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INTELLIGENT THINKING

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Securing a positive outcome in the post-annuities world

Chris Wagstaff, Head of Pension & Investment Education, looks at the risks and challenges that lie ahead of the soon-to-be implemented pension freedoms and how asset managers can help retirees secure a positive outcome in the post-annuities world.

Key messages

- The pensions world has moved from collective passivity to individual responsibility, as revolution replaces evolution
- The Australian retirement market introduced pension freedoms 20 years ago and has seen most retirees adopt a cautious approach to income withdrawal
- Profligacy in the post-annuities world should be kept in check by the UK income tax system and the abolition of punitive rates of inheritance tax on income drawdown policies
- Managing a DC pensions pot in retirement exposes investors to accumulation phase-style risks, longevity risk and the risk of running out of money
- A sustainable and comfortable retirement demands access to web-based risk tools and intelligently constructed, well diversified and actively managed asset solutions that specifically address decumulation phase risks

Key statistics

- The average Australian retires at age 65 with a DC pensions pot of around £100K
- Annuities account for three per cent of the £39bn per annum Australian retirement market
- While annuities are bought by 90 per cent of UK retirees, with an average pensions pot of £26K, income drawdown is expected to account for 80 per cent of the UK's £11bn per annum retirement market
- Projections suggest that the number of people in the UK aged 100+ will increase from around 11,000 today to half a million in 2066
- There are four times as many plumbers and seven times as many car mechanics in the UK as financial advisers

The pensions industry has long been characterised by evolution rather than revolution. However, that all changed on 19 March 2014 when George Osborne delivered the most radical overhaul of the pension system for nearly a century in his Budget Speech.

As from next April *anyone* aged 55 or over will no longer face restrictions on the amounts they can withdraw from their defined contribution (DC) pensions pot. "No caps. No drawdown limits… No one will have to buy an annuity", is how the Chancellor so decisively outlined his measures[1].

So in one fell swoop the pensions world moved from collective passivity to individual responsibility, as revolution replaced evolution.

Previously, these freedoms were effectively only available to those who opted for so-called flexible drawdown over annuity purchase – an option first made available in 2011. However, as flexible drawdown was only made available to those DC investors who could prove they had a guaranteed annual income of at least £20,000, this measure excluded most retirees.

Despite meeting with a rapturous welcome from most corners of the pensions industry, this dramatic change of tack has had its detractors, with a number of commentators warning of those who may be tempted to blow their entire pension pot on an exotic mid-engined Italian sports car and then fall back on the State for support. The OECD, in particular, criticised the reforms, stating, "An annuity is the only instrument that provides complete protection in retirement and which safeguards individuals against the danger that they exhaust their savings before death."[2]

While expressing such concerns is laudable, the evidence from the other side of the globe, where pensions freedoms have been the norm for two decades, suggests that few diligent savers become spendthrifts overnight. Those that might be tempted to live life in the fast lane, albeit fleetingly, would likely be those with smaller pensions pots. Indeed, in Australia where the average pensioner retires at age 65 on a pot of around £100,000[3], common sense appears to prevail with most retirees paying off their debts before securing a steady income stream from income drawdown-style products and/or buy-to-let property. Although annuities are readily available in Australia, they only account for about three per cent of the £39bn per annum Australian retirement market. Furthermore, many err on the side of caution and accept a relatively modest income in retirement, recognising that their pension pot may need to last 25+ years. That said, the, 460-page, interim report from the Murray Review in July found that "around one-quarter of people with a superannuation balance at age 55 have depleted their balance by age 70". However, one suspects these are the retirees with pots much smaller than the national average.

So, given that "There's nothing to suggest that the Poms are any more stupid than Australians", to quote one Australian industry commentator[4], the evidence would suggest that the average Briton can be trusted with their own cash in retirement. And even if some can't, the UK income tax system of marginal tax rates will act as a first line of defence in preventing most people from adopting reckless behaviour – a point that Pensions Minister Steve Webb has made on numerous occasions. In addition, newly hatched government plans to abolish the 55 percent levied on unused portions of income drawdown policies on death could well result in some investors preserving their pension pots for IHT purposes.

While annuity purchase in the UK has not been compulsory since April 2011 and despite their poor value in the current low interest rate environment, not to mention their lack of transparency and poor fit with typical spending patterns in retirement, annuities are still bought by more than 90 per cent of the 400,000 or so who retire each year in the UK, with an average pensions pot of £26,000[5]. Less than 10 per cent take the drawdown route. With the introduction of the new pension freedoms, industry projections suggest that this c.90/10 split for the UK's £11bn per annum retirement market will potentially move to 80/20 in favour of drawdown, with recent survey evidence from Hymans Robertson suggesting that only around 25 per cent of retirees would use "most or all" of their retirement funds to buy an annuity[6].

This newly hatched libertarian approach to managing a DC pensions pot in retirement does, of course, expose these newly empowered investors to a myriad of risks – risks that would otherwise have been assumed by the annuity provider. These naturally comprise volatility, potential drawdown and inflation risks, similar to those assumed by DC pension savers during the accumulation phase. Collectively these risks, termed real capital preservation risk, threaten the preservation of the investor's capital – capital on which the investor relies to generate a stream of, ideally inflation-busting, returns to finance spending. However, in addition, the pensioner assumes perhaps the biggest imponderable of them all, longevity risk. That said, help is at hand with the recent introduction of a number of online longevity guides that, on answering a few simple questions about gender, current age, postcode, state of health and lifestyle, provides the prospective DC pensioner with a likely estimate of their remaining lifespan. Of course, the DC pensioner also needs to plan for their likely spending

pattern during retirement and factor in their intentions for passing on wealth on death, if they don't intend to treat their pension pot as a sinking fund. In so doing, the DC investor should be mindful of projections for those in the UK aged 100+ increasing exponentially over the next 50 years from around 11,000 today to quite possibly half a million in 2066[7]. Taken together, the combination of these risks effectively translates into the biggest risk of them all – that the pensioner will run out of money.

All of the above is, of course, an awful lot to take on board for someone well versed in financial matters, let alone someone who isn't, which is probably the vast majority of prospective DC retirees. Although free and impartial *guidance* on all of these matters will be readily available, from organisations such as the Money Advice Service (MAS) and The Pensions Advisory Service (TPAS), this "guaranteed guidance" is unlikely to be a direct substitute for fully fledged independent financial advice. And therein lies the rub.

In the post-RDR world, the number of independent financial advisers (IFAs) in the UK has fallen to around 22,000, while the number of tied and restricted advisers has dwindled to 7,000 or so[8]. To put these numbers into perspective, there are about four times as many plumbers and seven times as many car mechanics in the UK as advisers[9]. Additionally, the post-RDR IFA business model is generally only economically viable for case sizes of £100,000+. As noted earlier, the average DC pension pot is around £26,000. Equally concerning, however, is the fact that, while the vast majority of people in the UK wouldn't service their own car or mend their household plumbing, around two-thirds don't seek financial advice for some or all of their investment decisions either as a consequence of being priced out of the market or choosing not to seek financial advice[10].

Consequently, the "advice gap" that exists for the mass market and mass affluent – those who will constitute the majority of DC pension savers – looks destined to widen yet further. This is obviously concerning, as most of those who previously took advantage of the limited freedoms afforded by the introduction of drawdown in the mid-1990s, subsequently termed "capped drawdown", and the more recently introduced freedoms of flexible drawdown, were in receipt of financial advice. Hence the very real concern that some very poor investment decisions will be made and unsuitable products and solutions will be sold into this nascent market.

However, as the new DC pension freedoms naturally play into the hands of the asset and wealth management industry, these institutions are ideally placed to provide tailored, flexible solutions which, through highly individualised asset allocations, actively manage the key risks faced by these newly empowered investors seeking positive outcomes in the post-annuities world. At the very least these solutions should, through the provision of intelligently constructed, well diversified and actively managed absolute return bond funds, diversified growth funds with specific CPI plus return targets and high yielding multi-asset income funds, respectively offer the genuine prospect of real capital preservation, real investment returns and a real long-term income stream.

A comprehensive solution should additionally provide access to a suite of user-friendly web-based tools for the retiree to stipulate the relative importance placed on real capital preservation, real investment returns and income provision, on an ongoing basis, so that their highly individual asset allocations to the above fund types reflects their changing priorities over time. Additionally, these tools should necessarily help the retiree, or their adviser, determine likely longevity in the de-accumulation period and long-run investment returns on an ongoing basis, as investment assumptions and risk premia change over time.

Only by combining these characteristics and attributes in a simple, intuitive and user-friendly manner, can the retiree, or their adviser, determine whether the prospective time horizon over which the pensions pot will be invested will likely be sufficient to fund planned spending and a possible legacy on death. It is therefore incumbent on the asset management industry to rise to the challenge if this new generation of post-DC investors are to experience a comfortable retirement. Anything less will prospectively amount to a sub-par outcome for those taking personal responsibility for a secure retirement in a post-annuities world.

"As the new DC pension freedoms naturally play into the hands of the asset and wealth management industry, it is incumbent on these institutions to provide tailored, flexible solutions, that actively manage the key risks faced by these newly empowered investors seeking positive outcomes in the post-annuities world."

[1] Budget 2014: Pension reforms offer freedoms to savers. FT.com, 19 March 2014.
[2] OECD criticises UK pension reforms. FT.com, 20 June 2014.
[3] Budget 2014: Australians dismiss fear of pension profligacy. FT.com, 20 March 2014.
[4] Interim report by the Murray Review, published July 2014.
[5] Source: Budget 2014: Pensions revolution casts pall on insurers. FT.com, 20 March 2014.
[6] Source: Survey shows potential damage to annuity business. FT.com, 7 April 2014.
[7] Source: Number of Future Centenarians by Age Group. Department for Work and Pensions, April 2011.
[8] Source: FundWeb.co.uk, 15 August 2013.
[9] Source: DIY investment – a crisis in the making? FT.com, 11 October 2013.
[10] Source: Recognising RDR Reality: the Need to Change Planning Assumptions. Deloitte, August 2013.

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