FOR PROFESSIONAL INVESTORS ONLY

GREAT EXPECTATIONS: MANAGING RETIREMENT INCOME

- **Dealing with decumulation introduction**
- **Setting out an approach to decumulation**
- **The three known unknowns of decumulation**
- **How much can you withdraw?**
- **How do you withdraw**
- **Bespoke vs multi asset**
- **Why a discretionary investment manager?**

DEALING WITH DECUMULATION

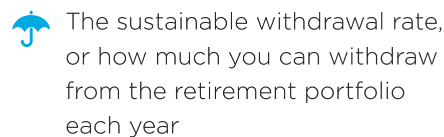
The introduction of pensions freedoms in 2015 marked a significant change in the pensions landscape. Building on previous reforms, the UK government hoped to provide retirees with greater choice over how their retirement funding, particularly in light of record low annuity rates.

In the years since, the need for pension advice has only grown more acute. Pension freedom means more people are seeking advice, with many adviser firms benefitting from this growing demand for their services.

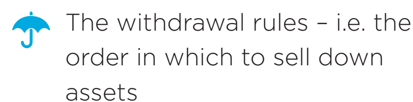
In this document, we hope to set out some of the investment considerations around decumulation, and to help set these in context for how adviser firms can develop their retirement proposition. While this is often seen as a technical area, we believe that decumulation does not need to be complex or frightening. Appropriate financial planning, combined with an effective investment strategy, can solve many of the issues which first appear.

SETTING OUT AN APPROACH TO DECUMULATION

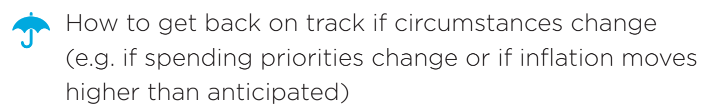
Documenting your approach to decumulation can help to structure your retirement proposition and provide clarity to clients. A common way to do this is through a withdrawal policy statement. This sets out the following in writing:



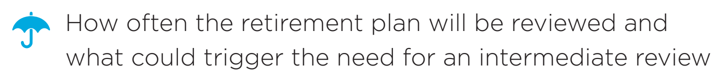
The sustainable withdrawal rate, or how much you can withdraw from the retirement portfolio each year



The withdrawal rules – i.e. the order in which to sell down assets

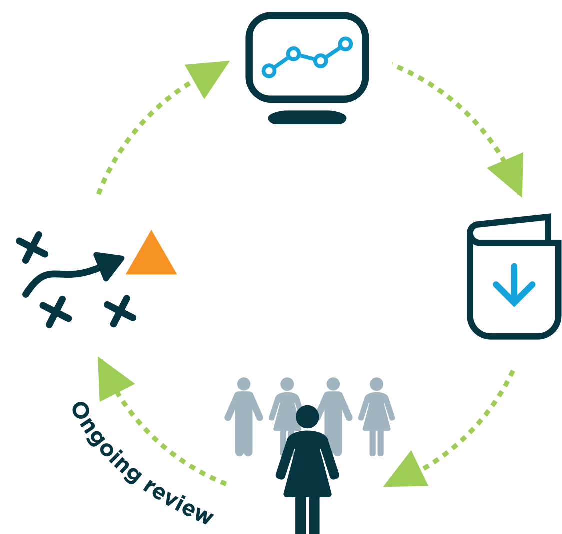


How to get back on track if circumstances change (e.g. if spending priorities change or if inflation moves higher than anticipated)



How often the retirement plan will be reviewed and what could trigger the need for an intermediate review

A discretionary manager can be useful in discussions of this type. They allow you to bring in a third party for potentially difficult discussions with a client – including if investment performance has been difficult, or to help explain the consequences of taking more investment risk if the client has overspent.

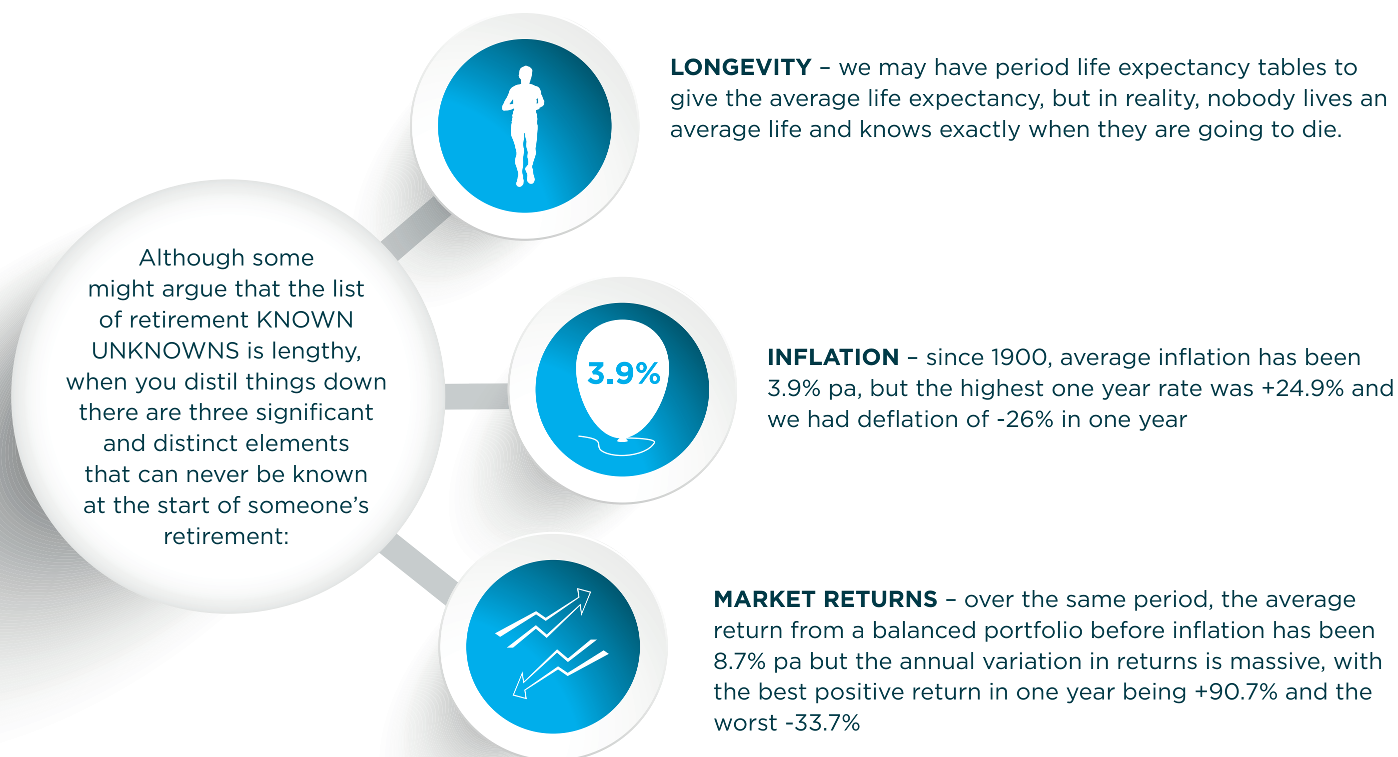


THE THREE KNOWN UNKNOWNS OF DECUMULATION

A withdrawal policy statement is particularly useful when considering the three ‘known unknowns’ of decumulation – factors which need to be considered but which are not known about in advance. The three known unknowns include:

1. Longevity
2. Inflation
3. Market return

We have explored these three factors in a little more depth below.



The challenge these KNOWN UNKNOWNS present to the adviser are significant and the risks of relying on averages to create a retirement plan are real and ever present.

(sources of inflation and market data are Thomas, R and Dimsdale, N (2016) “Three Centuries of Data – Version 2.3”, Bank of England and Morningstar DMS Database, all complied by FinalytiQ)

LONGEVITY

Although UK life expectancy has fluctuated in recent years, it has generally been on an upwards trend. In the year 2000, a man at age 65 could expect to live for another 15.8 years, whereas a woman could expect to live for another 19 years. By 2018, however, UK men and women could respectively expect to live for a further 18.9 years and 21.1 years at age 65.[1]

While an increase of a few years might not sound like much, these gains in life expectancy at age 65 equate to a 20% and 11% increase in retirement length for men and women. You do not know how long you will live for, but there is a good chance that a quarter or even a third of your life can be spent in retirement.

INFLATION

Since 1900, average inflation has been 3.9% per annum. The average masks large differences however. The highest one-year rate was +24.9%, whilst the lowest was -26%.[2]

While the past two decades have seen inflation remain relatively stable, at around 2% a year, even a modest level of inflation can seriously erode pension savings over time. The challenge for retirees is making sure that their pension savings can keep up with inflation.

1 https://data.oecd.org/healthstat/life-expectancy-at-65.htm

2 Inflation figures from Thomas, R and Dimsdale, N (2016) “Three Centuries of Data – Version 2.3”, Bank of England and Morningstar DMS Database, all complied by FinalytiQ, see original Unknown Knowns sales aid for original citation

MARKET RETURNS

Market returns can be highly variable, although a good rule of thumb is for stock markets to return 7% per annum over the long term – inclusive of dividends and inflation. If we look at the past twenty years, global shares have pretty much delivered on this, returning just over 6.3% per annum.[3]

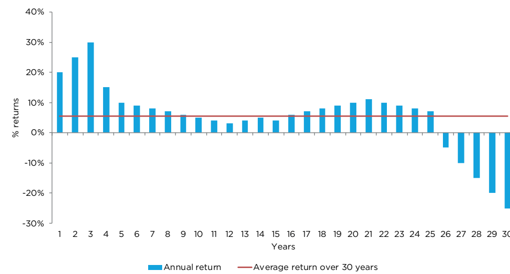
Such returns are by no means guaranteed, however. Few clients will want or need to be invested solely in shares as they begin their decumulation journey. Advisers and investment managers need to consider carefully what market returns might look like going forward, and how reliant a retiree is on a benign set of outcomes.

Related to 'market return' risk is sequencing risk. This is the danger that a retiree suffers poor returns early on in their retirement, potentially at the same time as withdrawing capital to fund their retirement. By contrast, poor returns at the end of retirement may have less of an impact on a retiree's journey.

To help illustrate this risk, consider the three charts below. Each chart has the same average annual return of 5.5% over thirty years. The return fluctuates significantly by year, however, with the sequence of returns falling into one of three groups.

Chart 1: strong start, bad finish

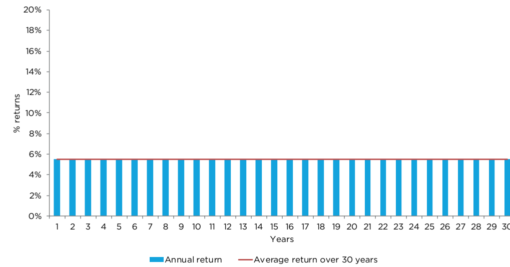
Strong start, bad finish



= £2,788,954

Chart 2: never a negative year

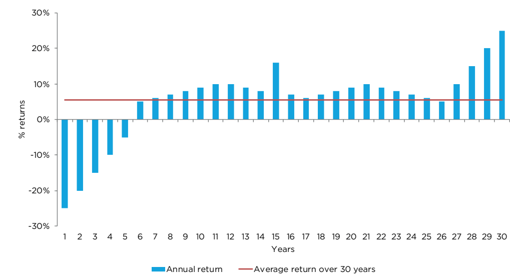
Never a negative year



= £2,086,532

Chart 3: bad start, strong finish

Bad start, strong finish



= -£1,480,096

Source: Quilter Cheviot calculations

In our final scenario, 'bad start, strong finish', a client never recovers from the poor returns experienced at the start of their retirement from both sharply negative market returns and regular withdrawals of £40,000 a year. By the time markets begin to perform better again, they are already withdrawing more than the annual gain they make from being invested, leading to a vicious cycle of lower portfolio values.

In practice, this last scenario should not happen. An investment manager should be attuned to sequencing risk and act to protect the portfolio from negative returns by investing in a broad range of uncorrelated assets. Retirees can also act to reduce the income demands on their portfolio, though many can be reluctant to do so.

3 FTSE All-World (£), dividends reinvested

HOW MUCH CAN YOU WITHDRAW?

The amount able to be withdrawn from a portfolio without risking its collapse is known as the sustainable withdrawal rate. This number sits at the heart of most retirement propositions. Advisers commonly make reference to the 4% rule, with this figure originating from an American financial planner, Bill Bengen.

Bengen's analysis identified an annual withdrawal of around 4% as the safe rate. It is important to note that Bengen followed a 'safety first' approach, ensuring that his clients would not run out of money over a thirty-year retirement, even in the worst-case historical scenario. By extension, some retirees would have been left with significant assets at the end of their thirty-year retirement period.

For some retirees, the idea of leaving something aside for loved ones or charitable causes might be appealing. However, this then raises issues around inheritance planning and whether investments in assets such as AIM stocks should be considered.

HOW DO YOU WITHDRAW?

Once you have worked out how much to withdraw, you then have to decide in what order to sell down a retirement portfolio. We have provided a brief overview of the four main options below, together with some considerations for why you might choose each option.

1 Vertical slicing

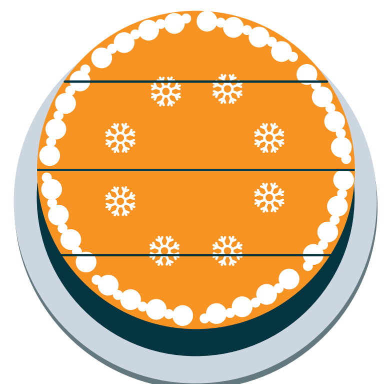
This effectively divides a client's assets up into cash, fixed income and equities. Lower risk assets are spent first, as these are relatively stable in the short term and can be depended upon to fund immediate spending.

Once cash reserves have been spent, a retiree would then start drawing on their fixed income investments. These would hopefully have grown in value whilst the retiree was living on their cash reserves, leaving more of a buffer if the portfolio value falls as the client is withdrawing from the market.

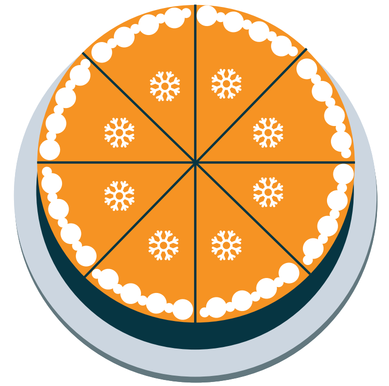
Finally, you start enchasing your stock assets. While stock values can fluctuate significantly in the short term, the long-term time horizon you have given them to grow should ensure that there is enough of a buffer for a suitable financing at the end of retirement.

2 Horizontal slicing

Horizontal slicing effectively tries to match assets to liabilities. A simple example would be to split a client's spending into two categories, essential and discretionary. Essential spending might include regular bills and food expenses, with things such as holidays counted as discretionary spending. You might buy an annuity to cover essential spending and the remainder of a pension pot to fund discretionary spending.



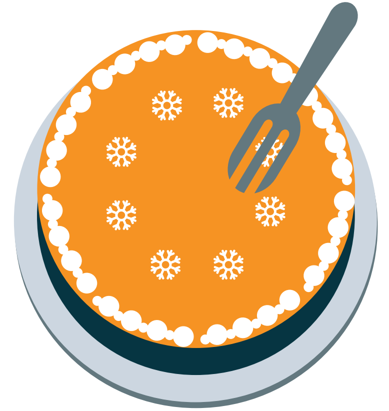
3 Encash equally



Encashing a portfolio equally is perhaps the simplest option – both from a conceptual and practical perspective. It simply involves selling a fixed amount of a portfolio in order to fund retirement on an ongoing basis.

From an investment perspective, this approach has the advantage of not affecting the overall characteristics or risk profile of a retirement portfolio. The flip side is that that risk profile must match the client's retirement needs and objectives, as any mismatch will become more severe over time.

4 Natural income



Given how low interest rates are, our fourth option might be the most difficult to achieve from an investment perspective. The natural income approach means a retiree lives only on the income from their portfolio, i.e. that from bond coupons or dividend payments.

A natural income approach should theoretically diminish the risk of eating into the capital value of your portfolio. If you set too high an income target, however, you risk 'chasing' income in stocks with unsustainable dividends and seeing your portfolio value fall as these companies cut dividends or default on their debts.

BESPOKE VS. MULTI ASSET

In retirement, you are drawing down savings, and are in decumulation. This has consequences for how you invest. A bespoke portfolio can reflect this more accurately than a solution based on unitised investments.

A discretionary manager, for example, can reduce risk ahead of big spending commitments, such as a grandchild's university education, or allocate more money to income producing investments. Doing this on a unitised basis can be difficult; blurring the responsibility between financial planning and investment advice. It can also be difficult to understand the risk profile of a portfolio with unitised investments – particularly if multi-asset funds are used which constantly adjust their asset allocation.

Pre-retirement, it is all about attitude to risk – how much risk are you willing to take with your investments. In retirement, it is far more about capacity for loss – how much of your pension pot can you afford to put at risk, given that you are dependent on it to fund your lifestyle. A discretionary manager portfolio can dynamically adjust to changes in a client's capacity for loss and, working with the adviser, can alter the schedule for selling down assets to maximise value for the end client.

WHY A DISCRETIONARY INVESTMENT MANAGER?

By outsourcing the investment management to a discretionary investment manager, advisers can reduce risks around potential pension performance and the sequence of those returns. Discretionary managers can add value through active management such as deciding where clients should generate their income from on an annual basis and advising on the best asset allocation through retirement. There is also a clearer distinction in the client's mind about where responsibility for your financial advice and our investment management lies.

Outsourcing the investment management to Quilter Cheviot allows you to:

- Add more value for your clients by providing specialist lifetime financial advice
- Offer a truly bespoke wealth management solution for your higher net worth clients
- Gain access to specialist investment resources, with Quilter Cheviot's expertise in direct equity investment, fixed income, and collective investment funds; and
- Outsource the risk of investment management

Our open-door policy means you will always have access to an investment manager to discuss the performance of your clients' portfolios and to deal with questions that your client may have.

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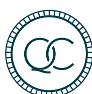

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