Alpha Beta
PARTNERS

Thought leaders in decumulation

Article 3.

"Securing income in retirement"

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Alpha Beta Partners

Thought leaders in decumulation

Securing income in retirement

"I would like to suggest a strategy which I am calling 'security plus flexibility'. The starting point involves securing the level of income the client needs in later life. Once secured, then the client has complete flexibility with their other assets, knowing that, even if they spend all of these, they will have enough money to live on later down the line".

Rory Percival, former FCA Regulator.

For many this strategy will make great sense, bring undoubted peace of mind and will likely fit with upcoming guidance from the FCA after its current income in drawdown review (ASR 2) is completed in 2021.

A state pension and income from any defined benefits scheme(s) may not be sufficient to meet a client's secure income need.

There is always the option of buying an annuity, though analysis shows that it is more efficient to postpone the purchase, if possible, until age and/or health issues enhance annuity income to the point that it meets or exceeds the level of the secure drawdown income.

What if a pension pot was thought of as comprising an allocation to four parts?

1. A cash holding, for peace of mind.
2. An amount with which to purchase an annuity in later life to maintain the flow of secure income for life, no matter how long that may be.
3. An amount to be drawn down at a sustainable rate to meet secure income needs.
4. The balance to be withdrawn to meet flexible spending.

Let us consider a retiree with a £500,000 pension pot and a need for £11,000 of secure income to supplement the new State Pension and so meet an essential income target of £20,110 per year and for the rest of life, all adjusted for inflation.

Part 1 Cash

We assume an allocation to cash equivalent of say 2 years of secure income spending or £22,000.

Part 2 The purchase of a delayed annuity

Based on current annuity rates, £82,500 in today's money is needed to buy an annuity at age 85, which would continue to provide an inflation adjusted £11,000 for the rest of life. All the income calculations presented below are adjusted by an anticipated 2% inflation rate to preserve purchasing power over the planning horizon.

Part 3 Sustainable drawdown income

The selection of an investment strategy that provides the greatest level of income sustainability is key. Once selected, we can then calculate that amount of the pension pot to allocate to the strategy to meet the secure income need.

Table 1 details the risk of having to take less than £11,000 in future years to maintain the retirement plan, associated with various popular investment options.

Table 1: Risk of having to reduce income in future years
when withdrawing £11,000 a year from various investment options

Basis £370,000 pension pot and a 25-year retirement horizon
Inflation 2%, Portfolio charges 0.4%, Advice fee 0.50%, Platform fee 0.3%, p.a.
Leaving an £82,500 final balance (adjusted for inflation) to buy an annuity in 25 years

Strategy	Shortfall Risk
AB Lifetime	3.3%
IA 0-35% shares	9.5%
20% Equity, 80% Bond	10.3%
Risk 5	18.2%
Risk 3	18.4%
Risk 4	21.1%
IA 40-85% shares	25.0%
IA 20-60% shares	26.1%
Smoothed Equity	27.0%
IA Flexible	28.5%
60% Equity allocation	45.7%
RPI+2%	100.0%

The AB Lifetime portfolio includes a methodology to mitigate sequence risk, or the risk of experiencing a poor series of investment returns particularly at or when just starting retirement and a pension pot is at its greatest.

£370,000 invested in the AB Lifetime portfolio with £82,500 left over to buy a delayed annuity in 25 years provides the secure £11,000 p.a. target with a very low risk of this having to be reduced in future years and indeed a high probability this can be increased.

Part 4 Flexible income drawdown

After an allocation to cash, sustainable drawdown and an allowance for advice fees, there is £100,500 which can be drawn down at a more flexible rate.

Table 2 provides an annual income ranking of popular investment options, when drawing down at a 50% shortfall risk. Half the time the retiree will be able to withdraw more and if a reduction is required it may not be by very much.

Table 2: Annual income from the £100,500 part of the pension pot, withdrawn with a 50% risk of having to reduce income in future years

Inflation 2%, Portfolio charges 0.4%, Advice fees 0.50%, Platform fee 0.3%

25-year planning horizon

	Annual Income
Risk 5	£ 5,914
AB Lifetime	£ 5,717
Risk 4	£ 5,613
IA Flexible	£ 5,573
Risk 3	£ 5,537
IA 40-85% shares	£ 5,502
IA 0-35% shares	£ 5,352
20% Equity allocation	£ 5,066
IA 20-60% shares	£ 5,173
Smoothed 3	£ 5,020
60% Equity allocation	£ 4,593
RPI+2%	£ 3,979

A Risk 5 portfolio provides the greatest amount of annual income and so may receive the final allocation, but this can be adjusted to meet a client's Attitude to Risk profile.

Pulling it all together

The forthcoming AB Pension Pathway app provides all the functionality necessary to deliver Rory Percival's '*security plus flexibility*' drawdown strategy.

Table 3: Allocation of a £500,000 pension pot.
(Inflation adjusted at 2%)
25-year planning horizon

	Allocation	Annual Income	Shortfall risk
Starting pension pot	£500,000		
2 years of secure income held in cash	£22,000	£0	0%
Annuity purchased from age 85	£82,500	£11,000	0%
Allocation to AB Lifetime before age 85	£370,000	£11,000	3.3%
Allocation to Risk 5 portfolio	£100,500	£9,774	50%
Provision for advice fees @ 1.5%	£7,500		
Total	£500,000	£20,774	

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