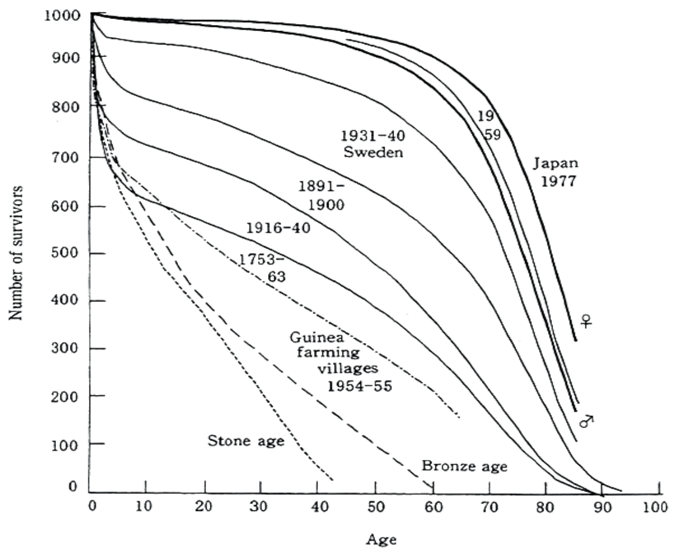
# Retiring the challenge of an ageing population

JLT INVESTMENT CONSULTING / JLT PENSION CAPITAL STRATEGIES

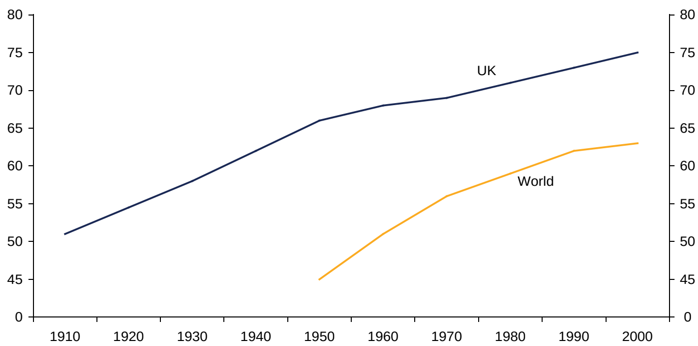
The unaffordability of retirement is regularly cited as being attributable to the doubling of post retirement life expectancy over the last 60-75 years.

The problem though is not really that we are living longer. Clearly we have been and are…globally, this is not just a UK phenomenon.




Like all "indices", life expectancy is but an average and is low when child deaths are common. For example, at a headline level life expectancy in, say, Burundi is apparently 31 years fewer than Sweden. However this is not because everyone in Burundi dies a little bit sooner, but because a lot die so much younger. It is possible to live to 80, 90 or more in Burundi as it is in Sweden or indeed the UK. However what makes a difference is the numbers of individuals living to this age.

Given this propensity to long life does exist, it is not unreasonable to assume that the export of western lifestyle, at least in terms of diet, healthcare and the rudiments of life will lead to a major increase in the numbers of Burundians reaching later life and so life expectancy will change, reflecting the same improvements in population averages witnessed in the UK over the last century. Indeed, the Global 60+ population was assessed at 759m in 2010, but is predicted to reach 2bn in 2050.




*Source: GAD for UK; United Nations for World*
*Note: These are "Period" Life expectations, which actually underestimate the expected life span of a baby born in the year specified, but which are easier to calculate than the correct "cohort" figures and therefore frequently used in international comparisons.*

It would seem (as illustrated above), that longevity is definitely a one way trend - and in that respect differs from many other risks and uncertainties faced by pension funds. So how bad (or good, depending on your personal perspective) could it get?

## The Secrets of Immortality

There have been some claims that the first person who could potentially live to 1000 already exists in the world today but even with the recent birth of the seventh billion individual, that seems intuitively unlikely. Although the numbers reaching their centenary seem to increasing, by and large no human seems to have lived past a verifiable 120 and the vast majority are dead by 105.

However, a quick glance at other planet dwellers appears to indicate the clues to long life.

Ignoring the jelly fish *Turritopsis dohrnii* that has worked out complete self-reproduction and so achieved immortality (although arguably this is like *Only Fools* Trigger's proverbial road sweeping broom - allegedly the same broom albeit it has had seven different brush heads and four new handles over the years) and the Quaking Aspen that has achieved 80,000 years, the progress chart runs from the two year living mouse through naked mole rats (10-20 years), sea anemones (60-80 years), lobsters (100 years), bow head whales (200 years) and giant tortoises (255 years) to ocean quahogs (400 years) and deep sea oysters (500 years). The propensity for long life on our planet is clear. But how do they do it?

The general rules seem to be

- Grow bigger
- Reduce exposure to sunlight and UV radiation
- Work less/Rest more
- Reduce stress
- Protect your proteins

This may sounds rather familiar, but is not a cosmetic or diet advert, this is how other planet dwellers have really succeeded and would seem to be the route we *homo sapiens* are also following with each generation taller than its parents, where the Australian "slip, slap, slop" sun care mantra has been exported to the rest of the globe, where work/life balance is an HR mission statement (and a European directive) and de-stressing vouchers can be bought from a spa on every street corner.

If we have "got the message", is longevity a one way trend, great for individuals but a looming financial disaster for pension funds and health care funders, private and public sector?

A few years ago *The Times* I believe ran a headline "Fat kids solve pension crisis". At the time there was more than a depressing ring of truth to child (and adult) obesity stemming population longevity improvements. Fortunately, the drug companies appear to be working wonders in both controlling obesity and mitigating the health effects of obesity - it seems we can grow bigger in all dimensions now and still expect to live long.

Unless, that is, we contract cancer.

Despite the successes of the anti-smoking lobby, cancer is now the greatest "natural cause". More people are getting more cancers - in part this is an abuse of statistics as the population is increasing in number generally, diagnosis is improving and, most importantly, people aren't dying from other causes first - Health & Safety legislation does have some advantages, as has taking workers out of the mines and giving them fresh air and good food. We can also hypothesise that the majority of men over 80 probably suffer prostate cancer - however in many it will remain undiagnosed and may well not be what ultimately kills them.

That said, poor diet and lifestyle still make up the major causes of cancer - it's estimated 25% of new cases could be saved through better choices and exercise; that's 80,000 saveable lives in Britain alone.

Britain now ranks 22/50 in the developed world cancer league - Ireland is worse and Denmark tops the table. The developed world appears to suffer more cancers (although this may just be a weight of numbers at older ages and lack of prior cause of death), but the evidence would suggest now that this is not down to factors such as mobile phones, artificial colours and sweeteners, fluoridisation of water or the use of deodorants. Unfortunately the developing world is catching up as it aspires to and achieves "western" standards of living.

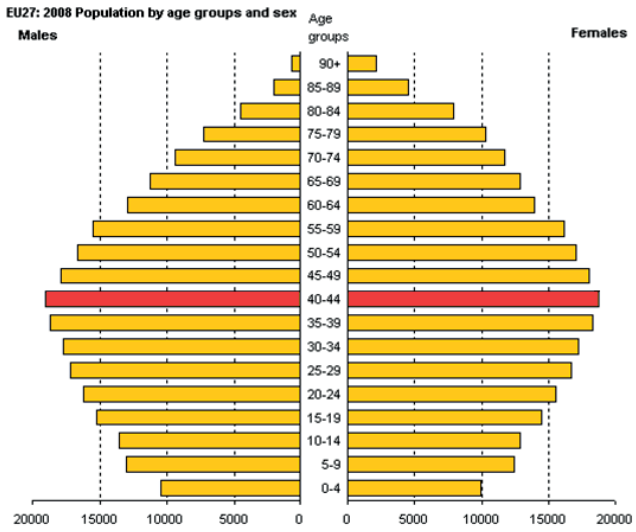
From a financial management perspective though, what this highlights is that the most likely longevity improvement factor will be the proverbial "cure for cancer" that will impact all schemes. Hence the better and cheaper form of protection may well be the longevity index-based hedge rather than more bespoke forms of indemnity insurance. In any case, a sufficiently large basket of index-based hedges can provide a pretty close proxy to an indemnity structure, certainly close enough given the 30-40% typical cost saving. Index-based transactions will have greater future liquidity too as they are based on standardised contracts with more universal appeal. Given how uncertain future longevity and other demographics are, being affordably "roughly right" seems a good place to be.

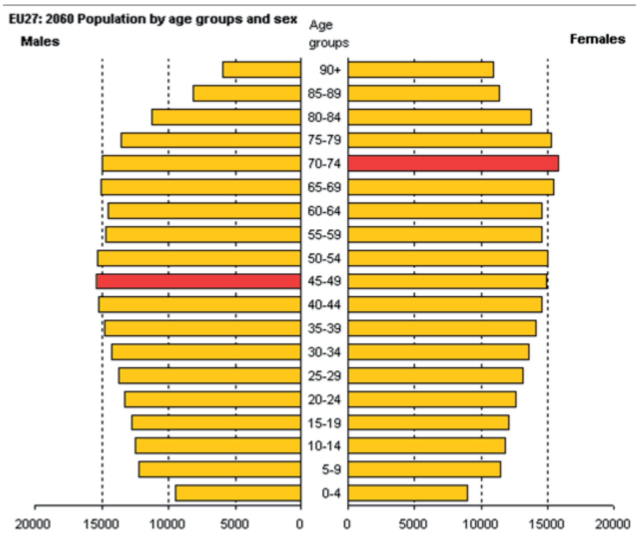
## The Real Big Issue

We can agree that we are living longer and longer yet - the real problem though is that we are retiring too soon. Setting aside the debate over age discrimination and the general lack of employment opportunities in the economy today, the truth is we are now retired for too long. If you consider the period an individual spends in childhood and education (and enters the workforce with "negative capital") and add this to the retirement years, it seems that we spend half of our lives not working.

Despite the increases in state retirement age, actual and proposed, the current UK age of withdrawal is 62.4 years for women and 64.5 years for men.

*This must change.*




People are leaving the UK labour market earlier than they did in 1970 but this is not a uniquely domestic trend. Indeed, across Europe only Switzerland and Ireland have effective retirement ages above the official NRD with France and Netherlands having the lowest. Not only are we not working across Europe, we're not breeding either. From 2012 the working age population in Europe will begin to shrink. Labour force growth decline is inevitably followed by GDP growth decline and this is at a time when we can collectively least afford it.

Surely it was better in the "good old days"?

## The Lessons of History

The general consensus is that the only lesson we learn from history is that we don't learn what history can teach us. So how did we get here?

1670 - First organised pension scheme, being for Royal Navy Officers

1908 - First general old age pension (effective 1/1/1909)

This pension was worth about £20pw in today's money (it was 5 shillings). However you had to be **70** to get it (when life expectancy was 51.5 remember) and have no convictions under the "Inebriates Act"!

1921 - Tax relief for pension schemes

1946 - Basic State Pension (effective 1948)

At that time, the expectation of retired years was around nine at most; today it is at least twice that amount.

1947 - Tax relief and tax-free cash restricted

But that's not all. Longevity is not the only rising trend - red tape is too.

There are now 5 Pension Acts!

– Pension Schemes Act 1993

– Pensions Act 1995

– Pensions Act 2004

– Pensions Act 2007

– Pensions Act 2008

and yet more to follow with the Pensions Bill 2011. Politics will always be backward looking and hence regulation is always a follower…..and pension funds follow regulation. As we lay on our defined benefit ("DB") pension death bed, a lot will flash before our eyes:

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| 1950s | • Emergence and growth of private sector DB schemes |
| 1960s | • Significant growth in pension scheme investment in equities |
| 1970s | • Period of high inflation and interest rates - Creation of SERPS and contracting-out |
| 1980s | • Legislation emerges requiring increasing guarantees in DB benefit provision |
| | • Introduction of inflation index-linked gilts, especially for pension funds - who roundly ignore them |
| | • Overfunding legislation introduced |
| | • Legislation introduced to cap pensions for high earners |
| 1990s | • EU requirement for sex equality (Barber vs. GRE) |
| | • Significant tightening in accounting for pension schemes (SSAP24 and then FRS17) |
| | • Pensions Act introduces Minimum Funding Requirements |
| | • Real yields on index-linked bonds peak at over 4% as they are shunned still by pension funds |
| | • Increases in DB pension scheme costs from increasing longevity and low interest rates / inflation |
| | • DB pension schemes start to close to new entrants |
| | • Pension schemes start to de-risk and switch out of equities into bonds to better match liabilities (Boots) |
| 2000s | • Debt on Employer legislation significantly increases corporate responsibility for pension scheme deficits |
| | • Pensions Act introduces the Pension Regulator and a tougher funding regime |
| | • Real yields on index-linked bonds are less than 0.4% - every pension fund wants to buy them! |
| | • De-risking of pension schemes extends to liability management exercises and derivatives (WH Smith) |
| | • DB pension schemes start to close to all employees |
| | • Turmoil in financial markets….and again….. |
| | • Significant restrictions (and tax penalties) on pensions for high earners |

There's clearly a fiscal and welfare storm coming, but does "government" have the resource or expertise to generate solutions? Are ministers in office long enough to care or make a difference?

State Pensions may not be enough to live off, but are you going to die on them though?

Personal responsibility is key to financial security - it is a myth that "the State" is somebody else and this somebody else will fund our comfortable retirement. Whether by taxes, NI contributions, occupational and personal pension schemes, personal savings and housing equity, there is only one person who ultimately pays for my retirement….me. Once accepted, then the only real question is "how much to save?" and this is where education is really needed, however unpalatable the number.

When I received my first salary, the pay slip listed a number of deductions - I could debate the fairness of paying tax, but ultimately being a member of society requires that I do. I also have no influence on how much - when the Chancellor stands up to deliver his Budget or Autumn Statement, the rates to prevail are in his decree not mine. So should it be with pensions - if we do not compel individuals to save for retirement, they will not - consumption today is so much more enjoyable. Yes, it may be seem unaffordable today - but it's not obvious when personal finances will be any better and the longer we delay, the steeper the climb. As a rule of thumb, I often invite people to contemplate the home in which they want to live in at retirement - and then tell them they need to save twice the capital value, one house to live in, one to live off. Using this benchmark, those that crow they are saving £25-50 per month realise that it would not get them anywhere near the sort of mortgage they really need.

About 80% of UK defined benefit pension funds are closed to entrants now, the majority to accrual consistent with the increasing bias to defined contribution provision worldwide. But can a "blue collar" (or even white collar) workforce really define/understand means, trends, expectations and the plethora of other investment jargon? Some of the early economic philosophy theories include the basic hierarchy of needs and the division of labour. Whilst I can read books, or more likely download, all the theories on how to build houses, hunt, slaughter and butcher a cow and extract my own teeth, I do believe that such activities are best left to full-time professional builders, butchers and dentists.

Conversely the solution to the pension saving crisis is that if we educate these people enough about how to become investment and risk management specialists they will change behaviour voluntarily and save, not only saving well but in volume. This seems an unreasonable expectation though if we don't first make blunt the responsibility and the size of the personal responsibility. Risky investment alone is not a panacea - no pounds in, means no pounds out.

There is also the law of unintended consequences to consider - if we give people the tools and responsibility to manage their personal wealth, how many would be better spending their last years of working pre-retirement "day trading" their personal portfolio rather than getting on with the day job?

If the past is any guide though, the vast majority will abdicate this responsibility. Historically the most successful personal investment product, notwithstanding the Equitable experience, was the with-profits policy. This product was completely opaque as to the real charges incurred (by definition the distributable "profit" was after costs) which rather undermines the perception that the level or transparency of costs is a major bar to saving. What it did offer was a smoothed, reasonable and capital protected return where all the difficult decisions were handed over to professionals - it was the destination, not the route or the means of travel that mattered. The challenge of industry is to recreate the best aspects of the product whilst making it suitable for public consumption and today's more onerous regulatory environment.

The pensions crisis is still long on questions and short on answers and the long term goal seems increasingly unaffordable, latest projections of funding the shortfall in state backed pension and health care imply a 13p increase in basic rate income tax or VAT. Achieving a reasonable standard of living in retirement will cost considerably more. However it is not the State's problem, it is our problem - finger pointing or worse, putting our collective head in the sand and hoping the problem will go away, is not a strategy either.

We must not though be paralysed by fear and together do something now – it's always better to be roughly right than exactly wrong.


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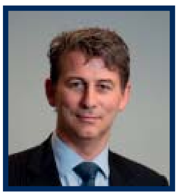

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