WEALTH
OF ADVICE
FINANCIAL PLANNERS

A Guide to Income Drawdown

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Introduction

This is a guide which aims to simplify a complicated subject; Income Drawdown is a wonderfully flexible way for you to manage your pension, providing you with an income which you can control and offering numerous added and other benefits.

HOWEVER there are risks and a number of factors to be aware of which could turn the attractions of a drawdown pension into something which causes you difficulty.

We will outline for you, over the following pages, all the key factors, the pros and cons, the way to think about drawdown, how to manage a drawdown pension and much more.

We offer this to you as a starting point; nothing, ultimately, is better than obtaining the best expertise and the best advice. If you are to use drawdown as a means of organising your income in retirement then you should only do so having taken such advice.

Hopefully, though, the following information and ideas around this subject will help you on your journey.

What is income drawdown?

Income drawdown is a way to take money out of your pension plan. You can take as much or as little as you like, as and when you need it, from the age of 55 onwards.

You can take a **tax-free** lump sum (normally 25% of your total pension pot), a taxable income or a combination of them both, giving you the ability to take your income in a tax efficient way.

Your pension remains invested – giving your money the opportunity to grow. However, the investment funds you use ***must*** grow to compensate for the income you withdraw. If that doesn't happen, the income you take will reduce your pension fund, possibly to nothing, especially if you choose to take a high level of income.

Unlike some other retirement products, the funds or money remaining in your Drawdown Pension Plan can be passed on to your beneficiaries when you die.

Income drawdown offers great flexibility, control, possible death benefit advantages, and the chance to keep your pension intact (or even growing) and has become especially attractive since the introduction of the new Pension Freedom legislation in 2015.

Previous to this, annuities were the pension income product most commonly used by retirees. However income drawdown now offers so much more, that annuities are no longer the premier option.

How income drawdown works

There are two main types of income drawdown "product":

- **flexi-access drawdown** – introduced from April 2015, where there is no limit on how much income you can choose to take from your drawdown funds
- **capped drawdown** – only available before 6 April 2015 and has limits on the income you can take out; if you are already in capped drawdown there are new rules about tax relief on future pension savings if you exceed your income cap

We will focus in this guide on flexi-access drawdown; if you want to find out more about capped drawdown, please contact us for further help.

How flexi-access drawdown works

You can choose to take a portion of your pension pot as a tax-free lump sum, this is normally a limit of 25% of the total pot value. You then move the rest into one or more funds that allow you to take **a taxable income** as you require. Most people will use it to take a regular amount, possibly to provide a monthly sum – but there are no restrictions, so withdrawals can be made to suit you.

You should invest into funds or other permitted investments that are right for your objectives and are in line with your risk position. Once you've taken your tax-free lump sum you can start taking the income right away or wait until a later date.

Alternatively you can move your pension pot ***gradually*** into income drawdown. You can take up to a quarter of each amount you move from your pot tax-free and place the rest into income drawdown.

This means you can ***stagger*** your position, the advantage of this is that you can keep your pot growing – and your tax free lump sum value may also increase. This can provide, in the right circumstances, very tax efficient withdrawals.

To help provide more certainty, you can at any time use all or part of the funds in your income drawdown to buy an annuity or other type of retirement income product that may offer guarantees about growth and/or income.

You need to carefully plan how much income you can afford to take under flexi-access drawdown otherwise there's a risk you'll run out of money. This could happen if:

- you take out too much in the early years
- your investments don't perform as well as you expect and you don't adjust the amount you take accordingly
- you live longer than you've planned for

If you choose flexi-access drawdown, it's important to regularly review your investments. This is an area of financial planning where specialised and expert help will come into its own.

Not all pension schemes or pension companies offer flexi-access drawdown. Even if yours does, it's important to compare what else is on the market as charges, the choice of funds and flexibility may vary from one provider to another. Comparing products yourself will be difficult so it's best to get financial advice.

The tax position

Any money you take from your pension pot using income drawdown will be added to your income for the year and taxed in the normal way. Large withdrawals could push you into a higher tax band so bear this in mind when deciding how much to take and when.

If the value of all of your pension savings is above £1m when you access your pot (2016-17 tax year) further tax charges may apply.

Continuing to make pension contributions once you have started income drawdown

Once you start to take income, the amount of defined contribution pension savings which you can get tax relief on each year falls from £40,000 (the 'annual allowance') to £4,000 (called the 'Money Purchase Annual Allowance' or MPAA). If you want to carry on building up your pension pot this may influence when you start taking income.

Investing within an income drawdown pension

The key feature of using income drawdown is that your pension pot ***remains invested***. This means you will need to decide which funds, or other types of investment, you wish to use to manage your pension through your retirement as you are taking your income from them.

This decision is probably the most important aspect of your arrangement.

This is because the growth you obtain will determine whether your pot remains intact and for how long – if your income exceeds your growth rate (after costs etc.) then your pot size **will decrease**. Of course, you may not get growth at all, if you choose investments or funds which fall in value then you would be withdrawing income from a depreciating pot size. A devastating combination. This highlights the biggest risk involved in using drawdown.

There are surprising aspects to this, most relevant is that the Safe Withdrawal Rate (SWR) is considerably lower than many people may realise. See further sections below. How you invest is a critical factor in the management of your position and could determine the success or failure of your retirement income targets. Failure could easily include your pension pot running dry in your lifetime.

The position on death

What happens when you die? You can nominate who you'd like to get any money left in your drawdown fund when you die.

- If you die **before the age of 75**, any money left in your drawdown fund passes tax free to your nominated beneficiary whether they take it as a lump sum or as income. These payments must begin within two years, or the beneficiary will have to pay income tax on them.
- If you die **after the age of 75** and your nominated beneficiary takes the money as income or lump sum, they will pay tax at their marginal rate. This means that any income or lump sum taken on or after this date will be added to their income and taxed in the normal way.

Comparing income drawdown to the alternatives

Is Flexi-access drawdown right for me?

Income drawdown is a complex product. We will be able to recommend whether it's suitable for you. If it is we will compare what's on the market and find you the most competitive product. Your other retirement income options include ***withdrawing the whole of your pension pot as cash and taking it out in one go***.

It is highly likely this is NOT a good idea in all but the most exceptional circumstances. Apart from any other reason, you would most probably be facing a significant tax charge for doing this, a tax charge that would probably be avoided either in whole or in part by taking the pension in stages or as income on a yearly basis.

A more realistic option may be ***an annuity***. Although annuities have become less popular due to their very low income rates (as at the time of writing) and are considered inflexible and, possibly, inefficient on death, they do retain some attractive features. For example they provide certainty of lifetime income, which for many people de-risks their position to a large extent.

There could be an alternative with ***fixed terms annuities***. Unlike annuities which are lifetime income products, the fixed term alternatives provide a short term income certainty, for example for five years, at which point they need to be rebased or something else done with the money. In an environment of low income returns, this could be a means of getting certainty for a short period without 'locking in' the income rate for life.

Blending your retirement options?

Another possible alternative could be to mix the income products used, for example you could put half your money into income drawdown and half into an annuity, either lifetime or fixed versions. You can play with such combinations as you like to fit your circumstances.

Making your choices

The most important factor is to get a full, professionally prepared, appraisal of your position before making your decision. Hopefully your retirement period is going to be long, stretching over decades, and one that is enjoyed in good health.

However, it is definitely the case that the future is almost certainly going to be difficult to predict, in many different ways. Not only is it probable you won't know how long you have to plan for, you will also not know for sure your health position (and therefore your care requirements) as well as much wider and more general factors like future investment returns from different asset classes; future annuity rates and the wider economic patterns (for example, how inflation will behave).

All of which suggests there is plenty of room for things not to work out; generally speaking this suggests that you will need to do two things:

- Make sure your plans are flexible
- Have an active ongoing management of your position to adjust for changes

We can help you with all of this.

The risks you will have to weigh up

Decumulation and Safe Withdrawal Rates

There are some incredibly subtle threats when it comes to drawing upon your income in retirement using an income drawdown approach; most people understand the big and well-known risks (which we will cover in a moment) but have little understanding of the more subtle ones which, arguably, are far more real and likely to strike.

We believe a good point to begin with is to look at what has been coined “safe withdrawal rates”; we think the findings from research in the US is exceptionally important for you to know.

In the US, retirees have had virtually unrestricted access to their retirement pots for several years. In trying to create ‘safe’ rates of withdrawal for their clients, a number of American Financial Planners have undertaken research aimed at working out how to implement a sustainable withdrawal strategy in retirement.

This includes the work of William Bengen, a retired financial planner, who ran a number of simulations of historical market behaviour, based on 75 years of data. He reached the conclusion that a first year withdrawal rate of 4.2% followed by inflation adjusted withdrawals in subsequent years, should be safe. This means that the investor should maintain their income without risk of outliving their money.

Other research by amongst others Gerstein Fisher and Cooley, Hubbard, and Walz comes to very similar conclusions.

This has led to a broad consensus that a safe withdrawal rate can be considered 4% per year; although this is by no means a certainty of security, merely a conclusion based on historical data in the States. And it generally considers a retirement period to be 30 years.

This means it is far from fool proof.

More valuable work has been done by Wade Pfau, a Professor of Retirement Income at The American College of Financial Services who extended the view to look at how the numbers would stack up in other countries.

Pfau’s research used 109 years of financial market data for 17 developed market economies, providing guidance as to what a sustainable withdrawal rate would be based on historical returns in each country.

On this basis he concluded that the safe withdrawal rate for the UK is 3.77%. If a UK investor is prepared to risk a 10% probability of failure, however, this rate improves to 4.17%. At a 5% withdrawal rate, however, the probability of failure is 27.5%.

The conclusion of this is clear: the risks of getting the withdrawal strategy wrong (the ‘decumulation’) are probably much higher than the average retiree may ever imagine; this places a huge premium on getting the strategy right both at the outset and throughout retirement, as the downside of failure is running out of money…

The big risks:

1. Getting scammed

The introduction of pension freedom legislation in 2015 provided completely unrestricted access to the over 55's to their pension pots; this increased flexibility was considered by most commentators to be a very good thing. However it had the knock-on effect of providing the unscrupulous market operator with an equally enticing opportunity. That of targeting retiring people. These operators can encourage inappropriate withdrawals or suggest fancy investment schemes 'promising' unrealistic returns. This risk can be managed by ensuring you only use the services of a UK based, fully regulated firm. Make sure you check out carefully the companies you choose to work with.

2. Spending the pension pot quickly/running out of money

One aspect of the new legislation is that it offered control to the pensioner themselves; they could now access their own pension pot with complete freedom to withdraw whatever they wanted, whenever they wanted. This does open up the distinct possibility that an undisciplined or naïve investor could misjudge their position and withdraw large sums (for example to pay for the holiday of a lifetime, a new car, house renovations) and deplete their pension at an alarming rate leaving insufficient behind to provide for income, both now and in the future.

The 96-page Social Market Foundation report, "Golden Years? What Freedom and Choice Will Mean for UK Pensioners", compared what Australian and US pensioners did with their pensions and found that 25 per cent of Australian pensioners exhausted their pots by age 70, and 40 per cent had run out of cash aged 75.

In the US, pensioners were depleting their wealth by 8 per cent of their pension pot each year, meaning the typical pensioner would run out of cash 17 years into retirement.

To manage this risk efficiently make sure you run a lifetime cash flow simulation and also that you have high regard for the SWR of income – and invest accordingly.

3. Rapid/big investment losses

One of the biggest problems could be that some investors fail to grasp the difference between investing to save ***for*** their retirement years and investing ***in*** those same years, when they get there.

It is an irony that financial advisers have been banging a drum for a long period to encourage or educate people that returns are based on a long game; to be successful at investing you need to ride out the poor years and stick with your growth investments for the longer term.

However this same strategy probably will not work for most in their retirement once they are making withdrawals, indeed this would, in all likelihood, prove disastrous. You cannot target a growth rate of say, 6.5% per year, taking 5% withdrawals, without realising that the risks involved are astronomical.

The reason why is simple: the risk, with this sort of approach, can be untenable.

If you invest to cover a 5% per year income and you factor in 1.5% per year in costs – then you need to get 6.5% per year return for your pot value to 'stand still'. However to target 6.5% per year you need to invest relatively aggressively, in risky assets.

The impact of a poor year, say a 10% downturn in the value of those assets, would entail a 16.5% reduction in pot value (10% investment loss + 5% withdrawal + 1.5% costs); two years of such losses and your pot value in now already a third less.

A saver (who is not taking withdrawals) in a similar position has seen a pot value reduction of about a quarter – and has more time and more flexibility to make this back up than the retiree who needs continuing income.

The subtle risks:

Each of these are a variation on the same theme, but have different aspects to them, they are all based on studying simulated returns:

1. Slow and gradual losses

Losses of any sort in a drawdown situation are damaging, but the gradual and long drawn out year-after-year losses can be unrecoverable. Although retirement may last a long time (many decades) the pattern of slow losses normally shows highly detrimental effects on pot values.

2. Poor early year returns

The early years of a drawdown are especially important to the success of the income withdrawal/pot value outcome and how long a pot will last. If losses occur earlier, rather than later, in the period it has a proportionately higher impact.

3. Sequential losses

You could have a 20 year period you are looking at where 15 years are positive returns and 5 years negative returns, but if these five years are all in one period (as opposed to being scattered throughout) then the impact is, again, more pronounced.

All of the risks covered can be managed to an extent. The important factor is to (a) be aware of them (b) get cash flow or other future projections of your income/expenditure patterns and possibilities undertaken and (c) implement a strategy to respect these risks and manage them.

Managing the risks may include such things as regular reviews and rebalances, blending the use of different products to produce your income, having a high cash balance to support your income in 'poor' investment years (so, for example you can temporarily switch off your income to reduce pot depletion) and many more such tactical approaches.

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About Us

Wealth of Advice Ltd was formed by Chris Breward, a successful Chartered Financial Planner with over 10 years industry experience at a time when good quality financial advice has never been so important for so many people.

After completing BA Honours degree in Financial Services, achieving a 2:1 classification, Chris entered the industry assisting a team of financial advisers before becoming adviser himself in 2003. In 2005 Chris took over the running of an established Financial Services operation attached to an accountancy practice where he developed and expanded both the client bank and the level of advice and services provided.

Chris felt that 2012 was an opportune time to build his own company, putting into practice all of the knowledge and expertise he has gained previously. He believes this will allow him to develop long lasting and effective relationships with his clients whilst delivering high level financial planning advice and solutions.

Chris is one of only a select band of advisers with the advanced financial planning qualifications necessary to attain Fellowship of the Personal Finance Society and has elected to use the title Chartered Financial Planner as he feels the term Chartered helps demonstrate to both existing and potential clients a high level of professionalism and dedication towards providing the right service and advice at all times.

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