

# GUARDING AGAINST SHORTFALLS IN RETIREMENT

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*As evidence emerges that a sizeable minority of defined contribution retirees are spending their savings too quickly, the investment industry can help to mitigate the problem.*



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- The commonly held view that spending in retirement is U-shaped is flawed.
- In fact, recent evidence shows that spending steadily declines as people age though the sandwich generation baby boomers may buck this trend.
- Even so, many people are drawing down their savings too quickly, leaving them at risk of running out of money.
- A well-diversified, dynamically-managed investment strategy can help to maximise retirement income.

It is a question that experts have long puzzled over. How much money do people need in retirement, and to what extent does this change over time? Evidence suggests that the most popular and enduring theory about spending patterns<sup>1</sup> is flawed, leaving millions of people in danger of running out of money too early.

The commonly held view is that spending in retirement is U-shaped. The theory goes that at the start of retirement, people are more active, spending more money on travel, home improvements and leisure. As they grow older, they slow down and their spending decreases. As they become elderly, they may need care, meaning their spending increases again, completing the U shape.

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<sup>1</sup> Friedman, Milton (1957). "The Permanent Income Hypothesis". *A Theory of the Consumption Function*. Princeton University Press. ISBN 0-691-04182-2.

In reality, a different story emerges from recent studies on both sides of the Atlantic. Consumption through retirement typically declines steadily, regardless of income level and the period analysed, according to a 2015 longitudinal study conducted by the International Longevity Centre - UK (ILS-UK).<sup>2</sup> This is consistent with contemporary US research, which suggests spending falls in real terms throughout retirement by one per cent per year.<sup>3</sup>

These steady declines can add up to something more significant, according to the ILS-UK research. For instance, the spending of a household headed by an individual aged 80-plus is on average 43 per cent less than one headed by a 50-year-old. Similarly, at age 80 spending is typically 35 per cent less in real terms than it was at age 65. Indeed, at age 80-plus the average annual amount being saved from retirement income is £5,870.

The conclusion to draw from this data, while nuanced, is broadly consistent regardless of lifestyle, income or the period analysed. Older people in the UK spend less than their younger counterparts, discretionary spending on life's luxuries all but disappears from age 75, while almost all cohorts progressively save more of their income as they become older.

## Retirement spending myths

The popular wisdom is that ill health restricts activities – and therefore spending – for some people in retirement. However, the ILS's UK research found that “even by age 90+, 65 per cent of the population say they can do the things they want often or sometimes”.<sup>4</sup>

This finding appears to contrast with ONS research, which suggests those aged 65 can, on average, only expect to remain in “good health” until their mid-70s, accepting that significant regional variations in health longevity exist.<sup>5</sup>

Perhaps, although people's health may be declining, they are still able to continue with many of their daily activities – and more so than previously suggested. However, anecdotal evidence certainly suggests that the desire to try new experiences, keep up with new technology, refurbish and renew declines with age, contributing to a steady decrease in consumption.

With reduced consumption in later life comes increased saving. Nowhere is the motivation to save stronger than when there is a desire to leave a bequest. Indeed, regardless of age group and income, on average people think they have a 70 per cent chance of leaving a bequest of £50,000 or more.<sup>6</sup>

<sup>2</sup> Cesira Urzi Brancati, Brian Beach, Ben Franklin and Matthew Jones. Understanding Retirement Journeys: Expectations versus Realities. International Longevity Centre - UK. 1 December 2015.

<sup>3</sup> Jonathan Fisher, David S. Johnson, Joseph Marchand, Timothy M. Smeeding, and Barbara Boyle Torrey. The Retirement Consumption Conundrum: Evidence from a Consumption Survey. Center for Retirement Research at Boston College. CRR WP 2005-14. Released: December 2005. See also Michael Kitces. Using Age Banding To Estimate How Spending Will Decline In Retirement. November 2, 2016. <https://www.kitces.com/blog/age-banding-by-basu-to-model-retirement-spending-needs-by-category/>.

<sup>4</sup> Brancati et al. (2015). op.cit. p.5.

<sup>5</sup> ONS (March 2016). op. cit.

<sup>6</sup> Brancati et al. (2015). op.cit. p.41.

As retirees enter their later years, the supposed upward curve in spending towards the end of one's life does not materialise. This could be explained by the fact that relatively few people spend long periods in residential care.

Only 16 per cent of people aged 85+ in the UK live in care homes, according to Age UK. Those who do live in care homes only tend to spend a short time there, with the median period from admission to the care home to death being 15 months.<sup>7</sup> The idiom 'long-term care' is perhaps a misnomer. Social care may be more apt.

### Will the U-shaped spending pattern in retirement remain atypical?

Most contemporary retirement spending studies have been conducted on those either born or who grew up during the Second World War, commonly referred to as the *make do and mend and never let anything go to waste* generation. By contrast, the generation below, the soon-to-retire, second wave baby boomers of the mid-1950s to mid-1960s, today's tech-savvy 50 to 60-somethings, adopt a more aspirational approach to life. They also have greater disposable income than their parents, typically have considerable defined benefit pension rights, and now possess the ability to accelerate access to this stream of income via freedom and choice.

They are also increasingly known as the *sandwich* generation in that many are caring for ageing parents while helping out their adult children, who are often financially dependent on their parents well into their 30s. Many also care for their young grandchildren. No generation before has simultaneously faced these dual challenges. Additionally, this generation will potentially be faced with the declining economics of social care in their twilight years. Given the backdrop of an ageing society, health longevity lagging longevity *per se*, the narrowing of the tax base that comes with a rising old age dependency ratio allied to a structural fiscal deficit that looks set to run for at least another decade, means making private provision for social care will inevitably become a greater imperative than the current statistics suggest.

However, if and when the time comes to seek social care, it will probably be the stock of unrealised owner-occupier housing wealth, rather than retirement income, which will be the predominant source of funding. That is certainly the way UK policy on social care is heading. However, this assumes that equity in the home hasn't already been unlocked via equity release, given the role the latter increasingly plays as part of a holistic approach to later life wealth planning. Indeed, since 1991, more than 380,000 people in the UK have taken out an equity release plan, unlocking over £19bn of housing wealth. In 2016 alone, £2.2bn of housing equity was released by those aged 55-plus; over 75 per cent of whom were aged under 75.<sup>8</sup>

Taken together, all of these things may well amount to the sandwich generation being the ones whose retirement spending doesn't decline in real terms but continually

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<sup>7</sup> Age UK (2017). op. cit. p.17.

<sup>8</sup> Equity Release Market Report. Spring 2017. Equity Release Council.

increases. One thing looks increasingly certain though; the U-shaped retirement spending pattern will remain atypical.

## Finding the formula

While retirees may have more straightforward income needs than most experts believe, finding the right formula for a sustainable retirement income is still complicated. This is especially true now that, because of freedom and choice, many people are no longer opting for the guaranteed income that an annuity provides and opting for income drawdown instead.

There is evidence that today's retirees are not taking their money at sustainable rates and are in danger of running out of money before they die. What constitutes a sustainable rate of drawdown is often debated and subject to many variables, from market conditions to life expectancy. However, many financial planners point to US financial planner Bill Bengen's 4 per cent rule as the benchmark sustainable real drawdown rate, despite yields, investment returns and inflation having moderated since Bengen's research was conducted in 1994.<sup>9</sup>

Although it is early days to look at drawdown trends, many defined contribution (DC) retirees are taking their money too quickly. Almost half (43 per cent) of people made a quarterly withdrawal equating to at least a four per cent annual withdrawal, with nearly 10 per cent withdrawing four per cent or more in a single quarter, according to an Association of British Insurers (ABI) study.<sup>10</sup>

More recently, investment platform AJ Bell found that of 250 individuals surveyed aged 55-plus, 77 per cent had, since April 2015, withdrawn more than four per cent of their pension savings annually, while 44 per cent had withdrawn more than 10 per cent. Moreover, these withdrawal rates were more prevalent among those aged 55-59 than those in the 60-64 and 65-69 age brackets.<sup>11</sup>

That leaves us with the question: what constitutes a sustainable withdrawal rate in 2018? To answer that, we need to look at investment strategy and the importance of limiting a portfolio's susceptibility to financial market drawdowns.

## A reliable income

A sustainable investment strategy underpins a comfortable retirement. This is more the case than ever now that income drawdown is becoming more popular among DC retirees. Up to 60 per cent of the income taken from drawdown in retirement depends on how that money is invested in the decumulation phase, as opposed to how much has been saved (up to 10 per cent) and how these savings were invested in the accumulation stage (up to 30 per cent).<sup>12</sup>

<sup>9</sup> William P. Bengen. Determining Withdrawal Rates Using Historical Data. Journal of Financial Planning. October 1994: 171-180. See: <http://www.retailinvestor.org/pdf/Bengen1.pdf>.

<sup>10</sup> <https://www.abi.org.uk/news/news-articles/2016/08/abi-publishes-full-year-of-pension-freedom-data/>.

<sup>11</sup> A J Bell. The Pension Freedoms Engagement Gap. December 2017. p.3. Average total savings of those surveyed was £118,000.

<sup>12</sup> The Russell 10/30/60 retirement rule.

Diversification is critical to mitigate the risk of suffering significant losses in a market downturn. Failing to diversify across multiple asset classes over time may leave income drawdown investors wide open to sequencing risk.

A genuinely well-diversified and dynamically-managed multi-asset fund, which taps into a multitude of diverse return drivers and risk premia, is well placed to underpin a resilient fixed real income withdrawal rate.<sup>13</sup> Indeed, recent modelling conducted by the Pensions Policy Institute and Cass Business School demonstrates the low susceptibility of well-managed multi-asset funds to financial market drawdowns.<sup>14</sup>

A well-diversified and dynamically-managed multi-asset fund provides a smoother returns experience than pure equity and equity/bond portfolios. If invested in such a fund, DC retirees should still be able to stick to the same withdrawal rates if and when financial markets turn tail.

In the third paper in this series, we will explain in greater detail what a fit-for-purpose decumulation strategy looks like for most DC retirees.

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<sup>13</sup> Principal among these diverse return drivers is the illiquidity premium. As *Cambridge Associates* recently illustrated, a highly diversified portfolio with 15 per cent invested in highly illiquid private market investments, would have handsomely outperformed an indexed global equity and a US equity/Treasuries portfolio over the 20 years to 30 June 2016. This was despite the indexed global equity portfolio having outperformed the highly diversified one in 12 of the 20 years. See: *Over the Long term, Diversification Still Wins*. Cambridge Associates. June 2017. <https://www.cambridgeassociates.com/research/long-term-diversification-still-wins/>

<sup>14</sup> *The Future Book: unravelling workplace pensions 2017*. The Pensions Policy Institute. Chapter 4 pp.58-59. Although the modelling was applied to multi-asset funds in the accumulation stage, the same conclusions hold true for multi asset-funds in decumulation. Also see: Andrew Clare, James Seaton, Peter N. Smith and Stephen Thomas. *Decumulation, Sequencing Risk and the Safe Withdrawal Rate: Why the 4% Withdrawal Rate leaves Money on the Table*. Cass Business School, City University, London, and the University of York. 27 June 2017.

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