Decumulation Demystified

Win, lose or withdraw: Factors that influence the optimal decumulation strategy

We outline some of the key factors that then influence how quickly an individual spends their retirement funds, including 'retirement outcome risk'. Whilst a one-size-fits-all approach is not possible, we suggest steps towards a framework that incorporates many of the factors involved.

Andrzej Pioch is a fund manager in the Multi-Asset Funds team with his responsibilities including portfolio management and ongoing development of a multi-factor equity strategy.

Graham Moles is Head of Portfolio Solutions. His principal responsibilities are for the LGIM Asset Liability Modelling capabilities and Solutions fund management activities. This is predominantly focused on DB and DC pension scheme clients.

The hit 1990s TV game show Win, Lose or Draw was based on the board game Pictionary. Teams took turns guessing phrases, titles or other things based on one team member's drawings. Critically, each contestant had to make a decision about how fast to draw – too quickly and their teammates couldn't decipher their pictures, yet too slowly was equally wasteful as the clock ticked down.

Whilst the game show was a bit of harmless fun, we can 'draw' parallels between it and an altogether more serious matter – how fast retirees can sustainably draw down their retirement funds. Withdraw too quickly and you risk running out of money. Withdraw too slowly and you risk suffering a sub-standard retirement and passing away with unused assets. (That said, currently many retirees are 'prudent with a purpose' with the aim of leaving their children a large inheritance).

In our first Decumulation Demystified article, we discussed some of the issues facing the once-popular 4% drawdown rule and considered whether it has now outlived its usefulness (answer: yes). Originally developed by US financial planner Bill Bengen in the 90s, the 4% rule was a mainstay for many advisers, guiding that retirees could safely withdraw 4% of their initial fund annually, adjusting for inflation, without running out of money over a 30-year time frame. But, as demonstrated by the shifting popularity of TV game shows, tastes change over the decades. Market conditions have changed (in particular interest rates have fallen) and Bengen's 4% rule has lost some of its appeal, with many advisors favouring a more flexible approach to decumulation, founded on considerations that are unique to each investor.

We see three primary factors which affect the pace of drawdown most worthy of consideration, each of which is broadly in line with FCA guidance on suitability, namely that "recommendations to retail investors consider all relevant circumstances, including investment objectives, current and future income requirements and the investor's attitude to risk."[1]

1 https://www.handbook.fca.org.uk/handbook/COBS/9/3.html

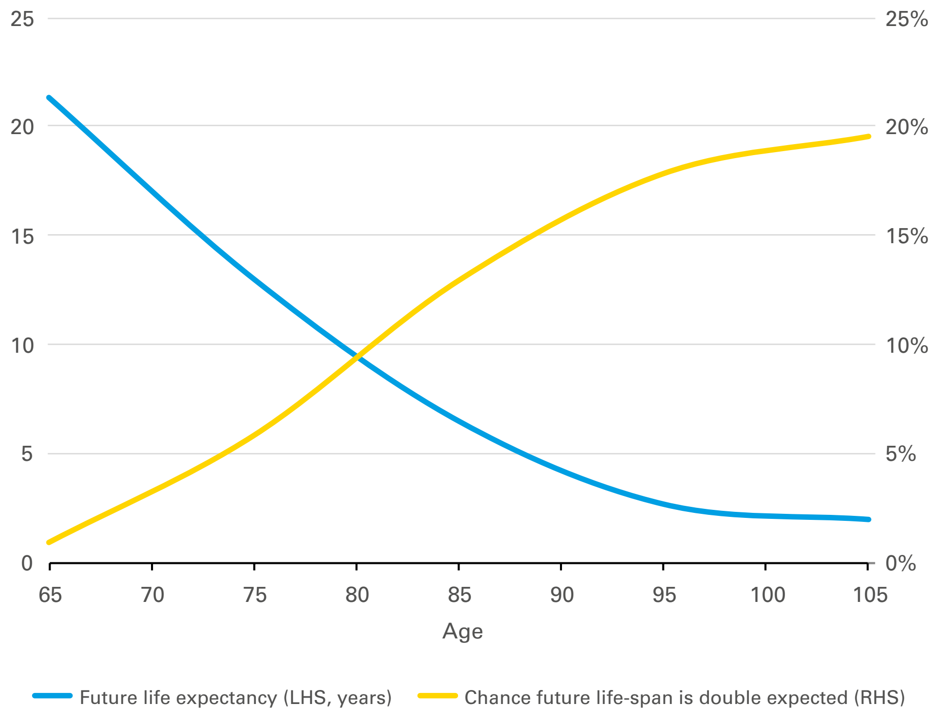
In terms of the retirement fund withdrawal strategy, we need to consider:

Asset drivers - The size of funds held and their risk and return characteristics

Spending drivers - Demands on capital such as one-off lump sums for once-in-a-lifetime cruises or financial support for children or grandchildren trying to get on the housing ladder

Attitude to risk - How much risk we're prepared to take, both in terms of short-term volatility and the longer-term risk of the fund running dry

Figure 1. Future life expectancy and its uncertainty



Source: LGIM calculations

ASSET DRIVERS

Size of fund

This is a relatively easy one to understand — a fund that's twice as big as another can support double the withdrawals (before tax) with all else being equal.

Expected return

We can break this down into interest rates and returns in excess of interest rates. Interest rates are a key driver of the expected return of any fund; return on growth assets represents a premium over that available from 'risk free' government bonds. In general, the higher interest rates are, the higher the level of income a given size of fund can support, rather like annuity rates being higher when interest rates are too.

The expected return from the chosen investment strategy over and above interest rates depends on both the asset allocation and views on those asset classes (there is no right answer). All else equal, a higher expected rate of return affords a higher income.

Uncertain returns

However, we need to tread carefully, as higher returns generally come with higher risk. For matters as important as a pension, investors generally may not wish to base decisions purely on expected outcomes. The degree of investment return uncertainty depends on the asset allocation strategy. Generally, strategies targeting higher returns will be more volatile; for example, investors allocating more to emerging market equities should typically expect a bumpier ride than those favouring government bonds. All else equal (that is not allowing for the fact that more volatile assets tend to earn higher returns), greater volatility leads to an increased risk of running out of money.

SPENDING DRIVERS

Age

As retirees age, it becomes safer to withdraw a greater percentage of the remaining fund each year. Perhaps counter-intuitively, however, the influence of longevity risk on withdrawal decisions increases with age. This is probably best demonstrated by looking at the numbers. Figure 1 shows the chance of a man living for twice as long as you might expect,[2] assuming he survives to a given age.

For pure income drawdown investors, the only way to guard against this longevity risk is to 'self-insure' by withdrawing income at a 'prudent' or 'sustainable' rate. However, the problem is that in old age the degree of prudence required can become crippling, pushing the sustainable rate below that available from an annuity.

2 Based on male Office for National Statistics mortality rates, for illustration

This may make annuitisation appear more attractive with age. Moreover, as we age, we may also favour a greater degree of simplicity.

Health

Being in poor health could be akin to retirees effectively being older (in terms of the mortality rates they are exposed to) than their years. Plainly the diverse range of retirees' health circumstances underlines how different pension investors can have widely differing needs.

Spending patterns

These will vary hugely across individuals. However, most people are exposed to similar drivers. Some of these drivers act to increase spending over time, such as the need for inflation protection, and long-term care costs. In contrast, others tend to decrease spending. For example, pensioners tend to become less active over time. Some advisers like to think of a U-shaped spending pattern in retirement – outgoings decreasing at first (adjusted for inflation) but then tending to increase in advanced age. However, some researchers have expressed doubts over this pattern.

Inheritance matters

Inheritance goals are usually only a secondary objective, other than for those with the luxury of very substantial pension funds. However, our discussions with independent financial advisers and wealth managers dealing with high net worth individuals suggest that inheritance objectives are becoming increasingly relevant to some investors.

Tax

In the case of defined contribution investors, for example, withdrawals are taxed as income (beyond the tax free lump sum), hence encouraging more steady withdrawal strategies from large funds. For ISAs, however, there are no tax implications, thereby affording greater flexibility, meaning that ISAs are typically the first port of call when investors require cashflow.

Other sources of income

Many retirees will qualify for a state pension. In practice, access to such a backstop income influences other risk preferences – investors are often more willing to take greater risks with their pension funds if they have another source of regular income to fall back on, particularly if it is guaranteed (such as a defined benefit pension).

ATTITUDE TO RISK

In the absence of annuitisation, investors bear both investment risk (given that, in general the return that will be earned on assets is not known in advance) and longevity risk (given that very few people know their date of death in advance). This effectively rules out the 'perfect' scenario for many retirees, namely that they get to enjoy every last penny just before their time comes. Retirees may want to adapt their investment strategy and their withdrawal rates over time to handle these risks. However, exactly how they adapt will depend on their attitude to risk. A retiree who's more willing to run the risk of exhausting their pension fund might be prepared to take money out more quickly. On the other extreme, those who want to play things ultra-safe would likely take the annuitisation route, and accept the lower income.

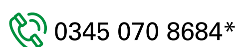
WORKING TOWARDS A NEW FRAMEWORK

Although it's easy to flag up the shortcomings of the Bengen 4% rule, devising a single comprehensive framework that factors in the many and varied considerations across the full spectrum of retirees is quite another matter. We can, nevertheless, use investment models to get a feel for the influence of some of the most important inputs.

By assessing both investment and longevity risk we can define a 'sustainable' withdrawal rate for a chosen investment strategy – this is the maximum sum that an investor could withdraw each year, subject to retirement outcome risk not creeping up beyond a certain tolerance for each retiree.

In the next edition of our series we'll use such models to find better rules-of-thumb than the 4% rule; investors could reference these to help assess how quickly to draw down on their pension funds.

CONTACT US



Important Notice

This is not a consumer advertisement. It is intended for professional financial advisers and should not be relied upon by private investors or any other persons.

The value of investments and any income from them may fall as well as rise and investors may get back less than they invest.

Legal & General (Unit Trust Managers) Limited. Authorised and regulated by the Financial Conduct Authority.

* Call charges will vary. As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time)) and will be provided to you upon request. Q0057453, 07/18. H0164471.