This document is for investment professionals only and should not be relied upon by private investors.

Investment risk and retirement

Pension decumulation

Adviser Solutions

Fidelity INTERNATIONAL

Introduction

Paul Squirrell
Head of Retirement
and Savings Development

In its recent thematic review, the FCA emphasised the need for robust measures of risk capacity and tolerance at retirement. This is particularly important given the popularity of drawdown. There's also evidence that suggests aversion to risk increases at retirement. Deprived of a regular earned income people may be reluctant to take risks with their savings. Yet with retirement often lasting 20-30 years, an overly conservative portfolio may not deliver the returns needed. Conversely, too great a reliance on high-risk assets can expose retirees to sequencing risk.

It's also critical that risk is regularly reassessed where clients are relying on managing their assets during retirement. Taking too much income, poor investment returns, high inflation or unexpected changes in expenditure can all require capacity for loss and attitude to risk to be reviewed throughout retirement.

Developing a deeper understanding of a client's attitude to risk and capacity for loss is essential, but this information then needs to translate into strategies and solutions that reflect a client's risk tolerance and capacity, while meeting their objectives for retirement.

In this report, we seek to develop a deeper understanding of risk. How we assess risk? What shapes our view of risk? And which characteristics define our perspective of risk? Then we evaluate some of the options advisers could consider to manage risk during retirement and explore the advantages and disadvantages of different solutions.

These are complex issues that today's professional adviser must successfully tackle to help clients meet their retirement objectives and enjoy their life after work.

Contents

Investment risk and retirement	4
What influences our view of risk?	7
Managing investment risk	11
Summary	22

Investment risk and retirement

Many of us fear flying. Anthony Brickhouse, a professor of aviation safety, claims 'You're more at risk to have an accident driving to the airport than you are flying at 38,000 feet[1]'. The data seems to bear this out. According to the Civil Aviation Organisation, the odds of dying in a plane crash are one in 11 million[2]. There is less likelihood of dying in a plane crash than tossing a coin 23 times and coming up heads every time[3]! The odds of being in a car crash averages around 1 in 5,000. This suggests we're not that objective when it comes to assessing risk.

> **Only on rare occasions can we completely eliminate the possibility of something bad occurring, so we need to assess risk along at least two dimensions. The likelihood of something bad happening and its impact if it does occur**

How can we assess risk?

Only on rare occasions can we completely eliminate the possibility of something bad occurring, so we need to assess risk along at least two dimensions. The likelihood of something bad happening and its impact if it does occur. In this sense, we define an acceptable risk as the level that is as low as reasonably practicable. For example, we can't completely eliminate the possibility of a fire in the home, but by using smoke alarms and taking other precautions, such as never leaving appliances like a washing machine running when out of the home, it's possible to both reduce the chance of a fire happening and limit the impact if it does.

What shapes our view of risk?

There are a number of factors that influence how we feel about risk:

- **Immediacy**
  Most smokers know the dangers of smoking, but the next cigarette isn't likely to cause death or illness. The implications of smoking may not become apparent for years.
- **Control**
  We fear what we can't control. So driving is okay, but flying isn't (though there may be other factors at play – such as not having our feet on the ground!).
- **Familiarity**
  When something becomes overly-familiar we may discount the risk. Someone who has invested in a particular stock or sector over many years may not objectively assess changing market conditions.

1. Worried about how safe it is to fly? Here's what the experts have to say, CNN, February 2024.
2. Is Flying Safer Than Driving?, Stephens Law, June 2024.
3. Omni Calculator, Coin Flip Probability Calculator, June 2024.

These three risks have been defined as 'situational factors'[4]. The characteristics of a risk based on our assessment – rational or otherwise. Another classification of risk has been defined as 'subconscious factors'. These include heuristics. Heuristics are mental shortcuts which we use to reach decisions quickly. These can be misleading or at best lead to decision making that is suboptimal. Though not strictly about heuristics, 'prospect theory' tells us that we often exhibit an asymmetrical view of risk. In financial terms, we fear loss, more than we value gains[5]. This may be hard coded into our psyche. Having too much food to eat would be an occasional and welcome occurrence for prehistoric man, but not having enough to eat could be life threatening. Needless to say, this has significant implications in financial planning.

“

Heuristics are mental shortcuts which we use to reach decisions quickly. These can be misleading or at best lead to decision making that is suboptimal

4. What drives risk attitudes?, Dr David Hillson, PMP FAPM, April 2008.
5. Prospect theory: An analysis of decision under risk, Daniel Kahneman and Amos Tversky, March 1979.

A final category of risk defined by Hillson covers 'affective factors'. Hillson describes these as 'gut-level visceral feelings and emotions which tend to rise up automatically or instinctively in a situation and influence how we react'. An example of this in financial markets could be our reaction to market movements and the impact fear and greed can have on decision making. A US study in 1995, over the five-year period ending in mid-1994, revealed that the average mutual fund returned 12.5% a year. In contrast, the actual returns obtained by investors in these same funds was a negative 2.2% [6]. A 2010 study of UK investors found that 'equity-related retail investment flows...tend to follow good performance and to anticipate poorer performance. This investment pattern has effectively cost the median UK retail equity investor a cumulated total return of 20% over the last 18 years.[7]'

> **Equity-related retail investment flows...tend to follow good performance and to anticipate poorer performance. This investment pattern has effectively cost the median UK retail equity investor a cumulated total return of 20% over the last 18 years**

These results support the widely held view that many investors buy shares at or near the top of a bull market. Greed takes over (so called 'FOMO' fear of missing out). They may be nervous investors, but a sustained rise in share prices eventually persuades them to take the plunge, rather than miss out. When a market correction occurs, they tell themselves that the market will recover so hang on but, as prices continue to fall, they eventually sell, often near the bottom of a bear market. This is a fictionalised version of events, but something akin to this may well account for the mismatch between actual mutual fund performance and investor returns.

Of course, investors who take expert advice from an independent adviser should avoid this scenario, as should more experienced investors, but it does serve to illustrate the irrational way many people approach financial risk.

Key points

- We're not always rational or accurate when we assess risk. We fear flying, but the drive to the airport is more dangerous.
- Risk is often assessed along two dimensions. How likely is something to occur and what would the impact be if it does happen?
- We have an asymmetrical view of risk where we fear loss more than we value gains.
- 'Affective factors' explain why investors may invest during the latter stages of a bull run and sell, realising a loss, during a market downturn.
- Advised clients benefit from the expertise of a professional, which means they are likely to have a better understanding of the nature of financial risk.

6. Investor Risk Tolerance: Testing The Efficacy Of Demographics As Differentiating And Classifying Factors, John E. Grable and Ruth H. Lytton.
7. Do UK retail investors buy at the top and sell at the bottom?, Andrew Clare and Nick Motson, Cass Business School, 2010.

What influences our view of risk?

There are several risks people need to navigate successfully when they retire. These include:

- Longevity risk
- Inflation risk
- Withdrawal risk
- Investment risk

The first three risks are covered in many of our retirement reports which can be viewed or downloaded from our website. The focus of this report is to cover investment risk.

If people are inherently risk averse, will this become more pronounced when they retire? It may be helpful to consider a range of influences that can shape attitudes to investment risk. Commonly researched characteristics include education, wealth, personal characteristics and age. Retirement has also been separately studied.

- **Education**
  Intuitively, higher levels of education should lead to a greater understanding of the nature of risk and therefore the higher the likelihood of a decrease in risk aversion, but the studies in this area are conflicting. Some do suggest a decrease in risk aversion, others the opposite. Some studies are simply inconclusive. This conundrum may be explained in part by a 2014 study based on data from the 1973 British Education Reform (when compulsory education increased from 15 to 16). This made it possible to monitor the effect of education reform on the risk attitude of different cohort groups. The study found that risk aversion increases for those with lower education. In contrast, in advanced or tertiary education, the extra years of schooling diminish risk aversion[8].
- **Wealth**
  This is also an area where it is difficult to be definitive about whether wealth is a determinant of the level of risk aversion. It's reasonable to assume that absolute risk aversion decreases with levels of wealth. So £1,000 invested in risky assets is largely inconsequential to a millionaire, but is much more significant at lower levels of wealth. However, research suggests there may not be a marked difference in relative risk aversion based on levels of wealth[9], which means the wealthy are keen to preserve their wealth and may be just as risk averse as other people.

"

£1,000 invested in risky assets is largely inconsequential to a millionaire, but is much more significant at lower levels of wealth. However, research suggests there may not be a marked difference in relative risk aversion based on levels of wealth

8. Seeun Jung. Does Education Affect Risk Aversion?: Evidence from the 1973 British Education Reform, 2014.
9. Chiappori, P., and Paiella, M. (2011). Relative Risk Aversion is Constant: Evidence from Panel Data, 2011, Journal of the European Economic Association, 9(6), 1021-1052.

- **Personal characteristics**
  While we can try and draw some general conclusions from features like education and wealth, personal characteristics may play a part in determining our relationship with risk and loss aversion. There have been a number of studies in this area. These include an analysis of the effect of Myers-Briggs personality types, which show that those inclined towards introversion are more likely to be more risk averse, than those leaning towards extroversion, though the results are more nuanced than this. There is an interaction effect between the thinking and feeling dimension. Extroverts with a feeling preference (ESFP, for example, using the Myers Briggs measure) were more likely to be risk averse than those with a thinking preference such as ESTP[10]. Separate research identified particular characteristics associated with loss aversion and investor behaviour. These personality traits are extraversion, agreeableness (which denotes trust straightforwardness and modesty), conscientiousness, neuroticism and openness to experience. People with higher levels of extraversion and openness to experience tend towards increase risk taking. In contrast, people with higher levels of conscientiousness, neuroticism and agreeableness exhibit decreased risk taking[11].

> **People with higher levels of extraversion and openness to experience tend towards increase risk taking. In contrast, people with higher levels of conscientiousness, neuroticism and agreeableness exhibit decreased risk taking**

10. Sherrie Haynie, Senior Director of US Professional Services at The Myers-Briggs Company writing for International Coaching Federation, July 2023.
11. Risk Attitudes and Personality Traits Predict Perceptions of Benefits and Risks for Medicinal Products: A Field Study of European Medical Assessors, Andrea R. Beyer MPH, Barbara Fasolo PhD, P.A. de Graeff MD, H.L. Hillege MD, Science Direct, 2015.

- **Age**
  It might seem intuitive that as people age they become more circumspect. Once more, the studies in this area are conflicting. There are many studies that do support the view that risk aversion increases with age. However, there are studies that suggest the opposite[12]. A more predictive indicator of risk tolerance as people age maybe the act of retirement itself, rather than simply getting older.
- **Retirement**
  A study measuring household wealth considered the proportion of net wealth invested in 'risky' assets for both retired and non-retired people at a range of ages[13]. The study revealed an overall decrease in risk aversion with age, but highlighted consistent differences between retired and non-retired people at the same age. Those still in the workplace held a higher proportion of their assets in 'riskier' investments. This does seem logical. Once retired, people no longer have the cushion of a regular salary and are drawing on savings that are finite and which they are unlikely to be able to replenish. It seems reasonable to conclude that they may be more reluctant to take risk than their employed counterparts of the same age.

  There are other factors that may influence risk aversion such as gender or marital status. Behavioural economics can also shape how people perceive and evaluate risks.

> **Attitude to risk is a subjective measurement of an individual's willingness to accept risk while capacity for loss relates to their ability to absorb losses**

Measuring risk tolerance

The two key measures we use to establish someone's risk tolerance are 'attitude to risk' (ATR) and 'capacity for loss' (CFL). The FCA describes these measures in its recent thematic review as[14]:

'ATR is a subjective measurement of an individual's willingness to accept risk while CFL relates to their ability to absorb losses. ATR and CFL are both key elements of risk profiling. When moving from accumulation to decumulation it is likely that the ATR and CFL for many customers will change so needs to be reassessed'.

12. Effect of Sociodemographic Factors and Multidimensional of Risk Toward Financial Risk Tolerance and Risk Tolerance Assessment Using Data Envelopment Analysis of Indonesian Investors, Irna Puji Lestari, International Journal of Scientific and Management Research, 2021.
13. Wang H, Hanna S, 1997 'Does risk tolerance increase with age?' Financial Counseling and Planning Vol 8 (2).
14. Retirement income advice thematic review, FCA, March 2024.

Attitude to loss is based on an individual's perception of risk and how they feel about taking on risk. In contrast, capacity for loss is an objective measure which determines to what extent a client can absorb falls in the value of their investment without suffering a detrimental impact on their standard of living.

Capacity for loss is a critical element of retirement planning. It requires a deep understanding of the client's resources and their expenditure to stress test how much risk clients can take without exposing themselves to peril. Research among nearly 25,000 advised clients suggested that around 60% of those aged 65-74 could absorb a small loss without reducing their standard of living, while about 1 in 4 people could afford a medium loss without reducing their living standards[15].

This data emphasises the need to undertake regular reviews of attitude to risk and capacity for loss throughout retirement, particularly for those people relying significantly on income from drawdown. Taking too much income, poor investment performance, rampant inflation, unexpected expenditure – all of these could affect capacity for loss.

The FCA also stated in its thematic review that attitude to risk and capacity for loss should be assessed separately to 'avoid the risk of conflating these outputs'[16]. At the same time, it's important to comment on their interaction. Someone relying on drawdown income should recognise that the degree of risk they can take with their investments may be compromised (even if their attitude to risk might imply otherwise). This may be a simplification. For example, it doesn't take into account other assets, like housing wealth, which could be used as a back stop.

Increasingly, advisers have access to cash flow models that can assess someone's overall risk capacity. It's critical that both attitude to risk and capacity for loss are reviewed throughout retirement.

Capacity for loss is a critical element of retirement planning. It requires a deep understanding of the client's resources and their expenditure to stress test how much risk clients can take without exposing themselves to peril

Key points

- Education, age and wealth have all been found to impact risk aversion, but the evidence is not conclusive with sometimes conflicting results.
- The act of retirement does appear to lead to an increase in risk aversion as people draw on savings that they are unlikely to be able to replenish.
- The key measures used to assess risk are attitude to loss and capacity for loss – the former is subjective while the latter is an objective measure.
- There are a number of moving parts that can disrupt retirement plans – inflation, withdrawal rates, investment performance, major shifts in expenditure – so risk tolerance should be reviewed regularly.
- Cash flow models are, and will continue to be, a key tool in assessing capacity for loss during retirement.

15. Dynamic Planner, October 2024. ATR summary data from 24,580 clients completing the Dynamic Planner capacity for risk questionnaire between January and September 2023
16. Retirement income advice thematic review, FCA, March 2024.

Managing investment risk

Given that people generally fear loss more than they value gain, and that the act of retirement can exacerbate loss aversion, it would seem logical to choose a lifetime annuity to provide income in retirement. Indeed, the latest research suggests that people value certainty above all else[17]. Buying a lifetime annuity means people don't need to worry about running out of money. They can focus on enjoying their retirement, rather than managing their investments.

Research in this area seems to support this view. A Demos study suggests that people who have annuitised are less likely to suffer from depression or feel sad compared with those who choose drawdown[18]. These findings were broadly mirrored in a US report from the Rand Corporation some years earlier[19]. Part of the reason may be that there is a greater likelihood that people spend the income they have each month in the certain knowledge that it will continue to be paid for life.

> **A Demos study suggests that people who have annuitised are less likely to suffer from depression or feel sad compared with those who choose drawdown**

17. Retirement Voice 2024, Standard Life.
18. The retirement income riddle, Demos, 2018.
19. Annuities and retirement satisfaction, Rand Corporation, 2003.

However, UK annuity sales only account for around a third of the level of drawdown sales[20]. This is despite an uptick in popularity following improvements in annuity rates over the last 18 months. The lack of success in marketing annuities is not a UK phenomenon. This is the so called 'annuity puzzle'. The annuity market in the US and several other developed countries remains small relative to other investment solutions[21]. Some of the reasons for this may include:

- **Lack of flexibility**
  People value flexibility almost as much as they value certainty. Annuities provide certainty, but are inflexible. The income can't be stopped or varied up or down (escalating options aside). Nor can an annuity be stopped or encashed. Ad hoc lump sums can't be paid from an annuity. This may make capital more attractive than income.
- **Bequest motive**
  Annuities have historically been seen as poor value if the recipient dies early. This is exacerbated by misconceptions about life expectancy. People continue to underestimate how long they will live[22]. Annuities now provide much more flexibility on death. Guaranteed periods often up to 30 years, value protection up to 100% of the original purchase price (less payments to the date of death) and beneficiaries' pensions. It's uncertain what effect the announcement that pensions will be subject to IHT on death after April 2027 may have on annuities.
- **Toxicity**
  Comments like George Osborne's 'No one will have to buy an annuity' are often used by people to make snap judgements. The behavioural economists call this 'availability bias'. The tendency to use information that comes to mind quickly and easily when making decisions. interestingly, people are often attracted to an annuity when the features are described[23]. A 2023 survey found that, of the two in five (44%) pre-retirees who said they wanted a guaranteed income for life, only around half said they either wanted or are considering annuities[24].

The FCA thematic review highlighted the need to consider annuitisation as part of any decumulation process. Coupled with the planned change in the tax treatment of pensions on death, this may catalyse renewed interest in annuities (perhaps as part of a broader solution).

"The FCA thematic review highlighted the need to consider annuitisation as part of any decumulation process. Coupled with the planned change in the tax treatment of pensions on death, this may catalyse renewed interest in annuities

20. Retirement income market data 2023/24, FCA, September 2024.
21. Ramsay, C. M., and Oguledo, V. I. (2018). The Annuity Puzzle and an Outline of Its Solution. North American Actuarial Journal, 22(4), 623–645. https://doi.org/10.1080/10920277.2018.1470936.
22. People continue to underestimate life expectancy, Professional Paraplanner, June 2023.
23. Annuities' Bad Rap, Elizabeth Harris, Plan Adviser, September 2022.
24. Nearly a million over-55s considering buying an annuity for first time, Pensions Age, January 2023 (L&G).

Drawdown

People can take what they want when they want from their pension savings if they choose drawdown. This raises the prospect that money could run out during retirement. Clients need to manage this risk carefully. Given that we are predisposed to fear losses more than we value gains, and that retirement exacerbates this fear, it might make sense to take a safety-first approach and invest in less risky assets, but this isn't necessarily the case.

An overly defensive portfolio of largely gilts and cash may not last the course. A low-risk portfolio might give retirees a sense of security, but it is illusory. Such a strategy could prove damaging over the long term. It eliminates the possibility of benefiting from the long-term growth historically produced by equities, which can provide a hedge against inflation. Clients may find they're exhausting their funds too quickly

In contrast, a significant emphasis on equities gives the greatest prospect of a portfolio lasting many years, but introduces volatility. This can give rise to sequencing risk, the potentially devastating impact of poor returns in the early years of retirement, which can affect a portfolio's capacity to meet income requirements.

Equities are important for retirees, but care is needed. Too high an exposure to equities can leave clients vulnerable, while too little means clients may be simply drawing down capital over the years. How can advisers combat this?

“

An overly defensive portfolio of largely gilts and cash may not last the course. A low-risk portfolio might give retirees a sense of security, but it is illusory

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 mitigated because income isn't taken from capital. Capital values could still be eroded by market falls but, as the assets aren't realised, they should recover. The key attraction of this strategy is that capital is preserved. The obvious disadvantage is that income will vary year by year.

Fixed percentage of the fund

A variation on this is to take a fixed percentage of the fund value each year (as opposed to a fixed percentage of the initial fund value). In years where markets are falling, less income is taken. The opposite is also true – income will increase when markets are rising. As with the previous strategy, income can rise and fall from year to year. What's more, in poor market conditions the income could be a trivial amount.

Cash buffer

Another approach is to hold a cash buffer. This usually involves dividing the fund into sub-funds or 'buckets', 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. US data suggests that the average length of a bear market is 289 days, or about 9.6 months. Since 1945, there have been 15 bear markets – one about every 5.1 years[25]. This suggests that over most time periods, markets rise. Consequently, while holding a cash buffer is a valuable strategy to deal with sequencing risk, holding more than the minimum in cash may have a detrimental impact on the funds' performance.

25. 10 Things You Should Know About Bear Markets, Hartford Funds, 2023.

Rising equity glide path

This approach was developed by Michael Kitces and Wade Pfau. 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 be most damaging. In contrast, market volatility has less impact later in retirement when equity exposure is much higher. If markets rise during the early years, there is an opportunity cost.

> **A further option to manage volatility is to use a smoothed managed fund. These are diversified funds that seek to cushion investors from the volatility of investment markets by including a smoothing mechanism**

Guardrails

Developed by financial planner Jonathan Guyton and business professor William Klinger, the guardrails approach is a dynamic process, which protects the fund by imposing limits. An initial withdrawal amount is defined, say 5%. The amount may then be adjusted each year based on the previous year's performance. If the fund has risen over the previous year and the new withdrawal amount (after increasing by inflation) is below 20% of its initial level, the income can be increased by the rate of inflation plus 10%. In contrast, if the portfolio performed poorly in the previous year, income is reduced by 10% if the withdrawal rate plus inflation is more than 20% of the initial amount.

Example

Peter has a fund of £1m when he retires and decides to withdraw £50,000. By the end of the first year, the fund has increased to £1.3m and inflation is 2%, so Peter could take his original withdrawal rate of 5% plus inflation, which equals £51,000. However, that figure is then divided by the fund value of £1.3m. The £51,000 equals 3.9% of the £1.3m. The 3.9% is 22% less than the initial income of 5%. As this is greater than 20%, it triggers the 10% increase, so the new income level would be £51,510 (£51,000 plus £510).

The process also works in reverse. Income is reduced by 10% if the withdrawal rate including inflation is 20% higher than the initial withdrawal rate.

Smoothed multi asset funds

A further option to manage volatility is to use a smoothed managed fund. These are diversified funds that seek to cushion investors from the volatility of investment markets by including a smoothing mechanism. The smoothing mechanism means the value of the funds will move up and down, but rounds off the sharp edges of stock market investing. When markets fall, the value of the fund may fall, but by less than the actual movement in the price of the underlying assets. This has two advantages:

- While it's important to continue to invest in equities during retirement, many clients find the prospect of equity investment unsettling. Knowing their funds are less volatile can bring peace of mind.
- By cushioning the funds during significant market falls, smoothed funds provide some mitigation against sequencing risk. These funds are likely to still fall in value during market downturns, but by less than the actual fall in the value of the underlying assets.

An integrated solution

Annuities and drawdown are polar opposites in so many ways but, combined, they can counter each other's weaknesses and bolster each other's strengths. Together they provide both certainty and flexibility: the two features most valued by retirees. Recent innovation has led to the development of products that provide a guaranteed income for life and can be included within a drawdown wrapper. These products have many of the features of a traditional annuity, but are available on investment platforms as assets of a drawdown portfolio.

The flexibility of drawdown comes at a price. People who choose drawdown face a number of risks. Poor investment markets, taking too much income, living too long. All of these can ravage a lifetime's savings. In contrast, annuities act as a foil to drawdown. They're a powerful counterpoint to the risks drawdown investors face. Whatever the market conditions, a lifetime income is guaranteed, which provides the certainty many people crave.

> **The flexibility of drawdown comes at a price. People who choose drawdown face a number of risks. Poor investment markets, taking too much income, living too long. All of these can ravage a lifetime's savings**

The benefits of including a guaranteed income for life within a drawdown portfolio are threefold:

1. **Peace of mind.** Whatever happens in investment markets, a guaranteed income for life can provide reassurance to cover essential and important expenditure (the latter may be more important for advised clients).
2. **Better outcomes.** Studies have shown that combining an annuity within drawdown can often deliver a higher safe withdrawal rate and greater benefits on death over the long term. It can also help combat sequencing risk too.
3. **Tax advantages.** If the guaranteed income for life is written as an investment of a drawdown fund there are additional benefits that can mitigate the tax that might otherwise be payable from a traditional annuity.

Let's consider each of these in turn:

Peace of mind

If it's imperative that essential expenses are protected to hedge against living too long, it makes sense to align these expenses with sources of guaranteed lifetime income. For example, the State Pension and any defined benefits. But how significant a concern is this for advised clients, most of whom will be higher income households? As income increases the proportion of the household budget required to cover essential expenses will decrease. For example, the wealthiest households spend around 15% of their income on housing, fuel and power compared with almost 28% of the total income of the poorest households[26].

26. Family spending in the UK: April 2022 to March 2023, ONS, August 2024.

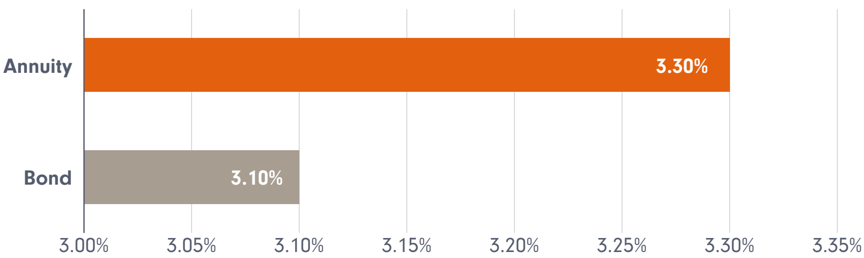
This suggests many higher income households could comfortably cover essential expenses from state pensions and any defined benefits, but there may be a need to guarantee income beyond this. For more affluent retirees, retirement isn't just about surviving. These people will often have ambitious goals. This may include fees to an exclusive golf club, extensive overseas travel or expensive new hobbies and interests. While not essential, this can be important expenditure. If these aspirations could seriously compromise someone's quality of life if not realised, it may make sense to cover the expenditure with a guaranteed income stream. Adding this to essential expenditure could require more guaranteed income than the State Pension and any defined benefit income provide.

A integrated solution can deliver better outcomes

A 2018 study by actuarial consultants, Milliman, showed that displacing the bond element of a drawdown portfolio with a lifetime annuity could be beneficial. The example in chart 1 shows how an annuity-equity strategy can produce a higher withdrawal rate of 3.3%, compared with a bond-equity strategy withdrawal rate of 3.1% over a 30 year period.

Chart 1: Sustainable withdrawal rate (increasing with inflation)

For a healthy 65-year-old female, fund: 55% equity, 5% cash, 40% bond or annuity.

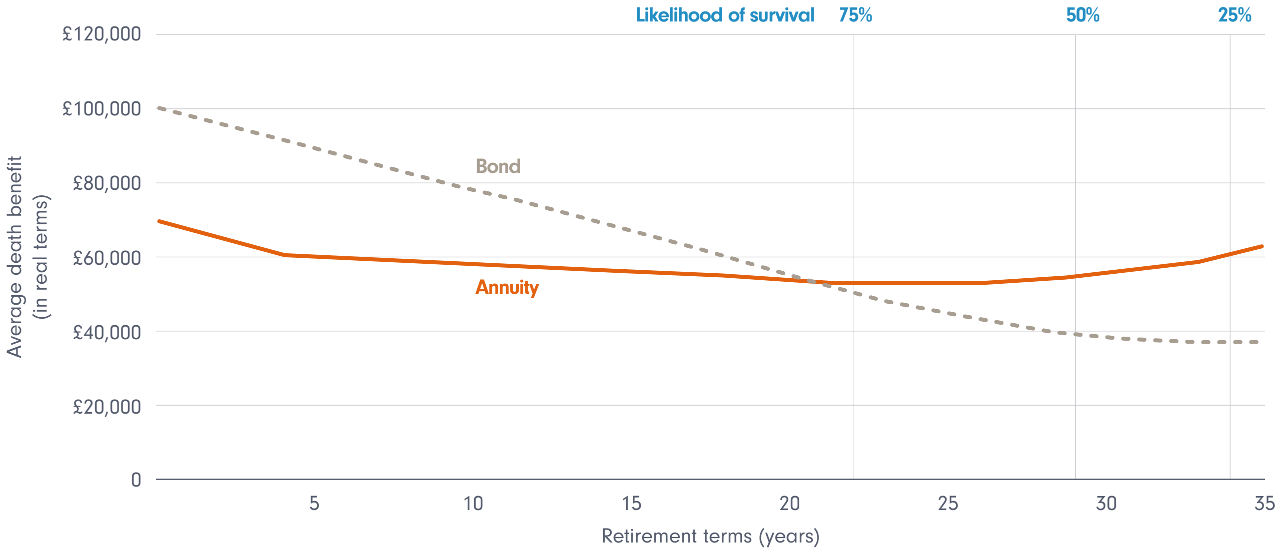


Source: 'Annuities reinvented: Are annuities the missing asset class for sustainable drawdown solutions?', Milliman, 2018.

It's also interesting to note that the annuity-equity and bond-equity strategy differ in terms of the level of death benefit they provide. Chart 2 shows the average death benefit (adjusted for inflation) at different points. Over the long term, the annuity-equity strategy may provide a higher death benefit.

Chart 2: Average death benefit (increasing with inflation)

For a healthy 65-year-old female, target income of £4,000 a year, fund: 55% equity, 5% cash, 40% bond or annuity (5 year guaranteed period).



Source: Annuities reinvented: Are annuities the missing asset class for sustainable drawdown solutions?, Milliman, 2018.

This may seem counter intuitive, but there are reasons. Firstly, the higher income from an annuity (compared to the bond element), means less needs to be withdrawn from the drawdown fund to provide a given amount of income. Secondly, the bond-equity strategy is rebalanced each year but, as annuities can't be bought and sold, the annuity-equity strategy is not rebalanced. It should also be noted that while annuities can't be encashed, further annuities could be bought during retirement. Given annuity rates are higher at older ages, a programme of phased annuitisation could boost sustainable withdrawal rates further (though this may reduce death benefits long term).

The Institute and Faculty of Actuaries modelled a range of strategies involving drawdown and annuitisation in 2018 and concluded that by adopting an integrated strategy 'consumers can potentially generate a larger overall income from their pension pot'[27]. The study considered phased annuitisation (chart 3).

27. Can we help consumers avoid running out of money in retirement?, Institute and Faculty of Actuaries, March 2018.

Chart 3: Example of phased annuitisation

Strategy reference	Initial annual income from drawdown	Proportion of remaining pension pot spent on annuity at different ages	Long term expected retirement income
1	£3,500	100% at age 75	£6,400 each year from age 75
2	£3,500	50% at age 70 100% at age 75	£6,600 each year from age 75
3	£1,750 (note: the remaining £1,750 comes from an annuity at age 65)	50% at age 65 50% at age 70 100% at age 75	£4,300 each year from age 70 £6,500 each year from age 75
Drawdown	£3,500	0%	Expected income starts to reduce from age 85

Source: Can we help consumers avoid running out of money in retirement?, Institute and Faculty of Actuaries, March 2018.

Strategy 1 shows that, on average, if a consumer withdraws £3,500 each year from a £100,000 drawdown fund from age 65 and fully annuitises at age 75, the average annual income would be around £6,400 from age 75. Strategy 2 shows that, on average, if a consumer withdraws £3,500 each year from age 65, then partially annuitises at age 70 with half of the pension pot and annuitises the remaining pot at age 75, they could receive an annual income of £6,600 from 75. Strategy 3 shows partial annuitisation at ages 65 and 70 then annuitising the balance at 75. The drawdown only strategy provides a stable income of £3,500 per annum until around age 85 or 90 when money runs out in some cases.

It should be noted that the average incomes shown are based on a range of investment strategies, which might be considered conservative when applied to more affluent advised clients. It's also worth noting that annuity rates are now much higher. The level, single life rate for a 65-year-old used in this survey was £5,308 per £100,000 purchase price. This compares with an equivalent rate currently of more than £7,000 per £100,000 purchase price[28]. These rates are for healthy lives and could be higher for those in poor health or whose lifestyle could impact their life expectancy. It should be noted that bond yields would have increased over this period.

28. Hargreaves Lansdown, January 2025 (based on a single life, level annuity for a 65-year-old, guaranteed 5).

Recent analysis from Standard Life revealed that a combined strategy can produce the highest overall income over a 25-year retirement. The analysis considered someone with a £150,000 pension pot and compared different scenarios. Buying a level annuity with 100% of their pension pot aged 65 would result in a total income of £253,775 by age 90. In contrast, purchasing a level annuity in four phases, starting with £90,000 at age 65, followed by £20,000 every five years, with the balance invested in drawdown (assuming 5% investment return per annum) and taking an income of 3% a year from the drawdown fund, would produce a total income of £259,115[29].

A degree of annuitisation can also mitigate the impact of sequencing risk. Consider a 65-year-old with a £500,000 fund planning to withdraw 4% or £20,000 income each year. If they buy a single life level annuity with £200,000 this would currently provide over £14,000 each year. That means the client would have to withdraw around 2% from the remaining £300,000 drawdown fund, so less has to be disinvested each year or set aside as a cash bucket. This is based on a level annuity, so future inflationary increase would need to be provided by the remaining fund, but this strategy can help overcome sequencing risk in the early years when it is most damaging.

> **Recent analysis from Standard Life revealed that a combined strategy can produce the highest overall income over a 25-year retirement**

29. Combining drawdown and phased annuitising could boost retirement income, Professional Paraplanner, January 2025.

Tax advantages

Where an annuity is bought as an asset of a drawdown fund there are potential tax advantages:

- If the income from the annuity isn't needed at any point, it is simply added to the drawdown pot (if the annuity is written separately, it would be taxed as income). This could be helpful for someone who is still working and wants to take advantage of high annuity rates. Assuming the annuity payments aren't required, they would simply be added to the fund without income tax being levied.
- On death after 75, there is scope to take death benefits, like value protection, from an annuity written under drawdown as a regular income, which may be taxable at a lower rate than would be the case if death benefits were payable from a separate annuity. The treatment of death benefits is set to change from April 2027, which may have implications for this approach.

Flexibility and certainty are both valued by people approaching retirement. An integrated solution can provide the certainty of income from an annuity with the flexibility of drawdown. This means clients can react to changes in circumstances, while knowing that part of their income is guaranteed for life. The FCA raised the need to consider annuities in its thematic review. It is no longer a binary decision. An integrated solution can offer clients the best of both worlds.

> **Flexibility and certainty are both valued by people approaching retirement. A hybrid approach can provide the certainty of income from an annuity with the flexibility of drawdown**

Key points

- Certainty is valued by retirees, but drawdown is more popular. Reasons might include lack of flexibility, treatment of annuities on death and unfavourable media commentary.
- Drawdown provides flexibility, which is also valued by many retirees, but exposes retirees to risks including investment market volatility.
- Strategies exist to combat sequencing risk. These include taking natural income, fixed percentage of the fund, cash buffers, rising glide path and guardrails.
- Smoothed funds can provide diversification and reduce volatility which can combat sequencing risk and provide peace of mind.
- An integrated solution can provide the best of both worlds – a degree of certainty and flexibility.
- Combining an element of annuitisation within drawdown can mean essential and important expenditure is covered, lead to better outcomes and provide tax advantages too.

Summary

- People are not particularly rational or objective when assessing risk. In particular, we have an asymmetrical view of risk. We fear loss far more than we value gains and this can affect how we invest money.
- A number of studies have identified education, wealth and age as factors that influence our perception of risk, but the results of these studies are often in conflict so it can be difficult to draw definitive conclusions.
- Retirement, in and of itself, would appear to have a material impact on risk aversion. This is likely to arise as a result of people drawing on savings that have often taken years to accumulate and are unlikely to be replenished.
- Given that retirement can increase risk aversion it is important that advisers assess attitude to risk and capacity for loss at retirement. It is equally important that these measures are regularly reassessed throughout retirement, particularly for drawdown clients, as factors like inflation, investment performance, withdrawal rates and changes in expenditure can all impact capacity for loss and attitude to risk.
- Retirees value certainty, yet sales of lifetime annuities lag behind drawdown sales. There are a number of reasons for this: a lack of flexibility – annuities can't be varied at will, nor can lump sums be taken. Annuities are perceived to offer poor value on early death – though death benefit options are much more flexible under lifetime annuities these days. What's more, the word 'annuity' has become toxic following unfavourable media coverage (though when the features are explained, people are attracted to the product).
- Drawdown provides flexibility which is also highly valued by retirees. It also introduces risk. Retirees could choose a low-risk portfolio of say bonds and cash, but there's a real likelihood that people might outlive their savings if they are too conservative. With retirement lasting perhaps 20-30 years some exposure to higher-risk assets makes sense, but it can give rise to sequencing risk.

- There are a range of strategies to tackle this issue. Living off natural income or taking a percentage of the value of the fund each year (rather than a percentage of the initial fund value). Both these strategies can result in a fluctuating income from year to year. Other strategies include cash buffers, a rising glide path and guardrails. Cash buffers and rising glide path are subject to the opportunity cost of reduced equity holdings in the early years, while guardrails can also give rise to a fluctuating income.
- Smoothed pension funds provide a degree of protection against investment volatility which in turn can help combat sequencing risk. They offer retirees a degree of reassurance that they are not fully exposed to the ups and downs of equity investing.
- Historically, retirees have faced a binary decision: annuity or drawdown? An integrated solution means retirees can now have a degree of certainty coupled with flexibility. The benefits of a hybrid approach include covering essential and important expenditure with a guaranteed lifetime income. Better outcomes (potentially higher safe withdrawal rates and greater death benefits). And tax advantages if the annuity is written as an asset of the drawdown fund.

Historically, retirees have faced a binary decision: annuity or drawdown? An integrated solution means retirees can now have a degree of certainty coupled with flexibility

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.

More insights on tax and pensions

We're committed to providing you with technical support to help you keep pace with the latest rules and legislation. Our range of practitioner material is designed to help you keep on top of all aspects of retirement planning. Themes covered include death benefits, pensions and divorce, the State Pension, pension withdrawals taxation and much more.

Visit the Technical matters hub on our website
fidelityadvisersolutions.co.uk/technicalmatters

For further information on our pension and investment options including Guaranteed Lifetime Income plan and Smoothed Fund please visit:
fidelityadvisersolutions.co.uk/guaranteed-lifetime-income
fidelityadvisersolutions.co.uk/smoothed

Adviser Solutions

Fidelity INTERNATIONAL