

# Is de-risking a good idea?

## ✓ John Southall questions the conventional wisdom to implement a de-risking investment strategy during retirement

### Should investors follow conventional wisdom?

UK pensioners can now withdraw large cash sums at times of their choosing, and in a recent announcement from HMRC, over £10.8 billion has already been cashed in by savers accessing their pension pots. In addition to annuity purchases, large numbers are opting to retain exposure to the investment markets during their retirement through 'income drawdown'.

Fears that self-managing income drawdown investors might use the proceeds to purchase sports cars or other extravagances have not materialised. In fact, many savers have chosen to withdraw carefully while reducing their exposure to 'risk' or 'growth' assets as they go through retirement.

However, these individuals still face several difficult decisions. One key question is whether they should de-risk or re-risk with age: should they decrease or increase (or maintain) the percentage of their portfolio in growth assets such as equities?

Conventional wisdom says they should de-risk. One rule of thumb suggests that investors should hold a percentage in equity equal to 100 minus their age, meaning a typical 65 year-old should hold 35 per cent in growth assets whereas an 85 year-old would hold 15 per cent. The rest would consist of relatively safe assets such as cash and high-quality bonds. The simplicity of this old guideline is appealing, but does it really stack up?

### A shifting balance of risks

Retirees are exposed to two key types of risk: investment risk (the risk that returns are lower than expected) and longevity

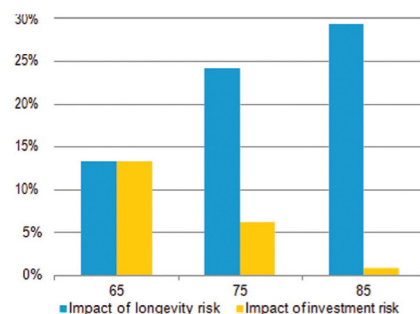
risk (the risk that they outlive their available funds). Both contribute to the overall risk of running out of money.

Our research shows that investment risk matters less as retirees age whereas longevity risk (which drawdown investors cannot 'pool') matters more with age. Eventually longevity risk, rather than investment risk, dominates the overall risk of running out of money, as shown in Figure 1.

There are two potential consequences: First, the benefits of taking investment risk in old age are small. Whilst 'reckless prudence' (reducing short-term risk at the expense of long term returns) can lead to poor outcomes for a highly loss-averse 65 year old, the same is not true for a 95 year old. This would suggest a de-risking strategy with age.

Second, the increasing importance of longevity risk means that annuitisation – where longevity risk (and investment risk) is passed to an insurer – may become more appealing with age. Planning ahead for this may involve de-risking into similar low-risk instruments to those held by insurance companies

**Figure 1: How the importance of investment and longevity risk change with age**



(government bonds and high-grade corporate bonds) so that assets move in line with changes in annuity prices close to the time of purchase.

### Sequence risk

Sequence risk is the risk that the same returns of different asset classes occurring in a different order leads to a different overall outcome. Post-retirement, consideration of sequence risk discourages overly aggressive de-risking since this can lead to losses that cannot be recovered from when markets recover, due to withdrawals in the meantime.

### Other factors

There are a range of other factors to consider including other assets held (e.g. properties), the aim of their savings (to support retirement or as an inheritance vehicle), risk appetite, health and uncertainty over the timing of an eventual annuity purchase if at all. The desire for simplicity is also likely to be a key factor, particularly for older pensioners. However, monitoring investment performance and making complicated withdrawal decisions could become more challenging with age; this is another reason annuities may gradually become more appealing.

### Managing the journey

In theory, if an investor never intends to buy an annuity and is not particularly concerned about short-term risk, there is little reason to de-risk. In reality, the precise journey taken depends on a variety of factors and an evolving set of individual circumstances. Investors should choose a journey appropriate to their needs and how these are likely to evolve over time.



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