ROYAL LONDON

ROYAL LONDON POLICY PAPER 22

Don’t Chase Risky Income in Retirement

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You Don't Need to Chase Risky Income in Retirement

Could trying to live off the 'natural income' of your investments be a recipe for poverty and uncertainty in old age?

1. Introduction

In a world where millions of people reached retirement with a guaranteed final salary pension or routinely used their pension pot to buy an annuity, the issue of how to manage your investments through retirement was of interest only to the relatively wealthy. But in a world where millions of people are now being enrolled into Defined Contribution (DC) pensions and where those reaching retirement have much more freedom on what to do with their pension pot, people will need much more help and support in deciding how best to manage that pot, to give them a decent standard of living through retirement.

Against this backdrop, there will be a temptation to turn to traditional 'rules of thumb' for managing money in retirement. In the past, it was possible to invest your pension pot in a mixture of company shares, commercial property, bonds and cash and ring-fence your capital, living only off the 'natural income' from your savings: the dividends from your shares, the rent from property, 'coupons' from your bonds and interest on your cash savings.

In the past, such a strategy would have enabled individuals with a large pension pot to enjoy a decent standard of living through retirement, while generating enough capital growth to beat inflation and leave a lump sum behind for their successors.

But the world has now changed.

The purpose of this paper is twofold. First, to explain why attempting to generate high levels of natural income in your retirement pot could have seriously damaging consequences. This is because of a combination of longer retirements, lower interest rates and the risks that are involved in seeking high levels of natural income against that backdrop. Second, to set out an alternative approach, which is more appropriate in the current environment.

We argue that you don't need to chase after investments with a high natural income. It makes more sense to focus on getting the risk/return trade off right, spreading your investments across a range of asset classes. You can choose a strategy that reinvests natural income back into your pension pot where the money should continue to grow. Drawing a retirement income is then a matter of gradually cashing in units of capital, making use of on-going financial advice to help you keep your plans on track.

In a world of pension freedoms, it is vital that a much wider group of investors is made aware of the risks of traditional approaches to generating income from their investments, as well as the potential for more effective ways of managing their money.

2. How to generate a retirement income?

Traditionally, people have used their accumulated pension pot to buy a life time income, or annuity, from an insurance company, perhaps taking a tax free lump sum at the same time. An annuity is guaranteed to pay out throughout your life but your capital is locked up, there is no way of accessing lump sums later in retirement and typically it doesn't leave in anything to pass on to your estate when you die.

In addition, today's low level of interest rates means you are locking in a low level of retirement income forever. A pension pot of £100,000 could have bought you a level retirement income of £7,000-£8,000 a year before the financial crisis in 2008, as shown in Figure 1. Today you're looking at £4,000-£5,000 a year.

Figure 1. Average level annuity for a £100,000 pension pot at age 65

Source: Royal London.

Pension freedoms give savers significant flexibility in deciding how much to take out of their pension each year and how to invest the money remaining in the pot, with a view to making that income last as long as possible. Improvements in life expectancy mean that average retirement periods of a quarter of a century will increasingly be the norm, and you need to take this into account when making your plans.

Figure 2 shows how life expectancy in retirement is changing. At the start of the 1980s a man reaching age 65 needed to plan for an average retirement of just 14 years and his female counterpart of 18 years. Today, the figure would be 22 years for a man and 24 years for a woman. For those starting work today who might reach retirement in the mid-2060s, both men and women need to think about planning to make their retirement income last for another 30 years or more.

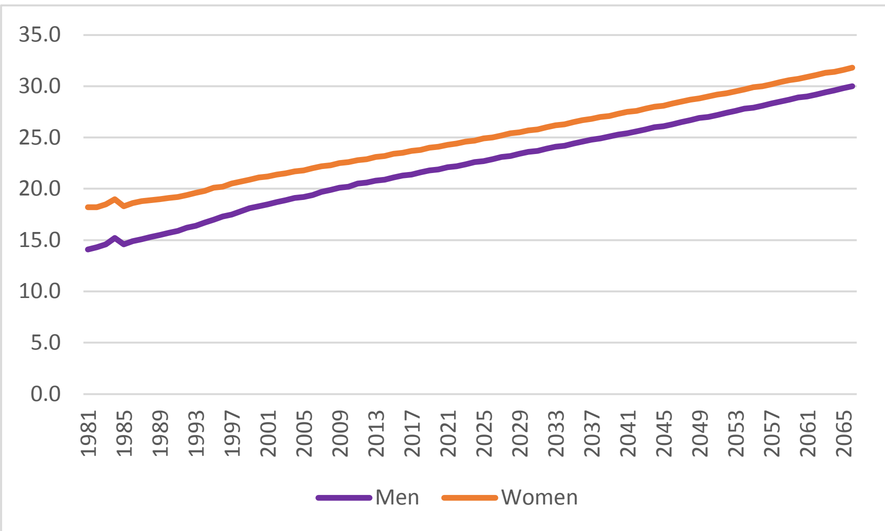


Figure 2. Cohort life expectancy at age 65 for a) men and b) women 1981-2066

Source: Office for National Statistics, 2016 based estimates
https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/lifeexpectancies/datasets/expectationoflifehighlifeexpectancyvariantengland

In this report, we focus on two ways to generate a retirement income from your pension pot.

- Living off natural income: invest the money in assets that pay an income to suit your requirements and leave your capital untouched.
- Using pensions drawdown: invest the money in a broad range of asset classes to control risk, reinvesting income, and draw down capital to live off.

We argue that you don't have to match the level of natural income from your investments with your chosen level of retirement income. In fact, doing so can be risky in today's low interest rates world, as we explain below.

3. Living off natural income: Not as easy as it used to be

Before the Great Financial Crisis a decade ago, it was possible to follow a 'natural income' strategy, living off dividends, rent and interest, whilst aiming to grow your capital and without the need to take excessive risk. In this section we ask what has changed to make this strategy problematic.

In the 10 years to 2008, you could have invested your pension pot in a wide range of mainstream asset classes generating a natural income of 4% or more, as Figure 3 shows (purple bars). Commercial property, corporate credit and gilts paid income of 5 to 6% on average while 'high yield' bonds paid 9%. Even cash in the bank earned interest of 5%, plus or minus. Company shares paid dividends of 2-3% a year. Rents and dividends would be expected to grow over time as the economy expanded.

In those days, a saver with a relatively large pension pot could spread their investments widely and live off the income in the expectation that they could leave their capital untouched to grow over time.

Figure 3. Levels of yield in different asset classes 1998-2008 and 2017

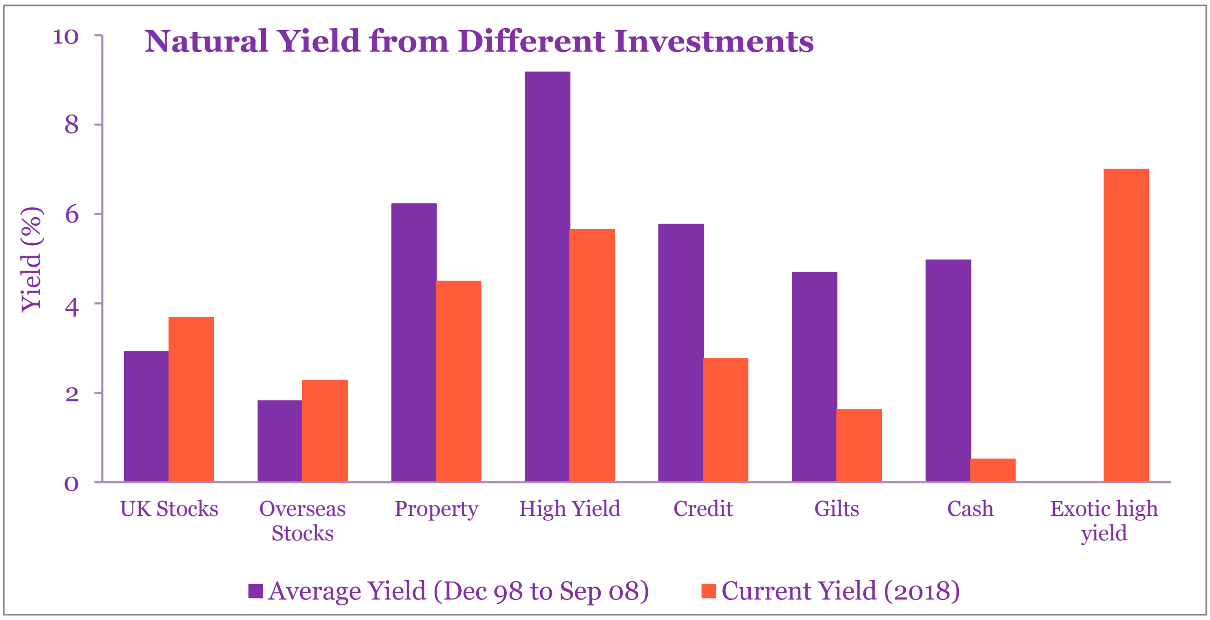
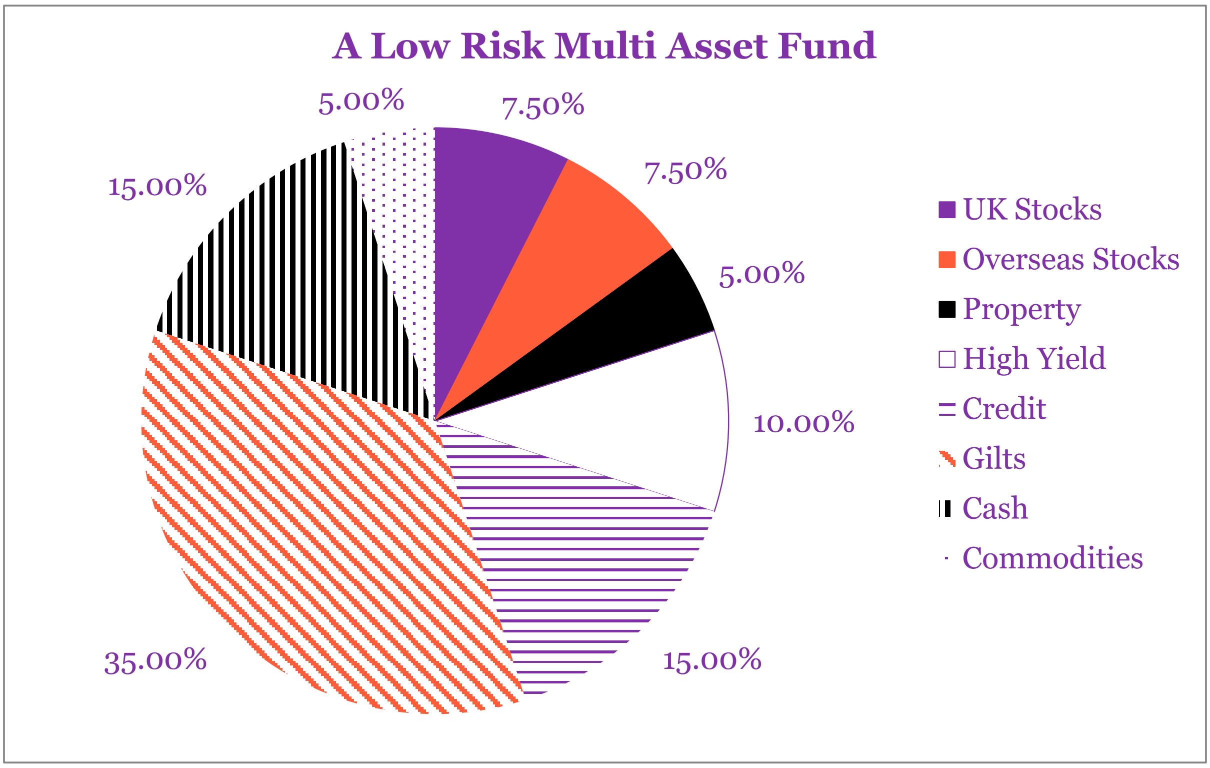


Figure 3 shows that the world looks very different in 2018 (orange bars). The Bank of England slashed base rates during the financial crisis and they remain very low today. As a result, the rate of interest on cash is close to zero and the natural income available from bonds of all kinds has dropped significantly.

Figure 4 shows a low risk multi asset fund that would have paid an income of about 5% a year before the financial crisis. Today the natural income from this fund would be a little over 2%.

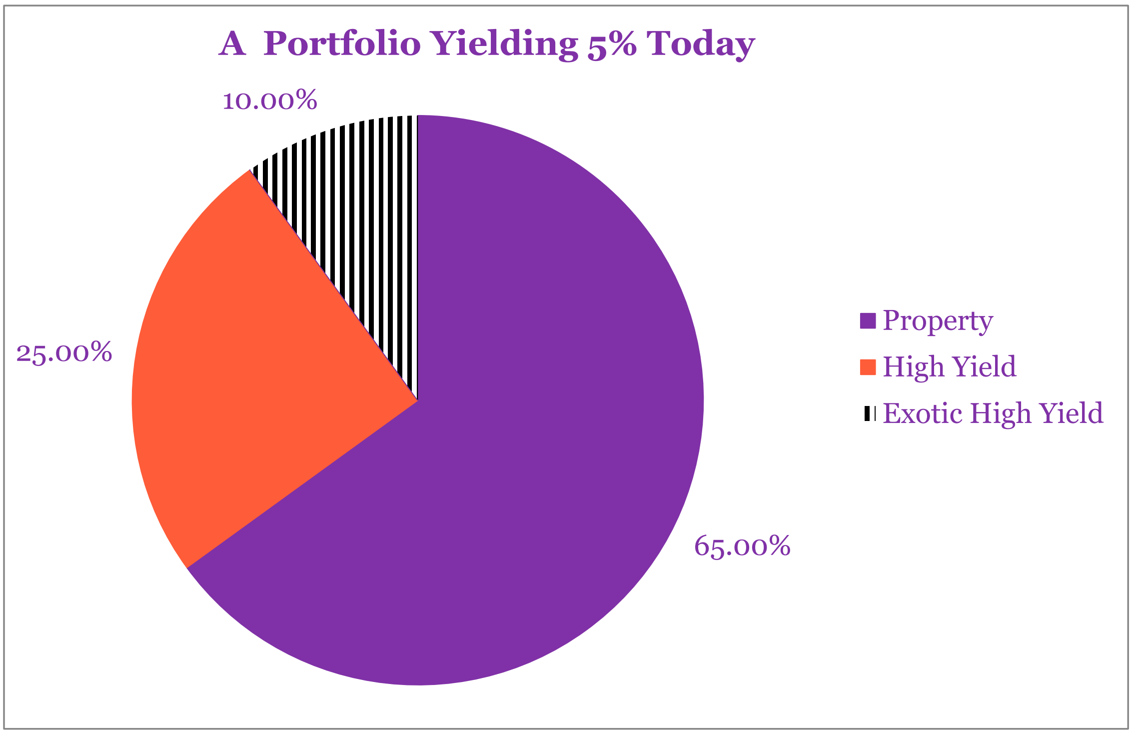
Figure 4. A Low Risk Multi Asset Fund, yielding close to 5% before 2008 but a little over 2% today



The drop in income levels since the financial crisis poses a challenge to savers aiming to live only off natural income. Either they are forced to live off less than half the income they would have enjoyed in the past, hardly an attractive option, or they must invest in an increasingly narrow range of riskier investments to maintain their living standards.

To secure a natural income of 5%, today would mean restricting yourself to high yield bonds, commercial property and the newer 'exotic' high yield investments like peer-to-peer lending or aircraft leasing. Figure 5 shows a mix that might just about do the job.

Figure 5. A mix of assets yielding 5% today



There are three very striking differences between the sort of investment mix that would have been viable in the past and the sort that would be required today by those seeking natural income of close to 5%, and all of these differences should be of concern to the investor:

a) Higher risk – the original multi asset portfolio has a high weighting in relatively low risk asset classes like credit, government bonds ('gilts') and cash; by contrast, the new portfolio has to invest in riskier investments to generate the same level of income today and would be likely to see much larger year-to-year swings in price;

b) Less diversified – the new portfolio invests in three asset classes rather than the eight in the original multi asset strategy; this can create additional risks, for example heading into a global recession when all three assets would probably come under downward pressure;

c) Less liquid – the new portfolio has a heavy weighting in commercial property and in high yield investments which can take longer, and cost more, to buy and sell than some of the other asset classes; this could be a problem for a saver who needs to access capital in stressed market conditions, especially as some of the newer exotic high yield asset classes have yet to be tested in a recession.

In simple terms, the shrinking categories of investment that will yield the income level savers have historically sought is leading investors to move to the high risk end of the investment spectrum.

Savers starting to draw a retirement income should care very much about risk, as large investment losses early in retirement can take years off your income sustainability and lead to lifelong damage to living standards. This is illustrated in Figure 6 which shows the value of a £100,000 retirement fund where a 4.5% income is taken each year under two scenarios – first, where there is a 15% fall in the value of the fund early in retirement and second where the 15% fall occurs late in retirement

Figure 6. Value of £100,000 pension pot over retirement with 4.5% annual withdrawals assuming the same simulated rate of return but with a) a 15% capital loss early in retirement and b) a 15% capital loss 20 years into retirement

As the chart shows, although in both cases there is a one-off shock of 15% and a regular withdrawal of 4.5%, the investor never really recovers from the early shock. In this case the pot is worth just over £42,000 twenty years into retirement, compared with about £60,000 if the shock comes later. The difference, caused only by timing, amounts to almost four years of income.

This difference shows the vital importance of an investment strategy which minimises the risk of an early capital shock. Any investment paying upwards of 7% income when interest rates at the bank are close to zero should trigger a pause for thought. You may be happy to live off this level of income but is your capital really safe? Or are you taking credit risks that could leave you nursing large losses out of the blue, especially as interest rates rise or when the world economy suffers a periodic setback?

4. Using pensions drawdown: focus on risk

Savers taking control of their investments in retirement don't need to chase after investments with a high natural income. For most people, it makes more sense to spread investments across a range of asset classes, focusing on getting the risk/return trade off right. You can choose a strategy that reinvests natural income back into your pension pot, where the money should continue to grow. Drawing a retirement income is then a matter of gradually cashing in units of capital, making use of on-going financial advice to help you keep your plans on track.

The return on an investment is not just the income from dividends and interest but it also comes in the form of capital growth. If the capital value of your investments grows, then this adds to the value of your pension pot in exactly the same way as receipt of a dividend or an interest payment would.

In the same way, when you draw out a dividend or an interest payment in order to live on, you are taking money out of the total pot. But you could also do this by selling a chunk of the assets of the fund. In either case you are reducing what is left in the fund to generate the income that you need to live on in future, but by moving away from the strict rule of spending only natural income from your investments you are no longer so restricted in the assets you invest in. This gives you the chance for a much better risk-return trade-off.

A diversified investment mix is no longer off-limits to the investor who is not obsessed with income-generating assets. You could, for example, choose to stay invested in the low risk multi asset fund shown in Figure 4 which seeks to offer a relatively good rate of return, but without exposing yourself to a high level of volatility. While this mix of investments may only generate natural income of about 2% a year, you could still opt to take a retirement income of 4% or 5% by gradually cashing in units of capital. How sustainable this will be will depend on the rate of return generated by your investment, taking reinvested income into account. A financial advisor can help you to set an appropriate withdrawal rate and match this to a portfolio with the right balance between risk and return.

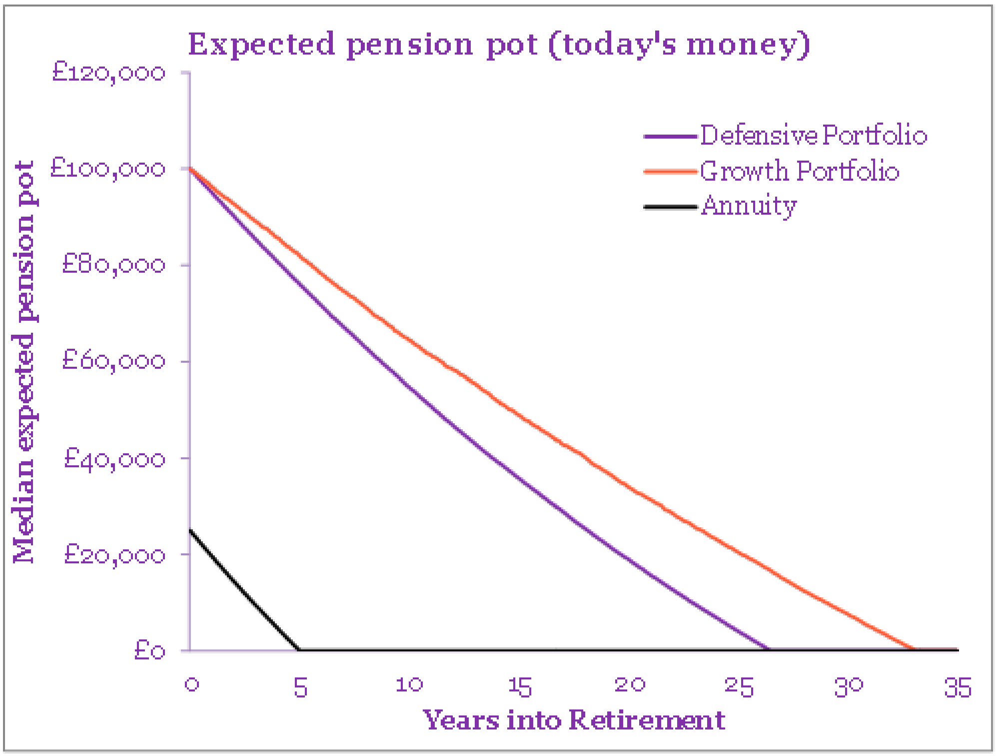
Playing it safe in the short term by investing heavily in cash and other low risk asset classes may not turn out the be the best approach over a retirement that could last 25 years or more. Savers adopting an ultra low-risk strategy will produce only very modest returns, as interest rates on cash are generally lower than returns on riskier growth-seeking investments. Current cash ISA rates around the 1% mark aren't even keeping pace with the cost of living with inflation in the 2%-3% range. Whilst this might not matter for a year or two, a saver keeping their money in very low risk investments is likely to end up taking out much more money for living expenses than their investments are putting in by way of return. The pension pot is likely to decline in value quickly. Facing year after year of belt tightening as the spending power of your savings declines is not an appealing prospect for most.

Another way of looking at this is to estimate how long it will take for you to run out of money based on how it is invested. Figure 7 illustrates how long a pension pot of £100,000 is likely to last on the basis of a retirement income of £4,500 under three different approaches:

- A completely 'risk-averse' strategy where your pension pot is used to buy an annuity;
- A 'defensive' strategy with an expected return of 2.5% before fees;
- A 'growth' strategy with an expected return of 4.3% before fees.

Figure 7. When might your money run out depending on your investment strategy

a) Defensive portfolio, b) Growth portfolio and c) Annuity with 5 year guarantee

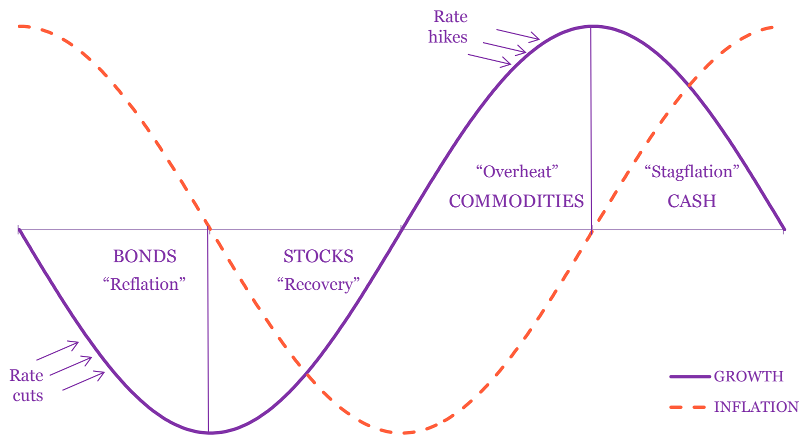


Source: RLAM for illustrative purposes only. Calculations based on the median outcome of 10,000 simulations on the basis of a retirement lasting 25 years. Rates of return based on standard mid-range return estimates from the FCA.

Those buying the annuity are guaranteed a lifetime income but have no access to capital and would typically have nothing to pass on to successors five years into retirement. The defensive multi asset fund in our simulation would run out of capital around twenty five years into retirement, assuming their income requirements hadn't reduced. Those willing to take a bit more risk in order to secure an average 4.5% return could expect their money to last well over 30 years.

One advantage that may be open to investors choosing to follow the pension drawdown approach with a broad spread of investments is the application of 'tactical' adjustments to the asset mix. This approach seeks to ensure it remains best positioned as the investment backdrop evolves. Different investments tend to offer their best returns at different stage of the economic cycle, as shown in Figure 8. Rather than stick rigidly to a fixed proportion in each asset class come what may, your asset manager can adjust the balance between different asset classes to favour those likely to do best at particular points in the cycle. This can improve returns and reduce the 'downside risk' which would be of particular concern to retired investors in the early years of their investment.

Figure 8. Different asset classes offer their best returns at different stages of the economic cycle



5. Conclusions

It would be very surprising if an investment approach which made sense in an era of relatively high interest rates and shorter retirements did not need to be revisited in the world in which we now live.

As we have seen, those determined to stick doggedly to the mantra of living only off the natural income from investments will find many traditional asset classes no longer open to them. Instead, they will find themselves driven to the edge of the risk-return spectrum, desperately seeking 'natural' income at higher and higher risk. This is unlikely to be a good strategy for retirement, where large losses early on can damage your standard of living.

But there is also a danger of over-reacting and going for an ultra-cautious approach in retirement. With low interest rates and rising longevity, this is a recipe either for an exceptionally low income in retirement or running out of money before the end.

Happily, there is an alternative strategy which is likely to provide a superior outcome. Investing across a range of asset classes to generate a good total return of income and capital growth can help to deliver a better risk/return trade-off and some protection against large losses in stressed markets and recessions. A financial advisor can help you to set a sustainable level of retirement income from your pension pot and match it with an appropriate investment strategy.

This is a case where 'received wisdom' needs to be revisited and where new ways of thinking and investing can deliver much better outcomes for investors. Avoiding an over-reliance on 'exotic' or high yield investments and investing in a diversified way with tactical adjustments should lead to better retirement outcomes with substantially reduced downside risk.