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DON'T LET RETIREMENT PENURY BECOME THE DEFAULT

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Chris Wagstaff
Head of Pensions and Investments Education, Columbia Threadneedle Investments, and Senior Visiting Fellow, Finance Faculty, Cass Business School, London

Many people retiring today are faced with making complex financial choices about how to access their Defined Contribution (DC) pots and how best to make their savings work for them throughout retirement. However, at this point in their lives, peoples' financial literacy and cognitive ability has often started to decline and decision making is largely based on life experience and gut feel. Therefore, calls for raising engagement levels at retirement are misplaced. Indeed, if these retirees are to be prevented from sleepwalking into retirement penury, a different approach is required. By combining the flexibility and income security most desire, a well-governed, auto enrolled decumulation default, that largely sidesteps active engagement, could be the solution.

The challenges to informed decision making

On average, those in the UK aged 55 today who, post freedom and choice, are now eligible to access their DC pension pots, are expected to live to their mid- to late-80s. However, around 9% of these male and 14% of these female 55 year olds are expected to receive their 100th birthday telegram.[1] Despite this, on average, those in their mid-50s today will fail to remain in good health much beyond their mid-70s.[2] Some, however, will enjoy good health well into their twilight years while others will succumb to poor health, or morbidity, much earlier in life.

[1] What are your chances of living to 100? Office for National Statistics. 14 January 2016. See: https://visual.ons.gov.uk/what-are-your-chances-of-living-to-100/.

[2] Healthy life expectancy at birth and age 65 by upper tier local authority and area deprivation: England, 2012-2014. Office for National Statistics. 10 March 2016.

In addition to taking account of the vagaries of longevity and health longevity, when making a decision about how and when to best to utilise one's pension pot, individuals also need to formulate a view on what retirement might look like and when that might occur. Indeed, for many, retirement is no longer a one-off event with a well-defined destination point. Rather, people are increasingly adopting a phased approach to retirement, with some choosing to continue to work well past State Pension age.[3] Couple that with having to contend with often unforeseen changed circumstances, whether health, family or financial, and the considerable cognitive impediments to informed decision making, which typically compound with age, and you have *the* most difficult of life's financial decisions.[4]

Moreover, most people are ill equipped, let alone sufficiently engaged, to determine how best to achieve a good financial outcome at and in retirement, given the alarmingly low level of basic numeracy and financial literacy amongst the UK adult population; the complexity and multiplicity of the decisions to be made; deeply engrained behavioural biases that incorrectly frame decision problems and focus on the short term; the lack of frames of reference and a paucity of guidance to evaluate complex choices; and a widespread unwillingness or inability to pay for financial advice. Additionally, this comes at a time in many people's lives when increased risk and loss aversion leads to sub optimal investment choices and a reluctance to engage with those technologies that can facilitate the decision-making process.

Of course, the potentially dire consequences of inertia, making a wrong decision, indecision or failing to adequately engage at and in retirement, not to mention making decisions without the full set of facts, will compound over time as Defined Benefit (DB) pension entitlements disappear, people start receiving their state pension ever later in life and increasingly become solely reliant on their DC pensions pots to support their desired standard of living in retirement. For many, this will extend to 30-plus years. Indeed, recent research suggests that only 69% of 55 to 64 years olds believe their pension pot will last for the full term of their retirement, with 26% failing to hazard a guess as to the likely duration of their retirement.[5] Given that over nine million people in the UK will turn 55 over the next 10 years, this is a situation that simply cannot be allowed to persist.[6]

The post-freedom and choice story so far

Post freedom and choice nearly £20bn has been accessed from over 1.5 million DC pots.[7] Of these, 55% of, mainly smaller, pots have been fully encashed, principally by those aged under 65. While there is limited evidence of people using their encashed

[3] According to the OECD, about 20% of those aged 65 to 69 in the UK are in paid employment. Many others are self employed. See: OECD Pensions at a Glance 2016: OECD and G20 indicators, OECD Publishing, Paris. Chart 7.6.p.160. Also see: Learning from our elders. Schroders Global Investor Study 2017.

[4] Financial Advice Market Review. Final Report. Financial Conduct Authority and H M Treasury. March 2016. p25. According to Nobel prize winning economist Bill Sharpe, this decision is "the nastiest, hardest problem in finance."

[5] Planning for retirement: Are people joining up the dots? Columbia Threadneedle Investments and YouGov. February 2018. Of the survey's 838 UK adults aged 55+, 328 were aged 55 to 64.

[6] In 2018, the UK's 50-54s cohort is the biggest at 4.76m people (7.2% of the UK population), followed by the third largest cohort, the 45-49s at 4.45m people (6.7%). PopulationPyramid.net.

[7] Flexible payments from pensions: July 2018. HMRC. 31 July 2018; Retirement Outcomes Review: Final report. FCA. June 2018. FCA data covers the period April 2015 to September 2017.

retirement savings recklessly, with almost all having other retirement income to draw upon, some would have needlessly suffered a considerable income tax charge. Additionally, those 32% putting their fully encashed pots into a cash savings account will likely experience compromised, and often tax-inefficient, investment returns.[8]

However, given that the fundamental premise of any pension system is to provide a secure long-term income stream to meet spending needs in retirement,[9] perhaps of greater concern is the increasing numbers of people opting for the flexibility of income drawdown over inflexible and ultra low yielding annuities, which are often seen as a longevity gamble. Prior to freedom and choice this sustainable income objective was largely met with over 90% of DC pension pots being annuitised. Today, however, with complete flexibility as to how DC pension assets can be accessed from age 55-plus, this figure has fallen to under 12%. Moreover, 31% of income drawdown contracts have been purchased without advice, compared to 5% before the freedoms, while 94% of non-advised retirement product sales are made to consumers who do not shop around for their annuity or income drawdown contract.[10] Not only that, securing a sustainable income stream has been further compromised by one third of non-advised drawdown consumers investing wholly in cash, with a further third not knowing where their money is invested.[11] Couple this with mounting evidence that a sizeable minority of DC retirees are drawing down their pension savings at an unsustainable rate, and you have all the ingredients for a retirement to endured and not enjoyed.[12]

Addressing the risks to achieving a good retirement outcome

If people are to achieve the flexibility and income security most desire by opting out of purchasing an annuity, they must somehow navigate their way around longevity risk, investment sequencing risk (poor/negative returns occurring early in decumulation) and unexpected inflation, otherwise they will fail to secure a sustainable level of income withdrawal that meets their desired standard of living in retirement.

The most pressing problem is that most people simply do not know what is feasible and realistic at and in retirement. Intuitively this would seem to suggest dramatically increasing levels of engagement from what is currently a very low base. However, such calls are misplaced. Indeed, as noted earlier, we should be mindful of older generations often experiencing a decline in financial literacy and cognitive ability and a tendency to shy away from using those technologies that facilitate decision making. Additionally, as people grow older so their decision making is founded upon life experience and gut feel. Very little can change that, aside from properly supporting people throughout the entire at and in retirement planning and implementation process via informed guidance and trusted advice, perhaps with subtle behavioural interventions.

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[8] See: Retirement Outcomes Review: Interim report. FCA. July 2017.

[9] For an analysis of spending needs in retirement, see: Generating retirement outcomes to be enjoyed and not endured. Chris Wagstaff. Columbia Threadneedle Investments. February 2018. pp.19-25.

[10] FCA (June 2018). op.cit.

[11] FCA (June 2018). op.cit. p.22 and p.32.

[12] A J Bell. The Pension Freedoms Engagement Gap. December 2017. p.3. Average total savings of those surveyed was £118,000.

For most, the answer lies in being defaulted to the default

Given this, there is a groundswell of opinion, post-pension freedom and choice, that most people will never truly engage with the complex decisions to be made at and in retirement. Rather than make an active choice, they might instead prefer a default option or an off-the- shelf investment pathway.[13]

Given the success of auto enrolment in the accumulation stage, one idea that continues to gain traction, which we support, is autenrolling people at the point of retirement into an institutionally-managed income drawdown default. Such a fund could manage both investment and longevity risks and, in so doing, offers a sustainable inflation-linked withdrawal rate (SWR),[14] perhaps with an explicit charge cap,[15] that contains costs without compromising the economics and performance of such an arrangement. Indeed, for most people, given the cognitive and structural impediments to raising engagement levels, a well thought out, relatively inexpensive default, with options to finesse the default's parameters and the provision of opt-outs for the engaged, is the best possible option. After all, these defaults would sidestep the enormous decision making burden at the point of retirement, while providing the desired flexibility and the income security most retirees need.

So what might an auto enrolled, appropriately charge-capped, default decumulation solution, that combines flexibility with income security, with options and opt outs, comprise? Taking account of likely future retirement ages, longevity and morbidity assumptions, while keeping things simple, might mean setting an initial 20- to 25-year default SWR at an appropriate level, maybe initially between 3 and 3.5%, perhaps with a 1.5 to 2% minimum income underpin, based on the 15 year gilt yield (and possibly supported by phased annuitisation), coupled with a 20 to 25 year deferred annuity providing longevity insurance and provision for, say, a bequest of maybe 10%. Of course, the more engaged, who are better able and willing to make their own decisions could opt out and, with lower cost regulated advice, create their own bespoke solution.

However, in allowing a degree of flexibility, which in itself would require more accessible guidance and lower cost advice, the default could be finessed at set times and within certain parameters to meet individual preferences. So, the term of the income withdrawal and the vesting of the deferred annuity could be flexed up or down by up to, say, five years, the SWR by up to 1.5% and the bequest by perhaps 10%. Of course, the extent to which each feature could be flexed would, in some cases, be constrained by the flexing of the other features, the individual's age and the size of the remaining pot.

Unsurprisingly, underpinning good decumulation default design and the need to support a SWR is equally good default investment fund design. This is best performed

[13] See: FCA (June 2018). op. cit.; Mercer (2017), Melbourne Mercer Global Pension Index, Australia Centre for Financial Studies, Melbourne.

[14] For an analysis of what constitutes a sustainable fixed real withdrawal rate, see: Wagstaff (2018). op.cit. pp.26-27 and pp.34-35.

[15] Although the FCA in its Retirement Outcomes Review final report didn't advocate an explicit cap on fees in decumulation, the high fees associated with income drawdown is well illustrated in: Member outcomes under freedom and choice. XPS Pensions. August 2018.

by those multi-asset funds with genuinely skilful and dynamic asset allocation and active fund management being applied to a genuinely well-diversified asset mix. In targeting a deliverable inflation-plus absolute return objective, while minimising volatility and sequencing risk, these could provide a smoother returns experience than that for equity and equity/bond portfolios and a prospectively better outcome per se than that offered by with-profits, CPPI or overlaying an equity portfolio with put options. Crucially, unless hit by a completely anomalous event, a multi-asset fund-derived SWF set at an appropriate level shouldn't be compromised when financial markets turn tail.[16]

Conclusion

In a world of freedom and choice, the decumulation stage for those seeking flexibility and income security and opting for income drawdown, as opposed to inflexible and ultra low yielding annuities, must successfully navigate a myriad of largely unquantifiable risks.

Therefore, if retirement is to be enjoyed and not endured, all stakeholders, including the government, regulators, product providers, asset managers, consultants, and financial advisers, must step up their thinking as to the design of genuinely fit-for-purpose default investment pathways. Indeed, without the provision of high quality, behaviourally robust, well governed and appropriately regulated defaults, with appropriate and transparent fee structures, that provide a secure long-term real income stream and longevity insurance, supported by the provision of accessible frames of reference, guidance and low-cost advice throughout retirement, people are at considerable risk of sleepwalking into retirement penury.

[16] Wagstaff (2018). op.cit. pp.34-35.