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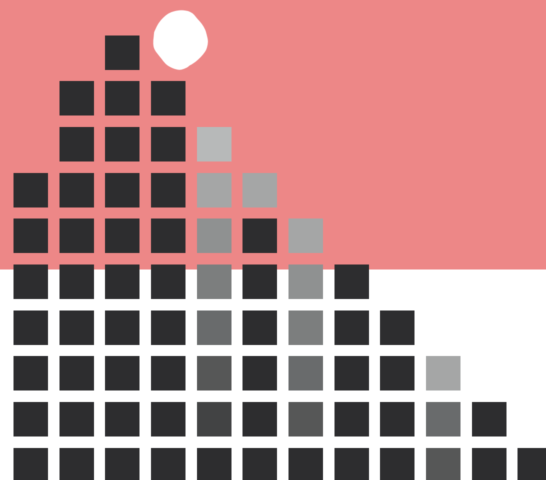
JUST.

THINK

A FRESH PERSPECTIVE



A PLACE FOR GUARANTEED INCOME IN AN INVESTED WORLD

Retirement is a complicated business these days. Don't get me wrong, retirees should have the freedom to do what they want with their retirement pots, it's their money after all. But what is clear, is that the complexities of ensuring that retirement funds last a lifetime has become a central focus for many people in or approaching retirement.

Deciphering the sheer volume of choices available can give anyone a headache, especially if they're not pension experts.

Having the freedom to access pension funds how and when a retiree chooses has led to a seismic shift in purchasing behaviour, with many people deciding to remain in drawdown when they would have previously chosen guaranteed income for life (GIfL), provided by an annuity.

It is this conscious move away from a product that was seen as restrictive and not providing value for money that is the most marked change.

However, now that retirees have their freedom, how many truly understand that by remaining invested they also continue to assume all of the risks, particularly longevity.

Is it now time to reconsider offsetting some of those risks, and re-think how a GIfL can work as part of a retirement portfolio when the question of income in retirement is eventually raised?

Chasing a sustainable withdrawal rate

For many retirees (excluding those with small pots for now), the extent of exercising their pension freedoms has been to withdraw their tax free cash lump sum, and retain their remaining funds in a holding pattern in a drawdown plan, but not actually drawing down on the funds…yet.

There are often good reasons for this; people continuing to work, funds being earmarked for legacy planning, or other wealth and assets being accessed first, such as property equity.

However, given the sheer volume of money that has been pouring into drawdown and onto platforms since pension freedoms, it won't be too long before the pent up demand for income starts to manifest itself. Clients will be looking to advisers to work their magic and provide a decumulation strategy that enables them to withdraw the level of income they choose, whilst allowing for capacity for loss and ensuring the funds will never run out.

This is a tall order, especially when you consider that often there is an expectation that the invested retirement fund will be able to provide all of this. But should it?

Annuities have long been considered the product of choice if a client had absolutely no capacity for loss or risk appetite whatsoever, and often the thinking is that they are only worth buying when the client is 'old enough for the rates to be good enough'.

This is where the thinking needs to be updated.

Annuity rates have been improving of late, and advances in underwriting techniques have led to a more personalised approach, which means that the old view of 'standard' and 'enhanced' rates have bitten the dust.

What we have now is the ability to provide a personalised rate based on an individual's specific circumstances. For example, height and weight, postcode, marital status, and alcohol consumption can all make a huge difference to rates.

An individual doesn't need to be ill to get an increased GIfL rate.

And everyone is different. If there were ten 65 year old people in a room, they would all have completely different rates, as they would all have their own specific longevity curve based on their individual circumstances.

So why is this important? Because it fits perfectly into the puzzle of sustainable withdrawal rates.

Every client that decides to switch on income from their drawdown plan will have their own idea about how much they need, the trick is to work out what is sustainable. What happens if they really need 5%, but can only sustainably withdraw 3.5%?

Is it time to stop looking at whether a retiree is 'old enough' and look instead at what income level they require, and see if the GIfL rate matches? Be income rate driven rather than age driven?

Let's look at three different retirees, using a range of typical health and lifestyle conditions*.

	Healthy	Respiratory	Diabetes Type 2
65	4.98%	5.64%	6.18%
70	5.40%	6.09%	6.83%
75	5.63%	6.24%	7.15%

As we can see from the table, the rates for a 65 year old (averaged from July 2018 to December 2018) show that they can achieve a lifetime income rate of between 5% and 6%. The respiratory and diabetes examples provide some context for underwriting, but the healthy rate is for someone with no illness. They can achieve a rate of over 5% with no investment risks and hedge against longevity at the same time.

This tells us it's time to start looking at GIfL based on the income rate the client can achieve rather than their age.

To blend or not to blend?

Let's address the obvious objection that is usually thrown in at this stage; the capital used to purchase the GIfL means not only disinvesting from the drawdown fund, but it's 'lost' to the insurer if the client dies early.

Options available with GIfL mean that the capital never has to be lost; death benefits can provide a guarantee period of up to 30 years of continued income, or a spouse's continuation of income at a chosen percentage. Alternatively capital protection (also known as 'value protection') can provide a return of capital less income already paid. The tax treatment is the same as drawdown. Exactly the same. So the argument that the money has to die with the annuitant is no longer valid.

As for disinvesting drawdown funds, there is an argument that if the client requires provision of income for the next 30 years for example, then a significant portion of capital would have to be earmarked to sustain this. If the money is going to be used for income anyway, purchasing a GIfL achieves the same goal, but removes certain risks such as longevity hedging that remain present in drawdown.

Of course there are myriad ways to generate income solely from an invested portfolio, each of which have their own pros and cons, for example:

- Natural yield – This can be a simple route to follow, especially for retirees, where they essentially match off returns on their investment (which may have been switched to income variant stocks) against their income needs. Where it can come slightly unstuck is if they have a particularly poor run of investment returns, which could mean lower income taken or potential capital erosion.
- Moving to more cautious funds, or drawing from cash – For retirees, this can engender a certain degree of confidence, particularly if money is felt to be in a 'safe' place, such as gilts, bonds, or cash. Using this method means assigning tranches of capital into more cautious assets to provide income over a set number of years, possibly whilst the remaining fund is invested more aggressively. However, not only do many of these funds still fluctuate in value, and retain continued longevity risk, but there is a catch-22 on how much growth the client is potentially missing out on by assigning this money to more cautious funds.

*Based on an individual with a fund value of £100,000. An annuity being payable monthly in advance, no dependant's pension, no escalation, 10 year guarantee period, no value protection. Rates cover July 2018 to December 2018.
Healthy Life - post code only. Respiratory - COPD diagnosed 13 years ago, lung function minimally impaired, hospitalised two years ago, takes one medication. Diabetes Type 2 - diagnosed nine years ago, one medication taken daily, HbA1c readings provided, monitors blood glucose levels once a day.

Whichever method is used, the question of risk is omnipresent. The idea of blending is more than just finding a good rate, it's about shifting risks for the retiree. And if GIfL is thought of as a 'pseudo asset', it's the only vehicle that can meet both of those requirements.

True blending for a personalised solution

There are two areas for consideration if thinking about using GIfL for blending purposes; the impact on the remaining capital, and the effect on the sustainable withdrawal rate.

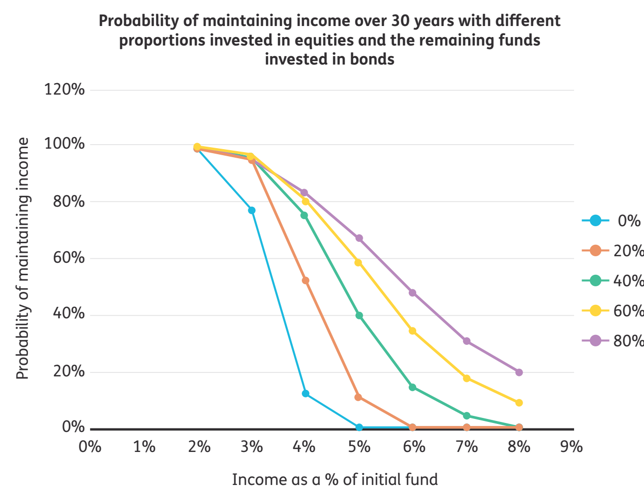
By securing an underpin of guaranteed income, the retiree (and adviser) are able to look again at how the scale of acceptable investment risk has moved for the client, and rebalance the remaining equities, incorporating the GIfL into the equation as part of the portfolio. If it's covering the secure end of risk, then there is more scope to look at a more aggressive approach with the equity holdings. A client who might have been veering towards a cautious approach out of necessity rather than choice can look at funds that are more adventurous, as the overall portfolio is balanced out by the guarantees of the annuity.

The real concern here though is to answer the question of whether this method provides an income rate for the retiree that is sustainable for the rest of their life. To do this, we can look at the impact of replacing the bonds element of an example portfolio with an annuity.

In chart 1, we have stochastically modelled the probability of maintaining income over a 30 year period, assuming this is a typical length of retirement for many.

This is based on a balanced set of equities, and the bond element is split 50:50 with high yielding and investment grade bonds.

Chart 1



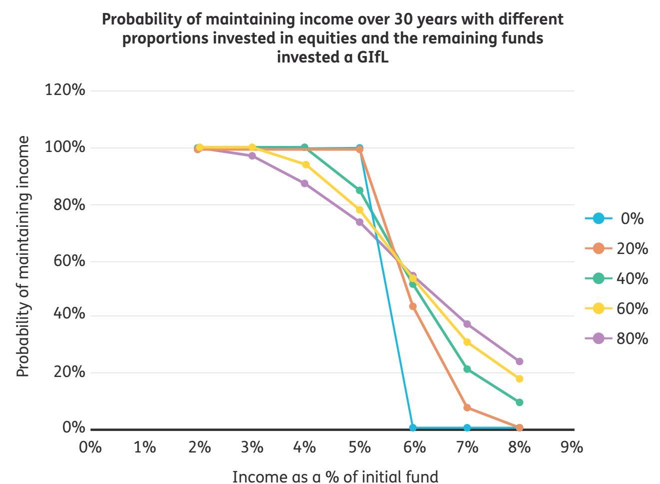
This shows that the higher the level of income taken, the probability of sustaining it over a 30 year period changes in accordance with the mix of equities and bonds held. For example, if the portfolio has a 40% holding in equities and 60% in bonds, there is a 40% chance of maintaining income at 5% over 30 years. This also reflects the results shown by Morningstar in their recent paper, so shows consistency in results.

If the split is flipped, for example 60% equities and 40% bonds is used, then the probability moves to 60% chance of success of delivering 5% income sustainably.

We can also see that if the entire fund is shifted into bonds, (for example 0% equities) then the probability of sustaining income at levels above 3% fall away rapidly. With a higher equity content of say 80% then we see the highest chance of sustaining higher levels of income above 5%.

Now taking it a step further, what happens when we strip out the bonds element, and replace it with a GIfL? This example assumes a 65 year old in 'reasonable' health, which generates an income rate of 5.8%, uses the same stochastic simulations.

Chart 2



Now we can see that the curves have shifted markedly to the right. If we examine the 40% equity holding again, with the balance in GIfL then the probability of sustaining 5% income has increased from 40% in the previous chart to 84.9%. (To clarify, the 0% equity holding will fall away from 100% probability to 0% after the 5.8% income level as this is would be the rate of income paid under GIfL).

Looking at a higher equity content of 60%, the probability of sustaining 5% income is pushed up from 60% to just under 80%. Using GIfL, even at higher withdrawal rates, increases the probability of maintaining income, as the volatility found in bond funds and the chance of a negative return has been removed.

Summary

The idea of blending invested solutions with a guaranteed underpin when it's time to put sustainable income in place has been around for a while now, and become more prominent since pension freedoms.

However, there doesn't seem to be any clear evidence that this is happening in any great volume, and there may be several reasons for this. Perhaps it comes down to the perception of annuities, or maybe it is recognition of where clients and advisers have chosen to do business and manage their retirement wealth.

Either way, there is no denying that when it comes to providing a sustainable withdrawal rate in retirement, treating GIfL as a guaranteed asset class and putting this into the mix shows that blending works.

The risk dynamic is shifted, allowing the retiree to be more aggressive (if they want to be) to chase after growth with the remaining equity investment. Not only does it meet the sustainable withdrawal rate conundrum, but it also provides a measure of capacity for loss protection.

It's inevitable that there will be a market correction at some point, and blending in this way will help to mitigate some of the downside, while providing longevity hedging. Although we have collectively been enjoying a strong run in the markets for many years now, 2008 wasn't that long ago, and if anyone remembers speaking to drawdown clients at the time, then blending retirement portfolios with GIfL suddenly seems like a no-brainer.

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FOR MORE INFORMATION

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