Managing income in retirement has become a conundrum for our times, with advisers, clients and the pension industry all offering different ideas on the best way to solve the same problem.

It's reasonable for retirees to want the best of both worlds; flexibility, access and control over their retirement savings along with the reassurance that their money will last for as long as they do. But is the likelihood of being able to deliver this like asking for the moon on a stick? How can advisers deliver a consistent and robust outcome for each client in retirement? Is a scientific approach best, or a gut feel and years of experience the way forward?

We decided to undertake our own research as well as considering other papers on this wide ranging subject, to try and understand the different views on offer, and to draw some conclusions on the art of managing income in retirement.

Days gone by...
The bedrock of pension planning, and delivery of income in retirement, in the UK has up until recently been state pensions, defined benefit schemes and lifetime annuities. The common characteristic of these sources of income is durability. Britons have never really had to confront the possibility of running out of money during retirement. Even when income drawdown was introduced in the nineties, safeguards existed. Limits were imposed on income and, for all intents and purposes, annuitisation was compulsory at age 75.

The pension freedoms introduced unfettered drawdown. Now people can take as much as they want, whenever they want. With greater freedom comes greater responsibility on the individual, and a review of what's happening around the globe doesn't bode well.

- 40% of Australians have exhausted their pension savings by age 75
- Americans withdraw eight percent each year and make their savings last for 17 years on average (five years before the average life expectancy for a 65 year old American)¹

Nearer home, stochastic modelling by Royal London suggests that the majority (54%) of its drawdown plans, where regular income is being taken, have less than a one in five chance of sustaining current income levels for life². There may be a variety of reasons why it is legitimate to take more than would usually be considered prudent, but the proportion of people adopting this approach suggests it may become endemic among UK retirees.

The new ‘normal’?
Not only is the prospect of people running out of money a worrying development, but the magnitude of the issue is far greater now. Drawdown has become the new ‘normal’. Before pension freedoms were introduced, annuities dominated the pension landscape. In 2013, 90% of consumers bought an annuity, while only 5% purchased a drawdown product³.

² Drawdown governance – how much income are people taking?, Royal London, June 2016
³ https://www.moneymarketing.co.uk/issues/26-january-2017/annuities-down-but-not-out/
Since 2013 drawdown sales have increased eight-fold\(^4\). In the first half of 2017, drawdown sales are three times higher than annuity sales\(^5\). Of course, many people may have taken their tax-free lump sum without taking income. Some of these people may annuitise when they eventually decide to take income, but it is difficult to deny that there has been a seminal shift from annuities to drawdown. This may have profound consequences in the future.

**Ascending vs descending the mountain**

Investment strategies that work in the accumulation phase may not make sense in the decumulation phase (see Chart 1). Retirement can be an unforgiving environment. Capital is reduced and converted to income. The time horizon is unknown and the opposite of pound cost averaging, pound cost ravaging, can be devastating.

**Chart 1: Accumulation is very different from decumulation**

<table>
<thead>
<tr>
<th>Accumulation</th>
<th>Decumulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Converting income into capital</td>
<td>Converting capital into income</td>
</tr>
<tr>
<td>Fixed term horizon</td>
<td>Unknown time horizon</td>
</tr>
<tr>
<td>Investing for growth</td>
<td>Investing for income</td>
</tr>
<tr>
<td>Increasing capital</td>
<td>Reducing capital</td>
</tr>
<tr>
<td>Pound cost averaging</td>
<td>Pound cost ravaging</td>
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</tbody>
</table>

Despite this, a 2016 survey of New Model Advisers top 100 advisers revealed that 86% offered the same Centralised Investment Proposition (CIP) to both pre and post retirement clients\(^6\). According to Danby Bloch, Plattforum 2017 revealed that some 60% of advisers do not have a Centralised Retirement Proposition (CRP)\(^7\).

Taken at face value, this is a worrying concern. It suggests that advisers are applying investment strategies designed for the accumulation phase with their decumulation clients. To understand this further we commissioned research. The objectives of the research were to:

- Confirm whether the penetration of CIP and CRP strategies aligned with the findings from other sources.
- Understand why advisers who don’t use CIPs and CRPs take this approach.
- Explore to what extent advisers that don’t use a CRP still take into account factors that should be explored in developing investment strategies for their decumulation clients.

Our research was undertaken with 257 advisers in March 2018, and found that in the pre-retirement wealth accumulation phase, the split was 47% of advisers using a standardised central investment proposition for their clients, with 53% using a bespoke approach, and treating each case on its own merits.

However, when asked about when clients move into the decumulation phase and require income, overall 57% of advisers still used the same investment strategies for their clients.

**What makes a Centralised Retirement Proposition?**

When asked specifically about use of a centralised retirement proposition, the research found that 53% of advisers said they adopted this approach, with the compliance services of networks, platform and product providers used as the main sources for support and guidance.

In trying to understand why some advisers use a centralised approach, the main reasons cited were it was a useful part of constructing advice, perhaps providing time saving and consistency of outcome. For those that didn’t, the reasons given where that client needs were deemed to be individual, and therefore one size didn’t fit all.

This led us to explore the component factors that advisers consider for decumulation, comparing those advisers that use a CIP for pre and post retirement, or bespoke approach, against those that use a CRP to create a suitable investment strategy for decumulation.

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\(^{4}\) Retirement Outcomes Review, FCA, July 2017

\(^{5}\) [https://www.moneymarketing.co.uk/drawdown-sipps-continue-boom-non-advised-sales-growing/](https://www.moneymarketing.co.uk/drawdown-sipps-continue-boom-non-advised-sales-growing/)

\(^{6}\) New Model Adviser, How advisers are building centralised investment propositions, July 2016

The encouraging results were that the same three issues dominated, with sustainable income withdrawal rates, attitude to risk and capacity for loss making up 61% of the ranking of importance for those using a CRP and 66% for those that didn’t use a CRP.

This tells us that when it comes to retirement, advisers are focusing on the main core issues that affect clients; managing risk and ensuring that their money will last as long as they do. However, it also shows that there are wide ranging approaches to achieving this.

This leaves a remaining concern – for those advisers using a pre-retirement strategy CIP for their clients’ post-retirement and decumulation needs, how broad are the range of assets being considered? A CIP wouldn’t necessarily include a guaranteed income for life product such as an annuity as this would sit outside of an investment portfolio and strategy in the accumulation stage.

Further to this, irrespective of whether a CRP is used or not, are those advisers who classify a client’s expenditure and identify the need for secure income to cover essential outgoings including products such as annuities? Is there too much of a heavy reliance on a portfolio of equities to provide the solution to every problem?

**Delivering sustainability**

It could be suggested that if sustainability of income is one of the main concerns for advisers and clients when facing the challenge of provision of income in retirement, then we need to examine how a guaranteed income for life (provided by an annuity) can fit into the picture. Also, whether the way in which an annuity is used needs rethinking.

What do we mean by this? It’s probably a safe bet to say that many advisers and clients alike think that the best time to buy a guaranteed income for life is when the client is much older, when rates are higher, and perceived to be better value for money.

Of course there are situations when this is the right course of action, but there is room for a more diverse take on the product. And that is to perhaps think of the annuity as an asset class in its own right.

If this sounds a bit daft, then consider how much time is spent trying to recreate what an annuity does using investment based vehicles to mimic the same level of security.

That is a secure sustainable level of income that most fund managers would give their right arm for.

Also, trying to replicate the income rate an annuity can deliver misses the other guarantee it offers, which is that the money will never run out, no matter how long the client lives for.

**Use of an annuity for income provision, even partially, allows the client to reshape and re-apportion their remaining equity holdings.** Rather than being forced to adopt a cautious approach, or switch from growth to income funds, use of an annuity allows the client to have a more aggressive demeanor on their equities for pure growth, whilst the annuity does the heavy lifting of income provision.

Using a guaranteed income for life, provided by an annuity, to underpin essential income requirements is a smart way of giving the rest of the client’s portfolio room to breathe. It also helps advisers by not requiring them to regularly dismantle parts of the portfolio they have carefully crafted for growth every time the client wants income.

When using a CIP or bespoke approach to retirement income provision, even if other assets are allowed for (such as ISAs, property equity etc), and expenditure is targeted by need, the strategy still faces longevity risk, volatility of capital risk, and sequencing risk. Assets can still be reduced in real term value or exhausted all together.

Let’s be clear though, this isn’t suggesting that annuities are the answer for everyone. No, this is more about how an annuity can be used, where appropriate, as an asset class to bolster sustainable income, and form a broader part of a CRP in the new era of pension freedoms.

**Forget 4%. Let’s get personal.**

In March 2018 the Institute and Faculty of Actuaries published their report on how a combination of drawdown and guaranteed income for life using an annuity could affect consumer outcomes, and what other factors should be considered to minimise the risk of running out of money in retirement.

In their modelling, they concluded that the main factors that determined sustainability were the age at which a client entered drawdown and started to withdraw income. For example, they found that a client aged 65 in good health could withdraw an income at 3.5% and would likely to have a sustainable income for the rest of their life.

**Where this comes undone, is that annuities can generate between 5% and 7% of income for many clients (depending on health and lifestyle) with no investment risk or volatility risk.**

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*Can we help consumers avoid running out of money in retirement? - Institute and Faculty of Actuaries, March 2018*
This was based on data using a balanced investment portfolio, and compared against income levels of £4,000, £5,000 and £6,000 (see Chart 2). Their findings showed that the higher withdrawal rates were more likely to exhaust the fund and the client run out of money between 85 and 95.

**Chart 2: Median fund value with balanced investment strategy for £3,500, £4,000, £5,000 and £6,000 per annum withdrawal rates**

<table>
<thead>
<tr>
<th>Term (years)</th>
<th>Income Rate (1%)</th>
<th>2%</th>
<th>3%</th>
<th>3.5%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
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<td>100%</td>
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<tr>
<td>15</td>
<td>100%</td>
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<td>100%</td>
<td>100%</td>
<td>98%</td>
<td>81%</td>
<td>36%</td>
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<td>98%</td>
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<td>50%</td>
<td>6%</td>
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<td>0%</td>
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<tr>
<td>30</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>90%</td>
<td>70%</td>
<td>13%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Note: A 100% figure indicated that none of the 1,000 stochastic scenarios used in our modelling led to the fund being exhausted at the relevant time, suggesting that there is only a very low chance of running out of money.

If we consider that many of today’s 65 year old retirees will be in retirement for 30 years, then anything above a 5% withdrawal rate means the probability of not exhausting the pot of money falls to zero (see Chart 3). No one wants to run out of money, let alone at an age when there could be a need for income to cover care needs.

They also considered whether a combination of annuity and drawdown provided a viable alternative outcome. They compared different annuity purchase strategies, either all at a later age, or in stages over a number of years.

They concluded: ‘Consumers can reduce the risk of a low income due to living longer than expected or adverse market conditions by combining drawdown with annuities. This enables them to balance flexible access vs a guaranteed income and has the potential to increase the level of income they are able to generate from their pot.

Nine out of ten typical 65 year olds are highly likely to be able to purchase an annuity worth at least 3.5% per annum at age 75 if they take their pension at a flat rate of 3.5% via drawdown for the first 10 years of their retirement. On average these consumers could expect an income of around 6.4% once they annuitise’. 

The Institute’s findings suggest that there is a place for a product that offers a secure income that can be run in tandem, or phased in, alongside an invested solution. There is no need for a client to give up all of the flexibility that they seek, but opening up to the possibility that a secure underpin removes some if not all longevity risk whilst providing a sustainable income, allows investment freedom to flourish.

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Summary
From the research we have undertaken with advisers, it is clear that they are placing the highest priority on the issues facing clients in retirement; mitigating risk and preserving capital whilst delivering income.

However, the challenge that is facing advisers of clients who are moving from accumulation to decumulation in retirement, is one of finding a way to use products and investments to mitigate income volatility rather than a complete focus on capital volatility.

What is also clear is that more work needs to be done to demonstrate that decumulation in retirement brings with it a different set of challenges compared to the accumulation stage, and maintaining the same investment strategy for both invites difficulties that could otherwise be avoided.

Adopting a robust de-risked decumulation strategy allows for a recognition of the need for an investment strategy that can adapt to the post retirement rigors of pound cost ravaging and sustainability of income for life. A de-risked decumulation proposition also widens the focus for what lies ahead in retired later life, the vulnerability challenges, and changes to risk perception and capacity for loss.

Advisers are at the centre of this revolution in retirement thinking; retirement will be a huge part of most people’s lives, and as such needs the focus, consistency and surety that a de-risked decumulation strategy can offer.

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FOR MORE INFORMATION
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