WHAT IS A SUSTAINABLE WITHDRAWAL RATE?

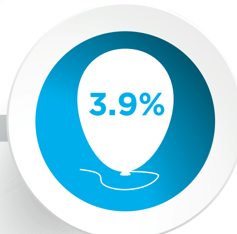
With a reported 80,000 people transferring from Defined Benefit to Defined Contribution in 2017, and the collapse in annuity sales since the Pension Schemes Act 2015, it seems that an ever increasing number of retirement roads lead to flexible access drawdown (FAD). It follows therefore that there should also be an increased reliance on a portfolio of asset-backed investments to deliver a reliable income over a lengthy period.

But how to calculate this period? Longevity, inflation and market returns are the three variables that make this calculation very difficult. Before the Pension Schemes Act, we had a safety-first philosophy that protected retirees from themselves and advisers from the risk that their advice could lead to clients either having to reduce their spending significantly in retirement, or worse, actually running out of money. However, this safety-first retirement advice philosophy is no longer sufficient because the variables have become ever more complex, making the future both unknown and unknowable. As an industry, therefore, we are adopting a probability-based methodology.

So what are the KNOWN UNKNOWNS of retirement?

Although some might argue that the list of retirement KNOWN UNKNOWNS is lengthy, when you distil things down there are three significant and distinct elements that can never be known at the start of someone's retirement:

LONGEVITY – we may have period life expectancy tables to give the average life expectancy, but in reality, nobody lives an average life and knows exactly when they are going to die.



INFLATION – since 1900, average inflation has been 3.9% pa, but the highest one year rate was +24.9% and we had deflation of -26% in one year

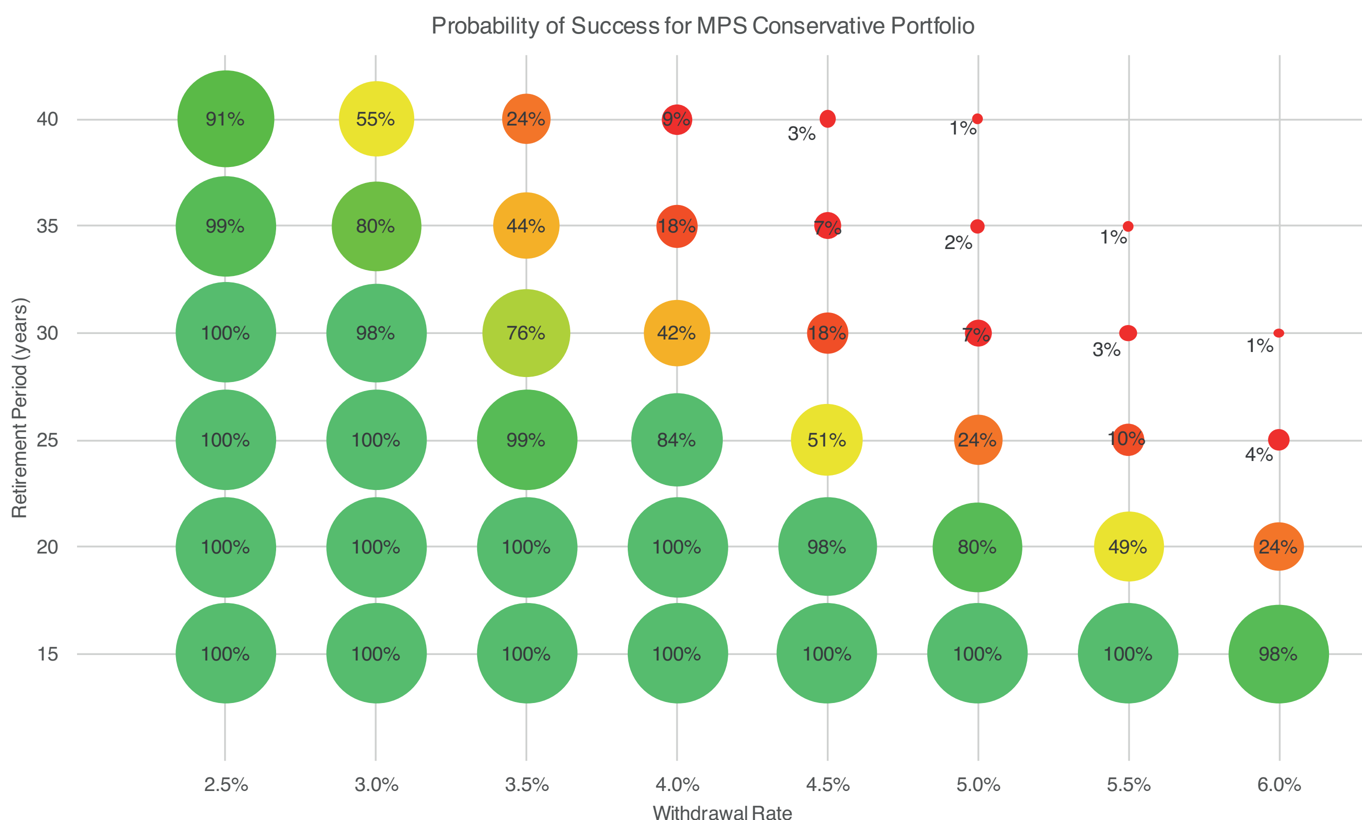
MARKET RETURNS – over the same period, the average return from a balanced portfolio before inflation has been 8.7% pa but the annual variation in returns is massive, with the best positive return in one year being +90.7% and the worst -33.7%

It's easy to look up average life expectancy but this is a theoretical number, as by definition the majority of people will either exceed or fall short of the stated average. Although a 65-year old male may have a life expectancy of a further 18 ½ years, there's a 24% probability (ie. nearly 1 in 4) that one of a couple aged 65 will still be alive at age 100 (an extra 35 years). As you can see, the possibility that savings could run out during retirement is real, and ensuring a pension lasts as long as necessary is a significant undertaking.

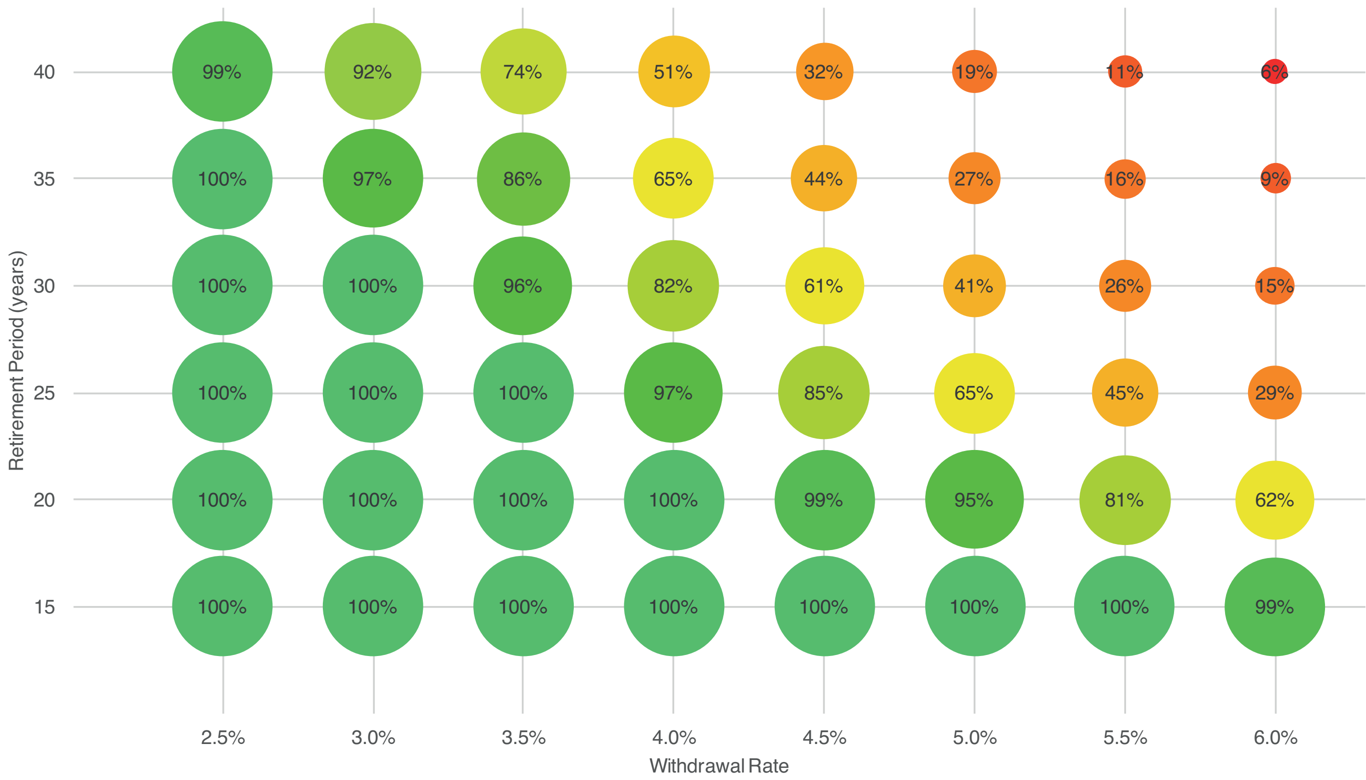
In the new world of drawdown without limits, advisers really do need to 'know your number', in terms of a sustainable drawdown rate, and be able to evidence it. A widely accepted figure is 4%. This has therefore led to the 'probability driven' retirement advice methodology, a structured and evidence-based approach to advising clients who have decided to shun annuities, guarantees and gold plated DB pensions in favour of using FAD. It is also used by those advisers who fundamentally believe that over the longer term capital markets will deliver the returns needed to meet their clients' retirement spending objectives.

We have therefore done some research on this magic number, and back-tested our portfolios to find where our MPS portfolio would fit, creating the model below. What is clear is that you need a separate retirement proposition to your central investment propositions.

Given the unknowns, a key factor in this calculation is the retiree's attitude to risk. At retirement, attitude to risk takes on a different perspective, as you need to take more risk for longer in order to have higher and more sustainable income, a concept that most retirees struggle to understand. Therefore an adviser needs to have a conversation with a client around realistic income expectations or a realistic approach to risk management. The retirement planning conversation is going to be different to a conversation about accumulating wealth for retirement.



Source: FinalytiQ, based on 10,000 Monte Carlo simulation. Results are net of portfolio and platform fees but does not include adviser fees.



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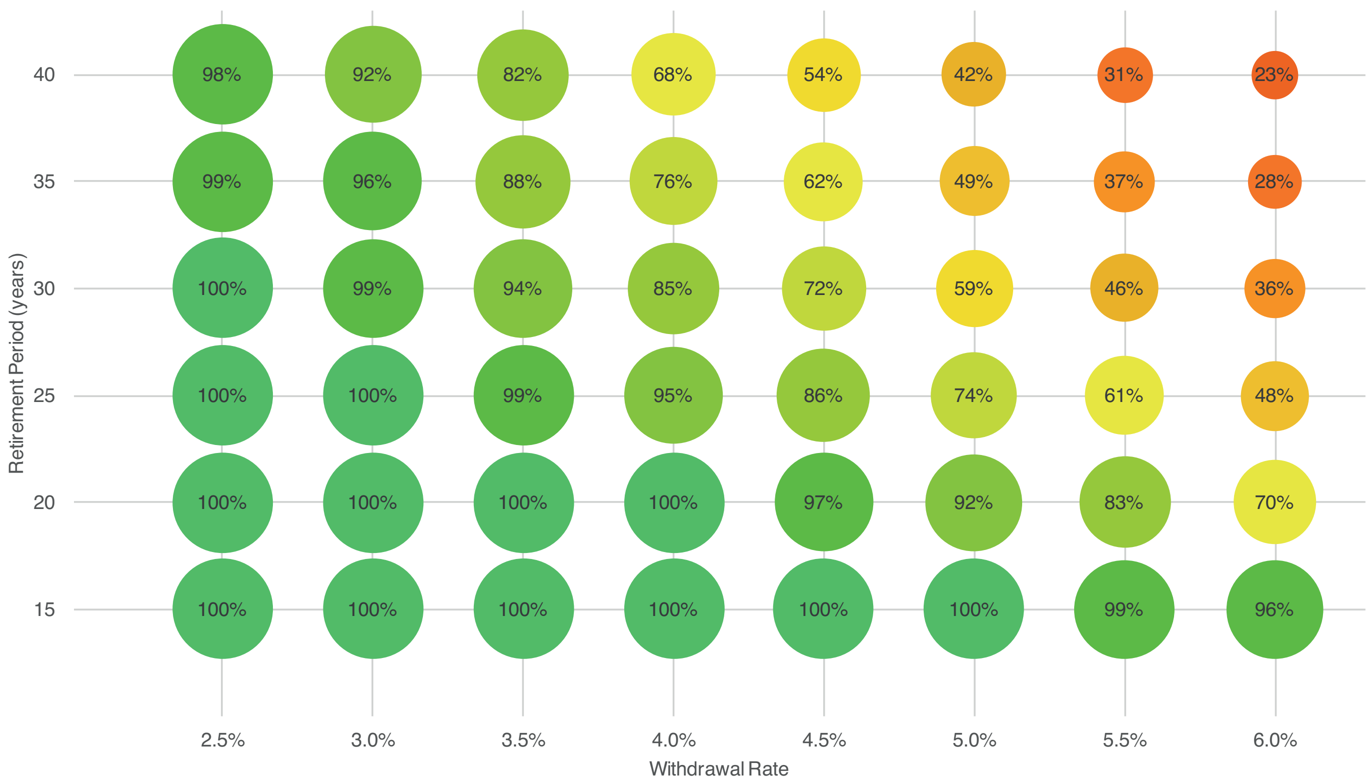

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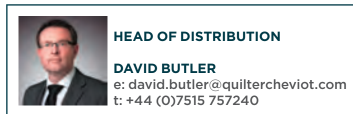

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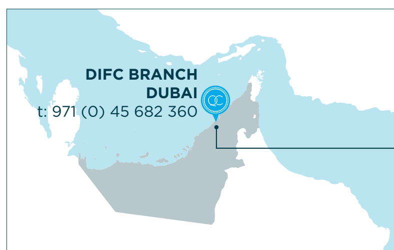

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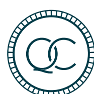

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