Not just pot luck
- Income security in old age

The Investment Network
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The pension revolution

- It is no longer necessary to annuitise Defined Contribution pensions pots
- This leaves unparalleled choice for pension pot owners to spent the money how they see fit
- While the change has met with almost universal approval the new rules pose a danger if they are abused
- However, we believe that the changes will lead to different approach to pension planning and also a move away from annuities
- Will people be able to manage the risk and how should they gear up?

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Principal findings

- People should have a financial health check when they take their pot
- All income streams and assets into should be taken into account as well as levels of risk
- In very few cases do we find that annuitisation the best option, drawdown is better
- As long as it is done carefully and sensibly the money should not run out before death if draw down is used
- If it does make sure there is a back stop or 'plan B'(e.g. housing assets, other guaranteed income)
- Tax planning is important whether income tax, capital gains or IHT. This may affect the timing of some decisions like gifting
- If drawdown is chosen a person should also seek regular financial advice including wealth planning to guard against longevity risk

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Key considerations

From an individual standpoint, there are three key considerations when deciding on a strategy to manage their pension pot:

1. The risk of living longer than expected and running out of cash, and hence whether to manage this risk by buying an annuity at some point during retirement

2. Any gift or bequest motive or plans for a major purchase that may affect the rate of drawdown or investment strategy

3. Desired investment returns in the absence of annuitisation including investment volatility and potential tax liabilities

Main options at retirement

Option	Instant and flexible access to whole pot	Avoid higher rate tax implications	Gift or bequest opportunity	No danger of money running out	Avoid Inheritance tax implications
(A) Withdraw all	✓	✗	✓	✗	✗
(B) Drawdown	✓	✓	✓	✗	✓
(C) Annuitise	✗	✓	✗	✓	✓

Key: Tick 'generally applies' : Cross 'generally does not apply'

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Individual circumstances

- <u>Health</u> – poor health may lead to an individual spending all their pot in one go or buying an impaired annuity

- <u>Home ownership</u> – if individuals own their home outright, then this can be considered as an asset that can be turned into cash or an annuity if their pot is exhausted

- <u>Bequest motive</u> – whether a person wishes to either gift money when they first access their pension pot or to have some money to bequeath on death to a surviving partner, relative, friend or organisation

<u>Note: Circumstances can change over time so there is a value in retaining flexibility</u>

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Additional points worth noting

- A person with a defined benefit pension scheme can take more investment risk with their DC pension pot
- It will usually be better to withdraw small pension pots in full but having regard to the tax liabilities
- Those with very large pension pots have the most flexibility and will be most influenced by their tax position
- For a person working beyond normal pension age, it is likely they will defer taking any income at all or very little income
- In couple households in which income is pooled, managing tax will be important

An options matrix

Person type	In poor health	Home owner	Bequest motive	Option (A)	Option (B)	Option (C)
1						✓
2	Y				✓	✓
3		Y			✓	
4			Y	✓		✓
5	Y	Y			✓	
6	Y		Y	✓		✓
7		Y	Y	✓	✓	
8	Y	Y	Y	✓	✓	

Key: ‘Y’ means ‘applies’: Tick means ‘option applies’

Longevity risk

There are two things to think about:

- Selection effect
- Longevity drift

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- Life expectancy changes with time. A male at age 65 can expect to live 19.1 years (i.e. 84.1 years). But if he is lucky and lives until 80 he can expect another 8.8 years i.e. 4.7 years longer than when he had expected to die at age 65! So the selection effect is: (80 + 8.8) – (65 + 19.1) = 4.7 years

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- Longevity drift

- If a man aged 65 today survives to age 80, based on ONS cohort life tables his expected age at death will be 91.4, 7.3 years older than it was at age 65 i.e. years. That is: (80 + 11.4) – (65+19.1) = 7.3 years . In other words, he gains 4.7 years from selection and 2.6 years from drift relative to what he had expected at age 65 (i.e. 7.3 – 4.7 = 2.6 years)

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Men are catching up with women but they are not there yet!

Gap highest in 1977

Y-axis	Difference in female-male life expectancy at age 60 (years)
X-axis	Year

Until 1900 the difference in male-female life expectancy at age 60 was less than one year. The gap then grew reaching a maximum in 1977, since when it has been falling rapidly, and is forecast to converge by around 2030

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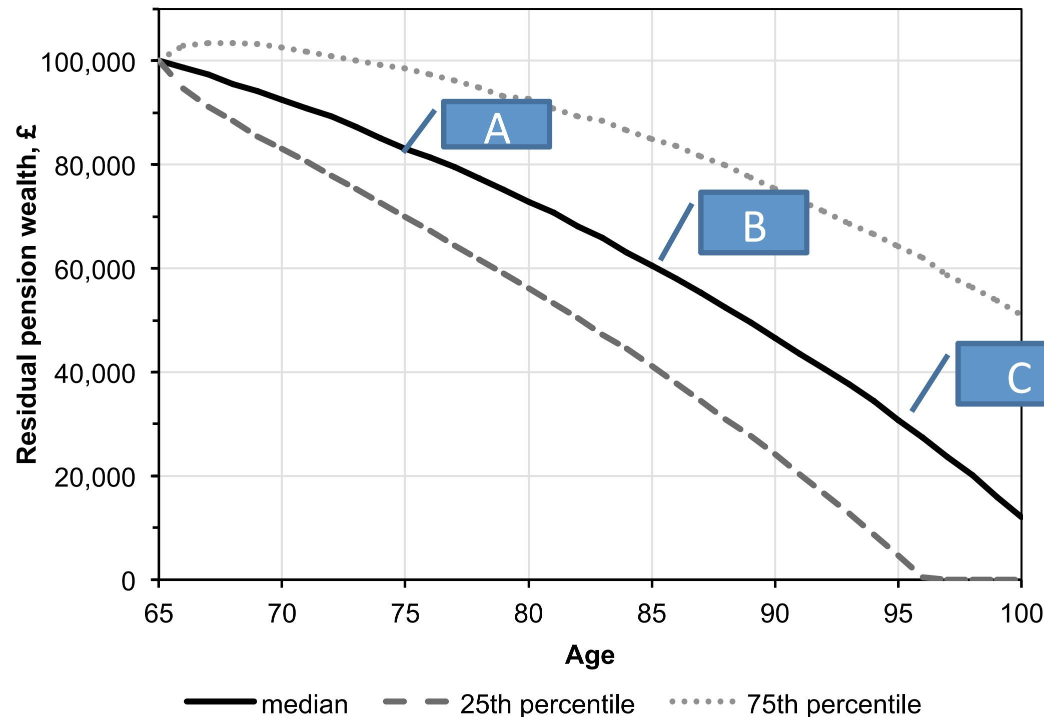
Fixed drawdown case:
Man aged 65with £100k pot



- At age 65 your pot would buy a unisex annuity of £4,328.82 p.a.
- At age 75 (point A), the median pot would be worth £83,139.30 and buy an annuity of £5,370.76 p.a.
- At age 85 (B) it will be £60,557.47 and buy an annuity of £6,728.61 p.a.
- At age 95 (C) it will be £30,738.29 and buy an annuity of £8,110.37 p.a.

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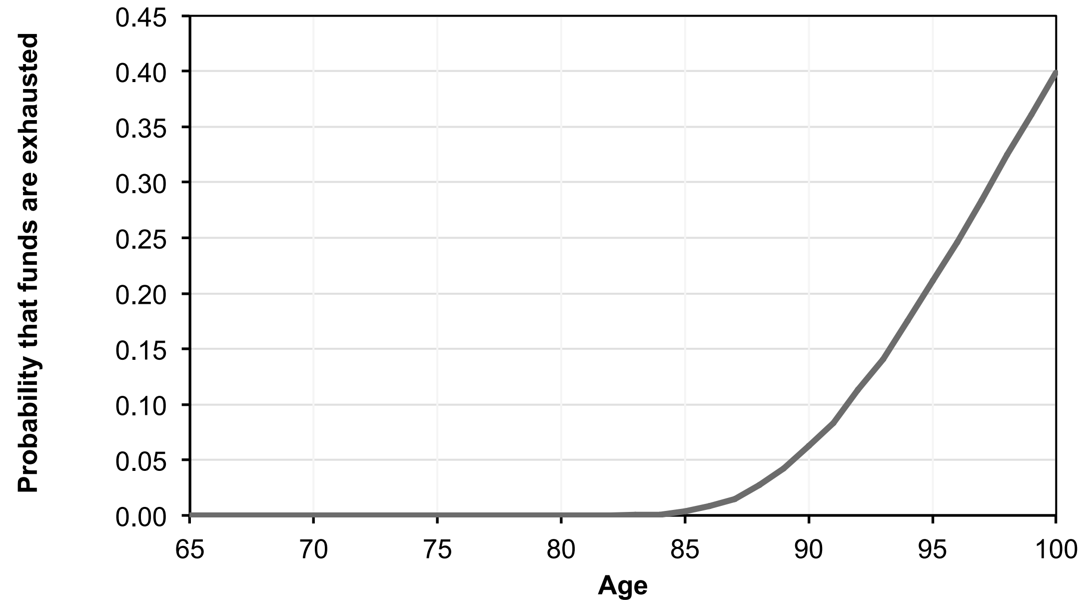
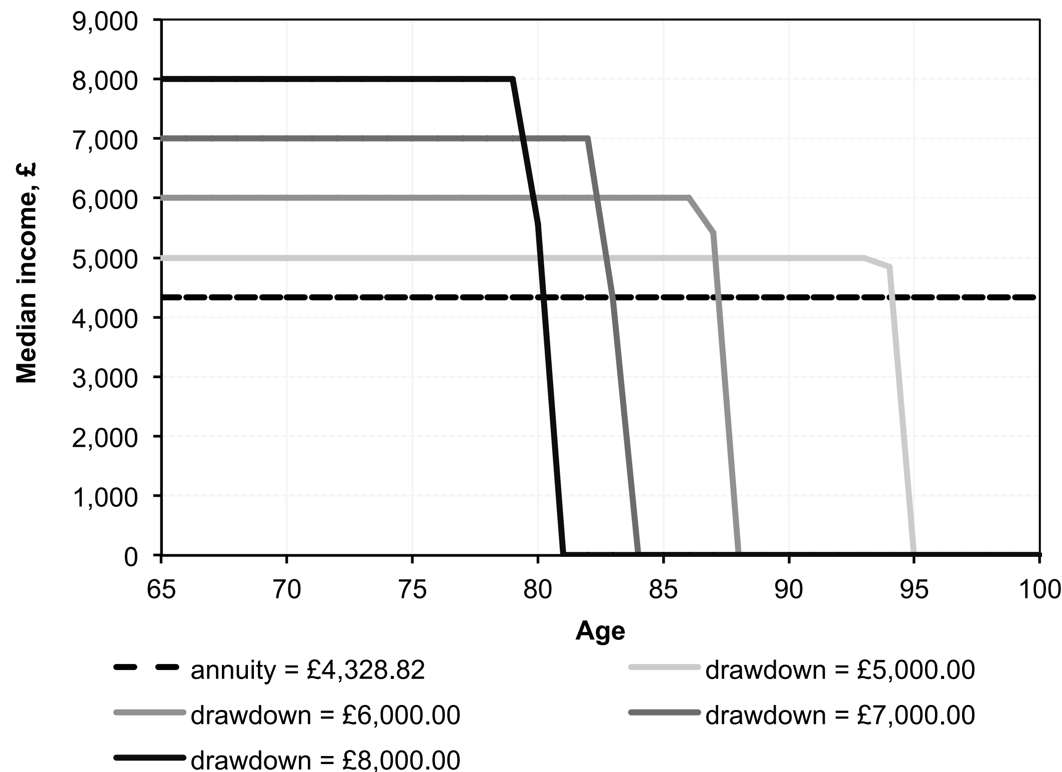
Longevity risk



The probability that fund is exhausted at each future age based on a level annual drawdown of £4,328.82. The probability of this occurring before death is relatively small (about 7% at age 90, an age to which only 42% of men can expect to survive).

Fixed income drawdown – Different amounts



Fixed drawn leads to a 'cliff edge' but the timing can be predicted so you have time to plan. The age when it occurs depends on the amount taken out each year. This charts shows examples from £5k to £8k

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Flexible income drawdown

- We can make the income taken each year a function of the pension pot e.g. a fixed % of that remaining or by linking it to life expectancy so that money never runs out.

- Based on life expectancy at 65 an initial pension pot of £100,000, a person could draw down an annual income of

$$\frac{100,000}{21.8955} = £4,567.15$$

- For simplicity, suppose now that the actual investment return achieved during the year of age 65 to 66 is exactly in line with expectations, the remaining fund at age 66 will be

$$£100,000 \times 1.03 - £4,567.15 = £98,432.85$$

Flexible income drawdown

- Then, based on the future life expectancy at age 66 of 21.1247 years, the individual will now be able to draw down an annual in the coming year of:

$$\frac{98,432.85}{21.1247} = £4,659.61$$

- And so on…

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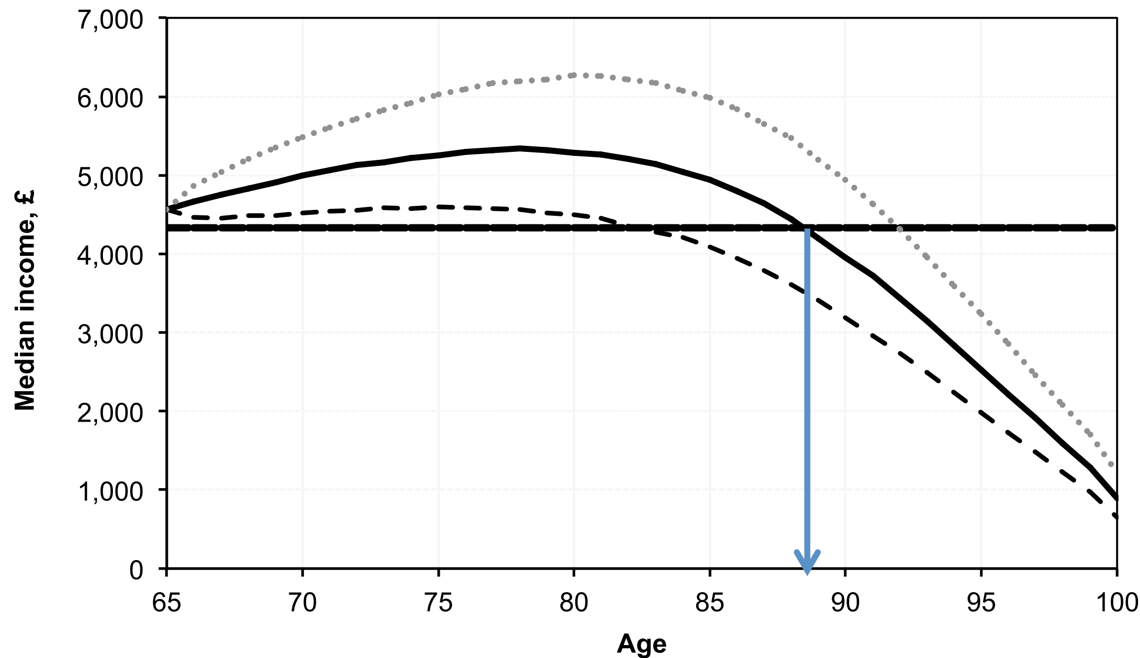
Variable drawdown – Different amounts



annuity = £4,328.82

variable drawdown (males - with longevity drift)

25th percentile (males)

75th percentile (males)

This graph shows what the annual income would be by basing withdrawals on future life expectancy (gross of tax). It does not fall below an annuity until ~ 88 years (see arrow)

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Gifting pension wealth

- It may be better for people to gift money at the start of their retirement rather than waiting until after death when it becomes a bequest
- The risk is that if we give away too much money at the start then you may run out of funds while still alive. This is another reason why good financial advice is important
- Bequests tend to benefit your grand children's generation whereas gifting benefits tend to benefit your children's

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Home ownership

- For the United Kingdom, most people entering retirement own their homes and depending upon where they live they can be highly valuable assets

- Home owners can think of their house as extra insurance against their pot running out and hence can take larger risks either investment and/or annual income taken if they wish

- Money can be released from the home through:

  - Equity Release
  - Downsizing

State Pension

- Not only is the regulation surrounding private pensions changing but so too is state pensions and other state support
- The state pension is moving towards an amount that should support most people in retirement, certainly in conjunction with other state aid and benefits
- It follows that the risk of depleting you pension pot and running out of income altogether is not such a problem as might be thought

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Paying for long-term care

- Around 20% of the population enters long-term care in later life and costs average around £1000 a week

- Even if all sources of retirement income are combined only a small minority would be able to afford it from income alone although there is a state safety net if you pass the assessment

- There are no products available to insure against this risk and so this may focus people's attention on making their pot last into their mid 80's rather than for their whole lifetime

- Housing assets provided a back stop but you may lose your home. To protect against this we have proposed an insurance product.

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Summary of key findings

- Annuitizing you pot is not the best way to provide for retirement but it is a tool that can be used in certain circumstances e.g. ill health
- Regulations mean that annuities are not a good investment as compared with other investment vehicles
- Inflation proofing and joint life annuities are expensive and reduce the nominal value of annuities
- Most pension pots are small (under £20k) providing only a small income stream. Annuitising them could cause means-tested benefits to be withdrawn such as support with Council Tax
- Drawdown is better because it provides more flexibility e.g. in relation to gifts or bequests but also if it is invested carefully it should not run out
- Especially for people with a state and/or occupational pension and/or a large pension pot or other assets it will be better to apply the pot in more creative ways
- However, a plan 'B' is advisable to cover longevity risk e.g. use the value in the home or defer annuitizing until you are much older
- Paying for long term care is an unfunded contingency. Consider using the value in the home to protect your assets.

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END

'No pension, no mortgage, no shares – suddenly I'm a financial genius'