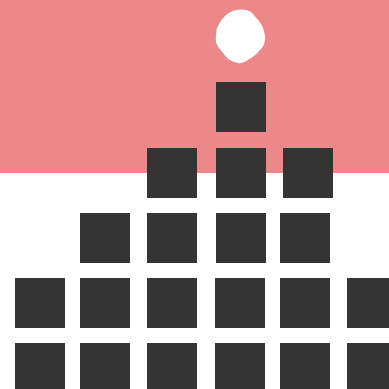


THINK

A FRESH PERSPECTIVE



DEFINING AND EVIDENCING SUSTAINABLE WITHDRAWAL RATES

Get next week's winning lottery numbers here! Wouldn't that be great, knowing what the future holds? But, until we can predict the future with certainty, finding a good way to calculate and more importantly, evidence a sustainable withdrawal rate (SWR) is vital to many retiree's future. You may feel you've already read and heard enough on this topic but, as we're not an investment house, you might find something new and different in this report.

Spinning plates

The subject of sustainable withdrawal rates has become a core advice issue for advisers who have retirement clients.

It's understandable of course; the retiree is not only choosing freedom and flexibility, but also accepting liability for longevity risk, which naturally goes hand in hand with ensuring any income taken won't exhaust their capital during retirement.

Advisers face a difficult challenge when a client decides to switch income on from their drawdown plan. Risks are turned on their head when moving from accumulation to decumulation. The adviser has to keep many plates spinning; pound cost ravaging, sequencing risk, timing risk and capacity for loss are all variables that have to be considered in helping a client safely withdraw money from their drawdown pot.

There are many methods for articulating what that rate could be, but how is this evidenced and relatable to the client's particular needs?

How do you put a consistent, robust and repeatable approach in place for every retiree when everyone's needs are different?

A de-risked decumulation strategy

Decumulation is a very different environment to accumulation, and as such requires a different strategy. For accumulation, the premise is largely to grow wealth whilst managing investment and market volatility in line with clients' risk appetites.

With decumulation however, in addition to the various different risks mentioned previously, there is a need to manage income volatility as well as capital preservation. This is a very different set of objectives. Where are the funds taken from to provide income? Is there a need to change asset types from growth to income generating? Do you use a cash buffer? What happens if the markets fall off a cliff in the middle of all this?

For adviser and client alike there is a fine line between draining capital to provide cash on demand, and genuinely creating a sustainable regular income. There are various methods that can be employed to do this, including using different asset classes and symbiotic products such as annuities.

Ironically, in this age of pension freedoms, whatever assets and methods you employ, generating sustainable income requires controls in place, which need to be effective. Many advisers are using (or investigating) a Centralised Retirement Proposition (CRP) for this purpose.

There is much debate around what constitutes a CRP. Perhaps the best way to describe it is as a de-risked decumulation strategy, or framework, to deploy various measures and tools which engender a deeper understanding and management of the different aspects of decumulation. Many advisers are already most of the way there using a Centralised Investment Proposition (CIP), and with a few refinements it can apply to the decumulation environment.

If we list out the component parts of a typical CRP, we can see the importance that sustainable withdrawal rates hold:

1. Consistently applied and documented advice principles
2. Robust approach to capacity for loss and spending hierarchy
3. Evidence based view on sustainable withdrawal rates
4. Use of appropriate planning tools
5. Adoption of Withdrawal Policy Statements
6. Consistent review process

Of course, every firm's decumulation strategy will be specific to their own business model, but at its core is the ability to articulate the various moving parts that go into establishing a sustainable withdrawal rate, and manage and record them.

Evidencing sustainable withdrawal rates

There have been many research papers in recent years (Bengen, Morningstar, Institute and Faculty of Actuaries et al) looking at finding the elusive 'magic number', with figures ranging from 2.5% to 4%, all with reasoned arguments to back it all up.

The issue though seems to be where these assumptions and calculations start – everything should start with the individual client, not the mass market.

Every client will have their own requirement for income, their own pension savings, debts and liabilities, their own needs and circumstances, their own views on what risks are acceptable. It will be different for everyone, and so everyone will have their own view on SWR.

The way to define, and evidence, the SWR applicable to each individual is to approach it from two perspectives.

1. **Define the income needs split between essential expenditure, and discretionary spending.** This is acknowledging the client will have ongoing lifetime costs they have to pay, and separately they will require money for the more leisurely aspects of retirement while they're able to enjoy them.
2. **Understand and establish the 'controls' for each income stream.** There are several moving parts that explicitly define how the SWR is arrived at for each income stream.

The first part employs fairly straight forward budget planning, assessing how much income is needed to match the different income needs in retirement. It's worth noting that essential expenditure can mean different things to different people. For some it could mean keeping the lights on, for others it's the weekly golf session. Once this exercise is carried out there is an income figure allocated for each component.

The next stage is to consider the 'controls'; these are the mechanics that drive the inputs into the adviser's stochastic modelling software, which can be (but not limited to) typically:

Time horizon – How long is the income stream needed for? Generally, the longer the time period, then the lower the SWR will be.

Inflation assumptions – If the income is covering ongoing bills and living expenses, then linking to CPI/RPI maintains purchasing power over time. This also has an impact on the SWR.

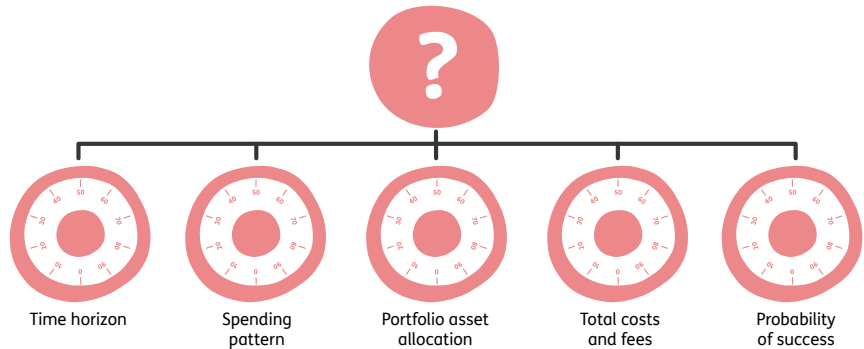
Portfolio asset allocation – This considers the equity exposure that is supporting the income stream. It is generally accepted that if a higher equity content is held, the SWR can be higher. However this needs to reflect the purpose of the income and risk capacity available. For essential expenditure, guarantees may be required, whereas for discretionary expenditure, a higher risk tolerance could be sustained.

Fees and charges – To obtain a realistic SWR, full costs need to be factored in, including platform fees, fund charges and ongoing adviser fees, apportioned across the income streams.

Probability of success – This defines the desired probability of a successful outcome. For essential expenditure it's likely to be close to 100%, but for discretionary spending could be lower to reflect lower importance.

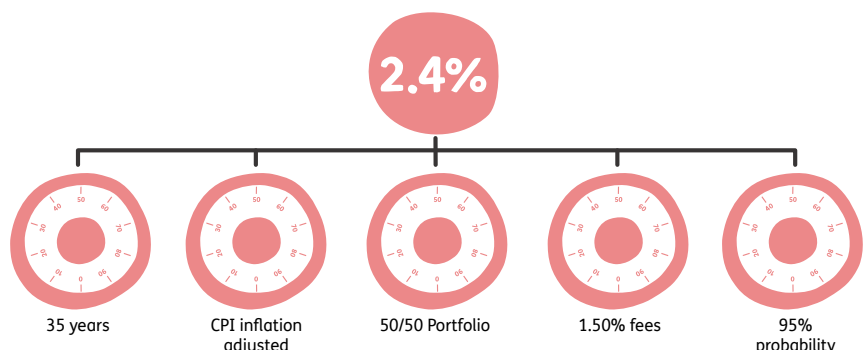
So what does this look like in practice?

If we imagine these controls as dials, and we set them in different positions, we get different SWR figures aligned to the respective income stream. This is what we start with:



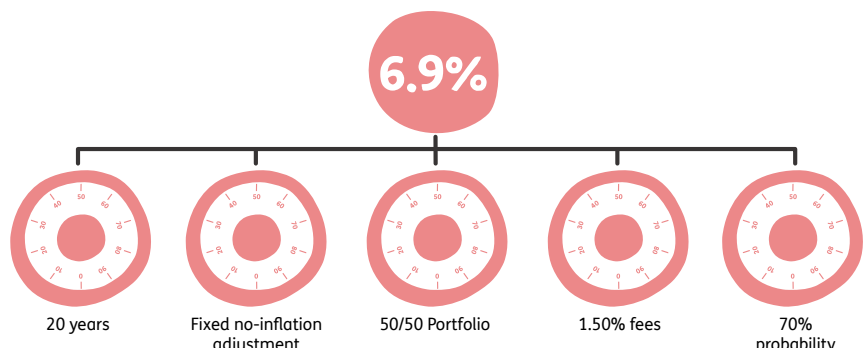
If for example we then looked at essential spending, it could look like this:

The timescale covers expected longevity, with income adjusted for inflation. The portfolio mix allows for use of secure or guaranteed assets to be included alongside equities. Real world fees are included, and the high probability of delivering the income reflects the security required. This could produce an example SWR of 2.4%.



For the discretionary spending, we then re-set the dials:

Now we have a different timescale. For the sake of argument, if the client was 65, then a 20 year period could reflect their more active years, with the recognition that income could be level, declining in real terms over the period as their need for the income diminishes with older age and they slow down. The probability of a successful outcome is lower to reflect the reduced importance placed on this portion of their income. It's 'nice to have' rather than 'need to have'.



The final step is to calculate the required capital to support the income levels needed at the defined SWRs. Advisers will then need to steer clients through the decisions needed depending on whether they have sufficient funds at their disposal.

One other point to consider is the use of a Withdrawal Policy Statement. Having gone through this exercise with the client, it is worthwhile using this document to record and evidence how the SWR was arrived at. These can clearly set out the reasons agreed with the client including what could impact the withdrawals, when changes might need to be made, how the income will be sourced and frequency of reviews. Various providers offer templates for these that are worth seeking out and using.

Summary

The importance of proving sustainability has been brought to the fore with the dissolution of income benchmarking using critical yields at review, regulatory safeguards and the absence of GAD limits on flexi-access drawdown. Pre freedoms, it might be argued that GAD limits were a restriction of freedoms, but by the same token, they provided a safety net to ensure funds couldn't be exhausted. Now the individual has complete ownership of all the risks, rather than the insurance provider.

This is where advisers can help clients to navigate their way through the various choices they will need to make to ensure they enjoy a tailored retirement income and not run out of money.

Achieving this could involve using a wider selection of products rather than relying on the investment portfolio to do all the heavy lifting. A combination of guaranteed income for life, provided by an annuity, DB pension, or state pension along with investment, or even tapping into property wealth, could give the right balance of income the client needs.

Calculating and evidencing a Sustainable Withdrawal Rate is just one part of managing a client's retirement funds (and expectations). Developing a de-risked decumulation strategy that's robust and repeatable is worth considering as there could well be a tsunami of retirement clients who took their tax free cash, kept their drawdown pots in a holding pattern, and are just waiting to switch the income on. This is heading our way, and advisers need to be ready.

FOR MORE INFORMATION

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