really didn't need them and really hadn't appreciated what it was they were buying. Three major providers have now settled with the US regulators, with compensation running into 100's of millions of dollars already.

Charges for these variable annuities can be high in the UK too. The Daily Telegraph last February reported on the major US life companies offering these products to UK customers, and found that Hartford charge up to 3% per year, Met Life charge 3.45% per year and Lincoln's charges can exceed 4% per year in addition to a 3% up front charge.

If a lot of money is going out in charges to pay for the guarantees and the fund management, then the investment performance will have to be excellent to keep up with more conventional products. Looking at these American companies, Tommy Trinder's war time phrase "over paid, over sexed and over here" comes to mind.

But there is an application for these products, and I hope that as more players enter the UK market the charges will come down. That application is always likely to be a niche. A survey by Watson Wyatt found IFAs regarding variable annuities as suitable for clients with funds of between around £50,000 and £100,000.

Hence the "third way" tag – the variable annuities could provide a useful alternative for clients with funds that are too large to annuities, but too small to go for income drawdown, where they would have to bear all the investment and longevity risk themselves.

In most cases, financial advisers can help pensioners plan for the future with the current range of traditional products. Rather than paying for expensive guarantees within a single product, a portfolio of different products can be built up to meet future needs at lower cost.

For money inside the pension tax wrapper, conventional annuities, income drawdown and alternatively secured pensions all have a role to play.

Conventional annuities provide important insurance against living too long, and the Department of Work and Pensions Research report 318 has found that conventional annuities are being priced fairly by insurers, with none of the concerns voiced about variable annuities.

For money outside the pensions tax wrapper, ISAs, collectives (unit trusts and open ended investment companies), life assurance bonds and offshore bonds are all used extensively by pensioners.

By taking a holistic view of a client's financial situation, an adviser can combine these traditional products in the right proportions, and give the pensioner the confidence to spend their money while they are best able to enjoy it.

You don't need to be an astrologer to tell people their financial future, you just need to use all the information and tools available to you, and modern platform technology will enable professional advisers to do just that.

Disclaimer

This is not a consumer advertisement and should not be used to make individual pension decisions. This document is a piece of academic research into the economic situation facing future pensioners and the options available to them. Any readers should take professional financial advice before taking any of the decisions discussed here and should not rely on the material in this document in any way.

A Tribute

This paper was inspired by an essay written by a distant cousin of mine in the 1960's, the late Kenneth Boulding, who was professor of economics at the University of Colorado. His work, titled "The Economics of the Coming Spaceship Earth" was a precursor to much of the thinking on environmental economics that is taking place today, 40 years later, and encouraged people to see the earth as a closed, rather than an open system.

I recommend it to you, and hope you find it as inspiring as I did.

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