Drawdown: the guide

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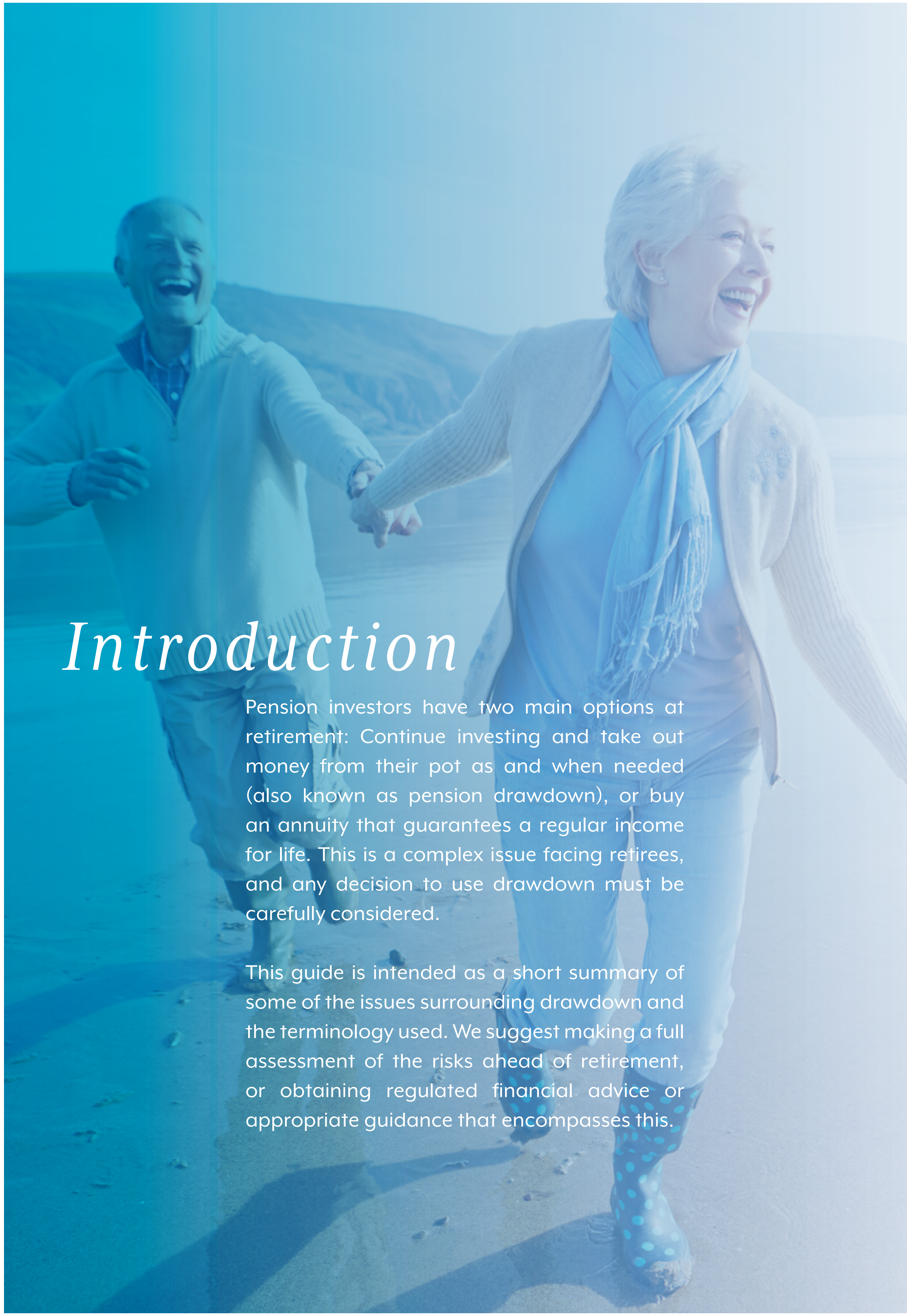


Introduction

Pension investors have two main options at retirement: Continue investing and take out money from their pot as and when needed (also known as pension drawdown), or buy an annuity that guarantees a regular income for life. This is a complex issue facing retirees, and any decision to use drawdown must be carefully considered.

This guide is intended as a short summary of some of the issues surrounding drawdown and the terminology used. We suggest making a full assessment of the risks ahead of retirement, or obtaining regulated financial advice or appropriate guidance that encompasses this.

Drawdown versus annuity

Drawdown offers extra flexibility and the potential for better returns or more income from a pension pot - given the relatively low returns on offer from annuities today.

It can also offer better benefits to a spouse or dependants on death. However, drawdown is also a risky option. Keeping your pension fund invested means the value can fluctuate according to what markets are doing. You also need to be careful about how much you draw out and when to ensure you leave enough for future needs.

In contrast, an annuity provides a secure income. The income is guaranteed for as long as you live, which is why it is considered a less risky approach. However, there is no longer any access to the pension fund, and once set up it can't usually be changed or cancelled. It's less flexible than drawdown but you can still choose some features to suit your needs. This includes income going to your spouse or partner after you die and the option to increase income in line with inflation.

It is possible to split your pension between an annuity and drawdown in order to 'mix and match' a secure income and flexible benefits. However, this may only be practical with a sufficiently large fund.

Drawdown basics

Tax free cash

You can take up to 25% of the value of the pension you use for drawdown as tax free cash. You must do this at the outset – you can't do it later. The remaining pension stays invested and you must choose what to invest in or take advice.

Retirement age

The earliest age you can normally take benefits from your pension, either through an annuity or drawdown is 55 (rising to 57 in 2028).

Income options

You can choose how much income to take and when. There's no minimum or maximum, and you can start, stop or vary the amount when you wish. Remember, income is taxable and drawdown does not offer a secure pension. Your pension fund and income could run out.

Death benefits

For many people, having flexibility and control when it comes to passing money on to loved ones, is a key benefit of drawdown. When you die, your pension can be passed on, usually free of inheritance tax.

If you die before you reach age 75, the value of your pension fund would be payable either in the form of a cash lump sum or as an income to the beneficiaries you choose. As long as the fund is less than your remaining lifetime allowance (up to a maximum of £1.03 million in the 2018/19 tax year) any payments will be tax-free.

If you die on or after your 75th birthday, the benefits can still be paid as a cash lump sum or as an income, but whoever receives them will have to pay income tax on what they receive. They may be able to reduce their tax bill by spreading the withdrawals over a number of years.

Alternatively, whatever age you were, it is usually possible for the beneficiaries to continue with the pension pot without taking any income or lump sums. There will normally be no inheritance tax to pay when passing this on, but in order to ensure your wishes are clear, you should nominate your chosen beneficiaries with your pension provider and ensure this information is kept up to date.

The main risks involved in drawdown

1. Longevity risk

This is the risk involved with outliving your resources. How long you live is unpredictable, and people can underestimate how long they will live. This is why guaranteed forms of income such as defined benefit (e.g. final salary) pension schemes and annuities can be valuable in providing a core income that can be depended on.

2. Investment risk

Investment risk is magnified for those taking income from their investments. Not only do income streams such as dividends from shares vary but values can fluctuate according to what markets are doing. If you are drawing a flexible income from your pension care must be taken to ensure enough is left for future needs. The sequence of returns and when (as well as how much) income is drawn can have a considerable impact on results – see the section below on the 'investment risks of drawdown in detail'.

3. 'Mortality drag'

Funds in drawdown must produce increasingly higher returns to match the income you could receive if you bought an annuity. That's because annuity rates increase as people age. In addition, someone deferring buying an annuity is missing out on 'mortality cross subsidy' which means annuity policyholders benefit from the pooling of longevity risk as some people die younger than expected.

4. Inflation risk

Inflation is a measure of the rate of increase in prices for goods and services. In the UK the main measures are the Retail Price Index (RPI) and the Consumer Price Index (CPI). If the return on your money is less than the rate of inflation, it will erode the purchasing power of your capital, but it's also something to bear in mind for retirement income. If a drawdown pension is rising by less than inflation it is losing spending power.

5. Changing circumstances and legislation

Retirement can last several decades. A change in circumstances may require different levels of expenditure and the need to build flexibility into income-generating portfolios. In addition pension and taxation rules are constantly changing and the pace of change shows no sign of abating.

How to invest in drawdown

There is a high level of investment flexibility available in drawdown, especially through a Self Invested Personal Pension (SIPP). You can pick from thousands of possible investments and your strategy can be as conservative or adventurous as you wish.

Asset classes

To achieve a greater return than cash, some or all of your capital is exposed to potential losses. A basic rule is that if the level of risk is low, your return is also expected to be low, whereas if the level of risk is high there is greater potential to make a better return – but you could also lose money, and in extreme circumstances all of the investment amount.

Leaving money in cash is the lowest risk approach. It provides very little return (if any currently) but it does have the important advantage of keeping capital secure. However, cash is unlikely to grow fast enough to keep up with the increase in the cost of living. Historically, the buying power of cash has fallen over time, which is why many people turn to other assets to help grow their capital in order to meet longer term objectives such as retirement.

The main types of assets - equities, fixed interest securities, property, commodities and cash – have different characteristics, but, unlike cash, all can fall as well as rise in value to a greater or lesser extent. History shows that over the long term the stock market (representing shares in individual companies) is the most volatile asset class but has also provided the best returns.

Balancing risk and reward

There are significant risks involved in drawing down on the pension pot too early, or taking an unsustainable level of income. This means there can be a fine line between the success and failure of a drawdown investment strategy. If you take too much investment risk, your capital might fluctuate excessively with any market fall causing problems and an eventual shortfall. Take too little risk and the return generated may not meet your objectives.

The bottom line is that drawdown carries the risk that your money could run out. However, it depends on a variety of factors: how long you live, the size of your pension pot, the amount you take out, when you take it out and your investment returns. Improvements in our health mean we are living longer but income needs to last for those extra years.

A person with a large drawdown fund, say £1,000,000, can take withdrawals of £10,000 annually, knowing that it is unlikely to run out. Even if there is no net investment return, it would take 100 years to run the pot down to zero. However, an investor requiring £10,000 a year from a £200,000 pension pot would have to think very carefully about how to invest the money to meet this objective and determine the age at which they could realistically afford to retire.

There is no right or wrong answer as everybody has a different attitude to risk. However, it is probably fair to say that in most cases a balanced approach with a variety of asset classes producing a combination of income and growth makes sense; aiming for returns that are higher than inflation but with a wide spread of assets reducing volatility.

It is important to consider the size and frequency of withdrawals and whether these are sustainable. The less you leave invested, the greater risk of investment returns failing to meet future income payments. If you want to take a low risk approach, and/or want to receive a high income from a smaller pot, an annuity may be worth considering.

Selecting investments

Income-producing investments are a natural starting point for drawdown. Withdrawing the income from a portfolio rather than drawing on capital by selling investments can be more sustainable – this is known as taking the 'natural yield'.

Income investments include dividend-paying shares, bonds, and funds that invest in them. But remember investment income isn't guaranteed and the amount will go up and down. If you're investing in funds, you can choose 'income units', which pay out income rather than 'accumulation' units that roll it up in the price.

If you plan to draw from capital or not take any income at all, you will likely require investments that give you good long-term growth potential. Again, there are funds you can choose which aim to grow over time, or you can choose individual shares if you prefer. However, you will need to spend more time researching and reviewing your investments, and it will be harder to spread your investments over a number of areas.

If you're drawing from capital, you may want to take extra steps to reduce the risk of your portfolio suddenly falling in value. This could be done by choosing a diverse spread of investments, or by choosing funds where the manager specifically tries to reduce the impact of any market falls.

While there is always some risk with investing, making sure there is a mixture of investments in your portfolio can help reduce its impact. Different types of investments perform well at different times, and so do different stock markets around the world. So holding a range of investments across various markets can help shelter you when some areas don't perform as well as others.

Reviewing your drawdown plan

In order to check you are on track to achieve your goals your drawdown pension should be reviewed regularly in terms of investment choice and, if you are taking an income, that the amount being withdrawn is sustainable.

The investment risks of drawdown in detail

Volatility drag

This is industry jargon for the simple idea that if a portfolio falls in value, it needs to work harder to get back to its initial value. For instance, if a £100,000 portfolio falls 10% in one year and rises 10% in the next, it will not return to £100,000, it will be £99,000.

Most long term investors tend to get used to volatility, and accept that in the long run the destination is more important that the journey. However, for those in drawdown, the journey is just as important as the destination. High volatility increases the chances that you will be taking money out when the portfolio is falling, locking in losses and reducing the chance of there being enough money invested to meet future needs.

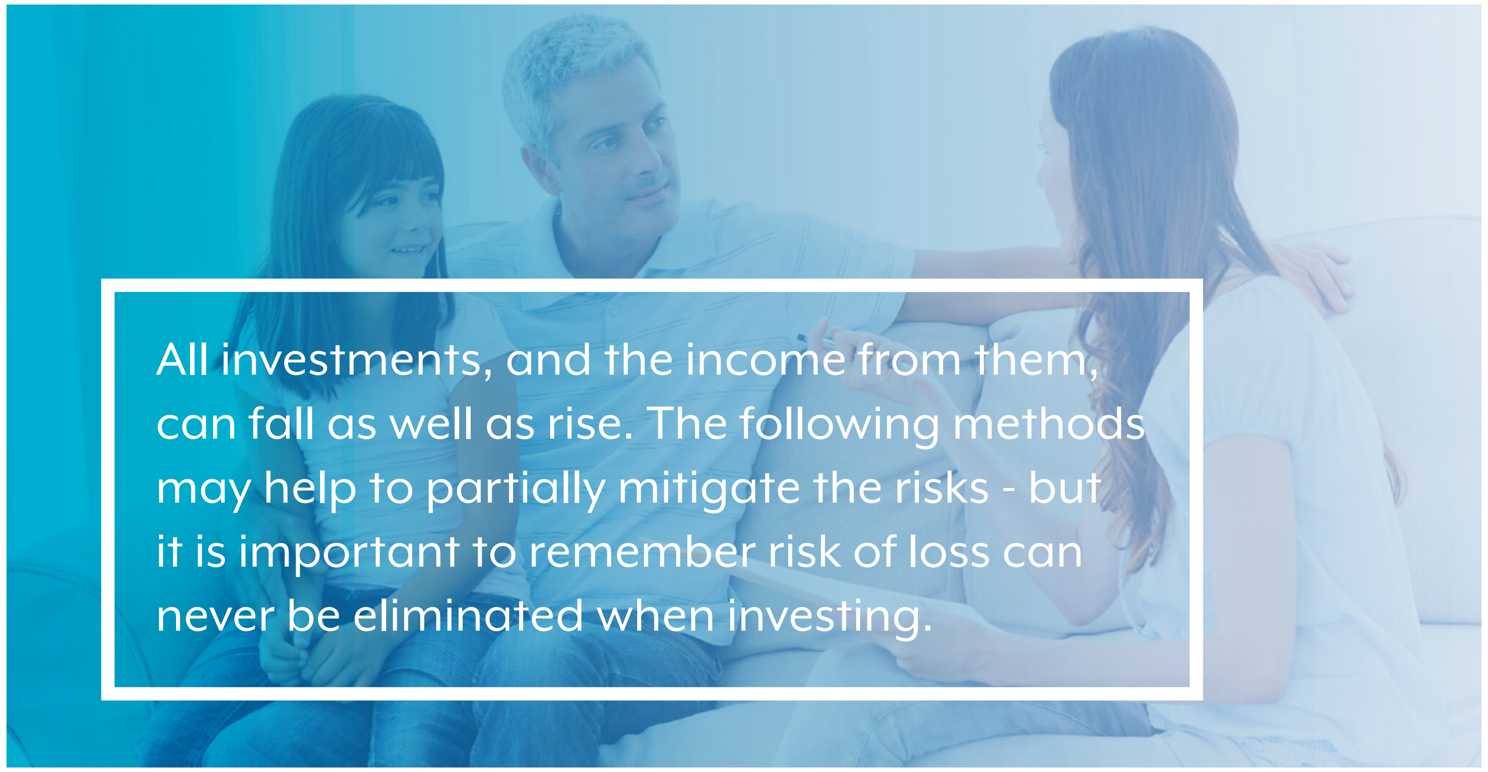
Sequencing risk

When you are drawing a flexible income from your pension pot it is not just the long-term average return that matters but the sequence of returns. Negative returns in the early years can have a particularly detrimental impact on the value of a drawdown fund, even if they are then followed by good returns. Essentially, they have a disproportionate effect on the eventual outcome.

"Pound-cost ravaging"

So-called pound-cost ravaging (a play on "pound-cost averaging", a positive effect of investing regularly) is a term used to describe how the effects of volatility drag and sequencing risk are amplified by regular withdrawals, potentially derailing retirement plans. Losses created by selling assets to meet income requirements can never be recovered, and taking too much out of a fund just after market falls can damage your wealth and run the risk of exhausting the fund too early.

How to help combat the investment risks



Keep volatility low

Diversification, populating a portfolio with various asset classes that move independently of one another rather than in unison, can help smooth out returns but without compromising overall performance too much. This, combined with periodic rebalancing to keep to the intended asset mix, can help protect against the dangerous effects of pound cost ravaging.

Take a sustainable level of income

Some have argued that if you withdraw 4% a year from your fund you will be relatively safe, given the normal level of income available and the likely growth rate of dividends. However, assumptions based on long-term averages can be dangerous. It may be that 4% is too high an income to draw while keeping enough of your capital, especially now we have enjoyed a long bull market recently which has lowered dividend yields. Bond yields are also currently very low by historical standards, limiting income on lower risk portfolios.

One approach is identifying the likely income flows from the investment portfolio and using this as the base case for the amount it is safe to drawdown without eating into any capital. In other words, simply taking the natural income rather than committing to a fixed level of withdrawals.

Adapt to changing conditions

Increasing drawdown after a period of good growth in the capital value of the portfolio may be a safer way of avoiding sequencing risk and volatility drag and allow drawdown of some of the capital gains. Similarly, it might be prudent to forego drawing as much income following market falls.

Keep a cash reserve

Keeping a cash reserve in your drawdown pot can help when markets fall or don't deliver the anticipated level of income. The more cash you hold the less you lose when markets do fall, but the rest of the time it can be a hindrance to performance.

If in doubt seek advice or guidance

Drawdown offers great flexibility and the chance to increase income but it isn't right for everyone.

Investments can fall and you might get back less than you invest. If you do not have sufficient secure resources to cover your essential expenses, or you cannot accept that your income could fall, or even run out, then drawdown is unlikely to be for you and an annuity should be considered.

What you do with your pension is an important decision. We recommend you understand your options and ensure your chosen route is suitable for your circumstances. Seek regulated financial advice or appropriate guidance if you are at all unsure. The government's Pension Wise service (www.pensionwise.gov.uk) provides free impartial guidance on your retirement options, or get in touch with a Charles Stanley Financial Planning consultant. Please visit www.charles-stanley.co.uk/products-and-services/financial-planning-services for information on their services.

The value of investments, and the income derived from them, can fall as well as rise. Investors may get back less than invested. This guide does not constitute personal advice based on your circumstances. If you are unsure of the suitability of any investment please seek professional advice. The information in this article/presentation is based on our understanding of UK Legislation, Taxation and HMRC guidance, all of which are subject to change. The tax treatment of pensions depends on individual circumstances and is subject to change in future.

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