

GENERATING RETIREMENT OUTCOMES TO BE ENJOYED AND NOT ENDURED: WHY WE MUST HARNESS THE OPPORTUNITIES AND OVERCOME THE RISKS AT AND IN RETIREMENT IN A WORLD OF FREEDOM AND CHOICE.



GENERATING RETIREMENT OUTCOMES TO BE ENJOYED AND NOT ENDURED: WHY WE MUST HARNESS THE OPPORTUNITIES AND OVERCOME THE RISKS AT AND IN RETIREMENT IN A WORLD OF FREEDOM AND CHOICE.

Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments, and Senior Visiting Fellow, Finance Faculty, Cass Business School, London.

INTRODUCTION

Throughout 2016 and 2017, our defined contribution (DC) thought leadership concentrated on the very real issues of individuals not saving sufficiently for their retirement and not investing these accumulated savings appropriately during their working lives. For many, the end result will be a retirement to be endured and not enjoyed. Indeed, addressing the inadequacy of retirement provision is fast becoming the biggest socio-economic challenge facing the UK, given the move from a system of generous pension provision and collective passivity, where *everything was done for you* and little engagement was required, to one that is increasingly less generous with ever greater levels of individual responsibility and decision making, where *everything is down to you*.

Given this, the potentially dire consequences of inertia, making a wrong decision or decision paralysis continues to rise over time, as defined benefit (DB) pensions disappear, people start receiving their state pension ever later in life and increasingly become solely reliant on their DC pension pot to support their standard of living in retirement which, for many, will extend to 30-plus years. Despite this, there continues to be a reluctance to engage with retirement provision and outcomes; a reluctance that has proved remarkably difficult to overcome.

Indeed, given the many thwarted attempts to improve consumer engagement, our accumulation stage research, instead concentrated on how the behavioural barriers to the level and coverage of long-term saving might be overcome by employing simple and subtle behavioural interventions. This comprised a combination of using associative words to prime thinking, introducing frames of reference, reframing terms and messages and creating positive social norms. Likewise, in accepting that the default fund is overwhelmingly the passive choice of the disengaged for investing accumulated retirement savings, and acknowledging that default fund design can fundamentally affect retirement outcomes, both our proprietary research and that which we commissioned from the Pensions Policy Institute, focused on the critical importance of investing in a fit-for-purpose default fund.¹ Both sets of research met with an enthusiastic response from trustees, industry practitioners, policymakers and other interested stakeholders alike.

However, while improving financial outcomes to retirement remains the principal focus of policymakers and industry thought leaders, DC decumulation is steadily attracting the attention of both. Moreover, given the myriad of issues that surround DC decumulation, the focus of attention should increasingly tip towards this latter phase of the DC cycle. Indeed, the laissez-faire approach to the freedom and choice reforms of April 2015, which allows complete flexibility as to how pension pots can be accessed from age 55, has largely been unsupported by the provision of accessible frames of reference, guidance and advice. Consequently, an enormous decision-making burden has been put on the shoulders of a rapidly ageing population, ill equipped to decide for themselves. Despite this, over £14 billion has been accessed from more than one million

¹ Please see: <http://www.columbiathreadneedle.co.uk/en/investment-themes/defined-contribution-the-future-book/>.

DC pension pots since April 2015.² This laissez-faire approach has also meant the development of fit-for-purpose DC decumulation solutions has been left to a somewhat rudderless pensions community, seeking a suggested framework or template from policymakers and regulators. Allied to the continued dearth of guidance and advice and a definitive statement of what differentiates one from the other, along with few solid international experiences to draw upon, product development in this increasingly critical area of retirement provision remains stymied.

Therefore, for 2018, in a logical progression of our earlier papers, we have identified the socio-economic, demographic, financial and investment risks and challenges posed to those individuals principally reliant on their DC pension pots at and in retirement, who either encash or draw down, rather than annuitise, their pension savings. In so doing, we acknowledge that at one end of the DC pension pot spectrum there will be those with small pots who will withdraw their entire pot as cash and those at the other who can afford to leave their pot untouched for Inheritance Tax planning. Ultimately, however, this paper seeks to identify what fit-for-purpose decumulation solutions might look like for the majority – the unadvised mass market – that falls between these two extremes if retirement is to be enjoyed and not endured. Developing fit-for-purpose decumulation default options, determining a sustainable income withdrawal rate and devising a suitable investment strategy all have their part to play in meeting the fundamental premise and ultimate objective of any pension system; that of providing a secure long-term income stream to meet spending needs in retirement.

While principally focused on the UK, this paper also has a subtle global dimension in that those countries undergoing fundamental pension reform continue to scrutinise the UK's experience of making the transition from DB to DC, not only in the accumulation stage but also in moving to a world of freedom and choice in the decumulation stage. After all, as the world's second largest pensions market by assets and one of the most mature, it is also proving to be a fertile testing ground. Likewise the UK can learn from the experiences of those others for whom DC has long been the dominant pensions medium. This paper therefore seeks to engage with policymakers, thought leaders and other stakeholders not only in the UK but also much further afield.

²HMRC, October 2017.

CONTENTS

01	What are people doing with their DC pension pots at and in retirement and why?	6
	The challenges to informed decision making	
	Break out box: The ageing UK population – present and projected	
	What decisions have people been making at and in retirement since the introduction of freedom and choice?	
	Break out box: Planning for retirement: Are people joining up the dots?	
	Break out box: New Choices, Big Decisions	
	Break out box: What have people done with their fully encashed pension pots?	
	Break out box: Does the wording of retirement income options matter?	
	DB to DC transfers	
02	Spending patterns in retirement	19
	Break out box: Have we reached peak pensioner incomes?	
	Break out box: The origins and future of the State Pension	
	Will the U-shaped spending pattern in retirement remain atypical?	
	So how much income do people need in retirement?	
03	Sustainable withdrawal rates (SWRs)	26
	What constitutes a sustainable level of withdrawals that meets a retiree’s spending needs?	
	The origins and development of the SWR	
04	What constitutes a fit-for-purpose decumulation investment strategy?	28
	Break out box: The dangers of investing in an undiversified manner and taking an unsustainable level of withdrawals	
	Equities versus an equity/bond versus a multi-asset approach	
	The decumulation journey now favours multi asset	
	Break out box: Asset allocation: the pivotal decision in constructing a fit-for-purpose decumulation strategy	
	Linking SWRs to investment strategy	
05	Generating retirement outcomes to be enjoyed and not endured.	36
	The risks to achieving a good retirement outcome	
	Everyone needs guidance and not just the once	
	Perhaps some just require a gentle nudge in the right direction?	
	Break out box: The EAST framework	
	For most, the answer lies in being defaulted to the default	
	Designing a fit-for-purpose decumulation default solution	
06	Conclusion	43

ABSTRACT

- **The problem:** freedom and choice has put an enormous decision-making burden on the shoulders of a largely unsupported and rapidly ageing population, ill equipped to decide for themselves. In failing to successfully manage a myriad of largely unquantifiable risks at and in retirement, people are in danger of sleepwalking into retirement penury.
- **The solution:** for a largely unsupported and unadvised mass market, that seeks both flexibility and income security in retirement, the solution lies in a behaviourally robust, auto enrolled, well-governed, institutionally-managed default income drawdown fund, appropriately charge capped, with opt-out provisions and the option to finesse the default's key defined parameters. Underpinned by a dynamically managed multi-asset fund, longevity insurance and a minimum income guarantee, the resulting secure and sustainable long-term income stream, with built in flexibility, would lay the foundations for a retirement to be enjoyed and not endured.

EXECUTIVE SUMMARY

- The ultimate objective of any pension system is to provide a secure long-term income stream to meet spending needs in retirement.
- Today, 18 per cent of the UK population are aged 65+, of whom 14,570 are centenarians. By 2034, those aged 65+ will represent nearly 25 per cent of the population, while in 2040 nearly one in five people currently living in the UK are likely to reach 100. However, without significant medical breakthroughs, improvements in healthy life expectancy will continue to lag rising longevity.
- Freedom and choice has put an enormous decision-making burden on the shoulders of a largely unsupported and rapidly ageing population, ill equipped to decide for themselves. Individuals must navigate a myriad of largely unquantifiable risks which, if not managed well, can add up to an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings or living in penury in fear of the latter.
- Prior to the introduction of the freedom and choice reforms in April 2015, over 90 per cent of DC pension pots were annuitised and so provided a secure income in retirement, albeit with no flexibility.
- Since freedom and choice, over £14bn has been accessed from more than one million DC pension pots. Of the 53 per cent of pots fully encashed, 25 per cent has been spent on home improvements and discretionary items and over 50 per cent has been invested in other savings and investments, including 32 per cent in low yielding cash deposits. Additionally, nearly 60 per cent of annuity and income drawdown contracts were purchased by consumers without shopping around and more than two thirds of annuity purchases and around one third of income drawdown purchases were made without regulated financial advice.
- The commonly held view that spending in retirement is U-shaped is flawed. Spending in retirement for the 'make do and mend' generation typically follows a downward trajectory in real terms regardless of income level, lifestyle and the period analysed. By contrast, the retirement spending of mid-to-late baby boomers, particularly the 'sandwich' generation, is unlikely to decline but prospectively rise in real terms.
- The Pensions and Lifetime Savings Association has suggested that £10K-£15K per annum is the bare minimum gross income required in retirement. £15K-£20K would be sufficient to support a modest retirement, while a comfortable retirement would require £25K+ gross per annum.

- Recent research conducted by Columbia Threadneedle Investments, in conjunction with YouGov, suggests that those typically at retirement (the mid- to late-baby boomers aged 55-64) are failing to align how long their pension pot will probably last in retirement with the expected duration of their retirement, while also underestimating the level of income required to support a comfortable retirement.
- The sustainable income drawdown withdrawal rate (SWR) is the rate at which systematic income withdrawals that escalate in real terms can be made over a defined period from a portfolio of typically risky assets, without the pension pot running dry in the interim. The level of SWR is contingent on the underlying investment strategy and its susceptibility to sequencing risk (poor/negative returns occurring early in decumulation).
- Failing to diversify across multiple lowly correlated risky assets across multiple time periods may leave income drawdown investors wide open to sequencing risk. Only by minimising the sensitivity to sequencing risk can both flexibility and income security be achieved through income drawdown.
- By limiting susceptibility to financial market drawdowns, a genuinely well diversified and dynamically managed multi-asset fund provides a smoother returns experience than pure equity and equity/bond portfolios. Therefore, the SWR typically isn't compromised when financial markets turn tail. A dynamically managed multi-asset fund should also deliver a better outcome than that generated by capital protection strategies such as with-profits, constant proportion portfolio insurance or overlaying an equity portfolio with put options.
- Although behavioural interventions and the availability of user-friendly, online tools at and in retirement are helpful at the margins, given the complexity of the decisions to be made most people need to be properly supported with accessible sources of guidance and simple and affordable financial advice throughout the entire at and in retirement planning and implementation process.
- For the largely unsupported and unadvised mass market, which seeks both flexibility and income security, the solution lies in an auto-enrolled, well-governed and behaviourally robust, institutionally-managed default income drawdown fund, appropriately charge capped, with opt-out provisions and the option to finesse the default's key defined parameters. Underpinned by a dynamically-managed multi-asset fund, longevity insurance and a minimum income guarantee, the resulting secure and sustainable long-term income stream would lay the foundations for a retirement to be enjoyed and not endured.

WHAT ARE PEOPLE DOING WITH THEIR DC PENSION POTS AT AND IN RETIREMENT AND WHY?

THE CHALLENGES TO INFORMED DECISION MAKING

“Most people are ill equipped, let alone sufficiently engaged, to determine how best to achieve a good financial outcome at and in retirement.”

On average, those in the UK aged 55 today, who are now eligible to access their DC pension pots, are expected to live to their mid- to late-80s. However, longevity isn't a one-size-fits-all number, as around 9 per cent of these male and 14 per cent of these female 55 year olds are expected to receive their 100th birthday telegram from the incumbent King or Queen.³ Despite this, on average, those in their mid-50s today will fail to remain in good health much beyond their mid-70s.⁴ Some, however, will enjoy good health well into their twilight years while others will succumb to poor health, or morbidity, much earlier in life.

In addition to taking account of the vagaries of longevity and health longevity (both of which have a strong postcode lottery element),⁵ when making a decision about how and when to best to utilise one's pension pot, individuals also need to formulate a view on what retirement might look like and when that might occur.⁶ Indeed, for many, retirement is no longer a one-off event with a well-defined destination point. Rather, people are increasingly adopting a phased approach to retirement, with some choosing to continue to work well past State Pension age (SPa).⁷ Couple that with having to contend with often unforeseen changed circumstances, whether family or financial, along the way and the considerable cognitive impediments to informed decision making, which typically compound with age, and you have, according to the Financial Conduct Authority (FCA), *the most difficult of life's financial decisions to make.*⁸

Indeed, most people are ill equipped, let alone sufficiently engaged, to determine how best to achieve a good financial outcome at and in retirement, given the alarmingly low level of basic numeracy and financial literacy that exists amongst the UK adult population; the complexity and multiplicity of the decisions to be made; a behaviourally-driven focus on the short term; the lack of frames of reference and a paucity of guidance to evaluate complex choices; and a widespread unwillingness or inability to pay for financial advice. Moreover, as noted above, this comes at a time in many people's lives when financial literacy and cognitive ability often starts to decline, and is frequently exacerbated by increased risk and loss aversion⁹ and a reluctance to engage with technology that can facilitate the decision-making process.

Of course, the potentially dire consequences of inertia, making a wrong decision, indecision or failing to adequately engage at and in retirement, will compound over time as defined benefit (DB) pensions disappear, people start receiving their state pension ever later in life and increasingly become solely reliant on their DC pensions pots to support their desired standard of living in retirement which, for many, will extend to 30-plus years. Indeed, if not managed well, the risks of sub-optimal decision making, decision paralysis and inertia, combined with a continued lack

³What are your chances of living to 100? Office for National Statistics. 14 January 2016. See: <https://visual.ons.gov.uk/what-are-your-chances-of-living-to-100/>.

⁴Healthy life expectancy at birth and age 65 by upper tier local authority and area deprivation: England, 2012-2014. Office for National Statistics. 10 March 2016.

⁵Somewhat surprisingly, those areas in the UK with the highest longevity do not necessarily have the longest health longevity. See: ONS (March 2016), op. cit.

⁶The 100-Year Life: Living and working in an age of longevity. Lynda Gratton and Andrew Scott. Bloomsbury. (2016) explains how, against the backdrop of increased longevity, the well established pathway of progressing from education to work and then retirement, is changing. People are increasingly taking sabbaticals and career breaks to re-educate themselves and learn new skills as well as seeking out new ways of working, as they adopt new and increasingly multiple careers well into their 60s and often into their 70s.

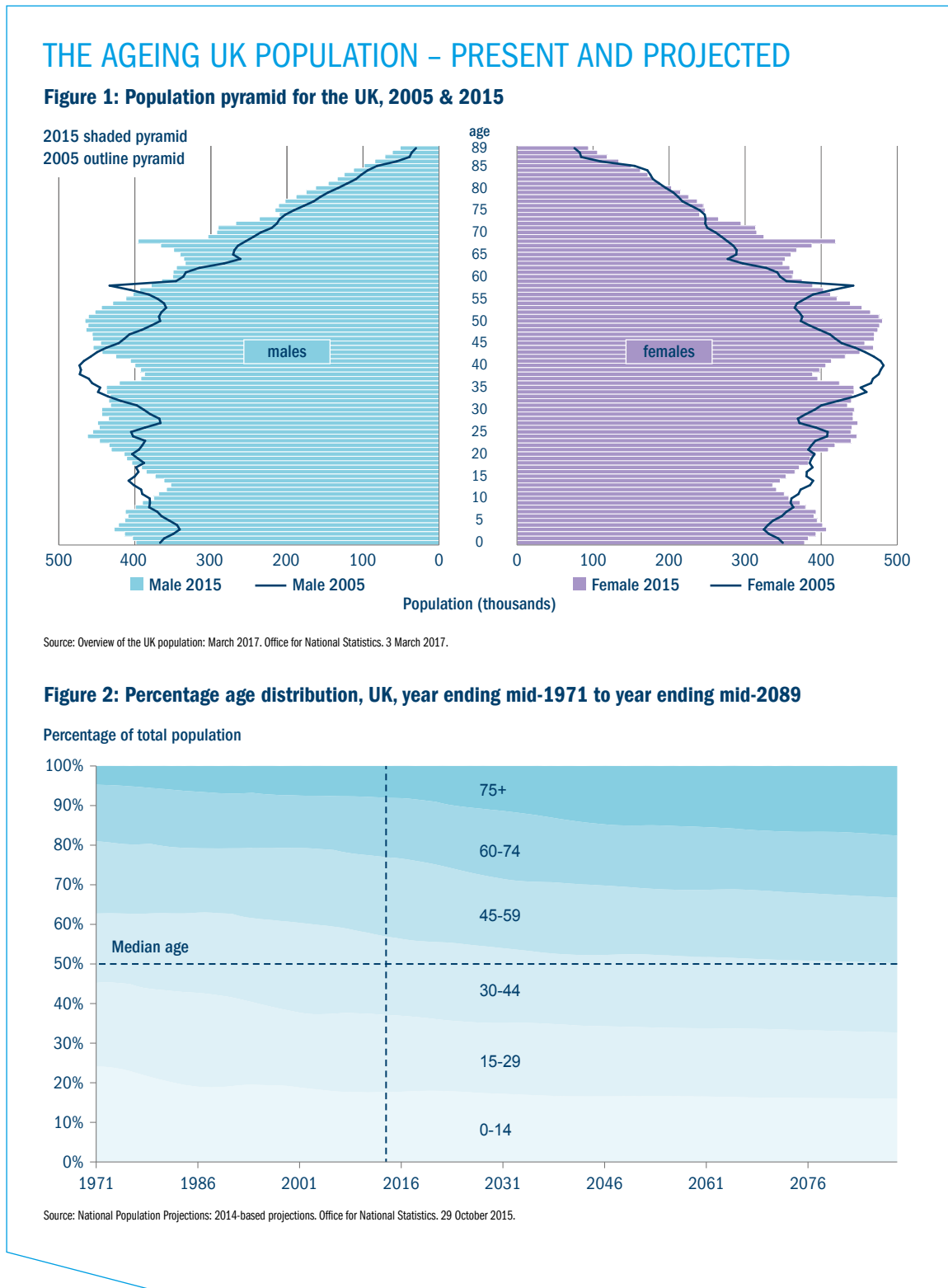
⁷According to the OECD, about 20% of those aged 65 to 69 in the UK are in paid employment. Many others are self employed. See: OECD Pensions at a Glance 2016: OECD and G20 indicators, OECD Publishing, Paris. Chart 7.6. p.160. Also see: Learning from our elders. Schroders Global Investor Study 2017.

⁸Financial Advice Market Review. Final Report. Financial Conduct Authority and H M Treasury. March 2016. p25. According to Nobel prize winning economist Bill Sharpe, this decision is “the nastiest, hardest problem in finance.”

⁹Loss aversion is when the pain of financial losses exceeds the pleasure from a financial gain of the same magnitude. Loss aversion often results in a reluctance to invest in those asset classes, like equities that, while volatile in the short-term, typically preserve capital and income in real terms over the longer run, unlike lower volatility assets, like cash.

of guidance and accessible advice and the absence of behaviourally robust and well-governed default solutions, will culminate in an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings.

Before considering the multitude of factors that should inform this decision making, the impediments to the decision-making process and whether the solutions currently offered are fit-for-purpose, we'll start by taking a look at what people have actually been doing with their DC pension pots since the introduction of the freedom and choice reforms in April 2015.



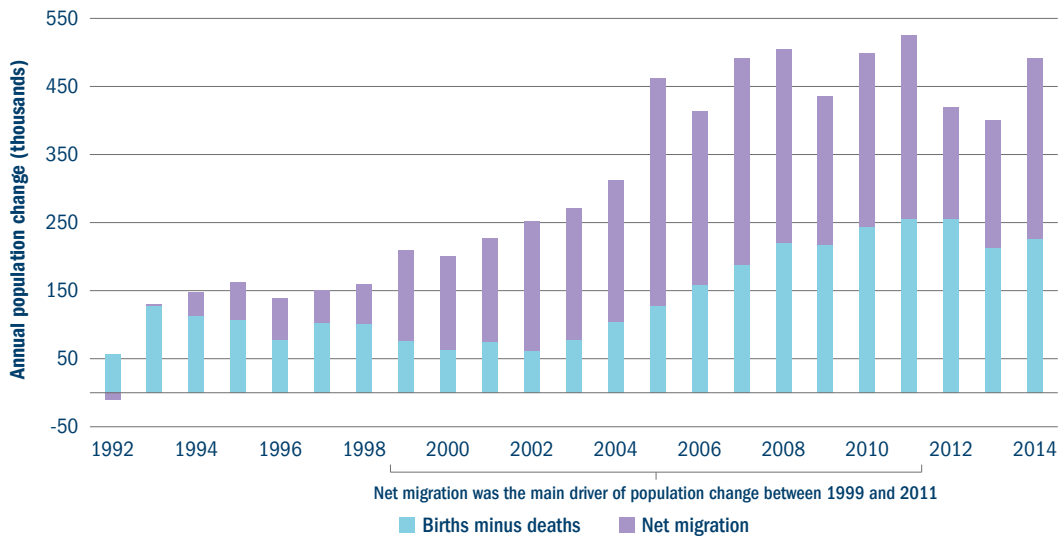
Figures 1 and 2 above, supplied by the Office for National Statistics (ONS), illustrate the extent to which the UK population has aged and will continue to do so. Today, according to the ONS¹⁰ and Age UK,¹¹ out of an estimated UK population of 65.6m people:¹² 18% are aged 65+, 23% are aged 60+ (that's more than those aged under 18), over a third of the population are aged 50+, 2.4% are aged 85+, while over half a million people (0.8%) are aged 90+, of which 14,570 are centenarians.

So what factors explain the ageing population and why should we expect this ageing to continue?

Factors driving UK population size, composition and change

“The current composition of the UK’s ageing population is largely a result of two factors: the fertility, or birth, rate having declined between the highs of the mid-1960s and the lows of 2001 and the dramatic improvements in longevity experienced over the 20th Century.”

Figure 3: Factors driving UK population change, mid-year estimates, 1992 to 2014



Source: UK Perspectives 2016: The changing UK population. ONS. 26 May 2016.

Three factors drive change in the size and composition of any population: births, deaths and net international migration – the net difference between immigration and emigration.

As shown in Figure 3, population growth in the UK over the past 20 years can be explained by the number of births in the UK having exceeded the number of deaths (as they have done for the last 60 years), with net international migration having increasingly become the main driver of population growth.

¹⁰ Overview of the UK population: July 2017. Office for National Statistics. 21 July 2017.

¹¹ Later Life in the United Kingdom. Age UK. April 2017. p.1 unless otherwise stated.

¹² ONS (July 2017). op. cit.

However, the current composition of the UK's ageing population is largely a result of two factors: the fertility, or birth, rate having declined between the highs of the mid-1960s and the lows of 2001 and the dramatic improvements in longevity experienced over the 20th Century.¹³ Indeed, as a consequence of the latter, the likelihood of dying between age 65 and 75 has halved over the lifetime of someone born in 1949 to two out of 10 for the average man and one out of 10 for the average woman.¹⁴ Consequently, men and women aged 65 in the UK can expect to live on average for an additional 18.2 and 21.2 years respectively, albeit with a regional variation between those areas with the highest and lowest life expectancy of 1.4 years for men and 1.9 years for women.¹⁵ As noted earlier, when it comes to longevity, there is no one-size-fits-all number.

Indeed, a considerable number of statistics suggest that longevity improvements will continue unabated. For instance:

- 50 per cent of babies born in 2007 have a 50 per cent chance of living to 103,¹⁶ while
- females born in 2064 will have a life expectancy of 100 years.¹⁷

However, as already noted, rising longevity is in marked contrast to the declining birth rate. Although since 2002 there has been a significant increase in the number of births, with 2012 having experienced the highest number of births since 1972, fertility rates remain far below the highs of the mid-1960s, when almost one million babies were born annually and the fertility rate per woman was almost three, compared to 650,000 and 1.63 respectively in 2001. Although this increased birth rate is principally attributable to the rising fertility of indigenous women, an increasing percentage of live births are attributable to the immigration of women of childbearing age: a factor that may yet help moderate the UK's skewed demographics.¹⁸

UK population projections – the continued skewing of demographics

As a consequence of the above trends, it probably comes as no surprise that the ONS suggests by 2039 the UK population will number 74.3m.¹⁹ However, even after taking account of the projected beneficial demographic effects of net international migration and the increasing birth rate, population projections by the ONS and Age UK suggest the number of people aged:

- 65+ will rise by nearly 40 per cent in 2034 to 16 million+ and will represent nearly 25 per cent of the population;
- 85+ will more than double by 2040 to 3.4 million+, with nearly one in five people currently living in the UK likely to reach 100.²⁰

¹³ How has life expectancy changed over time? ONS, 9 September 2015. <https://visual.ons.gov.uk/tag/life-expectancy/>. Increased life expectancy in the first half of 20th century was largely attributable to childhood immunisation, while in the second half it was principally due to improvements in addressing the chronic health conditions of the older population. For a greater insight into the reasons for much improved longevity and the likely extent of possible future longevity improvements, see: Gratton and Scott (2016) op. cit. pp.23-34.

¹⁴ Douglas Anderson. Why do people underestimate their longevity? ILG-UK, 25 April 2016.

¹⁵ Life expectancy at birth and at age 65 in local areas in England and Wales: 2012 – 2014. Office for National Statistics, 4 November 2015.

¹⁶ Human Mortality Database. University of California, Berkeley, and Max Planck Institute for Demographic Research.

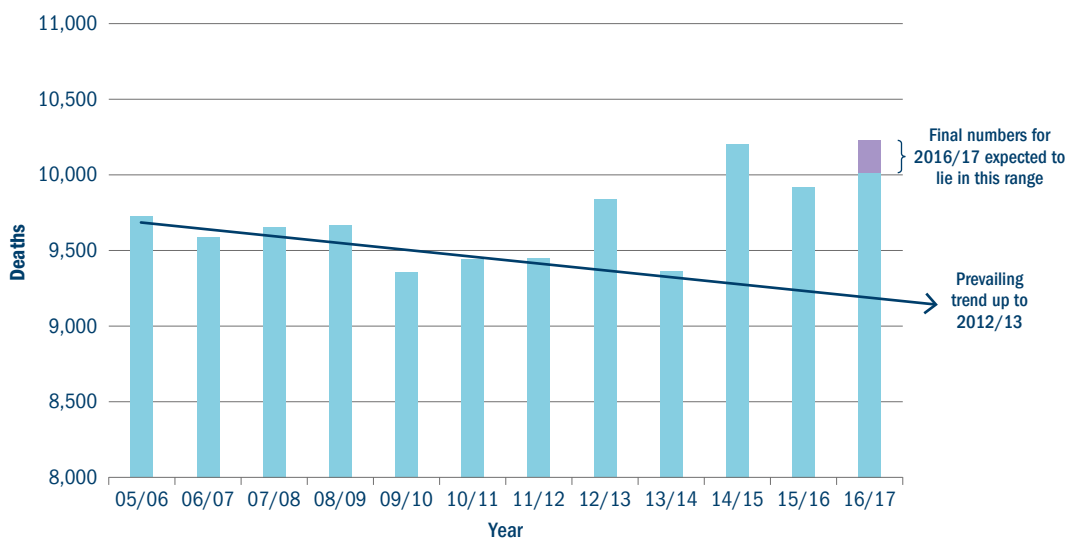
¹⁷ Past and projected data from the period and cohort life tables, 2014-based, UK, 1981 to 2064. Office for National Statistics, 11 December 2015.

¹⁸ For a fascinating analysis of the factors that have shaped UK demographics since the Second World War, see: David Willetts. The Pinch. Atlantic Books (2010). Chapter 3 and p.271.

¹⁹ Overview of the UK population: July 2017. Office for National Statistics, 21 July 2017.

²⁰ ONS (July 2017). op. cit. Age UK (April 2017). op. cit.

Figure 4: Average deaths per week in England and Wales (July – June)



Source: Longevity trends. Does one size fit all? PLSA and Club Vita. June 2017. p6.

Impediments to ageing

However, despite the foregoing analysis, when it comes to ageing in the UK it's not all one way traffic. As suggested in Figure 4, prior to 2012/13, deaths in the UK had been on a very steady downward trajectory and life expectancy had been rising rapidly. Since then there have been five 'off trend' years with death registrations in England and Wales showing a 5.6 per cent increase in deaths in 2015 (to 529,613); the biggest year-on-year percentage increase seen since 1967/68. This was principally attributable to deaths from dementia or Alzheimer's and respiratory disease, including a particularly virulent flu virus and pneumonia.²¹ Moreover, the 2016 iteration of the CMI (Continuous Mortality Investigation) mortality tables suggests that "the direction of travel of mortality improvements is negative" citing "mortality improvements [having] peaked some time ago with the highest improvements being seen in 2004 for males and 2006 for females."²²

However, by contrast, analysis by the PLSA and Club Vita in June 2017 of 2.5m pensioners of over 200 UK DB schemes finds that the recent slowdown in longevity has only been experienced by lower income pensioners who have seen little, if any, increases in longevity since 2011. Indeed, life expectancy for male pensioners aged 65 with an annual DB pension income of more than £7,500, living in all but the most deprived areas of the UK, has increased from 19.9 to 20.3 years.²³

²¹ Dementia and respiratory disease behind biggest annual deaths increase since the 1960s. Office for National Statistics. 7 April 2016. An extra 28,189 deaths were registered in 2015 compared with 12 months earlier, increasing from 501,424 deaths in 2014 to 529,613 in 2015. People aged 75 and over made up 86% of the 28,189 increase in deaths between 2014 and 2015 – a figure of 24,201. The largest increase was seen for those aged 90 and over, whose age specific mortality rate increased by 9.3%.

²² Mortality Projections Committee Summary of Working Paper 97: "CMI Mortality Projections Model: CMI_2016" March 2017 © Continuous Mortality Investigation Limited. Also see: Actuarial Profession releases new mortality projections confirming a fall in life expectancy. Willis Towers Watson. 28 March 2017. The CMI mortality tables are used by the Faculty and Institute of Actuaries, to project future changes in mortality. Life expectancies at age 65 in CMI 2016 compared to CMI 2015 are projected to be 1.3% lower for males (minus 4 months) and 2.0% lower for females (minus 6 months), with falls in life expectancy are greater at the oldest ages. Also see: Making sense of longevity trends – a guide to the key issues for defined benefit pension schemes. LCP. November 2017.

²³ Longevity trends. Does one size fit all? PLSA and Club Vita. June 2017. See: http://www.clubvita.co.uk/assets/images/general/170623_16_PLSA-Longevity-model.pdf.

Healthy life expectancy

“Men and women aged 65 can expect, on average, to live just over half their likely remaining lives in ‘good health.’”

Then there's the issue of healthy ageing. While increasing longevity in itself is seen as desirable, remaining healthy for as long as possible is perhaps the greater imperative. According to the ONS in 2016, men and women aged 65 can expect, on average, to live just over half their likely remaining lives in 'good health' though significant inequalities exist in healthy life expectancy (HLE). At birth, for example, this inequality between those born into affluent rather than deprived areas amounts to 19 years. Indeed, more generally, there has been an expansion of morbidity (the number of years spent in 'not good' health) for both males and females given that increases in HLE continue to lag increases in life expectancy. Moreover, at birth, males and females in the UK are currently expected only to live in good health on average to around age 64, which is below the current, let alone the projected, State Pension age.²⁴ Also, elderly people are getting frailer for longer as they reach the final years of their life, with men spending 2.4 years on average needing regular care and women three years. This includes everything from help with washing and dressing each day to round-the-clock care.²⁵

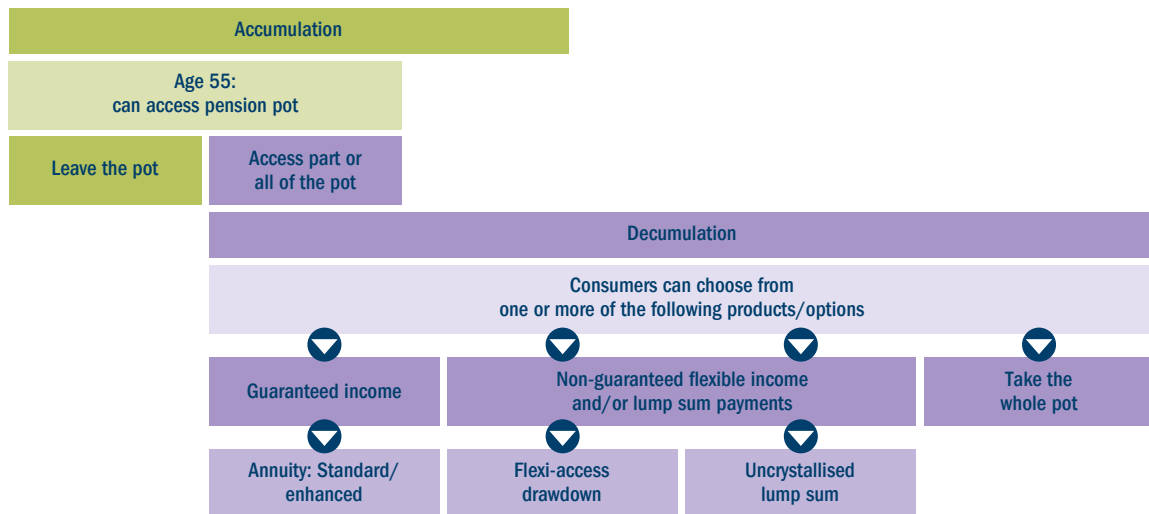
WHAT DECISIONS HAVE PEOPLE BEEN MAKING AT AND IN RETIREMENT SINCE THE INTRODUCTION OF FREEDOM AND CHOICE?

The fundamental premise of any pension system is to provide a secure long-term income stream to meet spending needs in retirement. Prior to the introduction of the freedom and choice reforms in April 2015, this objective was largely met with over 90 per cent of DC pension pots being annuitised and 466K annuities having been purchased at their peak in 2009. Indeed, despite the introduction of income drawdown in 1995, and the various conditions that were attached to income withdrawal over time, with limited provision to take small pension pots as a cash lump sum, there was still a requirement to annuitise by age 75.

²⁴ Healthy life expectancy at birth and age 65 by upper tier local authority and area deprivation: England, 2012-2014. Office for National Statistics. 10 March 2016. Between 2012 and 2014, men at age 65 could expect to live for a further 18.8 years with 10.6 of these years spent in "Good" health. On the other hand, women could expect to live a further 21.2 years of which 11.5 years could be spent in "Good" health. For a greater insight into morbidity trends and projections, see: Gratton and Scott (2016) op. cit. pp.34-38.

²⁵ <https://research.ncl.ac.uk/seed/>.

Figure 5: Retirement income consumer options



Source: Retirement Outcomes Review Interim Report, FCA, July 2017.

“The fundamental premise of any pension system is to provide a secure long-term income stream to meet spending needs in retirement.”

Today, there is complete flexibility as to how DC pension assets can be accessed from age 55-plus. The three principal choices, which are not mutually exclusive, are illustrated in Figure 5 above. These are to take DC pension pots as cash; via income drawdown, from which an income (flexi-access drawdown) or a series of lump sums (uncrystallised lump sums) are drawn and a legacy may be left; via an annuity which will provide a guaranteed level, variable or escalating income for life; or a combination of each of these options. However, unless people mix and match, ultimately they must trade off the security and certainty of an annuity against the flexibility and uncertainty of taking one or a series of cash lump sums and/or an income via income drawdown.

With over £14bn having been accessed from more than one million DC pots since the introduction of the freedom and choice reforms,²⁶ the FCA and Association of British Insurers (ABI) periodically publish quarterly figures on how those at or in retirement are accessing their DC pension pots, the total and average amounts involved and whether advice was taken in making these decisions. However, in drawing on differing data sets, the FCA and ABI publish different annuity and markedly different income drawdown statistics which makes the analysis of trends difficult.

According to the ABI, after an initial dash for cash immediately post-freedom and choice, with over 120K cash withdrawals in Q215 alone, the market is settling. While at 55K per quarter, the numbers of those taking their pensions as a cash lump sum remains high, the sum being withdrawn – mainly by those age under 70 – has fallen from an average of just over £15,200 to £13,900. However, these people are potentially easy prey to scammers who, through fraudulent emails and phone calls, attempt to lure people with cash lump sums with promises of one-off ‘deals’ offering guaranteed high returns.²⁷

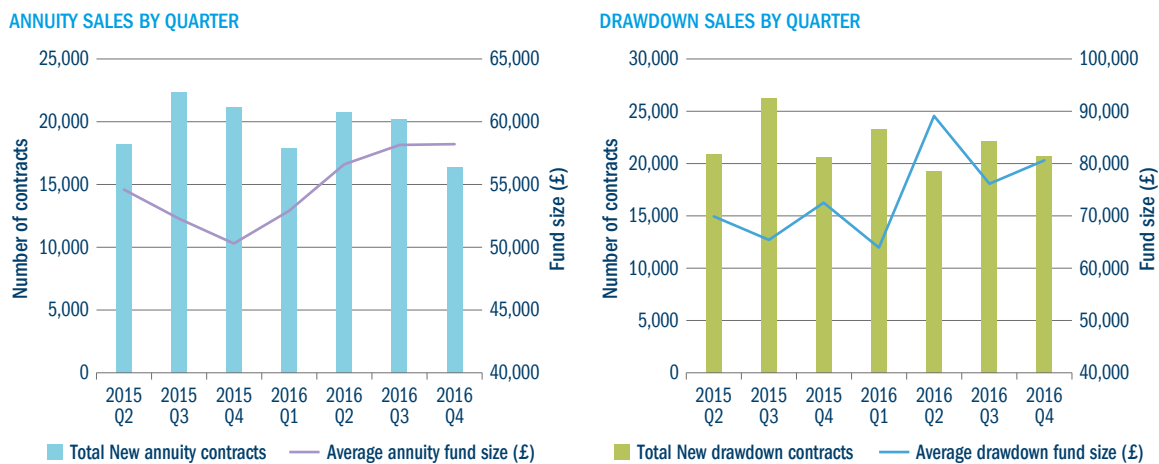
²⁶ Retirement Outcomes Review Interim Report, FCA, MS16/1.2, July 2017, p.3. HMRC, October 2017. Additionally, the FCA found that 5.6 million pension pots held by consumers aged over 55 had not been accessed as of September 2016.

²⁷ See: <http://www.thepensionsregulator.gov.uk/pension-scams.aspx>.

The number of contracts and amounts invested in annuities and income drawdown since the advent of freedom and choice are shown in Figure 6 below. Although income drawdown has proved more popular than annuities by both *number* of contracts and *amounts* invested, the differences are less marked than was anticipated immediately before the reforms had been introduced. A little under 20K annuities per quarter at an average £58,100 are now being purchased, compared to a little over 20K income drawdown contracts per quarter with an average investment of £76,000.²⁸

By contrast, FCA data suggests that full cash withdrawals are running at 80K per quarter, annuity purchases at just over 20K per quarter and income drawdown investment at around 40K contracts per quarter.²⁹ Separately, the FCA estimates that 53 per cent of pension pots accessed since the reforms have been fully encashed.³⁰ Anecdotally, this ‘dash for cash’ may be explained by an opportunity to make good the lack of any medium-term savings by those who might otherwise have considered income drawdown.

Figure 6: Annuity and income drawdown sales, Q215 to Q416



Source: The new retirement market: the evolution continues.ABI. 11 April 2017.

“Nearly 60 per cent of consumers purchase annuity and income drawdown contracts from their existing pensions provider without shopping around.”

Of course, what isn’t captured in this quantitative analysis is the rationale and motivation behind these decisions, the inertia and indecision that often results from most people being ill equipped to make an informed decision at and in retirement and whether decision regret is experienced after a decision has been implemented. What is apparent from the FCA data is that nearly 60 per cent of consumers purchase annuity and income drawdown contracts from their existing pensions provider without shopping around,³¹ while a dwindling percentage of these purchases are made on the back of regulated advice. In Q316, 33 per cent of annuity and 65 per cent of income drawdown purchases were advised.³² The ABI figures tell a similar story at 26 per cent and 68 per cent respectively.³³

To date, three industry studies, compiled by Columbia Threadneedle Investments, The People’s Pension and the FCA have attempted to document and rationalise the choices people make at and in retirement. Each is summarised below.

²⁸ The new retirement market: the evolution continues.ABI. 11 April 2017. <https://www.abi.org.uk/news/news-articles/2017/04/the-new-retirement-market-the-evolution-continues/>
²⁹ Data Bulletin. Issue 8. Financial Conduct Authority. February 2017. pp14-15.
³⁰ FCA (July 2017). op. cit.
³¹ Data Bulletin. Issue 8. Financial Conduct Authority. February 2017. p.16.
³² FCA (February 2017). op. cit. p.17.
³³ ABI (April 2017). op. cit.

PLANNING FOR RETIREMENT: ARE PEOPLE JOINING UP THE DOTS?

In February 2018, Columbia Threadneedle Investments, working in conjunction with YouGov, surveyed 838 UK adults aged 55+ to gauge how much thought, post-freedom and choice, is being given by those at and in retirement to retirement outcomes and also to better understand the challenges people face in making decisions around their retirement.

The report, *Planning for retirement: Are people joining up the dots?*, revealed that while 72 per cent of respondents were aware of the pension freedoms, 28 per cent weren't, with the latter statistic all too apparent in many of the responses given. However, it was the responses of the survey's 328 55-64 year olds, those mid- to late-baby boomers typically at retirement, of whom almost one fifth (19 per cent) weren't aware of the pension freedoms, that were the most revealing. Indeed, those at retirement appear to be failing to align how long their pension pots will last in retirement with the expected duration of their retirement, while also underestimating the level of income required to support a comfortable retirement.

The highlights from the research for this cohort, excluding those who responded as "don't knows", are as follows:

- 60 per cent of respondents either had retired or planned to retire between the ages of 60 and 69, with over three quarters (77 per cent) expecting their retirement to last for 20+ years. However, only 69 per cent believed their pension pot would last for the full term of their retirement. This might explain why over half (52 per cent) of respondents are expecting to work until or beyond state pension age.
- Disconcertingly, 38 per cent didn't know how long their pension savings would last, while over a quarter (26 per cent) didn't hazard a guess as to the likely duration of their retirement, despite only 7 per cent being uncomfortable thinking about their own mortality.
- The most important consideration for over half (51 per cent) of this group was securing a standard of living in retirement equivalent to that enjoyed pre-retirement, with three quarters (74 per cent) believing that an annual gross income below £25K would provide a "comfortable" retirement. By contrast, the Pensions and Lifetime Savings Association (PLSA) recently suggested that securing a comfortable retirement would require a minimum gross income of £25K per annum.³⁴
- 50 per cent of this group had DB benefits, while over half (55 per cent) had a DC pensions pot and/or a SIPP. DB comprised the most significant source of retirement income for 38 per cent, closely followed by 30 per cent being heavily reliant on the state pension (85 per cent of the group expect to receive a state pension) and 19 per cent on their DC and/or SIPP pots.
- For those with a DC pensions pot and/or a SIPP, over a third (35 per cent) have yet to make a decision on how to convert their pension pot into income. When asked why a decision hadn't been made, 30 per cent said that retirement was a long way off, almost a quarter (23 per cent) didn't know what the available options were, 17 per cent didn't trust the pensions and/or investment industry with their money, while 14 per cent weren't prepared to pay for financial advice. (These latter two issues were a bigger concern for the survey's 65+ year old respondents). Of those who had made a decision and had opted for income drawdown, nearly two-thirds (63 per cent) did so because of the flexibility it offered.
- When asked how difficult making this decision was, over a half (52 per cent) said it was more difficult than naming a child. Moreover, of those who had made a decision, 37 per cent had yet to implement it. Given this, 53 per cent believed that being automatically enrolled into a default income drawdown fund with a defined but flexible income withdrawal policy, underpinned by a default multi asset investment fund would simplify the decision making process, though nearly a quarter (22 per cent) didn't offer a view.

³⁴In a recent survey of 55 to 64 year olds, the PLSA suggested that securing a comfortable retirement would require a minimum gross income of £25K per annum. See: *Hitting the Target - Delivering Better Retirement Outcomes*. PLSA, October 2017.

NEW CHOICES, BIG DECISIONS

The People's Pension followed 80 DC investors, who were considering accessing their DC pension pots over the eight months from June 2015 to February 2016, to see what decisions they made over the subsequent 12 months. As the initial stage of a much larger longitudinal study, *New Choices, Big Decisions*³⁵ documents the decisions made by the 80 and any actions taken since. Categorising their 80 subjects into seven personas, ranging from the 'Procrastinators' to the 'I Can Do Betters', the following behaviours were observed:

- The risk adverse either opted for annuitisation, treating this route as passing on the investment risk (no mention of longevity risk is made) to "the experts", or investing any money withdrawn into a cash-based account in the belief they were "taking control" and their money was now "safe". For many, the opportunity cost of taking the latter decision hadn't been adequately considered.
- There was little evidence of serial dipping into pension pots to finance excessive discretionary spending. This was particularly true of many who had fully encashed their DC pots. Rather than (recklessly) spend the entire sum, as was initially feared by many financial commentators, the money was instead placed into cash deposits to engender an enhanced sense of financial security. Once again, the potential financial ramifications of taking this course of action typically failed to be considered.

"Sometimes it is best to be blissfully ignorant of what you should have done, try not to think too much. Do what you think is right and hope for the best."

Male, total encashment

- Many of those making a decision were influenced by recent family events or health issues rather than formulating a long-term financial plan. For the *sandwich generation*, those with elderly parents and often still financially-dependent adult children, sometimes with children of their own, family events and health issues can have a strong short-term impact on decision making.
- Indecision and procrastination meant that many had failed to do anything with their pension pot(s).
- Some were well aware of the need to live within their means if they are not to outlive their savings.

"My main strategy for survival is very small overheads. I do house-sitting, looking after animals, so I'm off to Cornwall where I'll be using someone else's fuel and there is no wear and tear on my property. I'm not spending any more on food and it's good to have a change of scene. Like a holiday without the cost, and it keeps me busy which is important."

Male, full encashment

³⁵ *New Choices, Big Decisions. Exploring Consumer Decision Making and Behaviours Under Pension Freedom and Choice. The People's Pension and State Street Global Advisers. April 2017. <http://bandce.co.uk/wp-content/uploads/2017/04/TPP-SSGA-Joint-Research.pdf>.*

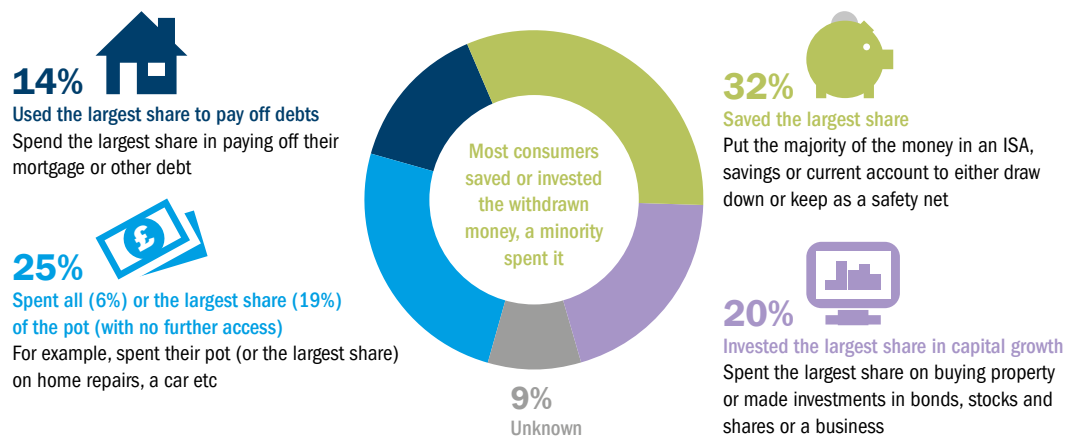
WHAT HAVE PEOPLE DONE WITH THEIR FULLY ENCASHED PENSION POTS?

Of those pots fully withdrawn, 25 per cent was spent on home improvements and discretionary items, while 52 per cent was transferred into other savings and investments.”

In July 2017, the FCA published the interim findings of its investigation into how consumers had responded to the pension freedoms and used their pension savings.³⁶ Surveying 1,000 consumers who had fully encashed their pensions pot of at least £10K without taking regulated advice, interviewing 171 of them, while drawing on the retirement income data gathered by the ABI and 56 retirement income providers, the FCA found that:

- 53 per cent of the one million-plus DC pots accessed since the reforms have been *fully* withdrawn as cash lump sums, with 90 per cent being smaller than £30K.
- 72 per cent of these pots have been accessed by consumers aged under 65, most of whom have taken cash lump sums rather than a regular income.
- There was limited evidence of people using their encashed retirement savings recklessly. Of those pots fully withdrawn, 25 per cent was spent on home improvements and discretionary items, while 52 per cent was transferred into other savings and investments, including low yielding cash savings accounts and cash ISAs. This is illustrated in Figure 7 below. The latter was partially motivated by a mistrust of pensions and of government pensions policy. In some cases, this would have resulted in a considerable income tax charge and in many cases compromised, tax-inefficient investment returns.
- In taking an holistic view of retirement income, 94 per cent of consumers who fully withdrew their pension savings had other sources of retirement income other than the State Pension, notably DB pensions, property and other DC pension pots. However, as identified earlier in this paper, greater reliance will increasingly be placed on DC pension pots in retirement as DB pensions dwindle over time and the State Pension is paid ever later in life.

Figure 7: What have people done with their fully encashed pension pots?



Source: Retirement Outcomes Review Interim Report. FCA. July 2017.

³⁶FCA (July 2017). op. cit.

In addition, just prior to the implementation of freedom and choice, the FCA conducted behavioural research to better understand whether people were being unduly influenced in their decision to either annuitise or drawdown their decumulation pot by the linguistic context in which annuities or drawdown contracts were framed. The results of this December 2014 study are summarised below.

DOES THE WORDING OF RETIREMENT INCOME OPTIONS MATTER?

“Words are loaded pistols”

John-Paul Sartre

According to FCA research, the way in which annuities and drawdown contracts are framed, or the linguistic context in which they are presented to investors, can dramatically affect the choices made.³⁷

When positioned in a ‘consumption frame’, that is, when set in the context of the likely income to be made available for spending in retirement, 66 per cent of consumers surveyed preferred the characteristics of annuities over income drawdown. However, when an ‘investment frame’ was used, set solely in the context of the size of the pension pot invested and the returns accruing on that investment, to the exclusion of income generation and consumption considerations, the reverse was true, with only 17 per cent opting for an annuity. Indeed, the latter frame when applied to an annuity causes many investors to conjure up thoughts of their pension pot being used as a one-off longevity gamble, with their money remaining with the annuity provider, the insurance company, and not forming part of their estate on death.

Interestingly, when the term ‘annuity’, rather than a simple description of what an annuity provides, was used within the consumption frame, the preference for annuities declined from 66 per cent to 50 per cent. So while the characteristics of an annuity appear to be valued, the term itself has perhaps become associated with poor value.

The research also found that, regardless of the frame and whether or not annuities were referenced, those without children had a greater preference for annuities than those with children, given the importance the latter placed on being able to make a bequest.

Of particular note was the fact that those with household incomes of less than £30K were influenced more by the framing of the retirement income decision in their choices than those with higher levels of income. The former cohort more strongly favoured annuities under the consumption frame and income drawdown under the investment frame than the latter group.

This matters as lower income groups, which appear to be more influenced than most in their decision making by framing, are less likely to receive financial advice. This means the information they receive at retirement needs to be written in clear and unambiguous language that doesn’t skew their decision making.

However, the problem – not only for this group, but for all pension savers and investors – is that they are presented with the value of their pension pot in their pension statements throughout the accumulation stage and at retirement. This means their mindset is more geared to the investment rather than the consumption frame, leading to a possible aversion to annuities.

³⁷ Does the framing of retirement income options matter? A behavioural experiment. Financial Conduct Authority, December 2014. The methodologies and findings of the research were consistent with that conducted by Brown, J.R., Kling, J.R., Mullainathan, S., and Wrobel, V.M. (2008). Why Don't People insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle. *American Economic Review*, 98(2): 304-09.

DB TO DC TRANSFERS

Another consequence of the flexibilities offered by freedom and choice, allied to historically low real interest rates and the increased prevalence of Retirement Transfer Options (RTO) quoting transfer values (TVs) on DB members' retirement statements, has been the exponential increase in the number of DB to DC transfers. Indeed, research by investment consultant Willis Towers Watson (WTW)³⁸ suggests that in January 2017, 10 times the number and 18 times the monetary amount of DB to DC transfers were made compared to the monthly average over the 24 months prior to freedom and choice. Tapping into 170K DB scheme members of 350 DB schemes, the WTW study reveals that 55 per cent of DB members subject to a RTO exercise who spoke to an independent financial adviser, but didn't necessarily follow the adviser's advice, chose to transfer out of their DB scheme at retirement. Moreover, those with TVs of £500K+ were almost twice as likely to transfer from DB to DC as those with TVs of £100K or less. Disconcertingly, however, a not inconsiderable 43 per cent of those DB transfers made in 2016/17 were subsequently invested in annuities. In effect, an annuity with inflation protection and a spouse's and dependents' pension was substituted for another typically without these features. Interestingly, only four per cent was taken as cash.

Having considered how those at and in retirement are accessing their DC pension pots and the decision-making processes they adopt, we now turn to observed spending patterns in retirement and how these might be reshaped in the future.

³⁸ Willis Towers Watson. DB member choice survey 2017: The rise of pension flexibility. May 2017.

SPENDING PATTERNS IN RETIREMENT

“If I had a pound for every time someone in financial services talks about spending in retirement as being ‘U-shaped’, I’ll probably have enough money by now to never have to work again!”

Abraham Okusanya, FinalytiQ³⁹

“The inescapable truth is that, regardless of the period analysed, lifestyle or income level, older people in the UK spend less than their younger counterparts...while almost all cohorts progressively save more of their income as they become older.”

Since the 1950s, economic theory has assumed that an individual's spending remains reasonably constant throughout their lifetime, even when making the transition between work and retirement. Various known as the ‘lifecycle hypothesis’ and ‘permanent income hypothesis’, consumption at any point in time is assumed to be driven by the individual's expected average lifetime income, taking account of the likely accumulation and decumulation of physical and financial assets and human capital over their lifetime.⁴⁰

By contrast, the commonly held view of many in the pensions industry is that spending in retirement is ‘U-shaped’. That is, retirement is assumed to start with a spending spree in the ‘go-go’ years, despite most pensioners having lower spending commitments than those in work, with new retirees free to pursue their favourite activities and pastimes, take that vacation of a lifetime and refurbish their home. However, in the ‘slow-go’ years when the novelty of one's new-found freedom dissipates and morbidity begins to materialise, so spending in retirement then declines, only for it to skyrocket again in the ‘no-go’ years as the costs of long-term care surface.⁴¹ Or so the story goes.

As feasible as it may sound, the reality for most retirees, certainly at least prior to the implementation of the freedom and choice reforms in April 2015, appears to be somewhat different. Indeed, empirically, neither the permanent income hypothesis nor the U-shaped spending pattern seem to stand up in practice, with recent studies on both sides of the Atlantic suggesting that consumption through retirement typically declines in real terms as saving of retirement income steadily increases.

Indeed, in the UK, a 2015 longitudinal study conducted by the International Longevity Centre – UK (ILC - UK),⁴² based on household income and expenditure data but excluding those in care homes paying for their own care,⁴³ suggests that spending in retirement typically follows a downward trajectory in real terms regardless of income level and the period analysed. This is consistent with contemporary US research, which suggests spending falls in real terms throughout retirement by one per cent per annum.⁴⁴

³⁹ Abraham Okusanya, FinalytiQ. Busting the myth of ‘U-shaped’ retirement spending. 1 February 2017.

⁴⁰ See: Modigliani, F. and R. H. Brumberg (1954), “Utility analysis and the consumption function: an interpretation of cross-section data”, in K.K. Kurihara ed., Post Keynesian Economics, Rutgers University Press, New Brunswick, pp.388-436. Friedman, Milton (1957), “The Permanent Income Hypothesis”. *A Theory of the Consumption Function*. Princeton University Press. ISBN 0-691-04182-2.

⁴¹ The three phases of retirement [65 to 75 (the go-go years), 75 to 85 (the slow-go years) and 85 to 95 (the no-go years)], was coined by Michael K. Stein in *The Prosperous Retirement: Guide to the New Reality*. December 1961.

⁴² Cesira Urzi Brancati, Brian Beach, Ben Franklin and Matthew Jones. *Understanding Retirement Journeys: Expectations versus Realities*. International Longevity Centre - UK. 1 December 2015.

⁴³ Even when taking account of the 6.4 per cent of those aged 80+ identified by the study as paying for long-term care, U-shaped spending in retirement is atypical.

⁴⁴ 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/>.

Some of the statistics revealed by the ILC-UK research are quite startling. For instance, excluding mortgage payments and acknowledging that pre-retirement incomes are typically higher than those in retirement, the spending of a household headed by an individual aged 80+ 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+ the average annual amount being saved from retirement income is £5,870. Economists variously call this seemingly counterintuitive behaviour the retirement consumption puzzle and the savings puzzle.

Although this data can be sliced and diced in numerous ways, the resulting conclusion, while nuanced, is broadly consistent regardless of lifestyle, income or the period analysed. If analysed by income level, it's apparent that lower income groups who, understandably, have stable spending patterns throughout their lifetime (and conform most closely to the permanent income hypothesis), start to cut their expenditure in retirement later and less rapidly than those on higher incomes.⁴⁵ When analysed by lifestyle or persona, some cohorts, who enter retirement spending more than their income, like the 'Extravagant couples' at one end of the income spectrum and those 'Just getting by' at the other, begin moderating their spending as a percentage of income from their mid-60s. By contrast, others, such as 'Transport lovers' and 'Prudent families' start to rein in their spending as a proportion of income typically five or so years later than this.

However, the inescapable truth is that, regardless of the period analysed, lifestyle or income level, older people in the UK spend less than their younger counterparts, with discretionary spending on life's luxuries all but disappearing from age 75 and almost all cohorts progressively saving more of their income as they become older.

Intuitively, this reduced consumption and increased saving is likely to be driven by a combination of declining health, a desire to provide bequests and much changed personal preferences for goods and services in old age. However, while ailing health for some restricts certain activities in retirement, the ILC-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".⁴⁶ This finding appears to contrast with ONS research, considered earlier, which suggested 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.⁴⁷ That said, health longevity should not be confused with active daily living (ADL).⁴⁸ As regards changing personal preferences for goods and services, anecdotal evidence certainly suggests that the desire to try new experiences, keep up with new technology, refurbish and renew declines with age. With reduced consumption in later life comes increased saving and 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 £50K or more.⁴⁹

Needless to say, as retirees enter the no-go years, long-term care needs often surface. However, in a continuation of the theme of a progressive decline in consumption, the supposed J in the atypical U tends not to materialise. Indeed, somewhat surprisingly, Age UK finds that only 16 per cent of people aged 85+ in the UK live in care homes. Moreover, given that "the median period from admission to the care home to death is 462 days (15 months) ...[with] approximately 30 per cent of people using some form of local authority funded social care in the last year of life",⁵⁰ the idiom 'long-term care' is perhaps a misnomer. 'Social care' may be more apt.

⁴⁵ Brancati et al. (2015) op. cit. p.15.

⁴⁶ Brancati et al. (2015). op. cit. p.5.

⁴⁷ ONS (March 2016), op. cit.

⁴⁸ There are six basic ADLs: eating, bathing, dressing, toileting, transferring (walking) and continence. A person's ability to perform ADLs is important for determining what type of care provision and health coverage they need.

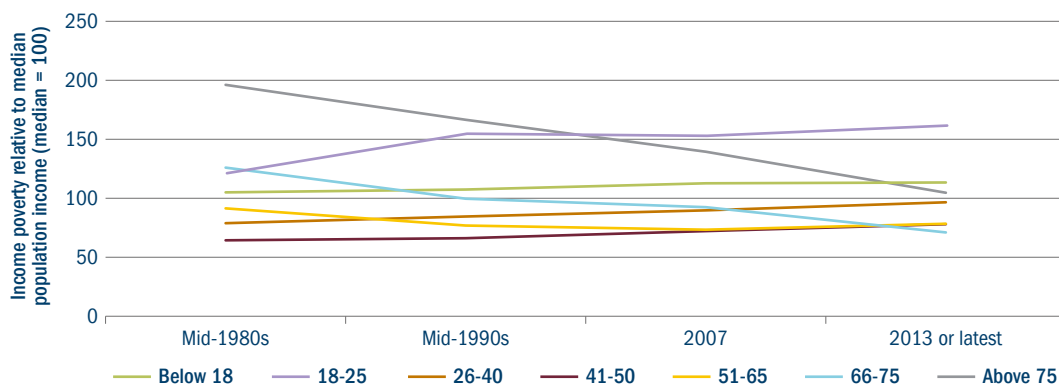
⁴⁹ Brancati et al. (2015). op. cit. p.41.

⁵⁰ Age UK (2017). op. cit. p.17.

HAVE WE REACHED PEAK PENSIONER INCOMES?⁵¹

“We have moved from a position where 30 years ago pensioners were at least three times as likely to be poor as non-pensioners, to one since 2011 where median pensioner incomes now exceed median non-pensioner incomes.”

Figure 8: Poverty has shifted from the old to the young across the OECD



Source: OECD (2015), Pensions at a Glance 2015: OECD and G20 indicators, OECD Publishing, Paris. http://dx.doi.org/10.1787/pension_glance-2015-en. Figure 1.3, p.18.

To be a pensioner 30 years ago in almost any OECD country typically meant living in relative poverty. Indeed, the over-75s, traditionally the poorest age cohort across the OECD, had an income level on average almost half of that of the wider population. However, since the early 2000s, this cohort has improved its relative position quite dramatically culminating with the average OECD 75+ year old today having an income level close to the median population income. Additionally, the relative income position of the average 66 to 75 year old has improved almost as dramatically, now with a median income level far *in excess* of the population median. Figure 8 above depicts the dramatic shift in the distribution of income amongst the old and the young across 18 OECD countries.

In the UK, we have moved from a position where 30 years ago pensioners were at least three times as likely to be poor as non-pensioners, to one since 2011 where median pensioner incomes now exceed median non-pensioner incomes. Indeed, pensioners' incomes have continued to rise post-global financial crisis as the real incomes and welfare benefits of working-age households have fallen, with pensioners having largely been insulated from government post-crisis austerity measures. Principal amongst these are the retention of the triple lock that provides a 2.5 per cent annual underpin to the state pension and welfare income benefits. As a result, a large proportion of those retiring now will actually be better off in retirement than they were on average during their working life. Indeed, Institute for Fiscal Studies modelling shows that pensioners' incomes will continue to rise for at least the next decade.⁵²

An opposing view is that we have reached peak pensioner incomes. DB pensions rapidly disappearing, the state pension being paid ever later in life and the increasing reliance people must place on their DC pension pots to support their standard of living in retirement suggests that we may be at or very near to peak pensioner incomes.

⁵¹ Patrick Collinson coined the phrase peak pensioner in *The Guardian*, 2 July 2016.

⁵² High levels of income for current retirees shouldn't blind us to future challenges. Paul Johnson. Institute for Fiscal Studies. 20 October 2015.

THE ORIGINS AND FUTURE OF THE STATE PENSION

The origins

Today, the first pillar of most developed pension systems is a basic state pension, designed to meet basic living needs in retirement. The origins of the state pension date back to Otto von Bismarck of Prussia who, in 1889, introduced a basic state pension in Germany for those over the age of 70, at a time when life expectancy was 45 and most of the population worked until their dying day. Participation was mandatory and contributions were taken from the employee, the employer and the government.

In the UK, a means tested *Old Age Pension* was introduced in 1909 and paid five shillings (£20 in today's money) per week to around 500,000 people aged 70 plus whose income was less than £21 a year, reducing to zero if that income exceeded £31. Married men received seven shillings and sixpence. Simplicity itself. This eventually became a universal, or non-means tested, state pension in 1948. Crucially, since its inception the state pension has been financed by the taxes of the working population, rather than from an underlying fund, on a so-called Pay As You Go (PAYG), or unfunded, basis.

Added complexity

Fast forward 100 years and the UK state pension, which has largely been based on working life national insurance contribution (NICs) records, had evolved into a somewhat complex and inequitable system, with women typically receiving much less than men, given women's generally shorter working lives, despite having a lower State Pension age (SPa). Indeed, up until 2010 the SPa for men was 65 and 60 for women. However, since then the SPa for women has gradually increased and will equalise at 65 by November 2018. The SPa for men and women will then progressively increase to 66 by October 2020 with further planned increases to 67 and 68 over the next couple of decades.

From two-tier to one-tier

For those who reached SPa before 6 April 2016, there were two tiers to the state pension: the basic state pension, which for 2017/18 pays £122.30 a week (£6,359.60 per annum) to those with at least a 30 year NICs record as an employee (as opposed to the ineligible self-employed), and an additional state pension related to earnings (S2P). Those with less than a full NICs record receive £73.30 per week (£3,811.60 per annum). However, for people reaching SPa on or after 6 April 2016 (i.e. women born on or after April 6, 1953 and men born on or after April 6, 1951), a new single-tier state pension replaced the two-tier system.

For 2017/18 the full single-tier flat rate of £159.55 per week (£8,296.60) is only paid to those who have accrued 35 qualifying years of NICs, whether having been an employee or self-employed. For those that haven't, the new state pension is paid on a pro rata basis and only if at least a 10-year NICs record has been achieved. Moreover, unlike for the pre-6 April 2016 state pension, that NICs record excludes any years when the individual was contracted out of S2P, whether through a workplace pension scheme or a private pension, during which time they would have paid NICs at a reduced rate. Consequently, typically under-pensioned lower paid workers and the self employed (not covered under the pre-6 April 2016 state pension) are likely to be the main beneficiaries of the single-tier state pension. Additionally, the 10.4 per cent annual uplift applied to deferring payment of the pre-6 April 2016 state pension for each year deferred has been almost halved for the post-5 April 2016 state pension.

The triple lock

“The triple lock has single-handedly made spending on state pensions the biggest item in the social security budget.”

Since 2010, the state pension has been uprated each year in line with the ‘triple lock’ – the highest of CPI inflation, average earnings growth or 2.5 per cent. This policy has led to a dramatic increase in the cost of the state pension from £66.9bn in 2009-10 to £91.6bn in 2016-17 – a 37 per cent increase according to the Office for Budget Responsibility (OBR). As a result, state pension costs now account for 4.7 per cent of national income, 12 per cent of total public spending and well over half of all government benefit expenditure. That’s equivalent to £3,300 per household.⁵³

Had the state pension been uprated via a double lock (by the higher of CPI inflation or earnings growth), the Exchequer would now be £4.4bn per annum better off, while if it had been indexed to the CPI rate of inflation government expenditure would be £8.6bn lower per year (equivalent to dropping the basic rate of income tax by around 2 per cent). This would rise to £11.4bn a year if it had been uplifted in line with average earnings growth.

Although these numbers take account of the fact that the number of pensioners to whom a state pension is paid had grown over this period by a little over 3 per cent, the triple lock has single-handedly made spending on state pensions the biggest item in the social security budget. Indeed, under the triple lock *individual* state pension costs have grown by 25.2 per cent, against 20.7 per cent if a double-lock had been applied, 16.5 per cent if linked to CPI increases and 13.6 per cent if uplifted by earnings growth. All of these numbers are a multiple of the rate at which GDP per adult grew over this period.⁵⁴ However, despite the rapid escalation in the cost of its provision, after-tax the UK state pension is only equivalent to 29 per cent of pre-retirement income for the average UK earner, as compared to an OECD average of more than twice that.⁵⁵

⁵³Source: OBR Forecasts. 23 March 2017.

⁵⁴Source: How the triple lock has hamstrung the Government since 2010. Daniel Mahoney, Centre for Policy Studies Economic Bulletin. 20 October 2017.

⁵⁵The OECD average represents the income paid from all mandatory pension sources which, in some OECD countries, extends to mandatory private provision. See: OECD (2017), Pensions at a Glance 2017: OECD and G20 Indicators, OECD Publishing, Paris. Table 4.11, p.109.

The future of the state pension

“Whatever the eventual outcome, relying on the state pension to meet basic living needs might prove to be foolhardy.”

It is clear from the above numbers that the state pension has become an unsustainable burden on the public purse. Despite this, all UK political parties remain committed to maintaining the triple lock, at least for now. However, given that well over five million second wave baby boomers, born in the early to mid-1960s, will attain SPa between 2026 and 2032, thereby further shrinking the UK workforce and the tax base from which the state pension is paid,⁵⁶ politicians may well be forced to review their position on the triple lock far sooner than they think. At best, this may result in a downgrading to a double lock of the higher of CPI and earnings growth or perhaps the higher of CPI and, say, 1.5 per cent. Worst case, spending on state pensions could actually decline in real terms. Indeed, moving from a universal to a means tested state pension has even been suggested by the OECD and prominent commentators, not least because the more affluent tend to live longer than the less affluent and so benefit more from a welfare benefit that is principally targeted at the less well off. In so doing, this may halt any further increases to the SPa and refocus the purpose of the state pension to that of its 1909 origins. Whatever the eventual outcome, relying on the state pension to meet basic living needs might prove to be foolhardy and result in a retirement that is endured rather than enjoyed.

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 DB pension rights, and now possess the ability to accelerate access to this stream of income via freedom and choice.

However, as noted earlier, 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 into their 30s because of the lingering aftermath of the global financial crisis and the cost of home ownership. Many also care for their young grandchildren. No generation before has simultaneously faced these dual challenges.

⁵⁶With the much reduced fertility rate of the noughties, relative to that of the early to mid-1960s, coupled with the dramatic longevity improvements experienced since the latter period, means the old age dependency ratio (OADR) (those of SPa expressed as a percentage of the population aged 16 to SPa) will (assuming no dramatic increase in net international migration to the UK over this period) rise exponentially once today’s 52 to 58 year olds reach SPa between 2026 and 2032. According to UK Perspectives 2016: the Changing UK Population. ONS. 26 May 2016, the OADR was steady at around 30% from the 1980s to 2006, but rose in 2007-09 as women born immediately post-World War 2 reached SPa. In the absence of any increases to SPa, the OADR would reach 48.7% by 2039; but, as a result of planned SPa increases taking place between 2010 and 2046 under current legislation, it is expected that in 2039 it will hit 37%. Separately, the OECD provides an international perspective on the OADR. According to the OECD, in 2015 the UK’s OADR stood at 31%, against an OECD average of 27.9% and 46.2% in Japan. In 2050, it is suggested that these numbers will be 48%, 53.2% and 77.8% respectively. OECD (2017). op. cit. Table 5.5, p.123.

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 budget 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 75.⁵⁷

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

SO HOW MUCH INCOME DO PEOPLE NEED IN RETIREMENT?

In October 2017, following on the back of their Australian counterparts, the PLSA suggested the adoption of national retirement income targets as a frame of reference by which to gauge the level of income needed to support a comfortable, modest or basic retirement.⁵⁸ However, whereas the Association of Superannuation Funds of Australia set out the size of the income drawdown lump sum needed, taking into account Australia's state pension, by either a single retiree or couple seeking to enjoy either a comfortable or modest retirement, the PLSA has focused on the level of income required, taking an holistic view of the assets potentially available to retirees in the UK at and in retirement. Surveying 55 to 64 year olds, and accepting that everyone's circumstances are different, the PLSA has suggested that £10K-£15K is the bare minimum gross annual income to survive on in retirement, £15K-£20K would be sufficient to support a modest retirement while, as noted earlier, a comfortable retirement would require £25K+ gross per annum.

⁵⁷ Equity Release Market Report. Spring 2017. Equity Release Council.

⁵⁸ Hitting the Target – Delivering Better Retirement Outcomes. PLSA. October 2017. Reference to this research was made earlier when considering Planning for retirement: Are people joining up the dots? Columbia Threadneedle Investments and YouGov. February 2018.

SUSTAINABLE WITHDRAWAL RATES (SWRs)

WHAT CONSTITUTES A SUSTAINABLE LEVEL OF WITHDRAWALS THAT MEETS A RETIREE'S SPENDING NEEDS?

"Most people attracted to the flexibility of income drawdown also crave the security, but not the rigidity, of an insurance company-backed annuity."

Of course, if retirement spending is to be financed sustainably, against the backdrop of DC savers increasingly opting for the flexibility of income drawdown over inflexible annuities, and in the absence of previously imposed maximum withdrawal rates,⁵⁹ then determining a safe, or sustainable, income drawdown withdrawal rate (SWR) is crucial. While income withdrawals can be either fixed or variable and taken in either nominal or real terms, researchers and practitioners tend to focus on sustainable fixed real withdrawals – those that escalate in real terms. Although variable withdrawals can be adjusted to changed assumptions and circumstances, continually revisiting variable withdrawals to avoid the retiree's spending rate from periodically suffering unduly while ensuring the real value of capital is preserved is usually impractical.

That said, the SWR, the fixed real rate at which systematic withdrawals can be made from a portfolio of typically risky assets over a defined period, must walk quite a tightrope in meeting the retiree's desired standard of living, reflecting the non-static nature of real spending in retirement while mitigating the risk of the retiree's pension pot running dry. The SWR must also guard against people typically underestimating their longevity,⁶⁰ overestimating their health longevity, ignoring prospectively modest future asset yields and the adverse sequencing of investment returns (poor/negative returns early in decumulation),⁶¹ and underestimating the damaging effects of unexpected inflation. Taking account of these potentially hazardous risks, it probably isn't any surprise that most people attracted to the flexibility of income drawdown also crave the security, but not the rigidity, of an insurance company-backed annuity, which pays out a defined regular income until death. And therein lies the conundrum: without explicit, and rather expensive, guarantees how can a SWR meet these seemingly conflicting objectives? The answer, which we'll consider shortly, resides in adopting an appropriate investment strategy.

THE ORIGINS AND DEVELOPMENT OF THE SWR

No discussion of SWRs could start without mentioning Bill Bengen who, in 1994, introduced *the 4 per cent rule* for systematic fixed real income withdrawals in retirement.⁶² Challenging the conventional wisdom of the time, Bengen recognised the naivety of using mean portfolio returns to guide the calculation of sustainable retirement withdrawal rates, with its inference that retirees wouldn't ever have to dip into their capital. Crucially, this approach ignored both the volatility of returns around the mean and the sequencing risk of portfolio returns over time, critically in the early stages of retirement. This approach also meant having to revisit the withdrawal rate more frequently than was practical or desirable.

Using historic US returns data, Bengen calculated the highest year-end annual withdrawal amount as a percentage of retirement date assets that, escalating with inflation, would be sustainable for a 30-year retirement, without the pension pot running dry. With a 50/50 US stocks and Treasuries

⁵⁹ Up until 5 April 2015, those who opted for income drawdown but didn't meet a *Minimum Income Requirement* (a documented guaranteed annual income outside of income drawdown) of at least £12K per annum were subject to annual income withdrawals capped at 150% of prevailing lifetime annuity rates, as calculated by the Government Actuaries Department (GAD).

⁶⁰ Recent research suggests that men typically underestimate their likely longevity by 5.4 years and women by 7.8 years. Anderson (2016) op. cit. Anecdotally, there is a tendency for people to reference their likely longevity to the age at which their parent of the same sex died.

⁶¹ Sequencing risk is when the same stream of returns occur in a different chronological order leading to different outcomes. Whereas, by definition, a DC pension pot experiences positive cash flows in the accumulation phase and so benefits from the pound cost averaging of those cash flows being invested at different market prices, cash outflows define decumulation, meaning retirement outcomes are most sensitive to the investment returns achieved at and early in retirement.

⁶² 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>. Admittedly, yields, investment returns and inflation have moderated since 1994.

portfolio, Bengen found that a 4.15 per cent initial withdrawal rate (for UK returns data, the SWR can be assumed to be about 0.3 per cent less) adjusted annually for inflation would have been sustainable in the worst-case scenario over successive rolling 30-year periods from 1926 to 1992. This became known as ‘the 4 per cent rule’.

While conventional wisdom over the past 20 years has been supportive of the 4 per cent rule, Bengen’s assumptions and research methodology has spurred much debate and scrutiny. This has revolved around the research applying solely to the US, whether 30 years is a reasonable decumulation period, on charges not having been taken into account and past returns being indicative of future returns.

Consequently, a number of studies suggest the use of *adaptive* rules to adjust the withdrawal rate to the dynamic nature of market and portfolio returns and spending patterns to prevent the decumulation pot running dry,⁶³ while others have sought to combine a shorter income drawdown period, and therefore higher SWRs, with a deferred annuity to insure against longevity risk in later life.⁶⁴

Of particular note is recent research conducted by *Morningstar*. Adopting a 40/60 UK stock and gilts portfolio, this considers both past and forward looking investment returns in setting, with 95 per cent confidence of a pension pot not running dry, a 2.8 per cent initial SWR uplifted annually by inflation for the UK over 30 years.⁶⁵ In an October 2017 update to this research, based on higher asset prices and therefore lower prospective returns, Morningstar suggested the SWR had declined to between 1.9 to 2.2 per cent. Illustrating the effect of this much reduced SWR, someone aiming to take inflation-adjusted withdrawals of 3.5 per cent a year for 30 years would face a 56 per cent chance of the decumulation pot running dry. The 2017 research also showed the impact fees can have on a decumulation portfolio’s survival rate. Assuming a three per cent annual fixed real withdrawal and a 0.5 per cent fee, there is a 78 per cent chance the portfolio will last for 30 years. However, this falls to only 46 per cent when annual fees hit two per cent.

Then, of course, there’s the assumption built into Bengen’s and subsequent SWR research that income withdrawals need to keep pace with inflation throughout the entire retirement period, despite this not being supported by empirical evidence on spending patterns in retirement. As ideally, a sustainable withdrawal strategy should follow the typical spending pattern in retirement, this has potential major implications for how we calculate sustainable income withdrawal rates from hereon. However, as noted earlier, contemporary spending patterns in retirement may well change as the composition of the retired population becomes increasingly dominated by the second wave baby boomer sandwich generation, and less by the current make do and mend generation. For that reason, we will assume that fixed real income withdrawal rates, rather declining nominal withdrawal rates, will increasingly best fit future spending patterns in retirement.

With this in mind, we now turn to recent UK income drawdown withdrawal rate data. Although somewhat sketchy, according to the ABI, 57 per cent of those making income withdrawals from drawdown contracts during Q116 withdrew less than one per cent of the amount invested. However, at the other end of the spectrum 43 per cent made a quarterly withdrawal equating to at least a four percent annual withdrawal, with nearly 10 per cent withdrawing four per cent or more in that quarter alone.⁶⁶ More recently, investment platform A J Bell found that of 250 individuals surveyed aged 55+, 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 amongst those aged 55-59 than those in the 60-64 and 65-69 age brackets.⁶⁷

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

⁶³ See: Jonathan T Guyton and William J Kinger. Decision Rules and Maximum Initial Withdrawal Rates. *Journal of Financial Planning*, March 2006: 50-58. Abraham Okusanya. Fixed Withdrawal: Sustainable withdrawal rate with a twist. *FinahytQ*, February 8, 2017.

⁶⁴ Chen, A., Haberman, S. and S. Thomas (2016). Why Deferred Annuities Make Sense, SSRN Working Paper, 2797795.

⁶⁵ Blanchett, D., Buffenoir, M., Kemp, D. and Watt, S. Safe Withdrawal Rates for Retirees in the United Kingdom Where did the 4% rule come from and what is the impact of today’s low bond yields? Morningstar Research. 1 May 2016. Updated October 2017. See: http://media.morningstar.com/uk%5CMEDIA%5CResearch_paper%5CUK_Safe_Withdrawal_Rates_ForRetirees.pdf.

⁶⁶ <https://www.abi.org.uk/news/news-articles/2016/08/abi-publishes-full-year-of-pension-freedom-data/>.

⁶⁷ A J Bell. The Pension Freedoms Engagement Gap. December 2017. p.3. Average total savings of those surveyed was £118,000.

WHAT CONSTITUTES A FIT-FOR-PURPOSE DECUMULATION INVESTMENT STRATEGY?

“Adopting an overly prudent investment strategy that shies away from risk assets early in decumulation could be described as imprudent prudence... this must be balanced against adopting an investment strategy that exposes the retiree to potentially large financial market downturns.”

Central to formulating a fit-for-purpose at and in retirement strategy that, through income drawdown, supports a desired standard of living is generating a sufficiently high and sustainable fixed real income withdrawal rate. This, in turn, demands a fit-for-purpose investment strategy. After all, up to 60 per cent of the income taken from drawdown in retirement is attributable to 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).⁶⁸

Despite conventional wisdom formulated prior to freedom and choice suggesting that investment strategies should de-risk with age to avoid sequencing risk,⁶⁹ adopting an overly prudent investment strategy that shies away from risk assets early in decumulation could be described as imprudent prudence. Similarly, trying to time, or second guess, financial markets is fraught with difficulty and typically opportunity cost. As the old adage says, “Time in the market, not timing the market” is what matters. However, this must be balanced against adopting an investment strategy that exposes the retiree to potentially large financial market downturns that don’t bounce back swiftly, especially in the early stages of decumulation.

Indeed, only by lowering an investment strategy’s sensitivity to sequencing risk, not to mention the susceptibility to unexpected inflation, both of which threaten the preservation of capital and its ability to underpin a sustainable income withdrawal rate, can both flexibility and income security be achieved through income drawdown. As noted earlier, if not managed well, these and other risks, such as underestimating longevity, can add up to an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings. Therefore, having access to a fit-for-purpose income drawdown investment strategy, one that, in combining a portfolio of risky assets, is sufficiently robust to successfully navigate a myriad of largely unquantifiable risks and which generates a smooth real return stream without unduly compromising realised returns, is critical.

⁶⁸ The Russell 10/30/60 retirement rule.

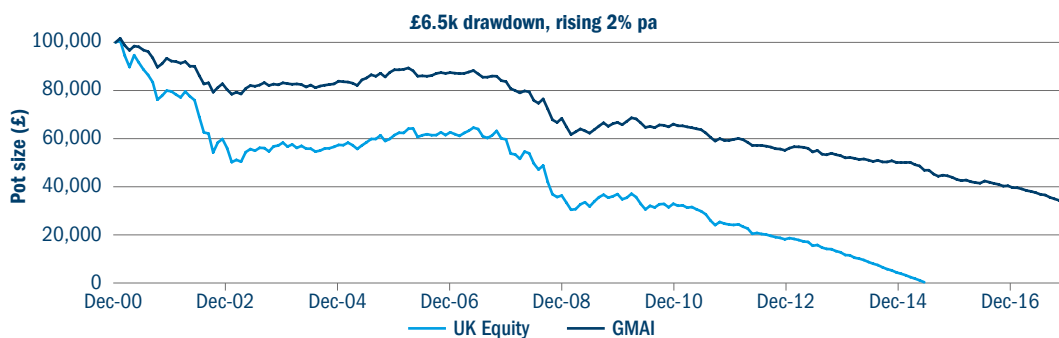
⁶⁹ A commonly cited rule of thumb (most rules of thumb are mental shortcuts so are sub optimal) states that investors should hold a percentage in stocks equal to 100 minus their age.

THE DANGERS OF INVESTING IN AN UNDIVERSIFIED MANNER AND TAKING AN UNSUSTAINABLE LEVEL OF WITHDRAWALS

If an investor had invested £100,000 in a relatively undiversified FTSE 100 index fund at the start of 2000 and had then withdrawn £6,500 per annum – increasing these withdrawals by two per cent each year to approximate the effect of price inflation – this £100,000 pot would have ran dry by the end of July 2015. However, if the same investment had been made in an actively managed and well-diversified global multi-asset income fund, and the same withdrawals had been made each year, then around one third of the investor’s capital would have remained intact at the end of 2017. This is illustrated in Figure 9.

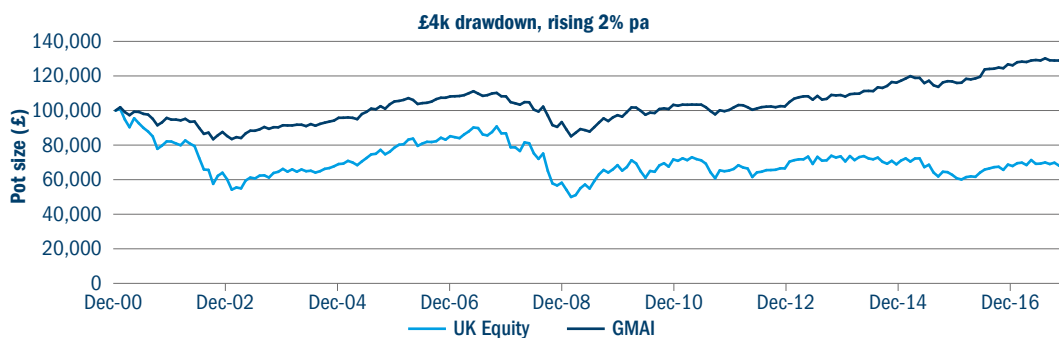
If, however, instead of a £6,500 annual withdrawal, a £4,000 annual withdrawal,⁷⁰ again escalating at two per cent per annum, had been made over the same time horizon, then the FTSE 100 index fund would have been worth about £71,000 at the end of 2017, while the global multi-asset income fund pot would have more than retained its original nominal value at around £129,000.⁷¹ This is illustrated in Figure 10.

Figure 9: Taking 6.5% annual withdrawals, indexed at 2% per annum, from a FTSE 100 index fund and an actively managed global multi-asset income fund.



Source: Columbia Threadneedle Investments, January 2018.

Figure 10: Taking 4% annual withdrawals, indexed at 2% per annum, from a FTSE 100 index fund and an actively managed global multi asset income fund.



Source: Columbia Threadneedle Investments, January 2018.

These simple examples illustrate two key points: the dangers of, firstly, investing in an undiversified manner (exacerbated by a passive approach that cannot position the portfolio for prevailing or expected market conditions) and, secondly, taking a somewhat unsustainable level of income withdrawals, against the backdrop of historically low annuity rates and the prospect of more modest long-run investment returns going forward. Both threaten the early depletion of the investor’s capital and its ability to generate a smooth income stream.

⁷⁰ A frequently applied rule of thumb is to take a 4% annual withdrawal from capital as, other things equal, that should provide the investor with a sustainable level of income for around 25 years – the often perceived length of an average retirement.

⁷¹ Source: Columbia Threadneedle Investments. The residual capital sums, before charges, at end-2017 were respectively for the £6,500 escalating annual withdrawals: £0 and £33,805; and for the £4,000 escalating annual withdrawals: £71,058 and £129,302.

EQUITIES VERSUS AN EQUITY/BOND VERSUS A MULTI-ASSET APPROACH⁷²

Long-run real equity returns are hard to beat but...

History tells us that over periods of 10+ years, equities typically deliver strong real returns, considerably in excess of price inflation, government bonds and cash. Both the Barclays Capital Equity Gilt Study 2017 and Credit Suisse Global Investment Returns Yearbook 2017⁷³ illustrate that since 1900 the real return on UK equities has exceeded that of gilts (the *ex-post equity risk premium*) by an impressive 3.7 per cent compound per annum. In addition, the Barclays Capital Equity Gilt Study 2017 illustrates that, over the same period, real UK equity returns have outperformed real gilt returns in 85 per cent of 18-year periods and 78 per cent of 10-year periods.

Equities also generate a robust income stream – reinvested dividend income being the most important contributor to long-run equity returns. Indeed, over the very long term, the Barclays Capital Equity Gilt Study 2017 illustrates that for the period 1900 to 2016 the real total return for UK equities is 164 times the capital return. More recently, with gross income reinvested, UK equities since 1992 have delivered a compound real return of 5.9 per cent, while since 2011 they have posted 7.8 per cent.⁷⁴ No other UK asset class can rival that.

That said, equities are not without risk. Indeed, as the risk capital of a company, the equity (or ordinary) shareholders share directly in the fortunes of the business, being last in line to receive both dividend income from the company's profit and cash flow and the return of capital in the event of the business's demise. As such, equities have high levels of uncertainty attached to their worth. This uncertainty tends to manifest itself in high degrees of price volatility over a market cycle, and also periodically large capital drawdowns, sometimes with recovery periods that extend far beyond the investment horizons of most investors.⁷⁵

Although this sequencing risk was relatively benign in the 1980s and early to mid-1990s, it was particularly prevalent and damaging in the early to mid-1970s (along with double-digit inflation that ate away at the purchasing power of capital),⁷⁶ late-1990s and throughout the noughties. Indeed, over the 20-year period 1997 to end-2016, real annual UK equity returns fell short of real gilt returns by 0.8 per cent.⁷⁷ Of course, during this exceptional period, UK equities were subject to the Asian currency crisis of 1997, the LTCM hedge fund crisis of 1998, the 2000 to 2003 bursting of the tech bubble and, of course, the global financial crisis of 2008 and its aftermath – events that statistically should only occur once in a blue moon. That said, equities still managed to deliver compound real annual returns of 3.7 per cent during what was an historically unparalleled period for real gilt returns.

So, while those investors seeking to achieve strong real returns and who have a high tolerance for volatility have generally found this mix in pure equity portfolios, not every retiree is willing to endure such equity price volatility, or has an investment horizon long enough to withstand those periods of drawdown that may compromise systematic fixed real income withdrawals in retirement. And not everyone has sufficient conviction that equities will continue to deliver the returns they have done in the recent or long-term past.

⁷² See: Toby Nangle. The role of multi asset in DC pensions: turn off the autopilot as the weather worsens. The Future Book: unravelling workplace pensions 2017. The Pensions Policy Institute. Chapter 5 pp.62-65.

⁷³ Elroy Dimson, Paul Marsh and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press, 2002.

⁷⁴ Barclays Capital (2017) op. cit. p.180.

⁷⁵ The Dow Jones Industrial Average failed to regain its 1929 high until 1948 in nominal terms and 1982 in real terms. The Nikkei Dow's 1990 high has yet to be retraced and the total return of the Finnish stock market is still negative after 18 years. However, nothing beats Austria's 97 year spell of being in negative territory in real terms. Furthermore, in instances of profound political change or revolution, hopes of recovery have been ultimately unfounded.

⁷⁶ While, between 1971 and 2015, UK equities delivered a compound real annual return of 5.08%, this figure disguises the annualised real volatility of these returns at 19.05% and the 73.85% real drawdown of 1974. 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.

⁷⁷ Source: Barclays Capital (2017), op. cit. p.142 and Credit Suisse (2017), op. cit.p.45.

60/40 equity/bond portfolios have delivered robust real returns but...

The past 25 years have also seen static mixes of equities and bonds, typified by 60/40 portfolios, deliver strong real returns but with low levels of volatility. This has been as a result of three conditions having held since the early 1990s. First, real equity returns have been positive. Second, real bond returns have, in delivering compound annual real returns of 4.1 per cent, easily beaten real cash returns.⁷⁸ They have also benefitted from positive term premia – with long-dated bonds yielding more than short dated. Lastly, bond returns have, in being lowly, even negatively, correlated with equity returns and quite volatile, truly diversified the latter. Indeed, bond yields have fallen (prices have risen) quickly during periods of equity market weakness and economic malaise, but have not risen (prices haven't fallen) during periods of economic strength. Consequently, bonds have provided a 'crash protection' to equity holdings in static portfolios, reducing overall portfolio volatility, while also contributing to strong positive returns.⁷⁹

However, when examining recent historical data in the context of the past 126 years, it's clear from the mean-variance analysis depicted in Figures 11 and 12 that the period 1991-2017 looks to be something of an historical freak.

Figure 11: Mixtures of equities and bonds beat mixtures of equities and cash.

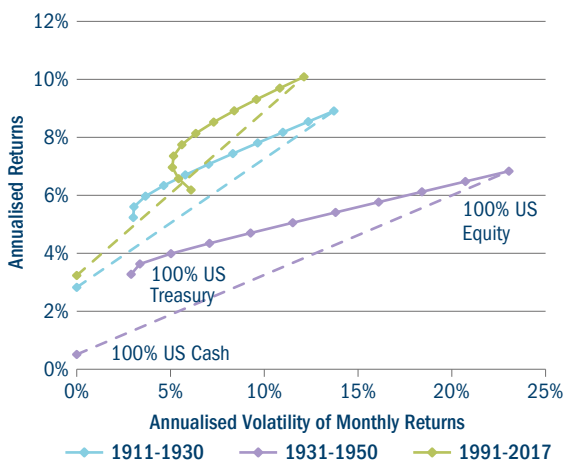
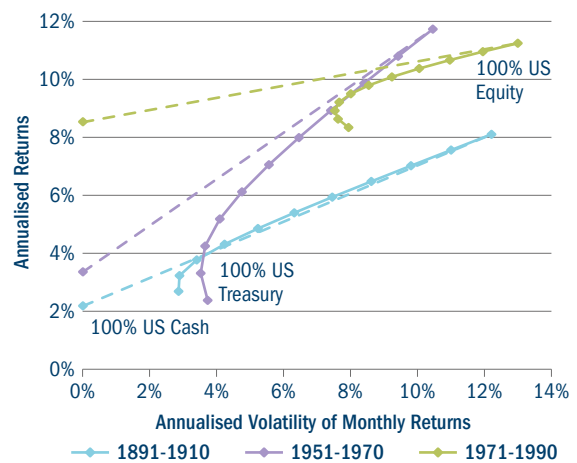


Figure 12: Mixtures of equities and cash beat mixtures of equities and bonds.



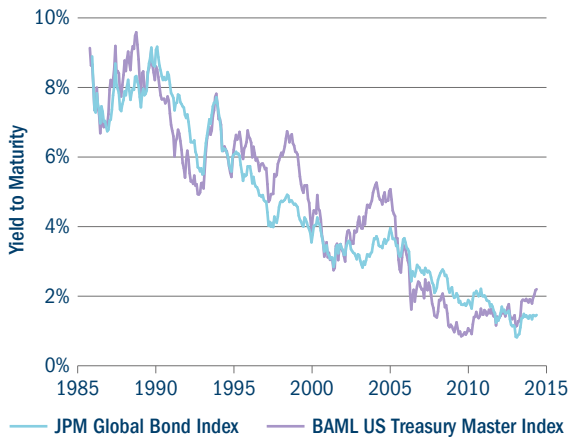
Source: Columbia Threadneedle Investments, September 2017.

Indeed, the reason why static asset allocation has worked so well appears to be found in the level and pattern of bond market returns. Bond returns are, over the medium-term, a function of starting yield and yield changes. As bond yields fall, so prices rise. Figure 13 shows the starting bond yield 1985 to date, which has been on a downward trajectory over the past 30+ years. Indeed, Figure 14 shows the relationship, since 1985, of five-year holding period returns that followed a given starting bond yield. Dots above the 45 degree line represent holding periods that experienced falling yields (and rising prices); dots below the line represent rising yield (falling prices) holding-periods. There are very few dots below the line.

⁷⁸ Barclays Capital (2017), op. cit. p.182.

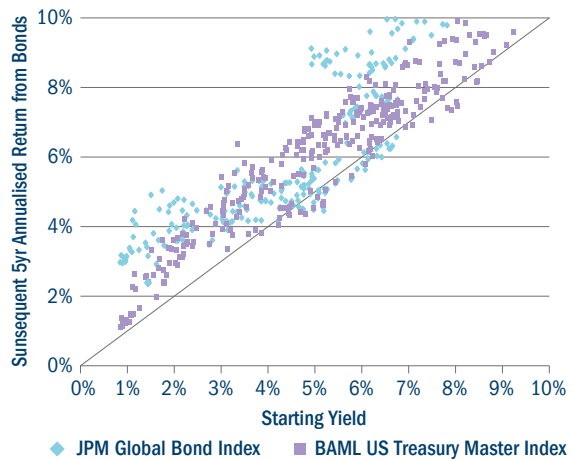
⁷⁹ Analysing the extent to which these conditions have held by using US data over the past 125 years, Toby Nangle, Head of Multi Asset, EMEA at Columbia Threadneedle Investments, combined US equities with US Treasuries and segmented the 1891 to 2016 data into five 20-year and one 25-year period; the latter being 1991 to 2016. Positive returns for all combinations of equities and Treasuries in excess of Treasury Bills were achieved in half of these periods, notably the most recent, as depicted in Figure 11. Low correlations between equities and Treasuries with high levels of returns volatility experienced by Treasuries dampening equity volatility, resulted in 'curvy', rather than 'flat', efficient frontiers in two of the six periods, between 1971 to 1990 in Figure 12 and 1991 to 2016 in Figure 11. The latter period also saw bond returns benefit from positive term premia. Indeed, notwithstanding the equity market corrections noted earlier, the past 25 years as a whole has been an exceptional period for both real equity and bond returns and the low returns correlation between each.

Figure 13: Yield to Maturity on BAML US Treasury Master Index and JP Morgan Global Bond Index 1985-2017.



Source: Columbia Threadneedle Investments, September 2017.

Figure 14: Five-year rolling return on BAML US Treasury Master Index and JP Morgan Global Bond Index versus starting yield to maturity.



THE DECUMULATION JOURNEY NOW FAVOURS MULTI ASSET

“A genuinely well diversified and dynamically managed multi-asset fund, which taps into a multitude of diverse return drivers and risk premia, may well be a better alternative for underpinning a resilient fixed real income withdrawal rate.”

Given the strong performance of both pure equity and equity/bond portfolios, not least since 2011, many investors have eschewed diversification, just as their predecessors did in the late-1990s, following the sustained equity bull market of the mid- to late-1990s.

However, the recent strong performance of equities and the three defining conditions of the past 25 years that have led to the robust performance of equity/bond portfolios are unlikely to be repeated over the next five years or even the next decade. Indeed, equity markets cannot perpetually generate strong real returns unless valuation expansion is supported by secular rather than cyclical company earnings growth, while very large yield falls are required from historically low starting yields for bonds to continue generating strong positive real returns, just as the world sits on the threshold of tightening monetary policy.

In short, failing to diversify across multiple lowly correlated risky assets across multiple time periods may leave income drawdown investors wide open to sequencing risk. Given this, a genuinely well diversified and dynamically managed multi-asset fund, which taps into a multitude of diverse return drivers and risk premia that, being less dependent on the macroeconomic environment, diversify equity and credit risk, may well be a better alternative for underpinning a resilient fixed real income withdrawal rate.⁸⁰ Indeed, recent modelling conducted by the Pensions Policy Institute demonstrates the low susceptibility of well managed multi-asset funds to drawdowns.⁸¹

⁸⁰ 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/US 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/>.

⁸¹ *The Future Book: unravelling workplace pensions 2017*. The Pensions Policy Institute, Chapter 4 pp58-59. Although the modelling was applied to multi asset funds in the accumulation stage, the same conclusions hold true for multi asset funds in decumulation.

While there are manifold approaches to managing multi-asset funds, all seek to deliver, but only the very best achieve, a combination of robust real returns with low levels of return volatility and susceptibility to sequencing risk. Robust returns are typically expressed as an ‘inflation plus 4%’ or a ‘cash plus X%’ target, where these targets are typically comparable to the long-run equity real return. Not that the objective of multi-asset funds is to rival equity performance or any of the other characteristics of equity. Rather, it’s to provide a smoother returns experience than that for equity and equity/bond portfolios, by limiting drawdowns, so that the SWR isn’t compromised when financial markets turn tail.

However, a successful multi-asset approach, of which equities remain a key component of the asset mix, is contingent on a number of conditions holding. Firstly, real equity returns and those of other asset classes in the multi-asset mix should be positive and outperform cash returns. Second, the returns of these other asset classes should be lowly correlated with equities and relatively volatile to dampen equity volatility. A successful multi-asset approach also demands genuinely skilful dynamic asset allocation and truly active management. Indeed, making the right asset allocation calls in selecting and dynamically altering the asset mix is by far the biggest determinant of success in adopting a multi-asset approach, with genuinely skilful active management providing the icing on the cake.⁸²

ASSET ALLOCATION: THE PIVOTAL DECISION IN CONSTRUCTING A FIT-FOR-PURPOSE DECUMULATION STRATEGY

Research conducted over the past 30 years suggests getting the asset mix right really is the big investment decision and is key to constructing any fit-for-purpose investment strategy. Indeed, asset allocation ‘explains’ between 90 to 94 per cent of the variability, or ups and downs, of pension fund returns over time if a broadly conventional asset allocation policy and conventional active fund management is employed.⁸³ The more dynamically managed the asset allocation mix the greater the potential contribution of dynamic asset allocation to the variability of returns. The remainder – the six to 10 per cent – is attributable to market timing and stock selection. Secondly, between 33 and 75 per cent of the difference in the variability of returns between funds can be explained by differences in their respective asset allocation mixes.⁸⁴

Finally, on the basis that active fund management *in aggregate* net of costs is typically positioned as a negative sum game, acknowledging the increased prevalence of “closet trackers” at one end of the spectrum that drag down the average active performance, and somewhat overwhelm those very talented active fund managers who exhibit genuine skill, at the other,⁸⁵ means that the asset allocation mix “explains”, on average, between 99 and 100+ per cent of absolute pension fund returns.⁸⁶ So getting the asset mix and the asset manager who can dynamically manage this asset allocation right really is the big investment decision. As well as being the biggest decision, it’s also the hardest to get right given the challenges of calculating the expected returns and risks – the volatilities and correlations – of all the asset classes considered for potential inclusion in the asset mix. This challenge is further complicated by the asset mix having become increasingly diverse, often including alternative and illiquid assets whose risks and returns are difficult to model. Arguably, as asset classes become more esoteric, so the asset mix should diversify by an asset class’ exposure to risk factors than by the name, or descriptor, of the asset class. So, if a DC decumulation investment fund is to be fit-for-purpose, then continually getting the asset allocation decision right is critically important.

⁸² See: 2017 Brave New World: Why active managers are well placed to take advantage of social, economic and political regime change. Chris Wagstaff. Columbia Threadneedle Investments. February 2017. Also see: Not all active managers are created equal – what to look for and why. Chris Wagstaff. Columbia Threadneedle Investments. June 2015.

⁸³ Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower. Determinants of Portfolio Performance. The Financial Analysts Journal, Vol 42 No4, July/August 1986. Roger G. Ibbotson. The Importance of Asset Allocation. Financial Analysts Journal, Vol 66 No2, 2010.

⁸⁴ Roger D. Ibbotson and Paul D. Kaplan. Does Asset Allocation Explain 40, 90 or 100 Percent of Performance? AIMR 2000.

⁸⁵ See: Wagstaff (2017). op. cit.

⁸⁶ Ibbotson and Kaplan (2000). op. cit.

LINKING SWRs TO INVESTMENT STRATEGY

“It is at the 5th percentile that sequencing risk is particularly severe and systematic income withdrawal rates are truly tested for their sustainability.”

The link between SWRs and investment strategy is well illustrated in a recent study conducted by researchers at Cass Business School.⁸⁷ Drawing on historic monthly sterling index returns data from 1971 to 2015 (a period selected for its significant number of equity market drawdowns and much varied inflation experiences), the study modelled the likely distribution of Perfect Withdrawal Rates (PWRs) over the next 20 years employing a range of investment strategies. The PWR is the fixed real withdrawal rate, based on underlying investment returns that are already known, which results in the pension pot running dry at the end of the decumulation period, so assumes no bequests are made.⁸⁸

Table 1: Asset class and portfolio summary statistics 1971 – 2015⁸⁹

	UK Equity	Global Equity	UK Gilts	60/40 UK Equity/Gilts	Equally weighted Multi Asset
Annualised real return %	5.08%	4.67%	2.60%	4.54%	4.62%
Annualised real volatility %	19.05%	15.21%	10.12%	13.04%	11.78%
Maximum real drawdown %	73.85%	51.72%	59.43%	67.21%	45.17%

Source: Cass Business School, June 2017.

Table 1 summarises the annualised real returns, volatility and maximum drawdowns of the individual asset classes and a select number of investment strategies, each represented by one or a number of financial market indices, analysed over this 25-year period. As Table 1 illustrates, an indexed multi-asset approach to portfolio construction, combining equities with gilts, commodities and real estate,⁹⁰ has delivered a more secure return stream than indexed equities in isolation over the long-term, albeit at the expense of a slightly lower annual real rate of return. This is borne out in Table 2, which shows that although the probable forecast median PWR over the next 20 years for a decumulation pot invested in an indexed global equity strategy is marginally higher than for an indexed 60/40 portfolio or indexed multi-asset portfolio, at the 5th percentile the likely PWR for an indexed global equity strategy is considerably lower than for an indexed multi-asset portfolio. It is at this 5th percentile that sequencing risk is particularly severe and systematic income withdrawal rates are truly tested for their sustainability. Indeed, in a world of known, unknowns and unknown unknowns, basing SWRs on median PWRs is probably foolhardy. Of course, while the actual results will only be known for certain 20 years from now, the research is instructive.

Adding an additional layer of smoothing

Table 2: Distribution of portfolio PWRs for the next 20 years from 20,000 Monte Carlo Simulations

Percentile outcome	Global Equity	60/40	Equally weighted Multi Asset
5th	3.65%	3.39%	5.20%
50th	8.02%	7.44%	7.49%
95th	14.05%	12.05%	11.91%

Source: Cass Business School, June 2017.

⁸⁷ Clare et. al. June 2017. op. cit.

⁸⁸ A 20-year decumulation period was chosen on the assumption a deferred annuity would be purchased at the start of this 20-year period to insure the retiree against outliving an assumed 20-year retirement.

⁸⁹ Clare et al. (2017), p.28 Tables 4 and 5.

⁹⁰ This approach does not incorporate skillful dynamic asset allocation or active management.

So as to further smooth returns from each decumulation investment strategy, the study added a trend-following rule to each. This seeks to minimise susceptibility to the often seismic drawdowns that result from a momentum-driven market turning tail. The rule works as follows: if a financial market index is trading above its 10-month moving average then a long position in that index is taken, otherwise the position is held in cash. By limiting the susceptibility to financial market drawdowns at the expense of forgoing returns as a market nears its peak, the resulting distribution of PWRs, as shown in Table 3, is less skewed than that in Table 2, with markedly higher PWRs at the 5th percentile, broadly similar median PWRs but considerably lower PWRs at the 95th percentile.

Table 3: Distribution of portfolio PWRs for the next 20 years from 20,000 Monte Carlo Simulations using a trend-following rule

Percentile	Global Equity	60/40	Multi Asset
5th	5.39%	5.04%	5.84%
50th	8.31%	7.01%	7.80%
95th	12.41%	9.59%	10.32%

Source: Cass Business School, June 2017.

How else might smoothing be achieved?

No consideration of smoothing and capital protection strategies could pass without mentioning *with-profits*. This actuarially-determined approach to smoothing investment returns, although highly popular up until the early noughties, became somewhat discredited after the endowment misselling scandal of the 1980s and 1990s and the Treasury's Retail Saving Review of 2002.⁹¹ Being highly reliant on the financial strength of the with-profits life office and equity backing ratio of the investment fund, the complexity and opacity surrounding investment performance, bonus and reserving policies, exit penalties and charging structures was heavily criticised. Even *The Actuary*, the magazine of the Institute & Faculty of Actuaries, declared at the time that, "With-profits investing has no place in a modern market for investment products."⁹² Moreover, the minimum performance guarantees within many with-profit funds are not without an implicit cost and opportunity cost of performance. That said, with-profits funds do pay out fairly consistent annual bonuses and some of the UK's largest insurers have combined or are looking at how multi-asset funds and with-profits could be combined to provide attractive SWRs in retirement.

Another method of potentially minimising sequencing risk that appears to have had its heyday is constant proportion portfolio insurance (CPPI). This is where the investor sets a percentage floor on the value of their portfolio, and then adopts a rules-based dynamic asset allocation using one risky asset, typically equities, and one 'safe' asset, either cash or government bonds, which mechanistically buys into a rising equity market and sells out of a falling one. The latter relies on market liquidity and can, in the absence of a ratcheting mechanism, also expose the investor to extended periods of being invested in low-yielding assets even when equity markets subsequently rise.⁹³

Finally, using put options to provide explicit protection against equity market downturns is yet another hedging strategy that has come in for considerable criticism, principally for its impact on investment returns. In fact, one recent study suggests that, "investing 40% in equity and 60% in cash has given similar returns as [a] puts [combined with a S&P 500 index] strategy but with under half the volatility and much improved peak-to-trough drawdown experience."⁹⁴ Additionally, many of the option-based strategies of the 1990s, such as cash and call and cap and collar protected equity growth fund strategies, that sought to provide positively-skewed investment returns with capital protection, ultimately delivered very little.

⁹¹ Medium and Long-Term Retail Saving in the UK, A Review. HM Treasury. July 2002.

⁹² No Future for With Profits. The Actuary. 3 June 2002. <http://www.theactuary.com/archive/old-articles/part-2/no-future-for-with-profits/>.

⁹³ See: <https://www.investopedia.com/terms/c/cppi.asp>. CPPI is based on the idea of Portfolio Insurance, a dynamic hedging strategy, introduced by H. Leland, J. O'Brien and M. Rubenstein in the early-1980s. Portfolio insurance, which involved the manufacturing of index put options, famously failed to withstand the equity market crash of October 1987, as a result of market illiquidity rendering trading all but impossible.

⁹⁴ Israelov, R., (2017). The Elusive Benefits of Protective Puts, AQR Capital Management Working Paper. Referenced in Clare et al. (June 2017) op. cit.

GENERATING RETIREMENT OUTCOMES TO BE ENJOYED AND NOT ENDURED

“With increasing numbers of people opting for income drawdown, not to mention those encashing their pension pots in full, the risks to realising a comfortable retirement are manifold...The most pressing problem is that most people simply do not know what is feasible and realistic at and in retirement.”

At the start of this paper, we set out to identify what fit-for-purpose decumulation solutions might look like for the majority, the largely unsupported and unadvised mass market, if calamitous retirement outcomes are to be avoided and a retirement is to be enjoyed rather than endured. Having examined all of the issues and the evidence, in this final section of the paper we attempt to do just that.

THE RISKS TO ACHIEVING A GOOD RETIREMENT OUTCOME

As we have already established, achieving a good retirement outcome is potentially compromised by three seemingly secular trends: the time spent in retirement increasing, more modest real investment returns and yields from hereon, and individuals having to contend with an ever-greater decision burden post-freedom and choice. The latter, in particular, comes at a stage in peoples' lives when financial literacy and cognitive ability often starts to decline and is exacerbated by a reluctance to engage with technology that can facilitate the decision-making process.

However, with increasing numbers of people opting for income drawdown over investing in an annuity, not to mention those encashing their pension pots in full, the risks to realising a comfortable retirement are manifold. Indeed, if people are to achieve the flexibility and income security most desire by opting out of purchasing an annuity, they must somehow navigate their way around longevity risk, sequencing risk and unexpected inflation, otherwise they will fail to secure a sustainable level of income withdrawal that meets their desired standard of living. Indeed, as already suggested, if not managed well, these risks can add up to an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings or increasing swaths of the population needlessly living in penury in fear of the latter.

So what is the solution? Well, if retirement outcomes aren't to be compromised, it is incumbent on policymakers, regulators and the pensions, asset management and adviser communities to be integral to the process of helping people achieve good financial outcomes *at and through* retirement.

Intuitively this would seem to suggest dramatically increasing levels of engagement from what is currently a very low base. However, that's easier said than done. Indeed, as noted earlier, most people (though not all) are ill equipped to determine how best to achieve a good retirement outcome, given the alarmingly low level of basic numeracy and financial literacy that exists amongst the UK adult population; the complexity and multiplicity of the decisions to be made; the lack of frames of reference and a paucity of guidance to evaluate complex choices; and a widespread unwillingness or inability to pay for financial advice. This is compounded by inertia, deeply engrained behavioural biases that incorrectly frame decision problems and a lack of trust in pensions and in government pensions policy.

Consequently, there remains a deep seated inability and reluctance to actively engage with retirement outcomes, resulting in pathways of least resistance being adopted. This is evidenced by the sheer number of people encashing their pension pots in full, potentially making them easy prey for scammers, or simply opting to stay with their accumulation fund provider and not seeking regulated advice when purchasing an annuity or income drawdown contract. Perhaps unsurprisingly, the answer to these many issues lies not in a single solution but one that is multi faceted.

EVERYONE NEEDS GUIDANCE AND NOT JUST THE ONCE

The most pressing problem is that most people simply do not know what is feasible and realistic at and in retirement. As a result, many are at risk of sleepwalking into poor active and passive decisions and ending up in a very bad place. Given this, the imperative is to find ways of directing those aged 50+ to helpful sources of free and easy-to-access guidance to set them on the right path. Of these, *Pension Wise*, the free-to-access telephone and face-to-face based generic pensions guidance service, is the most well established and best positioned to help those approaching or already in retirement make better and more informed decisions before a decision is made. Although not there to plug the advice gap for end investors, Pension Wise has, by approaching an ultimately complex decision via logical and well framed questioning within a series of simple steps, helped many achieve better retirement outcomes.

While an impressive 40K one-off appointments were made with Pension Wise in the first half of 2017, as compared to 60K for the whole of 2016, and 141K since early 2015,⁹⁵ this must be seen against the backdrop of over one million people having accessed their DC pension pots since April 2015. Much more signposting is needed. One solution, given the implicit trust most employees place in their employers, is for employers to signpost Pension Wise and accessible guidance more generally to those employees approaching retirement, via simple, personalised modes of communication. This could be in the form of a personal email, a personal text or perhaps detailed on employees' monthly payslips or prominently displayed in the retirement "wake up packs" issued by pension providers and workplace pension schemes to anyone who is within six months of their scheme's normal or their stated retirement age. Arguably, these should automatically be sent to anyone upon reaching 50.

However, one-off generic guidance from bodies like Pension Wise, typically at the point of retirement is unlikely to be sufficient, given that peoples' circumstances and spending patterns change throughout retirement. Of course, as a publically funded body, Pension Wise would require the necessary government funding and resources to maintain its current high standards if greater demands were placed upon its passionate and highly qualified staff. However, given public spending constraints, this additional support is unlikely to materialise unless, for instance, funding via a levy on annuity and drawdown providers was put in place.

That said, guidance is not advice. Although in recent years the automated advice market has made considerable advances in the provision of low cost advice to those at and in retirement, it is still very much at an embryonic stage. Therefore, the question of how to provide simple and affordable advice to those of a certain age, not least to those who are not tech-savvy, still needs to be answered.

⁹⁵ www.gov.uk/performance/pension-wise. 74% of these appointments were conducted face-to-face and 26% by telephone.

PERHAPS SOME JUST REQUIRE A GENTLE NUDGE IN THE RIGHT DIRECTION?

“Can behavioural interventions be used to improve decision making or retirement outcomes at and in retirement? Well, yes and no.”

Increasingly integral to the process of generating good financial outcomes to retirement has been the application of behavioural economics and interventions in an intelligent, practical, tried and tested and typically subtle manner. In the accumulation phase, reasonably simple behavioural interventions that seek to counter the emotional, cognitive and social factors that result in sub optimal long-term savings and investment decision making, decision paralysis and inaction, are used by policymakers to harness the inertia of the disengaged and by the pensions, asset management and adviser communities to help those who are willing and more able to make an active decision better help themselves. Indeed, policymakers have increasingly become more open to applying behavioural insights to public policy in many aspects of everyday life. Many now use nudges in particular to gently move individuals and/or society as a whole towards more positive outcomes. So can behavioural interventions be used to improve decision making or retirement outcomes at and in retirement? Well, yes and no.

A good place to start is with the simple, pragmatic and practical EAST framework (make it Easy, Attractive, Social and Timely), devised by the UK's The Behavioural Insights Team (BIT). Although not a panacea, this can be applied to the decumulation stage, just as it is in the accumulation stage, to potentially improve investment decision making and the management of the key risks faced at and in retirement.⁹⁶ Indeed, the EAST framework demonstrates that by employing the simplest of tactics, even just changing the merest detail to make an action simpler or outcome more attractive, behavioural interventions can often generate dramatic results in many aspects of everyday life.

⁹⁶ EAST. Four simple ways to apply behavioural insights. The Behavioural Insights Team. 2014. The EAST framework, initially devised in 2012, draws on The Behavioural Insights Team's, more expansive, MINDSPACE framework and adds additional behavioural insights to make behavioural interventions potentially easier for busy policymakers to apply.

THE EAST FRAMEWORK

At a generic level, BIT's EAST framework can be summarised as follows:

- *Making it Easy* is about minimising the hassle factor, making the process simpler, and reducing the amount of effort required to perform a desired action. As even the smallest increase in effort to perform an action can derail the process, this means conveying clear messages, breaking down the process or the achievement of a complex goal into simple, easy-to-manage steps. It's also about embracing new technologies, which enable more to be achieved with minimal effort, especially when engaging with those cohorts who are technology and social media savvy.
- *Making it Attractive* is about using colour, images, personalisation and incentives to make adopting a course of action appealing.
- *Making it Social* draws on the fact that humans, as social animals, rarely make decisions in a detached manner. People act on the information, opinions and actions of others and like to have their own actions and opinions validated by others. Therefore, making it social is about demonstrating the importance of publicising, increasingly via social networks, that a desirable behaviour is the social norm, and how, by encouraging people to publically commit to a desirable course of action (commitment devices) increases the chances of them seeing the action through.
- *Making it Timely* focuses on prompting people to change behaviours at times of major change or on special occasions in their lives when they are most receptive, overcoming intertemporal choice by better aligning the current costs and future benefits of a course of action, and committing to a plan of action to narrow the time gap between intention to act and implementation.

For example, much can potentially be achieved, with the reasonably tech-savvy, by using user-friendly online tools, such as interactive decision trees, that steadily take the individual step-by-step through the myriad of decisions they need to take to successfully arrive at their end goal. Then there are those interventions, used successfully by other industries, such as traffic lighting by the Food Standards Agency to develop simple and intuitive food labelling to encourage healthier eating, upon which decumulation guidance for the less tech-savvy can piggyback.⁹⁷

That said, given the complexity of the decisions to be made at and through retirement, there is a growing consensus that people cannot be left to their own devices, even with such tools. Although behavioural interventions at and in retirement are helpful at the margins, ultimately most people need to be properly supported throughout the entire at and in retirement planning and implementation process, by having their options, choices and potential outcomes explained and illustrated to them in a simple, clear, understandable, relevant and practical manner. As suggested earlier, this means directing people to accessible sources of guidance and providing them with simple and affordable financial advice. Only then will they engage with the process and feel empowered to make better and more informed decisions.

⁹⁷ Interestingly, the FCA in its Retirement Outcomes Review interim report was critical of the pensions industry simply focusing on the provision of consumer tools to aid at and in retirement decision making, rather than retirement income product innovation for the unadvised mass market.

This is particularly true of those older generations who, in shying away from using those technologies that facilitate the decision-making process, behavioural interventions may have a limited effect. Indeed, as people grow older so their decision making is founded upon life experience and gut feel and very little, aside from informed and trusted advice, can change that.

FOR MOST, THE ANSWER LIES IN BEING DEFAULTED TO THE DEFAULT

“Most people will never truly engage with the complex decisions to be made at and in retirement, nor will they ever have the confidence and capability to select and successfully manage the retirement solution that most closely meets their needs.”

Perhaps unsurprisingly, the contention of many prominent pension practitioners, commentators and academics post-pension freedom and choice, is that most people will never truly engage with the complex decisions to be made at and in retirement, nor will they ever have the confidence and capability to select and successfully manage the retirement solution that most closely meets their needs. Indeed, in its Retirement Outcomes Review interim report, the FCA, which has criticised the pensions industry for its lack of retirement income product innovation for the unadvised mass market, acknowledged that many people struggle with such complex financial decisions and might prefer a default option or an off-the-shelf investment pathway rather than make a choice.⁹⁸

This was also the conclusion of the highly influential annual Melbourne Mercer Global Pensions Index 2017.⁹⁹ Recognising that a sizeable number of DC pension pots are fully encashed rather than being used to secure a long-term income, those least equipped to do so are effectively self insuring themselves against investment and longevity risk and failing. Like many other commentators, the report focuses not only on the risk that people outlive their pension savings, but also that in seeking to avoid the early depletion of their pots, people risk living too frugally in retirement in fear of the latter.

The report therefore recommends introducing a default approach that combines flexibility and income security through income drawdown with annuity protection.¹⁰⁰ Interestingly, after over two decades of freedom and choice, and having similar concerns about the early depletion of pension pots and people living unnecessarily in penury, the Australian pension system has also started to consider options that will lead to greater income security in retirement.

In a world of freedom and choice with a paucity of accessible guidance and low cost advice, and with very little shopping around and advice being taken, the individual retail-type solutions adopted by most are rarely optimal. Many are also very costly, in both absolute and opportunity cost terms, and often unduly risky in the hands of the poorly informed and unadvised. Indeed, as noted earlier, 60 per cent of annuity and income drawdown contracts are purchased without scouring the market, with three quarters of annuity and one third of income drawdown purchases being unadvised. Moreover, around a third of cash withdrawals are invested into lower yielding cash deposits and cash ISAs. Rather, lower cost, collective institutionally-managed default solutions for the mass market, that enable people to release money from their pension pots efficiently, would seem to be the way forward.

⁹⁸ FCA (July 2017), op. cit. The Pensions Institute in its November 2017 report, “The Meaning of Life 2”, attributes the dearth of new products combining flexibility and income security to consolidation in the life assurance industry.

⁹⁹ Mercer (2017), Melbourne Mercer Global Pension Index, Australia Centre for Financial Studies, Melbourne.

¹⁰⁰ Mercer (2017), op. cit. This ninth annual addition of the report noted this shortcoming as one of its principal reasons for downgrading the UK pension system to 15th (a lowly C+ grade) out of the 29 systems it evaluates.

As industry commentator Henry Tapper starkly puts it, “In the absence of a clear default decumulation option, the fear is that cash-out or pension liberation will be seen by many as the line of least resistance and – in differing ways – people will find a large proportion of their hard earned saving going to HMRC or to comen.”¹⁰¹

Given the success of auto enrolment in the accumulation stage, the idea of auto enrolling people at the point of retirement into an institutionally-managed income drawdown fund that manages both investment and longevity risks by pooling the latter in a fair and transparent manner, and which offers a default fixed real income withdrawal rate, perhaps with an explicit auto enrolment-style charge cap, continues to gain traction. Indeed, for most people, given the behavioural and structural impediments to raising engagement levels, a well thought out, inexpensive default, with options to finesse the default’s parameters and the provision of opt-outs for the engaged, is the best possible option. It is also an approach which, as noted earlier, appears to resonate with those aged 55 to 64, typically at retirement.¹⁰² After all, these products would sidestep the enormous decision burden at the point of retirement, while providing the flexibility and income security most retirees need. Crucially, such defaults would help to avoid what might otherwise result in particularly poor retirement outcomes. Prominent among the many solutions put forward are the Centre for Policy Studies’ Michael Johnson’s pragmatic auto-protection proposal and the Pension Institute’s David Blake’s equally pragmatic and behaviourally aware SPEEDOMETER (or Spending Optimally Throughout Retirement) layered retirement expenditure plan.¹⁰³

Drawing on key elements of these and the many other suggestions put forward by other intellectual industry heavyweights, particularly the central roles of collectivity, income security and trust-based governance, one solution might be to draw on the experience and expertise of those larger MAF-accredited master trusts with well-proven investment, governance and administration credentials in the accumulation phase.¹⁰⁴ In managing investment and longevity risks, these well-governed institutional investors would determine the combination of default investment strategy and longevity insurance that would sustainably support a fixed real default income withdrawal rate and a guaranteed minimum income (possibly supported via phased annuitisation) throughout retirement, all within a regulated charging structure that contains costs without compromising the economics and performance of such an arrangement.

Of course, as we noted earlier, a sustainable withdrawal strategy should ideally support typical spending patterns in retirement. Although empirical evidence suggests spending in retirement progressively falls in nominal terms, we also noted that spending patterns in retirement may well change as the composition of the retired population becomes increasingly dominated by the second wave baby boomer sandwich generation, and less by the current make do and mend generation. For that reason, we will, as suggested earlier, assume that fixed real income withdrawal rates, rather declining nominal withdrawal rates, will best fit future spending in retirement and should be adopted within a default solution.

¹⁰¹ Henry Tapper. Good retirement outcomes depend on collective solutions. Pensions Playpen. 17 July 2016.

¹⁰² See: Planning for retirement. Are people joining up the dots? Columbia Threadneedle Investments and YouGov. February 2018.

¹⁰³ See: Michael Johnson. Auto-Protection: Auto-Drawdown at 55, Auto-Annuity at 80. Centre for Policy Studies. March 2017. ISBN 978-1-910627-47-1. <http://www.cps.org.uk/files/reports/original/170320153029-AutoProtection.pdf>. The Report of the Independent Review of Retirement Income. *We Need a National Narrative: Building a Consensus around Retirement Income* David Blake. March 2016. ISBN: 978-0-9935615-1-1 [v1/230216]. The latter paper seeks to optimally relate retirement spending to the speed with which assets are drawn down. As Blake points out, “a SPEEDOMETER is a useful device both for measuring and influencing speed.”

¹⁰⁴ The Master Trust Assurance Framework was developed by the ICAEW with TPR to demonstrate standards of governance and administration that meet with TPR’s DC Code. This will be replaced by a more formalised master trust authorisation regime which will require master trusts to meet five criteria, assessed by TPR. The master trust must be run by fit and proper persons; be financially sustainable; funded in a way that meets specific requirements; have sufficient systems and processes to be run effectively; and have an adequate continuity strategy.

DESIGNING A FIT-FOR-PURPOSE DECUMULATION DEFAULT SOLUTION

So what would an auto enrolled, appropriately charge-capped, default decumulation solution, that combines flexibility with income security, with options and opt outs, comprise? Taking account of likely retirement ages and longevity assumptions, while keeping things simple might mean setting an initial 20- to 25-year default fixed real withdrawal rate at an appropriate level, maybe between 3 and 4 per cent, perhaps with a 1.5 to 2 per cent minimum income underpin, coupled with a 20 to 25 year deferred annuity providing longevity insurance and provision for, say, a bequest of maybe 10 per cent. Of course, the more engaged, who are better able and willing to make their own decisions could opt out and, with regulated advice, create their own bespoke solution. However, in allowing a degree of flexibility, which in itself would require more accessible guidance and low cost advice, the default could be finessed at set times and within certain parameters to meet individual preferences. So, the term of the income withdrawal and the vesting of the deferred annuity could be flexed up or down by up to, say, five years, the fixed real withdrawal rate by up to 1.5 per cent and the bequest by perhaps 10 per cent. Of course, the extent to which each feature could be flexed would, in some cases, be constrained by the flexing of the other features, the individual's age and the size of the remaining pot.

Underpinning good decumulation default design and the need to support a sustainable fixed real income withdrawal rate is equally good default investment fund design. As noted earlier, this is best performed by those multi-asset funds with genuinely skilful and dynamic asset allocation and active fund management being applied to a genuinely well-diversified asset mix. In targeting a deliverable inflation-plus absolute return objective, while minimising volatility and sequencing risk, these funds provide a smoother returns experience than that for equity and equity/bond portfolios and a prospectively better outcome *per se* than that offered by with-profits, CPPI or overlaying an equity portfolio with put options. Crucially, unless hit by a completely anomalous event, a multi-asset fund-derived SWR set at an appropriate level shouldn't be compromised when financial markets turn tail. Moreover, when allied to a competitive charging structure, such funds in this context are hard to beat.

CONCLUSION

“Without the provision of high quality, behaviourally robust, well governed and appropriately regulated defaults that provide a secure long-term income stream and longevity insurance, supported by the provision of accessible frames of reference, guidance and low-cost advice, people are at risk of sleepwalking into retirement penury.”

In a world of freedom and choice, the decumulation stage of the DC journey is fraught with difficulty. Those at and in retirement, seeking flexibility and income security and opting for income drawdown, as opposed to inflexible and ultra low yielding annuities, must successfully navigate a myriad of largely unquantifiable risks. Financial market corrections, especially those occurring early in the decumulation journey, unexpected inflation and longevity risk, which is typically underestimated, all threaten the preservation of capital and its ability to underpin a sustainable fixed real income withdrawal rate to support a desired standard of living throughout retirement. If not managed well, these risks can add up to an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings or living in penury in fear of the latter.

Indeed, the potentially dire consequences of making a wrong decision or decision paralysis will continue to rise over time as DB pensions disappear, people start receiving their state pension ever later in life and increasingly become solely reliant on their DC pension pot to support their standard of living in retirement which, for many, will extend to 30-plus years.

If retirement is to be enjoyed and not endured, then the thought given by the pensions, asset management and adviser communities, with substantive input from the FCA, to the design of what can be considered genuinely fit-for-purpose default options, must be stepped up. Indeed, without the provision of high quality, behaviourally robust, well governed and appropriately regulated defaults that provide a secure long-term income stream and longevity insurance, supported by the provision of accessible frames of reference, guidance and low-cost advice, people are at risk of sleepwalking into retirement penury.

To find out more visit
COLUMBIATHREADNEEDLE.CO.UK



Important information: For internal use and for Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The analysis included in this document has been produced by Columbia Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice and should not be seen as investment advice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Asset Management Limited. Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority. Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.
columbiathreadneedle.com Issued 02.18 | Valid to 02.19 | J27429 | 2043633