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Money for life: The pros and cons of the Purpose Longevity Pension Fund

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A pioneering new retirement product offers a step forward in Canadians' continuing struggle to generate income for life. Most notably, it aims – but doesn't guarantee – to deliver a 6.15-per-cent annual return for life on contributions made by a 65-year-old investor.

The catch? The new Purpose Longevity Pension Fund, from Purpose Investments Inc. in Toronto, also demands that investors deal with a novel (and sometimes sticky) structure and accept some fundamental uncertainties.

The fund is the latest entry in the continuing race to develop better retirement alternatives. Last year, Vanguard Investments Canada Inc. launched its Retirement Income fund (VRIF), a balanced portfolio of low-cost exchange-traded funds that targets – but again, doesn't guarantee – a 4-per-cent payout. Other entries are sure to follow.

This burst of financial innovation is welcome news. It addresses a huge need among retirees desperate for steady sources of income in today's low-return environment. But you have to know what is going on under the hood to gauge whether any of these products will suit your individual situation. The Longevity fund, in particular, contains a lot of moving parts.

For starters, the new offering is structured as a mutual fund. You can buy or sell units in much the same way as you would with other mutual funds. But the Longevity fund aims to function in many ways like a defined-benefit pension plan. This is a pioneering concept.

So is its eye-popping 6.15-per-cent annual target return for 65-year-old do-it-yourself investors. At a time when long-term government bonds and guaranteed investment certificates can't pay even 2 per cent, the payout seems close to miraculous.

How can it aim to pay so much? One key is "mortality credits" – the time-honoured actuarial practice of having fund investors who die young subsidize those who live to a ripe old age.

Here is how it works in the case of the Longevity fund: When a unitholder dies, his or her estate will receive the unitholder's initial contribution minus the total amount of income payments the investor has received over the years. Any gains generated by the capital the person has invested will remain in the fund to bulk up monthly payments for everyone else.

The first time most people hear about such arrangements, they often rebel. It strikes them as wrong that anyone should benefit from another person's death. The possibility they could be one of those early deaths is particularly galling because it suggests they could be on the losing end of the transaction.

It's easy to understand those feelings. But there is nothing wrong or even novel about the basic concept of pooling longevity risk. It dates back to the tontines of the 17th century. These were essentially lotteries in which the person who lived longest took the prize.

Modern defined-benefit pension plans do away with the winner-take-all aspect and spread the payouts more equitably, but they still depend on pooling longevity risk to generate much of their results.

Think of it this way: If you retire at 65, one of your biggest challenges is figuring out how long you will live. You could still be ticking along merrily at 95 or even 100.

Individual retirees tend to deal with the inherent uncertainty of longevity by erring on the side of caution. To ensure they won't

outlive their money if they reach 100, they allow themselves to spend only measly portions of their wealth every year. Many seniors deprive themselves and pass away with large amounts of unspent money.

A pension plan offers a fundamentally better way to approach this longevity uncertainty. By pooling your money with that of other people, a pension plan transforms one of the great unknowns of retirement (how long you personally will live) into something that can be estimated with a high degree of accuracy (how long the average person in the plan will live).

As a result of this new precision, a plan can draw down its assets more aggressively than an individual could. It can safely assume, for instance, that its typical member will live to their mid-80s rather than 100. It can also calibrate its payouts to ensure the money left unused by those who pass away early is sufficient to balance off the needs of those who are still going strong at 90 and beyond.

To be sure, the people who do best from this arrangement are the Methuselahs. They receive a substantial boost in their later years from the contributions of those who expire early on.

But even the unfortunate people who pass away at younger ages usually get to live better in retirement than they otherwise would, because the pension structure allows them to draw on their pooled savings more aggressively than they would if budgeting on a solo basis.

If mortality credits form a big part of the Longevity fund's magic, so does its implicit willingness to tolerate a bit of potential volatility. Unlike an annuity, it reserves the right to cut payouts if its investment portfolio runs into a particularly rough patch.

How likely is a cut? Not very, Purpose insists. It needs to achieve only a 3.5-per-cent to 3.75-per-cent annual return on the fund's portfolio of stocks, bonds and alternative investments to maintain distributions. (The plan has apparently passed muster by actuaries, but Purpose has not immediately agreed to a request to share the actuarial review.)

If history is any guide, the Longevity fund should be able to increase payouts in later years thanks to mortality credits and investment returns. This suggests the Longevity fund is likely to deliver a substantially better return to long-lived unitholders than an annuity would.

Don't forget, though: Nothing is guaranteed. Investing in the Longevity fund requires a willingness to tolerate uncertainty. How you feel about embracing the uncertainty will hinge on your individual circumstances.

"You should invest in a product like this only if you are concerned about the possibility of living for a long time and outliving your money," says Tom Salisbury, a professor of mathematics at York University, and expert on tontines.

If you are in poor health, investing in the Longevity fund doesn't make sense because the bulk of the benefits go to those who live longer than average. Similarly, if you already have enough secure pension income to cover your basic expenses for life, the Longevity fund doesn't fill any obvious gap.

Some other caveats: The Longevity fund doesn't offer any reduced stream of payouts to your spouse after you die, the way employer-sponsored pension funds typically do, so it should be viewed as an individual solution.

In addition, it should not be the primary investment for anyone whose main goal is to leave behind a large bequest. This is because the terminal value of your investment in the fund declines rapidly once you start collecting payouts in the "decumulation" stage of life. For somewhat similar reasons, the fund is also a poor choice for retirees who think they might change their minds about staying invested.

The withdrawal value of your Longevity fund holdings is the lower of its net asset value or your initial investment amount minus the accumulated amount of monthly payments you have already received. Collect a 6.15-per-cent annual payout for three years and the withdrawal value of your original investment will shrink by more than 18 per cent. At that point, and subsequent points, most investors

are likely to find the withdrawal penalty too painful to contemplate.

Someone in the decumulation stage of their life "should view investing in the product as effectively a one-way street," says Dan Hallett, a principal at HighView Financial Group in Oakville, Ont. He says the sticky structure is potentially an issue because of the lack of guarantees with the product. An unusually bad run of market results could trim payouts. A possible acquisition of Purpose in years to come might result in management changes or other shifts you might not welcome.

Balancing such concerns are several positives. Fees on the Longevity fund are reasonable, Mr. Hallett says. (Purpose estimates the management expense ratio will be around 0.71 per cent for a Class D or F version and about 1.25 per cent for the A version.) The broad strokes of its approach also seem intelligently designed. "It is an interesting product and definitely addresses the need for many people to generate long-term sustainable income," Mr. Hallett says.

Bottom line? The Longevity fund is a pioneer. Its ability to offer access to mortality credits in a mutual-fund format is particularly noteworthy and is likely to lift returns for long-lived investors. If you are close to retirement age and don't have a defined-benefit pension, you should look at it carefully. But you should also consider other approaches – including ones that are likely to hit the market over the next couple of years.

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