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HOUSE VIEW

SERIES

WHY CRITICAL YIELD IS STILL IMPORTANT

Now pension freedoms – and in particular, flexi-access drawdown (FAD) – are firmly embedded, many are asking if critical yield in drawdown reviews is still relevant.

Critical yield doesn't appear on new FAD review statements. These days, it's only found on older capped drawdown review packs, as part of Government Actuary's Department (GAD) calculations. And this makes it seem a bit old fashioned and out of date.

Critical yield has had bad press recently. As well as being criticised for being complex, it's a calculation that's often difficult to explain to clients. And all of this makes it a bit too easy to gloss over.

Some advisers are using cash flow modelling software in conjunction with a client's pension funds to work out their income and lump-sum needs over time. So, are less people using a critical yield formula because it really is out of date?

Well, we think critical yield is still relevant. We also believe it's a crucial part of the review process that's overlooked at the retiree's peril. There are factors that support this view: sustainability and impact of the retiree's health and lifestyle.

Sustainability

Advisers who don't use cash flow modelling with drawdown clients need to use some form of benchmark to demonstrate sustainability. This measure is needed to satisfy not only compliance requirements, for suitability reports, but also to offer clients a way of managing their expectations.

The critical yield calculation is a good tool for benchmarking income withdrawal on older capped drawdown plans. It also works as a guideline for customers in new FAD. This might not be an issue for people intending on dying in drawdown and using it for legacy planning. But anyone using their fund for retirement income purposes will definitely need some point of reference for judging their risk of running out of money.

A critical yield calculation can also be useful for investors who:

- have taken their tax-free cash;
- chosen not to draw an income right now; and
- are staying in a holding pattern.

If these investors defer taking an income, a critical yield figure can provide a proxy benchmark for growth. It can also demonstrate the potential income – and therefore the equivalent return – that a guaranteed income for life solution (GIfL), provided by an annuity, can provide. The growth they achieve should be at least equal to this, otherwise it would call into question the ability for the portfolio to maintain the level of income required by the client.

To make sure a critical yield has meaningful value, it must be tailored to the client's circumstances. This means factoring in the client's health and the shape of their GIfL income. Most critical yields are worked out using standard assumptions. But there are calculators out there that allow individually underwritten GIfL figures to be used. And these provide very different results to those in the review packs.

Impact of health

With cash flow modelling, there's an argument that critical yield isn't needed. This is because the adviser can map out the various returns needed at any given point, over a period of time. These can then be linked into the client's pensions and investments, all of which can then be managed and adapted.

These models are only as good as the information that's fed in. If the adviser doesn't take into account the client's health – in other words, using a fully underwritten, individually shaped GIfL income as a comparison – then the growth calculation needed to sustain income withdrawals could be flawed. Shock to income flow (through sudden illness, say) can be built into a model. But a client who qualifies for a higher income at outset because of their health and lifestyle could make a big difference to the long-term yield comparison.

As well as underestimating the level of income that could be achieved using a personalised underwritten GIfL, it might also mean a lower capital amount's needed to deliver a targeted income for the rest of the client's lifetime. Using a personalised underwritten GIfL income figure that's run through a critical yield calculator provides a secondary sense check when building a client's income portfolio.

Summary

We think critical yield remains an integral part of any assessment of whether drawdown is still suitable for a client. It should be considered at outset – when the client's deciding on a retirement solution – as well as in every review, for both capped and flexi-access drawdown.

The fact that FAD review packs don't include a critical yield figure makes providing a tailored benchmark even more important. This way, the client will be fully aware of what level their plan needs to perform at. It'll also help show the client whether or not their plan is still viable when mapped against their ongoing capacity for loss, attitude to risk and crucially, their health.

You can find our critical yield calculator at: **justadviser.com/financial-planning/calculators/critical-yield/**

FOR MORE INFORMATION

Call: **0345 302 2287**
Lines are open Monday to Friday, 8.30am to 5.30pm

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