Investing in Context

Structuring a Sustainable Income in Retirement

- **Retirement income strategies are focussed primarily on managing the risk of running out of money, while at the same time, delivering a level of income that meets your needs as much as possible.**
- **When retired, having a robust strategy to manage withdrawals and monitor the longevity of your retirement pot is key.**

For over a decade in the UK, retirees have enjoyed 'Pension Freedoms'. In other words, they have had greater flexibility in how they wish to draw an income from their retirement savings. Prior to that point, retirees were required to use their pension pot to purchase an annuity – a contract that guarantees an income for life. However, while freedoms bring choice, they can also create some complexity. If not buying an annuity, how do you decide on the best strategy when drawing an income and importantly, how do you avoid running out of money? This short guide explores the topic of drawing a retirement income and sheds some light on several essential concepts.

At its simplest, saving for retirement involves accumulating assets through your working life, often using a pension for its tax efficiency, and then drawing an income from that pension when you come to retire. These two phases are sometimes described as the accumulation phase and the decumulation phase.

When you come to retire, the sum you have accumulated becomes your source of income. There are a variety of ways to take an income when you retire, and your financial adviser is well placed to advise on the most appropriate approach for you.

Having spent your working life accumulating retirement savings, it's important to adopt a retirement income strategy that will balance your need for income with the need to manage the risk of running out of money.

What will determine your retirement income?

In addition to the amount you have accumulated before retirement, there are various factors that will determine how much you can take as an income in retirement including:

- Whether you want to guarantee a level of income through an annuity
- How your money is invested and how those investments perform
- Your risk tolerance and capacity to withstand falls in the value of your investments
- How inflation affects the spending power of your retirement income
- The amount you choose to withdraw from your retirement savings
- What age you retire at and how long your retirement lasts
- Other sources of income such as state pension, rental income etc

With so many factors to consider, having a robust strategy to manage withdrawals and monitor the longevity of your retirement pot is key.

Withdrawal Strategy Considerations

Retirement income strategies are focussed primarily on managing the risk of running out of money, while at the same time, delivering a level of income that meets your needs as much as possible.

Withdrawal strategies can be described as static or dynamic.

A static strategy involves setting a rate of withdrawal and sticking with it. A popular example of this approach would be the 4% Rule. The 4% Rule suggests that retirees can safely withdraw 4% of their portfolio each year, and increase that withdrawal in line with inflation, with little risk of running out of money during a typical 30-year retirement.

While this approach is simple, well known and statistically reliable, it has a number of shortcomings:

- It fails to adapt to changes in investment performance or income needs (other than inflation increases) through retirement.
- It may provide too much or too little income as a result
- Retirees often end up accumulating significant sums

A dynamic strategy adapts income taken based on how the portfolio has performed. This means you may achieve higher income in years where the portfolio performs well while protecting the longevity of your retirement pot in years where markets are less favourable.

A dynamic approach will often also include guardrails. Guardrails are mathematical rules based on portfolio valuations or rates of withdrawal. These rules can indicate the need to adjust the income being taken. This can be particularly useful if performance is weak in the early years of retirement. Guardrails can also be used to indicate when income can be increased if markets are performing well.

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Guardrails Examples

PROSPERITY RULE When your portfolio is growing well:
If the percentage you are withdrawing, when measured against the current value of your portfolio has fallen by 20%, your income can increase by 10%. This rule enables increased income when markets are performing well.

CAPITAL PRESERVATION RULE When your portfolio is reducing in value too quickly:
If the percentage you are withdrawing, when measured against the current value of your portfolio has risen by 20%, your income should be reduced by 10%. This rule helps protect the longevity of your portfolio in falling markets.

The above are examples based on the 2006 Guyton-Klinger model; however, they are for illustration purposes only.

Your Financial Adviser Can Help You By:

- Helping you understand the level of income you will need in retirement
- Illustrating how your retirement savings can sustainably deliver income and how that will work with other sources of income, like any State Pension
- Developing a tailored retirement income strategy based on your own personal circumstances and preferences
- Providing ongoing monitoring and reviews of your retirement portfolio to ensure you achieve a sustainable level of income throughout your retirement

In summary

There are many factors that will determine the income you can achieve in retirement – not just the initial size of your pension pot. Those factors continue to influence your income throughout your retirement, and as such, developing a considered income withdrawal strategy will be essential.

You may prefer a simple, static approach like the 4% Rule, or a more dynamic model that will adapt your income based on portfolio performance and your income needs at the time. Whichever route you choose, your financial adviser will be able to guide you and provide ongoing reviews to enable you to make the most of your retirement savings.

Source: Determining Withdrawal Rates Using Historical Data, William P Bengen, Journal of Financial Planning, October 1994

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