Drawdown: The Mirror Image of Accumulation

FOREWORD

Decisions consumers take when accessing their pension savings invariably have many dimensions. Some of them are intractable and are likely to be highly influenced by emotion. They are possibly one of the most important long-term financial decisions which people have to make, and the consequences are profound and often irreversible.

The most important decision for most consumers revolves around the income to be taken from drawdown. Increasing numbers are using drawdown to provide themselves with an income. Recent consumer research indicates that 70% of consumers need their pension savings to provide a long-term income. And evidence is already indicating that many people are taking income at a level which is not sustainable.

The focus of this paper is on income drawdown. We have made this our focus because of its importance to consumers and because it is an area where the industry is not serving consumers well. We want to draw attention to what we believe is the lazy practice of applying accumulation solutions to managing drawdown.

Action needs to be taken now to start putting serious thought and effort into creating fit for purpose income-specific solutions for income drawdown.

We, therefore, take time in this white paper to describe what those solutions might look like.

We explore what's working, what's not working and what needs to be done to avert potentially disastrous consumer outcomes in the future. In a short white paper, while our analysis is not exhaustive, we do seek to cover what we believe are all the major areas needing urgent attention.

Lastly, we acknowledge our vested interest in the issues we've raised. However, we can speak with authority on them in this paper as they constitute the bread and butter of our business. Whereas others may be better placed to address specific day-to-day issues with their own valuable insight, we have focused on our key areas of expertise and experience.

We hope this paper provides food for thought. More importantly, however, we fervently hope that, for the benefit of consumers, it opens up the discussion for what we need to do as an industry to take the first steps in filling the innovation void in which drawdown has largely been languishing since the introduction of pension freedoms.

Bruce Moss
Founder and Strategy Director, EV

EXECUTIVE SUMMARY

In their current form, many of the tools, processes and communications used with drawdown products and services are short-changing consumers.

Frequently the wrong risks are being assessed and the wrong tools are being used to support decision-making. There is little sign that these industry-perpetuated shortcomings are being addressed urgently, which needs to happen as there is evidence that retirees are drawing income at unsustainable levels as a result. This has the potential to seriously derail advised as well as non-advised drawdown consumers' retirement plans and cause long-term financial damage. The reputational damage to the industry could be at least as great as the mortgage endowment scandal, pension mis-selling and DB transfers. Does the financial services industry really need another massive PR debacle with potentially costly compensation, particularly when some timely reaction can avoid it?

In this paper, we seek to highlight the issues undermining many tools and processes currently available and suggest simple steps that can, and we argue must, be taken urgently to ensure drawdown tools and services are purpose-built for the task in hand. We make the case for why the industry, by which we mean financial advisers, pension providers and fund managers, needs to stop using re-purposed accumulation solutions as fit-for-purpose for drawdown.

They categorically are not. Decumulation is, by definition, the opposite of accumulation and investment risks impact very differently on capital growth and the sustainable income which can be drawn. To use the mirror analogy, everything is back to front and so is the way that investment risk impacts on outcomes for consumers saving and drawing down on retirement savings. The problem is that currently, while most people agree that investment risks impact accumulation and decumulation differently, many in the industry are using the same tools to manage decumulation and accumulation. To use another analogy, it is similar to using a ship's echo sounder or sonic depth finder on board an aeroplane to measure altitude.

The result of using the wrong tools for the job of managing decumulation and for explaining risk to retirees using drawdown is that, at best, retirees will achieve suboptimal outcomes. At worst, however, they may experience serious hardship in retirement because their retirement capital is eroded rapidly and the income level they were relying on proves unsustainable. These bad outcomes for retirees are not inevitable. So far, as an industry, we have been lucky. Investment markets have been benign and many retirees have the 'safety net' of a defined benefit pension. This will not always be the case and we need to find and adopt better solutions for helping retirees as numbers and reliance on income drawdown increase. We are, therefore, calling on the industry to take the following actions:

- Currently, most advisers are using accumulation risk questionnaires for retirees looking to use drawdown to provide an income, which is inherently damaging as the attitude to the wrong risk is being measured – risk questionnaires need to be tailored to the needs of those drawing an income.
- Similarly, risk is frequently explained and communicated in terms of investment volatility when presenting the risk of investment options for income drawdown; the impact on sustainable income is the relevant communication, not investment volatility.
- Funds and portfolios used for income drawdown are typically rated for risk to capital whereas they should be risk-rated in terms of income sustainability.
- Particularly important for the non-advised (but also for advised), retirees should be urged to have annual income reviews, and these should also happen at times of severe market dislocation. In particular, the Financial Conduct Authority (FCA) should extend the requirement for Investment Pathway providers to provide updated guidance on sustainable income along with the annual statement. This could be achieved by providing access to a simple modelling tool.
- A distressingly significant number of providers and advisers are using the regulator's illustration rates for determining drawdown income levels. These are entirely inappropriate for determining income levels because they are infrequently reviewed and changed and were not intended to be used for this purpose. The FCA should clarify the purposes for which its illustration rates should be used.

These are not major initiatives. They are simple and achievable steps that can be taken relatively easily. To our mind, inaction would constitute a wilful neglect of duty to ensure positive consumer outcomes.

INTRODUCTION

The decisions consumers have to make about how to draw retirement income are by no means simple and flexi-access drawdown (the new form of drawdown introduced by George Osborne in 2015) presents particularly challenging problems.

And there are inevitably trade-offs to be made involving many uncertainties – personal and economic. In effect, retirees are attempting to predict the future.

Some will benefit from regulated financial advice (advised drawdown) while other consumers will be largely left to their own devices (non-advised drawdown). This is largely an economic divide creating an 'advice gap'. Let's look at the two processes and see what's working well and what could be improved.

Importance of providing a sustainable income

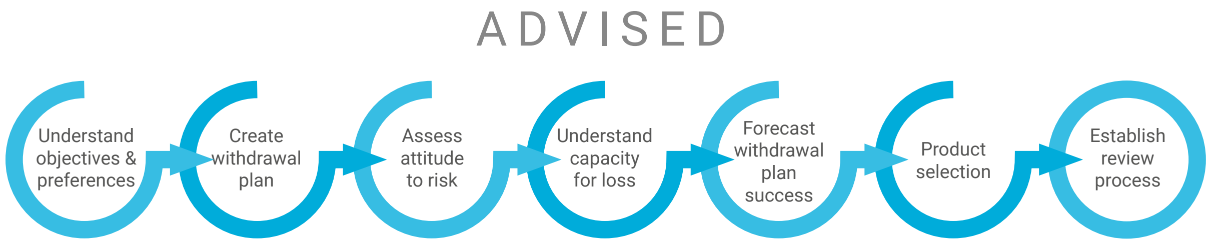
The primary purpose of pension savings is to provide consumers with an income to sustain them through their retirement. However it is the case that, today, many retirees have a source of income other than their Defined Contribution (DC) provision – in particular some Defined Benefit provision.

However, even today, research indicates that the majority of people want an income for life:

- Aon's *Keeping on track in challenging times: DC pension and financial wellbeing employee research 2021* found that 60% of individuals want an income for life in retirement
- NMG's *Walk this way: Pension savers' views on the FCA's Investment Pathways* (January 2021) found that 70% of prospective drawdown users said that the Investment Pathway closest to their current needs is one which provides a long-term income

In recent years 4% per annum withdrawals from a consumer's pension pot has been extensively used as a rule-of-thumb for a level of sustainable income. But, in today's economic climate, 4% is considered by many to be high. In this context the emerging data from the FCA (September 2020) should be noted. For consumers with a pot size in excess of £100,000, the FCA data show that for consumers taking regular withdrawals – some 160,000 pension plans – 60% are taking 4% or more (with some 23% taking greater than 8%).

The Association of British Insurers (ABI) *Future proofing the freedoms: Supporting consumer decisions about pension withdrawals* (June 2021) concludes that there are valid concerns about unsustainable withdrawals, and that future retirees will be much less likely to have other income to rely on and many will be relying solely on a DC pension.



Briefly these steps for advisers are:

- To understand whether income is the primary objective and whether the security of an annuity is more important than flexibility;
- To understand the 'shape' of income that is required;
- To assess risk appetite with a focus on income sustainability;
- To measure and communicate capacity for loss in terms of the impact on lifestyle in retirement;
- To enable retirees to understand the chances that their withdrawal plan will be achieved by producing reliable forecasts of outcomes;
- To select not just the flexi-access drawdown plan but most importantly the fund or portfolio that matches the retiree's attitude to income risk; and
- To set up (or promote the importance of) regular reviews.

There are many good financial advisers who are performing all of these steps (perhaps in a different order) but all are covered by a diligent adviser.

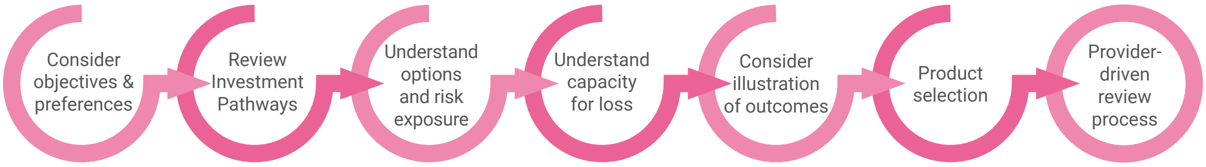
So, what could possibly be going wrong? The problem centres in the consistency of the linkage between the objectives and preferences and the assessment of risk, capacity for loss, forecast of outcomes and product selection. This paper will go into each of the elements in this process in subsequent sections but for now, suffice it to say that much of the advice given to retirees on the level and how to provide their retirement income is potentially unsuitable because:

- the objectives and preferences generally are at odds with the way risk is assessed and measured; and
- forecasts do not illustrate the risks accurately.

This deficiency in the advice given can have profound consequences that are often irreversible. The results may not be immediately obvious but will almost certainly emerge in the future.

The position of non-advised consumers is governed by the FCA's Investment Pathways requirements. To an extent, a similar path to the advised process is followed with considerable simplifications which recognise the limited capabilities of most mass market consumers.

NON-ADVISED



Briefly these steps are for consumers:

- To consider the four objectives that the FCA requires providers to present;
- To review the appropriateness of one or more of the pathways to fulfilling their objectives;
- To understand the risks associated with the Investment Pathways;
- To understand the potential downside impact that a poor outcome would have on their retirement lifestyle (it is difficult to overstate the importance of this because retirees have few options for recovering from a bad outcome);
- To select the product that best meets their objectives (this might not be an Investment Pathway);
- To understand the benefit of regular reviews (the annual statement required by the FCA for Investment Pathways falls short of what is required, in our opinion).

From a review of how drawdown providers have responded, it is evident that similar problems to advised drawdown exist - principally, that measuring and communicating risk exposure and capacity for loss were out of sync with the objectives of the different pathways. While the FCA's initiative with Investment Pathways was a good step in the right direction, the benefits to consumers have been severely constrained by the approach adopted and tools used by providers. It is the contention of this white paper that when the FCA comes to formally review the industry's response, major shortfalls on the part of product providers (and Independent Governance Committees) will be identified.

At the heart of most of the major problems is the failure to recognise that the approach and tools used for advising on accumulation are not fit for purpose with decumulation.

The good news is that there appears to be general industry agreement about what a good process looks like, whether advised or non-advised. The problems stem from the implementation, using techniques developed for accumulation which present different risks and challenges to consumers than decumulation. Fundamentally the objectives are different, the risks are different, the impact of loss and therefore the measurement of capacity for loss is different and what success looks like is different. It, therefore, should be no surprise that the approach and tools should be different. They don't need to be more complicated or onerous to use – just different!

Given the increased regulatory focus on product governance, through PROD (the FCA's Product Intervention and Product Governance Sourcebook), both 'manufacturers' and 'distributors' must be held to account in terms of their requirement to ensure that their products meet the needs of their target market – in this instance, consumers seeking a sustainable long-term income in retirement.

While advice is highly desirable and needed for most consumers to arrive at a good personal solution in this complex area, this is not practical for the mass market i.e. those with small or medium-sized DC funds without the use of digital or hybrid advice such as, using digital delivery to improve adviser productivity. This can reduce the cost of initial and ongoing advice to a level justifiable in context of the size of retiree assets. Although digital and hybrid advice are vital parts of any comprehensive solution to meet the needs of retirees, this will not be covered to any extent in this white paper and deserves its own paper dedicated to how to use a digital capability to transform the delivery of advice. As we said in our 2016 white paper: *Robo Advice – the catalyst for transformational change*, transformation can be achieved through judicious use of digital advice which should integrate seamlessly with adviser tools and human advisers so that consumers have choice and can move between options according to their needs.

Providing consumers with appropriate support

Platforum research (April 2020) found:

- 31% of adviser firms don't differentiate portfolio recommendations for clients in drawdown from those in accumulation
- 44% say the portfolio range is the same but the decumulation clients have a lower risk profile
- Just 24% offer an entirely different portfolio, designed with drawdown in mind

Research findings from The Lang Cat (February 2019) highlighted that access to software and tools that help consumers with their retirement planning needs, such as understanding how much money they are likely to need in retirement or whether other assets beside their pension could contribute to future income requirements, was sorely lacking.

The ABI's *Future proofing the freedoms: Supporting consumer decisions about pension withdrawals* (June 2021) notes that pension withdrawals are the key remaining challenge in helping people to navigate pension freedoms. The ABI concludes that most people are not getting the support they need to make decisions about withdrawals, and that the industry has an important role to play in providing this help.

INVESTMENT PATHWAYS

FCA Policy Statement 19/21, which gave life to Investment Pathways, was prompted by the rapid growth in the use of drawdown as the means of accessing pension savings after the introduction of pension freedoms.

The concern was that some providers were defaulting non-advised consumers to cash funds so that overall around one-third of drawdown accounts were held in cash. FCA-commissioned research, conducted by NatCen Social Research and supported by the Pensions Policy Institute, showed that many consumers moved into drawdown to get access to a Pension Commencement Lump Sum (PCLS) and not because they were interested in the product in its own right. Drawdown for the non-advised had become an inadvertent by-product of getting access to tax-free cash before retirement.

It was clear that putting the onus on non-advised consumers to navigate the many and complex considerations of drawdown would have a sadly predictable outcome, in all but exceptional circumstances.

For non-advised consumers using drawdown, setting realistic retirement objectives is daunting as it involves making assessments of longevity, investment returns, the level of income to draw each year, whether the income can be sustained, the relative merits of an annuity and, potentially, when and what type of annuity to buy.

While Investment Pathways are a useful step in helping frame the outcome from drawdown sought by the consumer, they do not go far enough on a number of fronts. Briefly, more help is needed to support retirees using drawdown to understand what a sustainable level of income might be. The annual statement to be supplied by product providers could usefully also be beefed up by providing guidance on the level of sustainable income in the light of the investment performance of the pathway investments.

Where Investment Pathways come into their own

NMG's *Walk this way: Pension savers' views on the FCA's Investment Pathways* (January 2021) shows that nine in 10 savers found an Investment Pathway option which matched their needs. And 60% of respondents were positive about Investment Pathways, with Generation X in particular finding them useful for their retirement planning (almost 70% of retirees-to-be under age 55 being positive about them). There will always be a group of more engaged and confident savers for whom the concept of Investment Pathways will seem too basic and, in this context, the figure of almost 70% finding them useful demonstrates that the policy intervention is targeting those consumers who are most likely to benefit from Investment Pathways. NMG concluded: "Those who previously confessed to having their head in the sand told us that this was a positive first step, a relatable and simple way to make retirement choices feel tangible, with a focus on the outcome of each decision".

The ABI's *Future proofing the freedoms: Supporting consumer decisions about pension withdrawals* (June 2021) notes that Investment Pathways help avoid a mismatch of investments and withdrawals, and found that the early evidence suggests they are being used as intended and validate an approach based on choice, as consumers are choosing different options. But the ABI notes that consumers still need to make multi-faceted decisions about withdrawals.

By their very nature the four pathways are prescriptive and self-contained, whereas the reality is that for many consumers the best outcome might be a combination of more than one pathway.

Of particular concern is what we've seen to date of how product providers are approaching implementing the pathways.

- It is unclear how many have made assumptions about the risk profile of consumers expected to be using the Investment Pathways.
- In selecting investment solutions, product providers appear to have focused on risk ratings based solely on volatility without making a differentiation about the objective of the pathway e.g. where the consumer has indicated they want to take a long-term income.
- Consumer communications seem to be very wide of the mark especially given the emphasis placed by the FCA on ensuring that they are fit for purpose – there is a certain irony that, with the introduction of outcome-focused Investment Pathways, most providers appear to have chosen to focus their communications on investment risk and have largely ignored outcomes.
- While the FCA has placed considerable emphasis on helping consumers assess their capacity for loss this has been almost totally ignored by providers – it appears to have fallen into the too difficult bucket which follows on naturally from the focus on investment risk rather than outcomes.

The industry and FCA in tandem need to take the next step to fix these clear failings in how Investment Pathways have been implemented – time and again shoe-horning accumulation practices into drawdown solutions. We set out some solutions (not the only ones), which would address these failures by simply following the FCA's lead and focusing on consumer objectives. Whether advised or non-advised, from a consumer's perspective, accessing pension savings is patently not the same as saving for retirement. Both advised and non-advised drawdown suffer from similar failings as a result.

And herein lies the rub of the current market failure. Tools and techniques that have been developed to support consumers when they are saving for retirement are being applied to drawing a sustainable long-term income in retirement. Such an approach does not stand up to scrutiny as the risks faced by consumers are different both in their nature and their severity.

Modelling risk and return realistically should mean understanding the sequence in which investment returns might be earned. Get off to a bad start with drawdown thanks to a run of poor investment returns and retirement prospects are irrevocably damaged, whereas an initial good run of returns initially can lead to a happy and successful retirement.

Yet many strategies and solutions are currently designed using an assumed fixed rate of investment return throughout retirement, the 'deterministic return'. This is unrealistic and ignores the important effect that the sequence of returns has on drawdown outcomes. The same problem applies with a common type of stochastic model, known as a Mean, Variance, Co-variance (MVC). Essentially, MVC models provide time independent forecasts and therefore ignore sequencing risk.

In addition to sequencing risk, a consumer using drawdown is also vulnerable to high levels of market volatility. Volatility can be beneficial to an investor making regular investments during the accumulation of wealth – the effect known as 'pound cost averaging'. For drawdown, the effect is the exact opposite. A retiree drawing a regular income from his or her investments is vulnerable to high market volatility – the higher the volatility the worse the effect and the greater the impact of what is often referred to as 'pound cost ravaging'.

The combined effect of using tools which ignore the negative effects of sequencing risk and 'pound cost ravaging', which all deterministic or MVC modelling tools do, is to overstate the level of income which can be drawn thereby exposing retirees to a greatly increased risk of running out of income in later life.

Another flawed approach quite widely used is to look at periods of past history. Essentially this gives undue weight to a very few potential scenarios i.e. those in the relatively recent past, quite apart from the fact that the future is very unlikely to exactly replicate the past. We only have to consider the current economic environment, which 20 years ago would have been inconceivable, so testing a drawdown withdrawal plan with past history which does not resemble current market conditions, prima facie, does not make a lot of sense. Is it very credible that starting from ultra low interest rates and ultra high equity markets, we are likely to experience markets similar to the past? Replaying past investment history can provide one or a few scenarios but there are many more plausible scenarios that need to be considered and should not be ignored.

There are models and then there are models

Deterministic forecasts typically have fixed rates of return i.e. outcomes are pre-determined by the parameters set.

MVC models, the most common way of presenting capital market assumptions or CMAs, also fail to account for volatility properly. These models do describe a stochastic model of sorts but the usual spreadsheet calculations only describe a final outcome and can't capture the effect of prices varying over time on withdrawals. They therefore do not capture either sequencing risk or pound cost ravaging effects. The spread of outcomes only describes the price movement of the underlying asset and does not take account of the investor's interaction with their funds.

Economic Scenario Generators are tools for making stochastic models where it is not possible to use a neat shortcut calculation like the matrix operations for MVC models. This includes complex calculations like those involving interactions over time of cash flows with investment markets. They are a form of Monte Carlo simulation and work by producing a set of scenarios which together have the range and distribution implied by an underlying model. Each scenario represents a possible joint future history of all the market prices, interest rates and any other economic factors being considered. Modelling is then done by calculating what happens to a retiree's income withdrawal plan in each scenario and then looking at how it looks across the entire collection of scenarios. Crucially this presentation of a model will automatically capture the effects described as sequencing risk and pound cost ravaging. Multiple questions can be addressed like for example, one simulation might answer: how much do I expect to have left after 10 years, what is the probability that my withdrawals can be sustained for 30 years, and how long will my capital last with 90% probability?

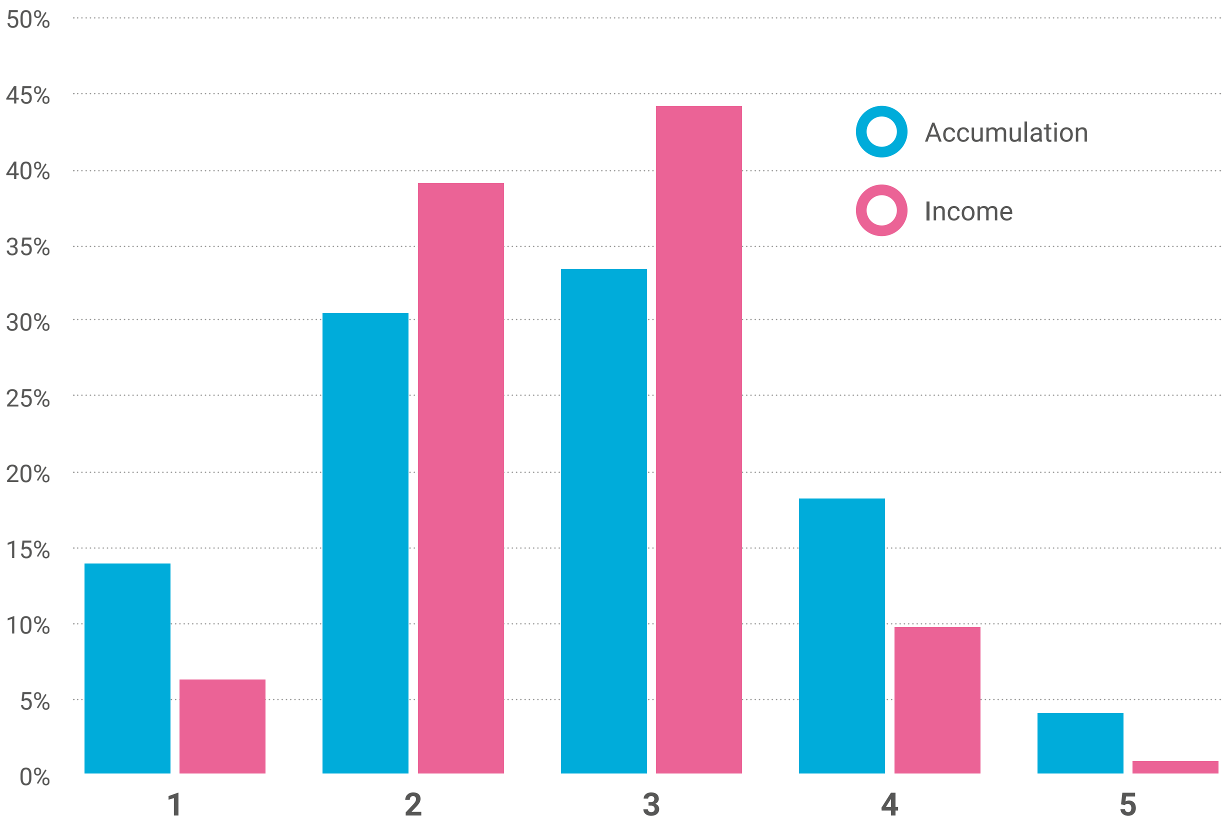
REVISITING THE 3 RS: RISK PROFILES, RISK RATINGS, WITHDRAWAL RATES

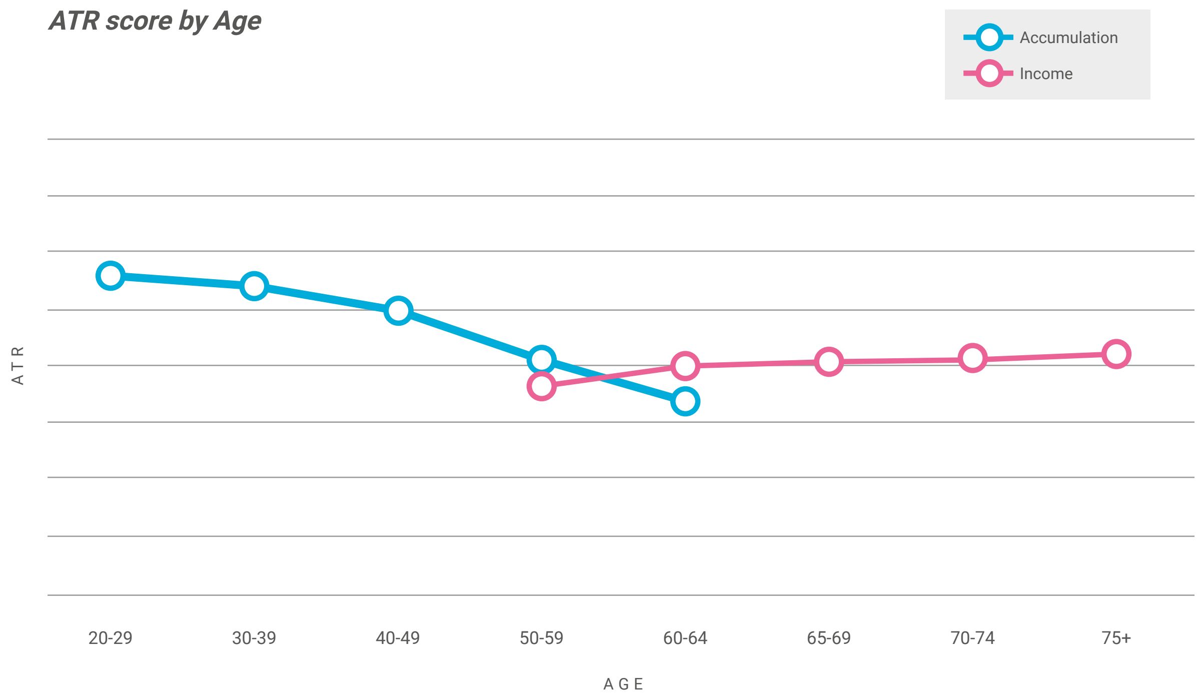
RISK PROFILES

Consumers' attitude to risk changes not only as they progress towards retirement but also, fundamentally, when their objective changes from saving for retirement to drawing an income from their retirement savings. Attitude to risk questionnaires are well established in the market and have proven to be an effective way of assessing a consumer's risk profile. Compared to someone saving for retirement, the concerns are very different for a retiree using pension assets to provide as high an income as possible in retirement while, at the same time, having the ongoing worry that a market downturn might mean that these assets might not last for the rest of life.

In these circumstances, it would seem to be obvious that a questionnaire designed for someone saving for retirement is not appropriate for someone looking to achieve a sustainable long-term income. And, indeed, the evidence bears this out. EV first produced an income risk questionnaire in 2017 and a summary of the results are compared below with our long-established accumulation questionnaire.

Distribution of risk profiles differs for accumulation and income





From the above, it is clear that the distribution of risk profiles for retirees seeking to draw an income from their pension assets is quite different to the profiles of consumers saving for retirement. The former seem to recognise that they need to take some risk in order to improve their income but are also quite risk averse and avoid taking high levels of risk with their income. The result is a clustering in the low to middle risk bands – a feature which appears to be independent of age. This contrasts with the risk profiles of consumers in accumulation mode who have a wider spread of profiles and a noticeable trend to become more risk averse with age. The evidence clearly shows that a well-designed attitude to risk questionnaire – developed with the specific purpose of income drawdown in mind – needs to be used. Anything less is not serving the consumers well, as otherwise, attitudes to the wrong risk are being measured.

For drawdown, assessing a consumer's capacity for loss is critically important because of the much higher level of detriment which can arise when a retiree's plan goes wrong compared to a retirement saver. The FCA clearly had this in mind when it emphasised the need with Investment Pathways to communicate clearly potential loss so that non-advised consumers could assess their capacity for loss and their ability to take risk. As things stand at present, capacity for loss for retirees using drawdown to provide an income is very hard to assess even for advisers. Because generally risk is not communicated in terms of income, it is very difficult to assess how serious a potential fall could be. This would need to be considered in the context of other sources of income e.g. State, and defined benefit pensions, annuity income, etc. and other assets which could generate income such as home equity release. Where it is done, advisers often use arbitrary 'stress testing' to see the effect that a fall in investment markets would have on a retiree's withdrawal plan. This stress testing frequently takes little or no account of the investment risk the retiree is actually running. It is better than nothing but is far from scientific.

Assessing capacity for loss involves accurately assessing how the investment risk, that consumers are actually exposed to, could impact their objectives. It needs to be done accurately, so that there is an objective way to recommend a change of risk exposure. For some, pension assets being drawn down will provide only a small part of the income they have to support them in retirement; for others, it will represent the bulk with only the State Pension offering a very low 'safety net'. Wherever consumers sit on this spectrum, the risk to them is clear – it relates to the sustainability of a long-term income.

Any approach to risk assessment for income drawdown needs to quantify the potential downside to income so that the impact can be assessed in the context of other assets and sources of income. It is vital that risk descriptions accompanying the outcome from a risk questionnaire explain risk in terms of potential income downside so that advisers and consumers can understand the implications of the risk level they are considering in the context of other income sources and assets. An approach along these lines represents a robust way of establishing a consumer's risk profile (taking account of capacity for loss) for drawdown and explaining the implications.

When the regulator conducts its review of advised drawdown and the response of drawdown providers to the introduction of Investment Pathways, it must be expected that the FCA will reiterate the need for a clear communication of the risks associated with income drawdown in a way that capacity for loss can easily be assessed.

RISK RATINGS

Redefining risk post retirement

The matching of the output from a risk questionnaire to a suitable investment which has the risk characteristics described for the selected risk profile is a critically important step. A lot of scrutiny is given to risk questionnaires and the methodology used in their construction, but little due diligence on the production of risk ratings.

Few providers publish their detailed methodology, particularly for income risk ratings. There is almost no transparency which gives rise to the suspicion that there is little being done beyond measuring the short-term volatility of the capital supporting the income.

As capital volatility has only a partial influence on the risk to income, this is not the right risk measure to use. Indeed, it appears that many advisers don't differentiate between accumulation and income when measuring risk and recommending investments. This is clearly not right on two counts – firstly it is measuring retirees' attitude to the wrong measure of risk i.e. capital loss rather than income sustainability and secondly matching to investments based on their volatility is, at the very best, only part of the picture (see Appendix for more information). As above, the income generated and its stability will have a major impact on the income risk associated with an investment. Short-term capital volatility misses this feature completely. In the example of a bond portfolio, the income risk is approximately half of the risk to capital. No big revelations here for fund managers but what seems to be lacking is a clear methodology for measuring the risk of income sustainability. This deficiency has the serious knock-on effect that capacity for loss for a retiree drawing income from a fund or portfolio is impossible to measure.

There is clear need, which we believe is not being adequately addressed by most of the industry, for measuring the risk of drawing an income by being able to quantify the potential downside risk associated with different investments. There is, of course, no one way to do this but after considerable experimentation and testing, EV has chosen to use Income at Risk (IaR) as the measure.

IaR measures the risk of a drop in the sustainable income (income for a duration matching life expectancy) over a 3 year period. IaR additionally benefits from being largely independent of the age of the retiree.

The approach taken with IaR is to assume that the sustainable income is drawn from the fund at an unchanged level for 3 years and then to measure the potential for a fall in income to occur if the sustainable income is recalculated. In effect, it is the situation that would arise if a retiree drew the maximum sustainable income and did not have a review from an adviser for 3 years. Depending on the fund's performance over the 3 years, it is possible that the adviser might recommend that the income could remain the same or be increased if the return on the fund has been good.

Conversely, the performance could have been poor. How bad could the outcome be? For each risk band a level should be set at which poor performance, whilst to be regretted, would nevertheless still be acceptable to the retiree. In other words, the outcome would not be so bad as to have a very detrimental impact on the retiree's lifestyle. This measure of downside risk is particularly useful in making the judgement about a retiree's capacity for loss as the potential downside in income can be considered in the context of other sources of income e.g. State and DB pensions and other sources of income producing wealth.

The table below gives some examples for five and ten risk profiles with IaR increasing in broadly equal steps.

Five Risk Bands

Risk Level	Income at Risk (IaR) 3 in 4 chance
1	Increase/no reduction or reduction less than **4%**
2	Increase/no reduction or reduction less than **7%**
3	Increase/no reduction or reduction less than **10%**
4	Increase/no reduction or reduction less than **13%**
5	Increase/no reduction or reduction less than **16%**

A refined simpler approach to the above could be used to communicate risk to non-advised consumers.

Ten Risk Bands

Risk Level	Income at Risk (IaR) 3 in 4 chance
1	Increase/no reduction or reduction less than **2.5%**
2	Increase/no reduction or reduction less than **4%**
3	Increase/no reduction or reduction less than **5.5%**
4	Increase/no reduction or reduction less than **7%**
5	Increase/no reduction or reduction less than **8.5%**
6	Increase/no reduction or reduction less than **10%**
7	Increase/no reduction or reduction less than **11.5%**
8	Increase/no reduction or reduction less than **13%**
9	Increase/no reduction or reduction less than **14.5%**
10	Increase/no reduction or reduction less than **16%**

CASH RESERVES/BUFFERS

Because of the absence of a robust method of assessing clients' attitude to income risk and risk rating investments and portfolios, selecting investments to match the assessed level of risk is very difficult for advisers. Not unnaturally, therefore, they tend to recommend investment strategies which are more cautious than would be ideal for some clients. There is widespread recognition of sequencing risk, i.e. a run of poor returns in the early years of retirement, and the harmful effects of high volatility which can lead to 'pound cost ravaging', both of which can have a serious impact on the sustainability of income. Consequently, many advisers often adopt 'safe-siding' strategies like setting up cash reserves or buffers of one or two years of income to be drawn on during market downturns. There is also positive psychological benefit to retirees from the feeling that they are not fully exposed to the vagaries of investment markets.

There are several points worth making about the use of cash reserves or buffers. Firstly, in practice, managing cash buffers is not easy. The timing of when to draw on a cash reserve or to top it up involves decisions on market timing which are well known to be tough even for experienced fund managers. This is particularly difficult when the prolonged period of underperformance is not dramatic but is nonetheless below the level required to sustain the required income for life. Additionally, setting up a cash reserve will lower risk and, as a result, potentially lead to a mis-match between the recommended investment strategy and the retiree's risk profile essentially resulting in an unsuitable recommendation as the effect of lowering investment risk will reduce prospective returns and the sustainable income that can be supported.

Cash reserves/buffers for mitigating investment falls, however, do have a place and offer consumers some psychological comfort that they are not fully exposed to investment markets. Certainly, a cash reserve to cover unexpected emergencies is required but, beyond this, many clients who have higher risk tolerance and capacity for loss would benefit with a higher prospective income if there was a more precise match between their attitude to risk and the investments backing their drawdown plan. With a precise risk rating methodology for income funds and portfolios, this can be achieved.

With a robust risk rating for income, the effect of holding a cash reserve can be quantified and adjusted for in the recommendation of a fund or portfolio. The table below shows the effect of holding a cash reserve for different risk profiles. For example, for a retiree with a risk profile of 8, the effect of setting up a cash reserve of 24 months' income when combined with a fund risk rated 8, will reduce the combined risk to 7 which does not therefore match the retiree's risk profile of 8. To get back from 7 to 8, the recommended fund or portfolio would need to have a risk rating of 9. To summarise 24 months of income plus a fund with a risk rating of 9 would be suitable for a retiree with a risk profile of 8.

Risk profile from income risk questionnaire	Months of income held as cash	Fund risk allowing for cash
9	24	10
8	24	9
7	30	8
6	30	7
5	36	6

A cash buffer for a client in the highest risk category i.e. 10 will reduce risk and potentially result in not matching the result from the income risk questionnaire. For low risk clients, cash buffers are not necessary as the potential downside is limited and increasingly sizeable cash reserves are required to reduce the risk level by a whole point.

As a final note, it is important to emphasise that cash reserves are required to cover unexpected emergencies and should not be confused with the setting up of a cash reserve/buffer to manage investment risk.

WITHDRAWAL PLANS

As with accumulation fund risk ratings, income risk ratings are designed to facilitate the selection of suitable funds or portfolios which match clients' risk appetite – in this instance, their willingness to take risk with their retirement income. Similarly, income risk ratings fit neatly within existing financial planning processes involving clients' income needs and retirement objectives. Understanding a client's income needs in retirement is central to the advice process and the income risk questionnaire and fund income risk ratings have been designed to fit around the cashflow modelling required for the development of an income withdrawal plan which reflects a retiree's income needs. Typically, a higher income may be sought in the early years of retirement when a retiree is likely to be most active.

Using stochastic modelling to build an income withdrawal plan is very important. Stochastic modelling, specifically using an economic scenario generator, produces a large number of plausible independent future investment journeys starting from current market conditions. Because of the large number of potential outcomes – some good, some bad, some with periods of high volatility, some with several years of poor returns – a realistic picture is given of what the future might hold. Sequencing risk and 'pound cost ravaging' are taken into account and given an appropriate emphasis in the future forecasts. This is important because the summation of all these future forecasts is reflected in the central or median outcome. The scenarios where sequencing risk and high volatility have most impact will reduce the central outcome. This feature of an economic scenario generator is very important because deterministic forecasts or forecasts using a Mean Variance Covariance (MVC) model do not vary with duration and therefore make no allowance for sequencing risk and periods of high volatility. These forecasts therefore tend to overestimate the income which can be supported within the withdrawal plan.

An additional advantage of using stochastic modelling is that the chances of success of the withdrawal plan can be assessed i.e. the probability that all the income requirements of a retiree can be met. This can be monitored by advisers at regular reviews along with changes to the withdrawal plan. A fall in the probability of achieving the withdrawal plan can also act as a prompt for an adviser to undertake a review. Reviews of withdrawal plans are essential as income needs will change and the investment performance achieved will impact the success of the plan.

It is important, here, to emphasise that the use of simplistic deterministic projections, which are used by some advisers in the cash flow modelling supporting withdrawal plans, are fundamentally flawed and potentially dangerous in that they are based on arbitrary assumptions which ignore the major risks which retirees using drawdown face. As stated above, any forecast which ignores the durational nature of investment returns (and this includes MVC models) cannot take account of the interaction of the timing of disinvestments with investment market movements. Sequencing risk and periods of high volatility are simply ignored with the consequence that the outlook from the projection is systematically flawed and over-optimistic. The result will be disappointment (potentially serious) for many retirees.

MODELLING

Creating reliable withdrawal plans for retirees that are developed, monitored, and reviewed using robust modelling is an essential component for the success of income drawdown. What is needed are models which forecast a wide range of realistic potential future investment scenarios, which develop year by year and allow for the possibility of high volatility and a sequence of bad returns in the early years - both of which are major threats to the success of a drawdown plan. Allowing for these real-world effects when modelling drawdown outcomes is essential and only economic scenario generator models, which reproduce real life characteristics of assets, do this.

Although such economic scenario generator models are built by looking at historical data to determine the characteristics of different investment classes and their correlations, using historic performance alone:

- does not provide enough independent scenarios
- is highly dependent on the periods selected
- is not a reliable indicator of future results

Using an economic scenario generator with thousands of forward-looking forecasts from the current economic situation is a uniquely powerful way of understanding the risks associated with drawdown and providing sensible and realistic forecasts of sustainable income.

Consumers and advisers need access to reliable modelling tools so that they can develop reliable withdrawal plans. Not allowing for sequencing risk and realistic changes in levels of investment volatility will systematically result in over-estimating the retirement income that can be supported by a drawdown plan.

MISUSE OF FCA ILLUSTRATION RATES COMPOUNDING THE PROBLEM

On the subject of projections and the creation of withdrawal plans, the use by many product providers and advisers of the FCA's illustration rates to make forecasts of outcomes is potentially giving rise to considerable consumer detriment and product bias. This may sound like a criticism of the FCA – it isn't. Rather it is a criticism of the use of the assumptions underpinning FCA illustrations for a purpose for which they were never intended to be used and for which they are entirely unsuited.

There seems to be a view that using the FCA's assumptions is a way of avoiding any criticism or comeback. If this is the view, it is a serious misjudgement as the assumptions used for FCA illustrations were never designed for making decisions about income drawdown. Rather the illustration basis was designed to provide a standard basis for seeing the effect of charges and making comparisons between products from different providers. To make judgements about withdrawal plans and the level of income that would be sustainable, forecasts need to be closely related to current investment market conditions and how they may develop into the future. This means that the assumptions used in the forecasts need to change regularly and frequently. The FCA's illustration basis was last reviewed in 2014!

The inappropriateness of using the FCA illustration basis for income drawdown forecasts is even more obvious when comparisons are made with annuities. The income produced by annuities is highly dependent on investment market conditions – the level of bond returns, in particular. If the comparison between annuities and drawdown was reasonable in 2014, the table shows that it certainly isn't now and substantial product bias is occurring. This in turn will cause detriment to potentially many retirees who would be better served by an annuity purchase rather than drawdown illustrated with an inflated forecast of the income which might be provided.

Economic Variable	April 2014	September 2021
15-year par yield (%)	**3.173**	**0.98**
5-year par yield (%)	**1.849**	**0.38**
6-month par yield (%)	**0.283**	**-0.04**

- **Is this in some way the FCA's fault?**
  - Clearly not, the illustration basis was never intended to be dynamic and reflect frequent changes in investment markets.
- **Is the use of the FCA's assumptions a minor aberration caused by a few rogue firms?**
  - No, incredibly there are some major well known firms offering modellers designed for use by consumers based on these FCA assumptions.
- **How can this be 'treating customers fairly'?**
  - It would seem quite clear that it isn't, particularly if consumers are making decisions about how much income to draw and whether to buy an annuity.

There are, of course, many views about how investment markets will perform in the future and the level of income that can be supported. What is clear is that today, many product providers and advisers are failing to capture the risks inherent with income drawdown and that, because of the way outcomes from drawdown are illustrated, there is a clear product bias in favour of drawdown compared to annuities.

We believe the FCA illustration rates are not suitable as a basis for illustrating the outcome from drawdown since the income levels forecast are unrealistically high with the result that consumers will be encouraged to draw a higher income than would be sustainable for life.

As a matter of urgency, the FCA should make it clear to product providers and advisers that they should not rely on these rates when offering guidance and advice to consumers about the use of flexi-access drawdown.

In addition, comparisons of flexi-access drawdown with annuities make annuity purchase seem economically very unattractive with the result that consumers may be encouraged to take more risk with the sustainability of their retirement income by using drawdown than would be appropriate given their attitude to risk and capacity for loss.

We believe that the misuse of the FCA illustration rates is a failure of product governance on behalf of a significant number of major product providers. The FCA illustration basis is providing false comfort to product providers and advisers that suitable advice and support is being given to consumers.

Assessing the chances that income may fall and illustrating the size of the potential fall in income are, in our view, key to helping consumers and advisers assess the risk of drawdown in the context of their capacity for loss.

Longer term, given the substantial change in economic conditions since the last review in 2014, we would suggest that a review of the FCA's illustration basis is also in order. But, to be clear, this will not make the revised FCA assumptions appropriate for modelling withdrawal plans or making decisions of the level of sustainable income or comparing income from annuities with drawdown.

INVESTING FOR INCOME DRAWDOWN

Moving into drawdown is switching from buying to selling. What's good for buyers is bad for sellers and vice versa so it should come as no surprise that what makes a good investment changes a bit in drawdown. Higher returns are still good of course but those dips that yielded extra units when money was flowing in become potholes that mean less cash or more units sold.

In other words, pound cost averaging becomes pound cost ravaging and volatility becomes expensive. In the same way sequencing risk becomes its mirror: low returns followed by high returns are good when you are gathering funds but expensive when harvesting.

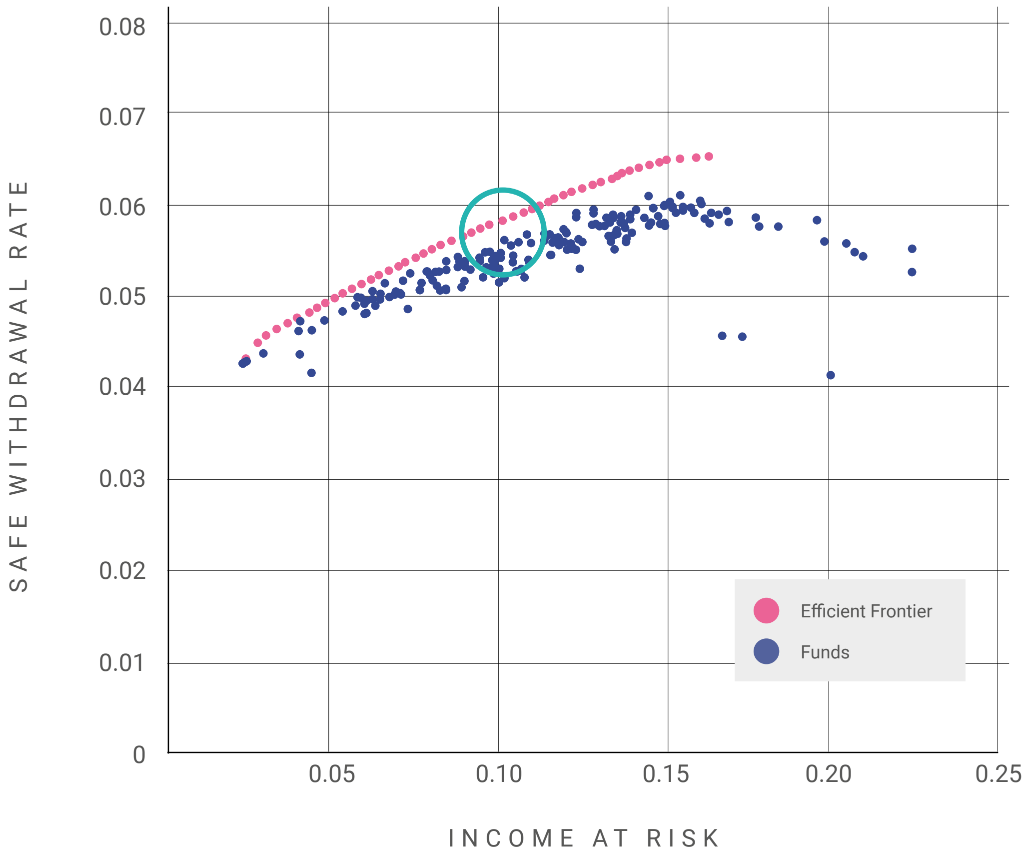
Less frequently mentioned is that if you are investing for income, you need to use a different scale for measuring how well you are doing.

Think about the lowest risk way you could invest to provide a future income: a perpetual bond. Once you own a perpetual bond your income is fixed. If you bought it with interest rates at 2% and they rise to 4%, the price will halve but your income is safe. With more mixed portfolios the picture is more blurry but similar considerations still matter and not all price movements are the same (see the Appendix for other examples).

Given these stark differences, it would be surprising if a successful investment strategy required to support income drawdown would be the same as for accumulation. There are several characteristics of a successful fund or portfolio to be used for drawing income:

- Bonds are less risky than cash for long-term income.
- Avoiding unnecessary volatility is important. For example, currency risk can be very expensive and hedging fixed income exposures is vital.
- Diversification is against a different risk benchmark and the cost of volatility gives extra impact to reducing it through diversification.
- The income risk efficient frontier reaches its peak at a lower risk level than would be expected from looking at the growth efficient frontier.

Decumulation Efficiency



As much as needing to understand risk, retirees will also want to know whether their investment is good at providing income. To answer this question, EV has summarised how well funds or portfolios are at delivering income in an efficiency rating. This shows the ratio of the median sustainable income of a fund or portfolio compared to what could be provided by a fund or portfolio on the efficient frontier for the same level of risk.

The above efficient frontier shows the median safe withdrawal rate (sustainable income) against Income at Risk (IaR) as the risk measure. The sustainable income shown is before charges. The blue dots represent funds also ignoring charges. The gap between a blue dot and the pink dot immediately above it is the measure of efficiency. For the fund indicated at an IaR of 0.1 (10%), the sustainable income is 0.0562 compared to the income for a fund on the efficient frontier of 0.0585. This gives the fund indicated an efficiency of 96%.

The absolute efficiency against the efficient frontier is interesting and shows, in this example, that an extra 4% of income would be available to a retiree. A sustainable income of £10,000 a year from a fund on the efficient frontier would be only £9,600 from the fund sitting directly below it. However, the really useful information is the relative efficiency between funds. Other things being equal, an adviser picking a fund for a client wishing to draw income should pick a fund with a higher income efficiency. For example, if the lowest fund shown on the above chart with an IaR of 0.1 (10%) is compared to the best, the respective efficiencies are 88.9% and 96% - effectively an 8% increase in the level of income that can be delivered for the same level of risk.

OPTIMISED OR 'EFFICIENT FRONTIER' ASSET ALLOCATIONS

There is no end to the range of factors that could make a difference to someone's personal assessment of a retirement plan: age, health, wealth, capital, outgoings, plans, family, etc., and the optimal solution may vary accordingly. Even so, it is possible to do much better than 'it's complicated' when discussing income and risk and we describe how next.

To address the risk of a potential retirement income investment we could, indeed can, incorporate many personal circumstances into our analysis and provide personalised results. However, while such analysis is very powerful it isn't necessarily great for comparing funds and portfolios and given that many retirees may not be as definite about their plans and requirements as their advisers might wish, there is a need for a measure that describes investments while still being concretely relevant to its use by advisers and retirees.

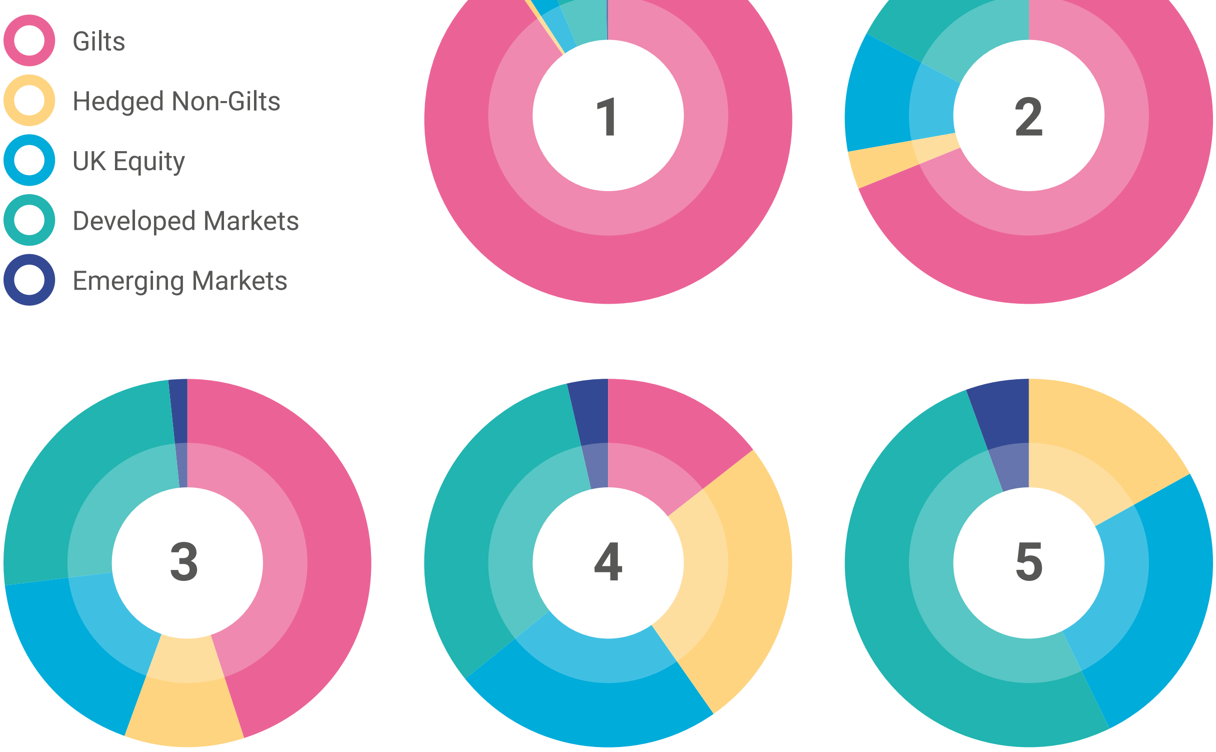
The Income at Risk measure, which we have chosen, provides an indicator of how much income could fall after three years of withdrawals and market movements. Specifically, it is the level of income that is better than the 25% worst outcomes. The key feature of this measure is that it takes into account movements not only in the capital value of the investment, including withdrawals, but changes in the level of income it can support.

An important feature of IaR is that the number would be the same for retirees in a broad range of ages. For those people, the level of sustainable income would be significantly different, but its variability would be more or less the same for the same fund. This is a very useful property of IaR.

Using IaR as the risk measure, we have carried out optimisations to determine asset allocations which support the highest level of sustainable income for increasing levels of risk. These are represented by the pink dots in the chart above and together these dots show an 'efficient frontier'. In producing this efficient frontier, we have used a very wide range of asset classes and applied no constraints. In practice, fewer asset classes would be used and constraints would be applied to the asset allocations produced when implementing a fund. These restrictions will result in a fund sitting below, but at the same time near, the efficient frontier depending on their extent.

There are, of course, options for the definition of income sustainability. Is income to be sustainable for life or some other fixed term? Is it to escalate with perhaps fixed increases or in line with inflation? The 'efficient frontier' of optimised asset allocations will depend on these definitions. The 'efficient frontier' shown above is based on a sustainable income for life (i.e. for the period of life expectancy) and assuming that the income is level. If an income with fixed increases is substituted for a level income, the optimised asset allocations are very similar to those below which are examples for level incomes calculated in July 2021. For inflationary increases there would be investment in index linked bonds at the expense of conventional fixed interest stocks.

Efficient Frontier Asset Allocations



SUPPORTING CONSUMERS

It is vital that consumers have access to appropriate support. This can come in the form of guidance or advice. Both these routes are currently significantly sub-optimal for some of the reasons this paper has sought to demonstrate. However, even if the deficiencies discussed were all addressed, guidance generally falls short of what consumers require and advice for most is far too expensive. While an analysis of what is not working, why and what could be done is beyond the scope of this white paper, there are some observations that are worth making.

Firstly, on guidance, while some of this can be delivered by product providers, it is imperative that the impartial Pension Wise service is more fully utilised than it is at present.

In Consultation Paper *21/11: The stronger nudge to pensions guidance*, the FCA notes that so far only a small proportion of DC pension pots accessed for the first time have used the Pension Wise service. Over the years several initiatives have been designed to increase take-up, including the provisions set out in the Financial Guidance and Claims Act 2018 (the Act). Pension providers are already required to signpost consumers to Pension Wise guidance and to encourage consumers to seek appropriate pension guidance or advice to help them understand their options for accessing their pension pots.

CP21/11 explores additional rules to implement the provisions of the Act to make the eponymous 'stronger nudge' to take up Pension Wise guidance 'more meaningful', including whether a "decision to opt out of guidance should include a cooling off period before a consumer can access their pension, so that declining the offer of a Pension Wise appointment isn't the quickest way to access pension savings".

The debate continues, most recently during the passage of the Pension Schemes Act 2021. But whatever the outcome and however successful the new rules end up being in driving up take-up, the guidance itself still needs to meet the real life needs of consumers. Observed behaviours following the introduction of pension freedoms shows that consumers do not respond well to 'on the one hand this, on the other hand that, go figure'. They want a clear steer that gives them the reassurance that the decision they are making is right for them personally. There is a need for industry and the FCA to explore more fully the boundary between 'guidance' and 'advice' so that the support provided to consumers is seen by them as being more helpful. There is discussion about 'tailored guidance' as a more helpful and personalised delivery of guidance. But given the 'grey area' and legal uncertainties at the border between guidance and advice, legislation may be needed, so don't expect any quick resolution. And, of course, there is no certainty that 'tailored guidance' will be as effective as hoped for.

There is little doubt that advice is the most effective way to help consumers and much work is being done to find ways to reduce the cost of delivering advice and to close the 'advice gap'. The challenge is to engage the consumer and help them through a quite complex advice process which needs to consider all the different assets and sources of income as well as to cater for the widely different personal circumstances that they may have. The most obvious solution is to try to digitise the advice process as much as possible whilst retaining a strong human element to support the consumer through the process. This option is frequently referred to as 'hybrid advice' with an adviser responsible for the delivery of the advice. Costs are reduced by the extent that it is possible to encourage the consumer to engage with and contribute to the process online. Digital advice (sometimes referred to generally and imprecisely as 'robo') uses algorithms to produce the advice. This too can use humans to support the consumer through the process. A lot of work is currently underway on both the hybrid and digital advice options with digital offering the most scope to greatly reduce the cost of delivering advice.

Much could be said on the development of guidance, hybrid and digital advice and there is little doubt that we shall see some dramatic developments which, together with seamless integration with 'full fat' advice, will transform the delivery of support to consumers. This topic is, however, beyond the scope of this white paper.

CONCLUSION

The worst outcome from a lack of immediate action is that in five or 10 years' time we have a cohort of retirees who, through no fault of their own, find their pension pot diminished to the point that it can no longer sustain them through their retirement.

Some may look to the Financial Ombudsman Service and the courts to recoup their losses, rightly or wrongly believing their product provider, fund manager or financial adviser should have done more to make them aware of the income risk they were running.

Consumers, together with consumer groups, may hold providers offering non-advised drawdown solutions and, in turn, their Independent Governance Committee (IGC) or Governance Advisory Arrangement (GAA) to account for their role in assessing appropriateness.

Whatever the course of action, the result will be a wholly unedifying spectacle and further erosion of consumer trust in financial services.

We are therefore calling on the industry to act now and implement the following:

- Address, squarely, the fact that many of the tools and solutions developed for accumulation are not adequate for decumulation where the risks are 180 degrees different.
- Ensure risk is adequately explained and communicated in terms of sustainability of income, not simply volatility, when presenting investment options for drawdown.
- Rate funds in terms of income sustainability.
- Ensure income reviews happen annually and at times of severe market dislocation.
- Recognise that the FCA's illustration rates were developed for a different purpose and are fundamentally unsuitable for setting sustainable income withdrawal plans.

These are not major initiatives. They are simple and achievable steps that can be taken relatively easily. To our mind, inaction would constitute a wilful neglect of duty to ensure positive consumer outcomes.

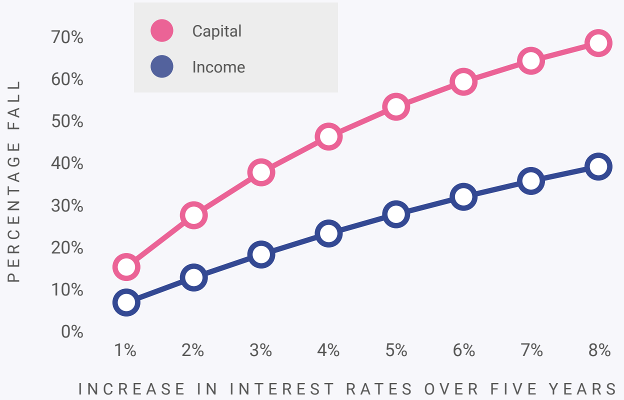
EV
September 2021

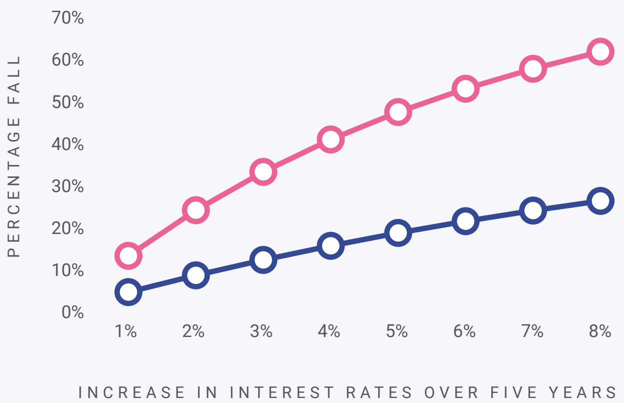
APPENDIX

To illustrate how using risk to capital is incorrect for measuring income risk, the following simple examples provide a good insight. The first involves using a 25 year bond with a 2% coupon to fund income which involves using interest payments and capital redemptions to fund income so that no capital remains at the end of

25 years. If over a period of 5 years interest rates rise, the capital value of the bond will fall. The chart below shows the effect on capital and the sustainable income for progressive increases in interest rates over the 5 years. As can be clearly seen the impact on capital is far greater than income.

Percentage fall in Capital vs Income





If the coupon on the 25 year bond is increased to 5%, the effect is even more pronounced. The impact of increases in interest rates on income sustainability is reduced by about one-third. The effect of the increased coupon on capital loss is much smaller.

What conclusions can we draw from these two examples?

- Interest rate rises have less impact on sustainable income than capital
- The higher the level of return delivered by safe income, the smaller the downside risk to income
- By extension, a similar consideration applies to equities – companies paying high stable dividends will exhibit less downside risk to income than companies paying low or no dividends.

In summary, because retirement income is made up from the natural income from a fund or portfolio and capital redemptions (which use up all of the capital over the life expectancy of the retiree), a fall in investment markets affects capital redemptions but not necessarily natural income if this remains reasonably stable. It is therefore normally to be expected that the downside risk with income would be less than with capital.

Because income risk is increased by high volatility ('pound cost ravaging') it is particularly important:

- To avoid unnecessary volatility e.g. currency risk can be very expensive and hedging fixed income exposures is vital
- To reduce the risk posed to income by volatility, diversification is even more important in reducing income risk

It is clear that investment falls impact capital and income very differently.

Drawdown:
The Mirror Image
of Accumulation

Benyon House, Newbury Business Park, Newbury, RG14 2PZ

T 01635 881180
E contact@ev.uk
W ev.uk