DEFINED CONTRIBUTION SCHEMES
REVIEWING YOUR INVESTMENT STRATEGY

6 April 2015 brought major changes on how members of defined contribution schemes can use pension savings to provide income in retirement. Investment strategies will need to change to reflect the new choices available to members.

What are the new flexibilities?

Members may now use their pension to provide an income from age 55. The options available are as follows:

Tax-Free Lump Sum

Members will usually be allowed to take up to 25% of their pension fund as a tax-free lump sum. Some may be able to take more than this.

Additional Taxable Lump Sum

Members will be able to take the balance of any pension savings as a cash lump sum, although this will be subject to income tax at the member's marginal rate.

Income Drawdown

Drawdown allows members to take an income from the pension fund pot while leaving it invested. This is not guaranteed but funds remain yours to pass on when you die. An annuity or lump sums can still be taken at any time.

Annuity

Members can use their accumulated pension fund to buy an annuity, which provides a regular, guaranteed, income for life. New flexibilities allow members to purchase reducing or guaranteed term annuities.

To avoid a higher or additional rate income tax charge, members could take a series of lump sums over different tax years, take income drawdown or purchase an annuity.

What's wrong with our current Lifestyle Strategy?

There are three components to any lifestyle strategy:
(a) The funds used in the growth and protection phases,
(b) The targeted option and mix of funds at retirement, and
(c) The length of the switching period before retirement.

Up until now, any benefits in excess of the tax-free lump sum had to be used to buy an annuity, in the majority of cases.

Therefore the investment strategy for most pension schemes revolved around the idea that the period leading up to retirement should protect the member from changes in the cost of buying an annuity. If this could be done, members would have greater certainty over what amount of pension to expect.

To achieve this, most pension schemes provided a lifestyle based default strategy that progressively switches from growth assets (often equities) into bonds and cash as the member approached retirement. The cash was to fund the 25% tax free lump sum. The bonds in which members would be invested at their target retirement age would typically be longer dated bonds that were highly sensitive to changes in interest rates, so are used to back an annuity provider's business and to determine annuity pricing.

As annuity prices rose or fell, members would be protected as their bond investments would also rise and fall in the same way.

It all works well so long as the member is planning to buy an annuity. However, this will no longer be the case for all.

New Lifestyle strategies may be needed for members planning on taking cash or income drawdown

It will be some time before we see a settled pattern of how members of defined contribution schemes exercise their new freedoms, but ideally pension scheme sponsors and Trustees should offer 'packaged' lifestyle strategies that target all three main post retirement options that members might be planning (i.e. annuity, income drawdown and cash), as well as a default for the likely majority, who won't decide until retirement. Schemes will usually already have a lifestyle strategy that targets annuity purchase at retirement.

Income Drawdown Lifestyle Strategies

Income drawdown will have significant attractions for many members, especially those that do not have sufficient funds to get the pension income that they need, or want, by buying an annuity. Insurance companies price annuities so that they will make a profit so members are expected to get a better deal with income drawdown, on average.

By taking on more investment risk for longer, members are likely to be able to draw a higher pension than they would receive if they purchased an annuity immediately after retirement.

The key downside of an income drawdown strategy is the uncertainty that members have. No one knows how long they will live so if members manage their own pension pots there is the possibility of running out of money. Even if members do not run out of money, the possibility is always there which may cause stress and the risk that members will not want to drawdown too much just in case.

We therefore consider building a lifestyle strategy for income drawdown by trying to minimise the probability that a member runs out of money, the probability of ruin. This is a trade-off between return and volatility. To minimise your probability of ruin you need a reasonable return but with a lower volatility than the growth assets members may typically have been invested in before approaching retirement.

Therefore, any lifestyle strategy to be used by members planning on taking income drawdown should reduce risk by introducing greater diversification but maintain a high expected return. Then, as the member approaches retirement, the lifestyle strategy should invest in target return equity and bond style funds that maintain return but target a lower level of volatility.

At retirement, long dated bonds, which are highly sensitive to changes in interest rates may not be appropriate. Instead we advocate a widely diversified mix of equities, bonds and other assets that target positive returns in all market conditions.

In reality, many members will want to take income drawdown initially and then purchase an annuity later in life or strip out some of the pot to buy a deferred annuity later in life. Our analysis suggests that members may want to purchase an annuity between ages 70 and 80. A strategy considering the whole of a member's life therefore needs to be designed based on savings and growth before retirement, income drawdown which involves taking investment risk for longer, and finally annuity purchase later in life.

Cash Lifestyle Strategies

A cash lifestyle strategy also relies on the need for greater diversification and a focus on positive returns in all market conditions. Therefore such a lifestyle strategy should have the same building blocks as the income drawdown strategy, except that the proportion held in cash at retirement will be 100%. Because the returns on cash are so low, we believe cash should be introduced over a relatively short period prior to retirement

What should the default Lifestyle strategy look like?

There is a general perception that annuities offer poor value. This perception, and the favourable tax charges on death, suggests that significant numbers of members are more likely to elect cash or income drawdown. This may change as new and more innovative products are developed by annuity providers.

We believe that taking cash in excess of the tax-free lump sum will be driven by the size of the member's pension fund and other sources of income. Where the majority of schemes members are likely to accumulate significant pension funds over their working lives, they are more likely to opt for income drawdown that will provide investment flexibility and income.

The reality is that many members are still likely to only consider the DC pot option as they get closer to retirement. Reform of the default strategy should be based around the 'keep your options open' approach.

Our experienced investment team can assist in setting up a range of alternative lifestyle strategies and redesigning your default fund.

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