Help your clients survive retirement

Pension decumulation

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Introduction

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Around four out of five advisers cite retirement planning as the most important benefit they provide to clients[1] and this is hardly surprising. The trend away from defined benefit to defined contribution shifts risk from the company to the individual. The introduction of unfettered drawdown increases the prospect of fund exhaustion. And the continuing rise in longevity means record numbers of people are living well into their 80s and 90s. Advisers have to factor these issues into retirement planning for their clients.

Identifying a sustainable withdrawal rate often lies at the heart of any retirement strategy.

Initially, this appeared to be a straightforward process. The '4% rule' seemed a simple, safe way to ensure income should last a lifetime. But times change. The effectiveness of the '4% rule' has been challenged. For example, as life expectancy rises, is a 30 year timeframe still appropriate? Are assumptions about investment returns, predicated on historical data, still relevant? Does it make sense to inflation-proof income during retirement if expenditure is likely to fall?

In this report, we review how the thinking around sustainable withdrawal rates has changed. We'll explore which factors determine how much can safely be withdrawn and consider strategies advisers can use to mitigate the risks of running out of money.

With the increasing number of individuals relying on defined contribution pensions for their retirement and drawdown often the preferred route, this is an important issue for today's retirees and their advisers.

1. Investment Trends, 2021 UK Adviser Pension & Products Report, Deep Insights Research, February 2022

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Help your clients survive retirement

A review of sustainable withdrawal rates during retirement

For most of the last century, retirement income was provided by defined benefit schemes, annuities and state pensions. The income from these sources share one important feature. Durability. Retirees never had to worry about running out of money. Even when income drawdown was launched in the mid 1990s it came with safeguards. There was a limit on how much could be withdrawn and, effectively, a requirement to annuitise at 75.

The rise in defined contribution plans mean people now have to choose how their retirement income is paid. Before 2015, many chose the security of an annuity. In the 2014 budget, the seeds of a profound change were sown. The then chancellor announced that 'no one will have to buy an annuity'. At the same time, unfettered drawdown was introduced. People could take what they want, when they want.

The unintended consequence of 'pension freedoms' is that many people risk outliving their savings. The 2022 FCA data suggests that nearly three times as many people opt for drawdown to fund their retirement than choose an annuity[2]. Data for 2023 is unavailable at this time, but this gap has probably narrowed given substantial improvements in annuity rates during the year. Nevertheless, drawdown is still likely to prove an attractive option for many retirees. The most popular rate of withdrawal is 8% or more (chart 1). Such rates are unlikely to be sustainable. Evidence from around the world suggests there is a real risk of running out of money[3].

At the same time, we should be cautious about taking the UK data at face value. The reality is likely to be nuanced. For example, the 8% rate is more pronounced among smaller funds where the pension pot may be incidental, perhaps supplementing a generous defined benefit pension. In contrast, for funds over £250,000 the most popular withdrawal rates are less than 4%, which suggests a more conservative approach. A fund worth more than £250,000 may be the major proportion of someone's retirement plan, so it's encouraging that more realistic withdrawal rates are being used. People with larger funds are more likely to take financial advice, which is probably another reason why withdrawal rates are lower.

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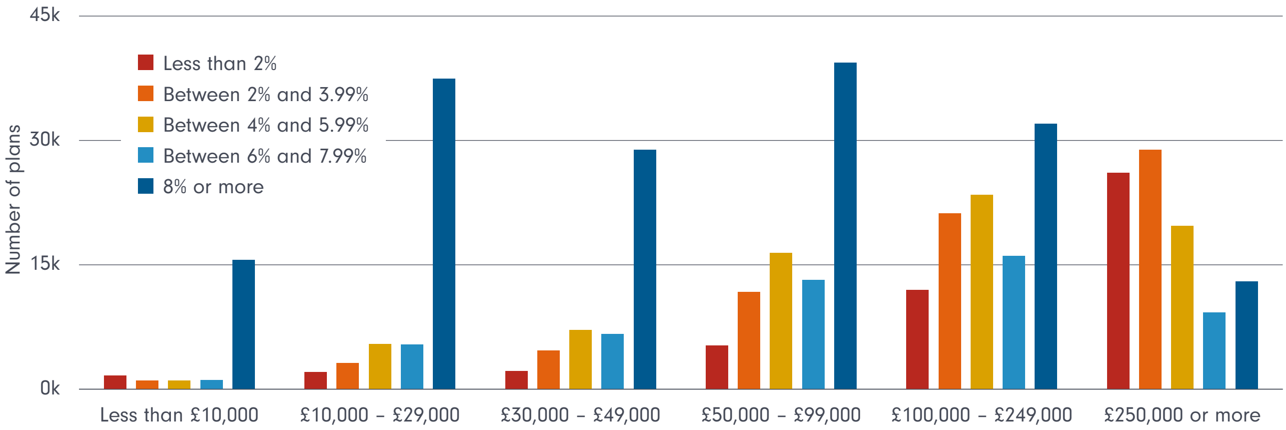
The unintended consequence of 'pension freedoms' is that many people risk outliving their savings

2. Retirement income makrket data 2021/22, FCA, October 2022.
3. http://www.telegraph.co.uk/finance/personalfinance/pensions/11970524/Australian-and-US-pension-data-predicts-penniless-decades-for-older-Britons.html

Though, on average, larger funds aren't withdrawing at such high rates, a significant number are still making regular withdrawals of more than 4%. It has been estimated that a couple need a gross income of £67,464 to provide a comfortable standard of living so perhaps this is unsurprising[4]. Given the importance of managing income through retirement, now may be a good time to review the sustainability of withdrawal rates and the influence of cash flow forecasting models to address changing patterns of expenditure.

Chart 1: Regular withdrawal rates by pot size 2021/22



Source: Retirement income market data, FCA, October 2022.

4. Retirement Living Standards, Pensions and Lifetime Savings Association, 2023.

Key points

- The likelihood of running out of money has not historically been an issue for UK retirees.
- The introduction of unfettered drawdown in 2015 threatens to undermine this.
- The evidence from overseas is not encouraging.
- Flexi-access drawdown is proving popular but withdrawal rates appear high.
- There may be valid reasons for high withdrawal rates, but this is a concern.

An overview of safe withdrawal rates

William Bengen is credited with the creation of 'the 4% rule'. This simply states that withdrawing 4% initially from a pension pot and increasing this each year by the rate of inflation means there is little likelihood of running out of money during a 30 year retirement.

Based on a 50/50 split between stocks and bonds, Bengen reviewed a 50 year period from 1926-76 and concluded that someone retiring at the start of each of these years could support an inflation adjusted 4% withdrawal for at least 30 years in the worse performing periods. In the majority of periods, the money would last much longer than this. Bear in mind, this timeframe covered the Great Depression of the late twenties and two further major stock-market declines that lasted more than a year, it suggests the results should be reasonably robust. For someone retiring after 1944, real data wasn't available for all of the 50 years so averages were used.

Subsequently, Bengen managed to increase his original 4% safe withdrawal rate to around 4.5% by including small cap stocks in the asset allocation mix[5].

Moving forward

The original Bengen analysis has been the subject of numerous reviews since it was first published. Some of the key issues explored include:

- The impact of charges
- Geographic influences
- Treatment of inflation
- Historic data v current forecasts

5. Small cap withdrawal magic, F A Magazine, William P Bengen, September 2016.

The impact of charges

Charges were excluded from the original Bengen analysis. The logic being that the level of fees varied widely. This is certainly true in the UK today. There are a number of charges a drawdown client could pay including advice fees, platform charges and investment management costs.

So how do charges affect the 4% rule? A common misconception is that a 1% charge on a fund with a 4% withdrawal rate equates to 25% of the income withdrawn. While this is literally correct in the context of the first year's withdrawal, over the course of retirement, assuming the income is inflation linked and the fund falls over time, the impact of a percentage-based fee is lessened.

It's estimated that a 1% fee each year reduces the safe withdrawal rate by around 0.5%[6].

"It's estimated that a 1% fee each year reduces the safe withdrawal rate by around 0.5%

Geographic influences

The development of the 4% rule was based on investing in US stocks and shares. It has been noted that this may not reflect the performance of other markets. Various studies have attempted to find the corresponding figure for different countries based on investing in the local market for stocks and shares. A 2010 study, found that the corresponding safe rate to the 4% rule for the UK was 3.77%[7].

Few people these days are likely to invest only in their local market. A 2019 study looked at withdrawing 4% from a 50/50 portfolio invested in local indexes compared with a 50/50 global asset allocation. A 1% charge was also applied. Over a 30 year period, the UK only portfolio would have worked in 70% of cases compared with 76% for the global composition[8].

While most people will diversify geographically, there is a behavioural trait called 'home bias'. Investors often tend to invest excessively in domestic assets. This may seem unusual, but people feel more comfortable with a market they're familiar with. Even professional advisers need to check that this innate behaviour doesn't colour their recommendations to clients.

"While most people will diversify geographically, there is a behavioural trait called 'home bias'. Investors often tend to invest excessively in domestic assets

6. Impact of Adviser Fees on Withdrawal Rates in Retirement Portfolios, Abraham Okusanya, February 2016.
7. An International Perspective on Safe Withdrawal Rates from Retirement Savings: The Demise of the 4 Percent Rule?, Wade D. Pfau, September 2010.
8. Bengen's 4% Rule Around The World, Abraham Okusanya, Timeline, April 2019.

Treatment of inflation

A 1998 study by Cooley Hubbard and Waltz, compared safe withdrawal rates, ignoring inflation, across different periods for a range of asset allocations[9]. It illustrated the results across two time periods. The first covered the period from 1926 to 1997 and the second covered the post war period from 1946 to 1997. The study showed that for a 50/50 allocation, ignoring inflation:

- A 6% withdrawal rate successfully lasted 30 years in all cases across the period 1946–1997 and a 98% probability of success over the period 1926–1997.
- Even a 7% withdrawal rate over both periods succeeded more than 80% of the time.

A separate 2020 study 'When QE broke the 4% rule' using 2020 bond yields, also looked at taking a fixed rate that isn't increased by the rate of inflation each year. Perhaps unsurprisingly, using 2020 bond yields produced lower withdrawal rates than those above, but the study still concluded that a withdrawal rate of more than 4% had a reasonable chance of success where there was a high allocation to equities[10].

Inflation is a key determinant in defining a safe withdrawal rate, but it comes at a price. Someone withdrawing £10,000 each year for 30 years, assuming 2.5% inflation, would need to withdraw £20,976 at the end of the period to maintain the same purchasing power.

There is a growing realisation that patterns of expenditure can change during retirement. Often, expenditure is characterised by three stages:

- **The active period.** At the start of retirement, people are usually in good health and keen to make the most of their new freedom. Consequently, expenditure can be high. On average, healthy life expectancy for a 65 year old lasts around 10 years for men and 11 years for women[11].
- **The transitional phase.** Eventually health issues catch up and people begin to slow down a little. They may still be active, but not quite as fit and able as they used to be. They start to feel their age a little more. This period is characterised by a reduction in expenditure.
- **The passive stage.** Eventually poor health becomes a significant impediment. For example, deteriorating eyesight can constrain mobility if it means giving up driving, which can limit opportunities to socialise. This will often lower costs further.

"There is a growing realisation that patterns of expenditure can change during retirement

9. Sustainable withdrawal Rates From Your Retirement Portfolio, P.L. Cooley, C. M. Hubbard, D.T. Waltz, 1998.
10. When QE broke the 4% rule, LCP on point, September 2020.
11. Health state life expectancies, UK: 2018 to 202, ONS, March 2022.

Of course, there is often an uptick in expenditure if long term care is required later in life. There are plans to change the way care is funded in the UK, which will cap the total amount payable. Also, most people will not require residential care later in life. Only about 1 in 4 men and 1 in 3 women aged 65 and over will require residential care at some point in their lives[12]. There is a rising trend for people to require care in their own home, but this is often carried out by family and friends. There are an estimated 5.7m unpaid carers England[13].

Against this background, it's questionable whether an inflation-linked income is required throughout retirement. Indeed, this thought is borne out further by the ONS Household Expenditure analysis which shows how average expenditure reduces by age. The 50-64 age group spend more than the 65-74 age group who in turn spend more than the over 75s. In fact, total expenditure almost halves over this period[14].

Bengen modelled a scenario where the first 10 years' payments were inflation linked. The next 10 years income grew with inflation less 4% each year (given inflation was often lower than 4% during this period, notional income declined). In the final 10 year period income was increased by inflation minus 2%.

The results still showed that higher withdrawal rates were possible:

- There was a 91% probability that a 5.25% withdrawal rate could be taken over 30 years without running out of funds.
- Even at 6%, there was a 75% chance of success over a 30 year period. This might work for many people if they have a backstop, like equity in the home, that they could leverage, if funds did run out.
- In contrast, if income is always increased by inflation each year the probability of a withdrawal rate of 5.25% lasting 30 years reduces to 70% and a 6% withdrawal rate falls to just 56%[15].

This approach recognises the need to include some degree of protection against inflation, but also acknowledges that expenditure often decreases during retirement. The difficulty is forecasting how and when changes might occur. One person could enjoy 20 healthy and productive years, while another may suffer a debilitating, chronic condition a few years into retirement.

"The difficulty is forecasting how and when changes might occur. One person could enjoy 20 healthy and productive years, while another may suffer a debilitating, chronic condition a few years into retirement

12. Pensions and the funding of long term care, Institute and Faculty of Actuaries, 2015 (p2).
13. Key facts and figures about caring, Carers UK, January 2024.
14. Household expenditure by age of household reference person: Table A9, ONS, January 2019.
15. Conserving client portfolios during retirement, part IV, William P Bengen, 2001.

Historic data v current forecasts

Bengen's original analysis used actual returns over the period 1926–1976 to model how long a portfolio would last at different rates of withdrawal for someone retiring in each of the 50 years (though after 1944, real data wasn't available for the full 50 years so averages were used).

Other studies have used Monte Carlo simulations. These show a range of possible results for a given portfolio of assets. Rather than taking a single look at what happened over a certain time period, a Monte Carlo simulation will examine hundreds or even thousands of possible future outcomes usually based on past market movements over a particular period.

More recently, commentators have suggested that perhaps it makes more sense to forecast future returns based on which is happening now – not what has happened in the past. The logic is that forecasts that incorporate what's happening in the markets now are likely to be more useful than simply looking back. In a 2023 study[16], Morningstar modelled safe withdrawal rates based on future assessments of returns based on current market conditions. Anticipated 30-year annual returns from equities are estimated to be 9.4% for an all-equity portfolio, while expected returns from fixed interest investments (including cash) are expected to be 4.8% Over a 30 year period, Morningstar estimate inflation will average 2.4%. On this basis, the safe withdrawal rate is calculated to be 4%.

The validity of using current forecasts over a 30 year period has been questioned[17], particulalry when forecasts were based on high stock market valuations, low bond yields and low inflation. Neverthless, this approach can alert investors to the prospect of a bear market, which can give rise to sequence of returns risk. Sequence of returns risk demonstrates that the actual returns over a long period are less relevant for drawdown clients than the sequence in which those returns occur. In short, poor returns in the early years of withdrawing income can have a devastating effect on drawdown investors, which positive returns in later years can't adequately redress.

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More recently, commentators have suggested that perhaps it makes more sense to forecast future returns based on which is happening now – not what has happened in the past

16. The State of Retirement Income: Safe Withdrawal Rates, Morningstar, 2023.

17. Why High Equity Valuations And Low Bond Yields won't (necessarily) Break The 4% Rule, B. Henry- Moreland, January 2022.

In the Kitces report, 2008[18] the 'Shiller CAPE' was used to define higher or lower safe withdrawal rates. The Shiller CAPE shows the current price earnings ratio for companies in the S&P 500, plus inflation adjusted earnings over the previous 10 years. Broadly, if markets are overvalued when income is taken, safe withdrawal rates should be lower than 4%. Conversely, if markets are undervalued the safe withdrawal rate can increase.

Bengen took this further adding into the mix the prospects for inflation[19]. If returns are inflation linked, then high inflation in the early years can have a significant impact on safe withdrawal rates. This is because inflation proofed increases are effectively 'baked in' to the income withdrawals for the full term. If inflation is high and markets are overvalued, a conservative withdrawal rate should be chosen. In contrast, if markets are undervalued and inflation is low, higher rates can be taken. Bengen suggested that withdrawal rates as high as 7.5% are possible.

Bengen also reviewed safe withdrawal rates during deflationary periods where the nominal income decreased. This produced safe withdrawal rates in the range 6-13%.

18. Resolving the Paradox – Is the Safe Withdrawal Rate Sometimes Too Safe?, Kitces Report, May 2008.
19. Choosing the highest safe withdrawal rate, William P Bengen, October 2020.

Key points

- Bengen's analysis ignored charges. It's been estimated that a 1% charge reduces the safe withdrawal rate by about 0.5%.
- The original 4% rule was based on the performance of US markets. The comparable safe withdrawal rate for investments in UK markets would be 3.77%.
- Inflation is a key driver of safe withdrawal rates. If inflation is ignored, safe withdrawal rates rise, but purchasing power will decrease.
- Given that expenditure is likely to reduce over the course of retirement, partially inflation linking withdrawals can produce higher safe withdrawal rates.
- If safe withdrawal rates are calculated using current market conditions to forecast future returns the safe withdrawal rate is currently estimated to be 7%.
- A combination of current equity valuations and inflationary pressures can help predict likely safe withdrawal rates.

What are the key factors that influence safe withdrawal rates?

The general view across most studies is that safe, inflation linked, withdrawal rates fall somewhere between 3 to 4%. For many people, this is not particularly comforting. They may struggle to survive even at the higher end of this range.

For example, a couple who've built up a retirement pot of £600,000 may think they're well placed for retirement. At 4%, this will provide an income of £24,000. Let's assume one partner has a maximum State Pension of £11,502, while the other, having taken career breaks, qualifies for half this amount (£5,751). This amounts to a total retirement income of £41,253, which would fall short of the amount it has been estimated is required for a comfortable retirement by more than £25,000[20]. So how can people boost their pension income? Here are some of the levers they can use:

How long is the income required for?

Most of the research is based on a 30 year period from age 65 (though increasingly financial planners are assuming a 100 year life). If a shorter period is used safe withdrawal rates increase. If we use the latest Morningstar figure of 4% based on 30% equity weighting, a 90% probability of success and current forecasts of returns, the rate increases as follows:

- For a 25 year period – 4.6%
- For a 20 year period – 5.5%
- For a 15 year period – 6.9%[21]

The reasons why someone might choose a shorter period include:

- They may be retiring later than normal. Someone retiring in their 70s may feel confident choosing a shorter period.
- They may be suffering from serious ill health which threatens to shorten their life expectancy significantly.

20. Retirement Living Standards, Pensions and Lifetime Savings Association, 2023.
21. The State of Retirement Income: Safe Withdrawal Rates, Morningstar, 2023.

Probability of success

Most of the studies assume a 90% probability of success. If this is lowered higher rates of withdrawal can be taken. For example, the 1998 US study by Cooley, Hubbard and Waltz[22], using historic data from 1926–1997 based on a 50/50 stocks/bonds split and an inflation-linked income found that:

- A 5% withdrawal rate has a 70% probability of success
- A 6% withdrawal rate has a 51% probability of success

If the equity allocation is increased to 75%, the probability of success increases to 86% for a 5% withdrawal rate or 63% for a 6% withdrawal rate. If someone has significant other assets or is anticipating an inheritance in the future, this may be a risk worth taking. Even at these higher rates, the money still lasts for 30 years in the majority of cases[23].

Charges

Charges can impact how much can be safely withdrawn. It has been estimated that a 1% charge broadly equates to a 0.5% reduction in the safe withdrawal rate, so keeping costs low makes a difference[24].

While charges are important, retirement planning is a complex area. Foregoing advice, for example, can be a false economy. Advisers can help to deliver better outcomes for clients and avoid costly mistakes.

The impact of inflation

Inflation is a key driver in determining safe withdrawal rates. The 1998 study by Cooley Hubbard and Waltz concluded that, if income is not inflation linked, a 6% withdrawal rate successfully lasted 30 years in all of the cases across the period 1946-97 (based on a 50/50 asset allocation) and a 98% probability of success over the period 1926-97. Even a 7% withdrawal rate over both periods succeeded more than 80% of the time[25].

The study ‘When QE broke the 4% rule’, calculates the probabilities of success when foregoing inflation rate increases in a low interest rate environment. Unsurprisingly, the figures are lower than those in the 1998 study. Even so, 5% is still considered ‘somewhat sustainable at higher growth asset allocations’ according to the study, even with charges of 2% p.a. applied[26].

There are ways to partially include inflation, which acknowledge that income needs often reduce during retirement. This was explored in the previous section.

There are ways to partially include inflation acknowledging that income needs often reduce during retirement

22. Sustainable withdrawal Rates From Your Retirement Portfolio, P.L. Cooley, C. M. Hubbard, D.T. Waltz, 1998.
23. This study also reviewed rates of withdrawal over the post war period 1946 – 1997 which reduced the probability of success.
24. Impact of Adviser Fees on Withdrawal Rates in Retirement Portfolios, Abraham Okusanya, 2016.
25. Sustainable withdrawal Rates From Your Retirement Portfolio, P.L. Cooley, C. M. Hubbard, D.T. Waltz, 1998.
26. When QE broke the 4% rule, LCP on point, September 2020.

Asset allocation

Over the long term, equities will generally outperform other asset classes, so it makes sense to hold high levels of equities. At the same time, retirement is an unforgiving environment. If markets fall in the early years of retirement, the results can be devastating. Someone who retired on New Year's Eve 1999, invested in the FTSE 100, would have found that their fund was 43% down by 1 January 2003 ignoring withdrawals. At a 4% withdrawal rate, they would have lost more than half the value of their fund in the first 3 years of their retirement (charges and dividends excluded)[27].

In contrast, holding everything in cash or bonds may give the illusion of security, but that's all it is. An overly conservative strategy increases the likelihood of running out of money in retirement. It eliminates the prospect of benefiting from any growth in equities.

"Holding everything in cash or bonds may give the illusion of security, but that's all it is. An overly conservative strategy increases the likelihood of running out of money in retirement

27. FTSE takes worst ever fall, The Guardian, January 2003.

Preservation of capital

A key question is whether the client plans to preserve as much of their capital as they can to leave a legacy when they die. If preservation of capital is important, one way to achieve this is to simply live off natural income. In other words, interest and dividend payments. But this has its own drawbacks – income will vary each year.

Another approach is to reduce the withdrawal rate to increase the likelihood of preserving capital. Bengen suggested that if the objective is to leave 100% of capital the safe withdrawal rate should be reduced by just under 0.2%[28]. It's worth pointing out that Bengen's original research demonstrated that, while there is no money remaining in the worst case scenarios at the end of the 30 year term, in 96% of cases all of the original capital is left. If it's not important to preserve a legacy, withdrawal rates could be increased.

Current market forecasts

While there are differing views on the efficacy of using historical data v current forecasts to identify returns over a 30 year period, there does appear to be broad agreement that current forecasts of returns over shorter terms are valuable in identifying the prospect of sequencing risk.

If, at the point of retirement, markets are considered overvalued and bond yields are low, this should give cause for concern. Low levels of inflation can mitigate the impact to some extent, while high levels of inflation in the early years can exacerbate the problem. Chart 4 is an overview of the key influences on withdrawal rates.

Chart 4: Main factors affecting withdrawal rates

	Charges	Life expectancy	Preserving capital	Current market forecasts	Inflation	Asset allocation	Access to other assets
+	Low charges	Lower than average	Low bequest motive	Markets undervalued – inflation low	Partial inflation linking	High equity content	Available as a backstop
–	High charges	Higher than average	High bequest motive	Markets overvalued – inflation high	Income inflation linked	Low equity content	Not available

28. 20 Years of Safe Withdrawal Rate Research, Kitces Report, March 2012.

Key points

- Broadly, the safe withdrawal rate for an inflation linked income with a 90% probability of success over a 30 year period still appears to be around 4%.
- Factors that influence this range include whether historic data is used to calculate returns or current forecasts, the level of charges and asset allocation.
- These rates may not generate sufficient income, but there are other solutions that can provide a higher income.
- These include ignoring or partially ignoring inflation, choosing a shorter term or accepting a lower probability of success.
- All of these measures can make sense in the right circumstances.

Strategies to mitigate the risks of running out of money

There are a number of ways advisers can help clients navigate the perils of retirement. Many of these try to lessen the damaging impact of sequencing risk. Here's an overview of several different approaches:

Living off natural income or yield

With this strategy, clients use the interest, dividends and income generated by their fund and withdraw this each year. Sequencing risk is reduced because income isn't taken from capital. Capital values could still be eroded by market falls, but should recover. The key attraction of this strategy is that capital is preserved. The obvious disadvantage is that income will vary year by year.

A variation on this is to take a fixed percentage of the fund value each year. In years where markets are falling, less income is taken. In both strategies, income can rise and fall from year to year which won't suit many people.

A cash bucket

Another approach is to hold a cash buffer. This usually involves dividing the fund into three sub-funds, typically cash, bonds and equities. The cash bucket might equate to 2-3 years income to ride out market falls. Significant market falls, without a relatively quick recovery are rare, so a cash buffer can mitigate sequencing risk. However, keeping money in cash usually has a detrimental impact on the fund's long term ability to sustain income.

Partial annuitisation

Introducing a degree of annuitisation can also mitigate sequencing risk and provide a guaranteed lifetime income to cover essential expenditure. Two 2018 actuarial reports highlighted the efficacy of including annuities within drawdown to deliver better outcomes[29,30]. A level annuity will generally pay a higher income than bonds, which means less needs to be withdrawn from the rest of the fund to provide a given rate of income. A level annuity will not protect against inflation, but people usually spend less as they age so it might not be important that part of the income isn't inflation linked.

29. 'Can we help consumers avoid running out of money in retirement?', Institute and Faculty of Actuaries, March 2018.
30. Annuities reinvented: Are annuities the missing asset class for sustainable drawdown solutions?, Milliman, October 2018.

Phased annuitisation

It's also worth considering the timing of any programme of annuitisation. The impact of mortality credit means annuity rates increase with age. There comes a point where it is difficult for drawdown to match the effective return from an annuity without taking significant risks.

Rising equity glide path

This approach was developed by Michael Kitces and Wade Pfau[31]. It involves starting with a low exposure to equities, usually between 20-40%, rising over time to between 40-80%. The benefit of this approach is that the equity proportion of a drawdown fund is lower in the early years when sequencing risk can derail the best laid plans. In contrast, market volatility has less impact later in retirement when equity exposure is much higher. Of course, if markets rise during the early years, there is an opportunity cost.

There are other strategies that have been explored over the years. Bengen himself suggested a strategy called 'floor and ceiling'[32]. This strategy protects the fund by imposing limits (the 'floor' and 'ceiling'). The withdrawal rate can rise by 20% of the original fixed rate withdrawal rate when markets are rising or reduce by 15% when they are falling.

Options that utilise tax-free cash, like uncrystallised funds pension lump sums, can also mitigate sequencing risk to an extent as less income needs to be withdrawn for a given income. Other tax-free sources of income could be used to protect a drawdown fund. For example, ISAs – even equity release – might help during market downturns.

31. Reducing Retirement Risk with a Rising Equity Glidepath, Wade D Pfau and Michael E Kitces, 2013.
32. Conserving Client Portfolios Durung Retirement, William P Bengen, 2001.

Key points

- Advisers have a number of strategies that can help sustain income during retirement.
- Living off natural income or taking a percentage of the fund each year will ensure money can't run out, but income is variable.
- Cash buckets mitigate the impact of falling markets early in retirement, but long term performance can suffer if too much is left in low risk assets.
- Partial annuitisation, using a level annuity, is another way to mitigate the impact of sequencing risk and cover essential expenditure, but will not protect against inflation.
- A rising equity glide path can offset sequencing risk in the early years because equity exposure is low, but there is an opportunity cost in a rising market.
- Other strategies have emerged over the years to combat sequencing risk and improve the prospect of income lasting a lifetime.

The way forward

It’s clear that there is a no one size fits all. Retirement today isn’t a homogenous experience. The range of retirement solutions and outcomes are many and varied, depending on a number of factors.

A single withdrawal rate throughout retirement doesn’t take into account individual needs and circumstances. It doesn’t recognise changing patterns of expenditure, the impact of health on life expectancy, what other assets are accessible, whether preservation of capital is important. All of these can influence the rate of withdrawal.

This has led to the emergence of cash flow forecasting models. Cash flow forecasts dispense with the need to define a fixed rate of withdrawal to last throughout retirement upfront. They offer a range of benefits:

Personal and bespoke

A cash flow forecast is based on the specific needs and objectives of the client. It can include lifetime gifts, buying a second home and leaving a legacy.

A holistic approach

Cash flow forecasting can take into account all of a clients’ assets and liabilities. It will usually also identify the most tax-efficient solution.

‘What if’ scenarios

Clients may want to know what the impact on their plans could be if certain events occur. For example, ‘what happens if there’s a stock market crash?’.

A dynamic review

It’s almost impossible to accurately forecast what will happen in the future, so it’s important to review cash flow forecasts regularly. The impact of new information can be considered and assessed.

A pictorial representation

‘A picture is worth a thousand words’ so the saying goes. Cash flow forecasts usually show the outputs graphically, which can make it easier to understand.

Every client is individual and cash flow forecasting provides the functionality to define a personal withdrawal rate for each client. This can be reviewed and updated regularly as circumstances change. This way, clients and their advisers can look to the future with confidence.

A 2020 survey by consultancy, the lang cat, covering 565 advisers revealed that cashflow software is becoming increasingly popular. Overall, 90% of advisers confirmed they use cash flow modelling in some form or other[33].

As an adviser in our recent IFA DNA research put it ‘Cash flow modelling tools help clients visually see their situation and this helps relieve some of the stress’[34]. Of course, cash flow modelling is only as good as the assumptions that lie behind it. But in the hands of a skilled professional it is a very powerful tool. Retirement planning will probably never be an exact science, but cash flow modelling can provide a robust, personalised vision to help navigate retirement successfully.

> **Cash flow modelling is only as good as the assumptions that lie behind it. But in the hands of a skilled professional it is a very powerful tool**

Key points

- Retirement can take many forms these days. That means it’s difficult to develop a single set of withdrawal rates that will work for most people.
- The emergence of cash flow modelling recognises the increasingly diverse nature of retirement. Even at an individual level, there can be a range of possible future outcomes.
- Because of the changing nature of retirement, there is a constant need to undertake periodic reviews to change and adapt financial plans.
- Cash flow models do need to be treated with care. The assumptions that lie behind the model are critical to the credibility of the outputs.
- Professional advisers are increasingly using cash flow models to augment the advice they can offer clients.

33. To Retirement and Beyond, the lang cat, December 2020.
34. IFA DNA research, Fidelity and Funds Network, April 2021.

Summary

- **Introduced in the 2014 Budget, flexi-access drawdown is proving the most popular option for UK retirees.** Without any of the constraints imposed on its predecessor, capped drawdown, flexi-access drawdown leaves UK retirees open to the prospect of running out of money during their lifetime. While the FCA data should not be taken at face value, it does suggest that this is a worrying possibility.
- **The '4% rule' has been the subject of a number of reviews.** For example, the original study ignored charges and relied on US data. Further studies have questioned the use of historic data rather than current forecasts of investment returns. Against this background, the safe range for an inflation-linked income with a 90% probability of success over a 30 year period still appears to be around 4%.
- **Bengen himself questioned the value of fully inflation proofing income throughout retirement** and demonstrated how partially inflation proofing income can boost the safe withdrawal rate. In a further study, he also considered the impact of using current market valuations and inflation forecasts to calculate safe withdrawal rates.
- **Some of the key factors that drive the calculation of a safe withdrawal rate** are the term chosen, the probability of success, current forecasts of returns v historic data, the extent to which income is inflation linked, the level of charges and asset allocation.
- **A number of strategies have been developed to help sustain income during retirement.** Some of these strategies, like living off natural income, will have limited applicability as income will vary each year. Other strategies like keeping a cash buffer, partial annuitisation and a rising equity glide path can be usefully employed by advisers to help income last a lifetime.
- **It's important to recognise the eclectic nature of retirement these days.** This makes it difficult to treat retirees as a homogenous group. Each person will travel their own path. Cash flow modelling can assist advisers by developing a bespoke model for each client that can be tested and regularly reviewed during the course of retirement.
- **Increasingly, people are using all of their assets to provide for a comfortable retirement.** The same principles governing sustainable withdrawal rates also apply to other sources of income.
- **It's little wonder that the majority of advisers cite retirement planning as the most important benefit they provide to clients.** The difficulties in navigating a secure path through retirement financially are likely to continue to present advisers with perhaps their greatest challenge.

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Important information

This document provides information and is only intended to provide an overview of the current law in this area and does not constitute financial advice, tax advice or legal advice, or provide any recommendations. The value of benefits depends on individual circumstances. The minimum age clients can normally access their pension savings is currently 55, and is due to rise to 57 on 6 April 2028, unless they have a lower protected pension age. Different options may have different effects for tax purposes, different implications for pension provision and different impacts on other assets and financial planning.

Past performance is not a guide to future returns. The value of the fund and the income from it can go down as well as up so you may get back less than you invested.

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