Heavy weighs the crown

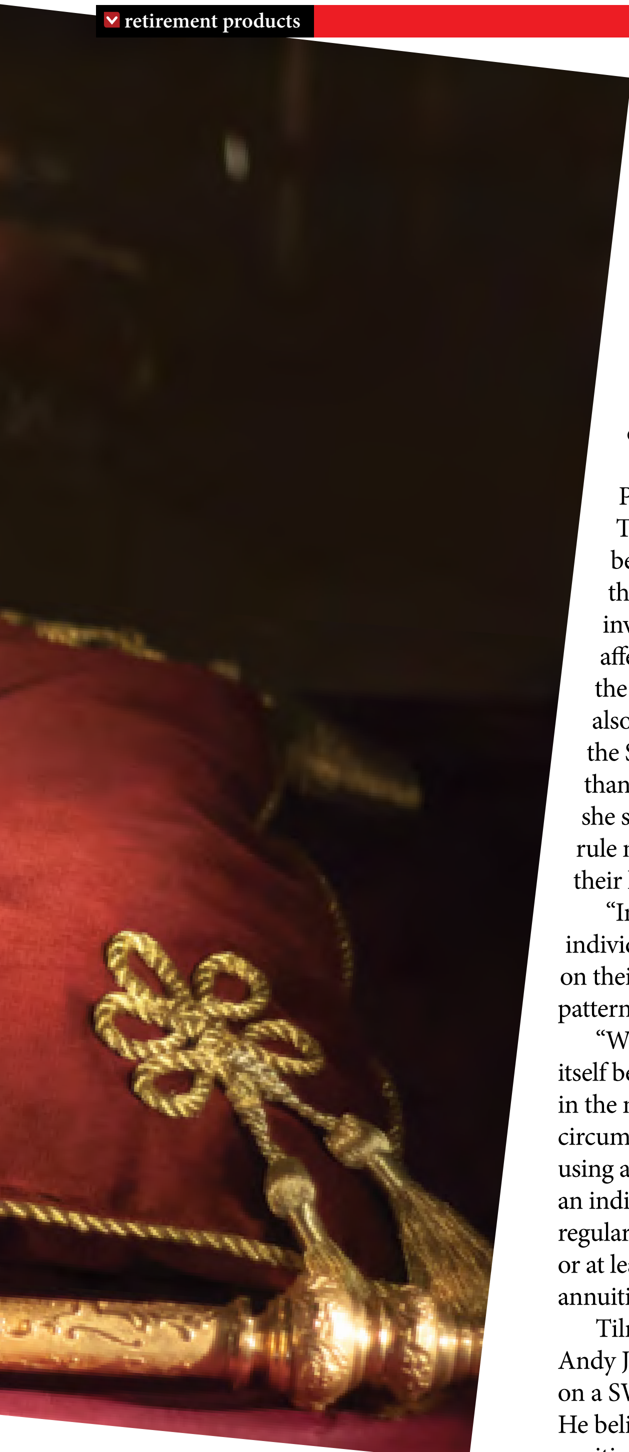
Drawdown has established a firm current rule over annuities in the at-retirement market. But with an advice gap and a dangerous sequence of returns risk, is the product wearing its crown comfortably?

When it comes to retirement products, drawdown is now king.

Figures from the Association of British Insurers (ABI) show that drawdown sales consistently beat those of annuities throughout 2016, while in September the Financial Conduct Authority (FCA) revealed that drawdown arrangements rose by 4 per cent during October 2016 to March 2017. Annuity sales fell by 16 per cent during the same time.

The period saw 33,561 annuity sales in comparison to 83,687 new drawdown

Summary
- Drawdown demand now outstrips annuities by almost three to one.
- There is no real consensus on a safe withdrawal rate anymore as plans are very much dependent on individual circumstances.
- Despite its popularity, significant risks such as sequence of returns need tackling in many drawdown plans.
- The amount of people using the product without advice is a concern and could lead to retirees running out of money sooner than expected.



plans; a demand for the latter that almost outstripped the former by three to one.

But questions remain over drawdown's suitability for many retirees, and its crown looks, at present at least, a heavy burden.

One of the most pertinent issues facing drawdown is the current withdrawal rate. Just how do you identify a safe rate in order to create a sustainable income stream?

Historically, the so-called Safe Withdrawal Rate (SWR) of 4 per cent – created by US financial adviser William Bengen using a 50/50 split of bonds and equities – has been a standard starting point for many advisers when approaching drawdown.

However, as Intelligent Pensions technical director Fiona Tait explains, this figure may now be too high. Firstly, the data behind the SWR is based on US historical investment conditions that were not affected by hyper-inflation during the war years. The effect of charges is also not included, which means that the SWR is likely to be much lower than 4 per cent in practice. As a result, she says, consumers who follow this rule may find themselves struggling in their later years.

"In addition, the SWR will be individual to each client, depending on their investment strategy, spending patterns and potential lifespan," says Tait.

"Whatever SWR is used, it will in itself become out of date due to changes in the markets and the client's own circumstances. This is why I advocate using a more tailored approach, using an individual cashflow model that is regularly updated throughout retirement or at least up to the point of full annuitisation."

Tilney head of retirement planning Andy James says that focusing too much on a SWR can sometimes be a mistake. He believes that having a fall-back position, where retirees can reduce or cease withdrawals for a time, can allow them to take more risk and, in the long term, get higher withdrawals.

"Over the long term, higher equity content in a portfolio will give better returns and therefore allow higher withdrawals," he says.

"The problem is that higher equity levels are likely to cause more volatility and this can be an issue, particularly in the early years of drawdown."

Sequence of returns risk

The threat that volatility poses to a drawdown income has commonly been referred to as sequence of returns, or simply, sequence risk.

Prudential retirement expert Vince Smith-Hughes stressed that the danger is an acute one.

"Even if you average 4 per cent, for example, then if you took a big hit at the front, then what you're doing by taking income is effectively crystallising that loss. So that's making it doubly hard to have a successful drawdown strategy later on. Even if the fund manages to recover."

Prudential has crunched some figures based on a scenario where a fund's value falls by 5, 20 and 15 per cent; and then grows by 5, 20 and 25 per cent, in the six years following retirement. Under such circumstances, the insurer has calculated that a £100,000 pot can be reduced to £64,017, based on an annual £5,000 withdrawal figure.

However, this falls to only £77,007 if the same amount of money is withdrawn but the funds grows in the early years of retirement. The difference equates to over two years of income payments.

Smith-Hughes outlines a number of strategies that can be used to mitigate the impact of pound-cost ravaging. These include using cash or deposit-based funds for income, as well as using a range of different assets and funds, the best performing of which a retiree would then take income from each year.

He also advocates taking the natural income from a portfolio of income producing assets. This strategy, also referred to as natural yield, was recently described by Hargreaves Lansdown as an attractive option for drawdown users who have large enough savings.

The provider has estimated that the return from an average UK equity portfolio could generate £4,180 from a £100,000 pension pot. In contrast, analysis of returns from the FTSE All Share showed that if someone had withdrawn 5 per cent every year from a £100,000 pension pot from 1 January

2000, then they would have less than half of their drawdown fund left.

Natural yield could also result in further gains for retirees who have the stomach for a bit more risk, says Aon Employee Benefits DC proposition leader Debbie Falvey.

"The word withdrawal seems to indicate erosion of capital, whereas people may wish to consider taking the natural yield on the underlying investment as their withdrawal, in which case 3.5-4 per cent natural yield is not an outdated concept. Depending on people's attitude and capacity for risk, this natural yield figure spread could be widened."

Whichever way retirees choose to handle their drawdown arrangements, Smith-Hughes argues that they will need regular reviews with an adviser to stay on top of their finances.

Advice vacuum

Despite commentators' unanimous agreement on the necessity of advice, there are many individuals who still go into drawdown unadvised, says James, leaving them with little or no understanding of options such as natural yield.

ARC Pensions Law partner Anna Copestake shares James' concern.

"Are people – even those who, on the face of it, are financially savvy – really equipped to manage their drawdown pot in order to secure long-term stability?" she asks.

"Are we confident that those members appreciate the need for, and are able to conduct, regular reviews of asset allocations, returns, costs and charges and relevant wider economic circumstances and then the projected impact on their retirement plans? Put bluntly, I'll wager some of these members haven't even heard of the safe withdrawal rate, never mind thought about whether it's the right way to go.

"There is an advice gap that may mean people run out of money years before they expect to."

Plugging this advice gap, however,

Annuities: A premature obituary

Drawdown may have trumped it for now, but the humble annuity still has a vital role to play in the at retirement market.

Annuity rates increased by 4.3 per cent in October, according to Moneyfacts, returning them to their July 2016 level. This may still be way below its pre-pension freedoms heyday, but it represents a mini revival following a tough third quarter in 2017, which saw rates fall by 6.4 per cent.

And with most economists forecasting further interest rate rises, rates could hit a steady upward trajectory, making annuities look a lot better value for money for savers.

This is good news, says ARC Pensions Law partner Anna Copestake.

"The pension freedoms have got people thinking more widely about what their finances in retirement might look like, but for some, the traditional annuity, although not the trendy product now, may still be the best bet," she says.

Annuities will also still play a vital role in later stages of retirement, says Prudential retirement expert Vince Smith-Hughes.

"It would be easy for me to say that annuities will wither on the vine," he says *[Prudential pulled out of the annuity market earlier this year]*.

"But I don't think they will.

"If you start to see interest rates go up, I think it is very possible that many people will switch into annuities later on as they're guaranteed to tap into a regular stream of income."

Intelligent Pensions technical director Fiona Tait does not foresee annuities ever returning to a position where they are the first option at retirement, but she believes that they still have an important role to play in a variety of ways.

"Rather than providing the whole solution at outset, annuities may initially be used as a cost-effective underpin to a drawdown plan, covering basic expenses and allowing greater equity exposure in order to maximise potential returns," she says.

"Hybrid products are also available, which achieve this within a single product wrapper. However they tend to carry higher charges than a standalone annuity alongside drawdown."

could be a slow process. Despite pension freedoms having been in place for over two years now, the FCA only underlined non-advised drawdown as a key concern in the interim *Retirement Outcomes Review* in July this year. And although the Work and Pensions Committee has prioritised the issue, that is no guarantee of any positive action being taken by the government.

The real cost of charges

James says that those who forego advice are in danger of using drawdown under the illusion that they are saving money, whereas in reality they will be losing more of it in the long term.

"You need to consider what you are getting for your money," he says.

"Fees and charges will eat into investments, and are therefore a drag on returns and what you can safely withdraw."

He argues that where someone has no real understanding of what they are getting for their money, then paying for advice is likely to be an investment in itself.

Part of the problem of going it alone, is that the many and various drawdown charge models can make comparisons tricky, says Falvey.

As she points out, it is not uncommon to see three sets of fees applied to a drawdown account: "Fees can span across various services – product charge, investment charge, advisory charge – all of which need to be considered and evaluated before a firm decision can be made on the right course of action. And often it is the headline platform fee that is promoted by providers."

Given drawdown's popularity, Copestake predicts further innovation, which will lead to further complexity in product design and fees.

"We have to be careful what we wish for," she warns.

Drawdown's crown will continue to weigh heavy for some time yet.

Written by Marek Handzel, a freelance journalist

Away from insurance

Drawdown may be booming at present, but question marks exist over how much money at-retirement products will attract in the long term.

The Pensions and Lifetime Savings Association (PLSA) published research in April highlighting that nearly half (47 per cent) of 35-54 year olds (Generation X) in the UK – some 8.3 million people – are planning to use property to help finance their retirement.

Coupled with low auto-enrolment DC contribution rates, this change in attitude could lead to a significant drop in income for drawdown providers.

The findings prompted the PLSA's director of external affairs, Graham Vidler, to call on ministers to provide support to people in understanding how their pension, property and any other savings might top up their state pension to give them a decent income in retirement.

For Generation Y, the Lifetime ISA (LISA), which was partly designed to help 18 to 39 year-olds put down a deposit for their first home, could make property as a retirement tool an even greater pull.

However, many advisers are warning of the dangers of the LISA. Accounting, tax and advisory practice Blick Rothenberg has said that the exit penalties attached to LISAs after April 2018 could lead some savers getting back less than the savings they initially put into the vehicle.

Speaking in April on the eve of LISA's launch, Blick Rothernberg director Suzanne Briggs gave the following example.

"If you put in £4,000 and receive the 25 per cent government bonus, your LISA is worth £5,000. You need the funds for a financial emergency so you withdraw the cash, but after the 25 per cent exit penalty is applied, you only receive £3,750 back. Even if the value of the fund grows steadily at the rate of say 4 per cent, the impact of the exit penalty could mean that you would get back less than the growth in value of the fund.

"Although the LISA is designed to work alongside pensions, those seeking to save for retirement may be better off maximising their pension contributions in the first instance."