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HOW DC RETIREES CAN AVOID SLEEPWALKING INTO RETIREMENT PENURY

JUNE 2018

A well-governed collective default decumulation fund is needed to give defined contribution retirees the reliable income stream they need and the flexibility they desire.

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- The government's decision to allow people more freedom with their retirement savings has been welcomed by many, but with these new freedoms comes greater responsibility.
- Without more support, many retirees are at risk of sleepwalking into retirement penury.
- Behavioural interventions and access to guidance will only go so far to help those at and in retirement.
- A better solution is a carefully considered, well-governed retirement collective default fund.

Savers in defined contribution (DC) schemes are retiring in a perfect storm of behavioural challenges. They are being asked to make one of the biggest financial decisions in their lives at retirement, having been auto enrolled into a DC pension scheme with little to no engagement required.

Many people are receiving little or no support to guide them through making retirement decisions. They may also be reluctant to engage with technology that could aid their decision-making process.

The cognitive challenges of wrestling with complex retirement choices are also acute. Some retirees are making decisions at a point where their financial literacy and cognitive ability is starting to decline. These issues are compounded by inertia, combined with a lack of trust in pensions policy and the pensions industry.

Following the introduction of pension freedoms, increasing numbers of people are opting for the flexibility of income drawdown over the inflexibilities of annuities. Others are

cashing in their pension pots, with either no plan or a misguided belief that their pension will be safer kept in cash. This can make them easy prey for pension scammers.

However, in seeking both flexibility and income security, those who opt for income drawdown 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 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 increasing swathes of the population needlessly living in penury in fear of the latter.

The solution to this perfect storm is multi-faceted. A combination of more guidance, behavioural interventions, and well-constructed defaults will help DC retirees to navigate their way through the storm.

Guidance is not a panacea

In a perfect world, savers would engage with retirement decisions, seek support and be empowered to make better choices with their money. Sadly, we do not live in such a world. Engagement levels with government guidance service Pension Wise are a good measure. 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,[1] this is still a relatively small number, considering over one million people have accessed their DC pension pots since April 2015. Much more signposting is needed.

Part of the solution is for employers to signpost Pension Wise and accessible guidance more generally to those employees approaching retirement. However, one-off generic guidance from Pension Wise, typically at the point of retirement is unlikely to be sufficient, given that people's circumstances and spending patterns change throughout retirement.

As a publicly funded body, Pension Wise also has finite resources. It would require the necessary government funding and resources to maintain its current high standards if greater demands were placed upon its 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.

Finally, 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 being developed. 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.

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

Behavioural interventions

Applying behavioural economics and interventions can help people with their decision-making. 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 government's behavioural insights team. Although not a panacea, this can be applied to the decumulation stage to potentially improve investment decision-making and the management of the key risks faced at and in retirement.[2]

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 intervention can often generate dramatic results in many aspects of everyday life.

That said, given the complexity of the decisions that people must make 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.

This is particularly true of those older generations who often shy away from using technologies that facilitate the decision-making process. Indeed, as people grow older, their decision-making tends to be increasingly founded upon life experience and gut feel. Very little, aside from informed and trusted advice, can change that.

Join the collective

Auto enrolment has been heralded as a great success so far. It harnesses people's intrinsic reluctance to engage with pensions, helping the disengaged to build better, though not optimal, financial futures . Perhaps the same principles should be applied at the point of retirement. People could be auto-enrolled into an institutionally-managed income drawdown fund at the point of retirement.

This collective fund would manage both investment and longevity risks by pooling the latter in a fair and transparent manner. It could offer a default fixed real withdrawal rate, which could be flexed within limits, perhaps with an explicit auto enrolment-style charge cap.

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. This solution would sidestep the enormous decision burden at the point of retirement, while providing the flexibility and income security most retirees need.

Institutional investors could determine the combination of default investment strategy and longevity insurance that would sustainably support a fixed real default income

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[2] 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.

withdrawal rate and a guaranteed minimum income (possibly supported via phased annuitisation) throughout retirement, all within a regulated charging structure.

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.[3]

Building a sustainable default

Taking account of likely retirement ages and longevity assumptions, constructing a default decumulation option might entail setting an initial 20- to 25-year default fixed real withdrawal rate at an appropriate level, maybe between 3 and 4 per cent . Indeed, many financial planners point to 4 per cent as being the benchmark sustainable fixed real withdrawal rate, following research conducted by US financial planner Bill Bengan in 1994. However, yields, investment returns and inflation have moderated since then.[4]

The fund could offer a minimum income underpin of 1.5 to 2 per cent. This could be coupled with a 20- to 25-year deferred annuity, providing longevity insurance and provision for, say, a bequest of maybe 10 per cent.

More engaged retirees, who are better able and willing to make their own decisions could opt out and, with regulated advice, create their own bespoke solution. In addition, the default itself could be finessed at set times and within certain parameters to meet individual preferences. So, the term of the income withdrawal and deferred annuity could be moved 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 retiree's age and the size of their remaining pot.

Good default investment design underpins this retirement solution, given how vital it is to give retirees a reliable stream of income. Multi-asset funds with a genuinely skilful and dynamic asset allocation applied to a well-diversified asset mix are best placed to meet DC retirees needs. In targeting an above-inflation, absolute return objective, while minimising volatility and sequencing risk, these funds provide a smoother returns experience than those of equity and equity/bond portfolios and a prospectively better outcome than that offered by with-profits, constant proportion portfolio insurance (CPPI) or overlaying an equity portfolio with put options.

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[3] See: Michael Johnson. Auto-Protection: Auto-Drawdown at 55, Auto-Annuitisation at 80. Centre for Policy Studies. March 2017. ISBN 978-1-910627-471. 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 outs, "a SPEEDOMETER is a useful device both for measuring and influencing speed."

[4] 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.

Crucially, unless hit by a completely anomalous event, a multi-asset fund-derived sustainable withdrawal rate, set at an appropriate level, shouldn't be compromised when financial markets hit challenging conditions. When accompanied by competitive charging structure, such funds are hard to beat.

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