FE Investments

FOR FINANCIAL ADVISERS ONLY

RETIREMENT GUIDE

Rethinking risk – providing sustainable income for clients in decumulation

fefundinfo.com

Contents

Important information

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Introduction

The all-important question in retirement is whether clients have saved enough in order to draw a sustainable income that matches their hopes and expectations. The answer is not as straightforward as you might expect and there are different views as to what is an appropriate level of savings. Retirement planning, and specifically drawdown, is one of the most difficult services an IFA can offer.

A primary objective of retirement planning is to replace the income from work with a retirement income from a variety of sources – investments, final salary pensions, annuities and the state pension. The goal is to achieve the retirement outcome that clients are comfortable with and not just one that they can survive on.

A well-thought-out plan reduces the probability of running out of money and improves retirees' financial confidence, giving them peace of mind.

There is an increasing demand for innovative decumulation solutions in income drawdown and, here at FE Investments, we have designed a product range, essential planning tools and investment solutions to meet this need.

In this guide, we explain how you can help clients understand whether they are on track to reach their retirement goals and the practical steps that can be taken to make their money go further in retirement.

Important considerations during the client's financial planning lifecycle

Accumulation

- Develop a savings plan that involves regular contributions
- Have an asset allocation strategy
- Regularly review the client's portfolio

Decumulation

- Consider different sources of income
- Build a financial plan that is flexible and includes growth or guarantees such as the state pension or annuities
- Determine what their essential expenditure, discretionary expenditure and one-off expenses could be

Retirement

- Can clients fund essential expenses with guaranteed income sources only?
- Is there a plan for discretionary expenditure?
- Are clients making the most of the things they can control?

	 65 year old male	 65 year old female
50% chance	85 years	87 years
25% chance	92 years	94 years

Source: ONS, life expectancy calculator, UK: 2017-2019

Longevity Risk

People are living longer for many reasons, including because they are staying active and healthy. You should help clients build financial plans that account for longevity risk because there is a possibility they could outlive their savings without careful financial planning.

Most retirees can do better

Much of the theory of retirement planning revolves around the sustainable withdrawal rate – the rate of income a client can take indefinitely without running out of money. As bond yields are currently depressed, this rate is incredibly low and is somewhere in the 2.5% to 3% range. This is going to be lower than most people are expecting, and will lead to many disappointing conversations with potential retirees if it is the only strategy on offer.

The investment industry has largely repackaged accumulation products for retirees, while a pre-pension freedoms emphasis on de-risking by moving from higher to lower risk strategies still pervades.

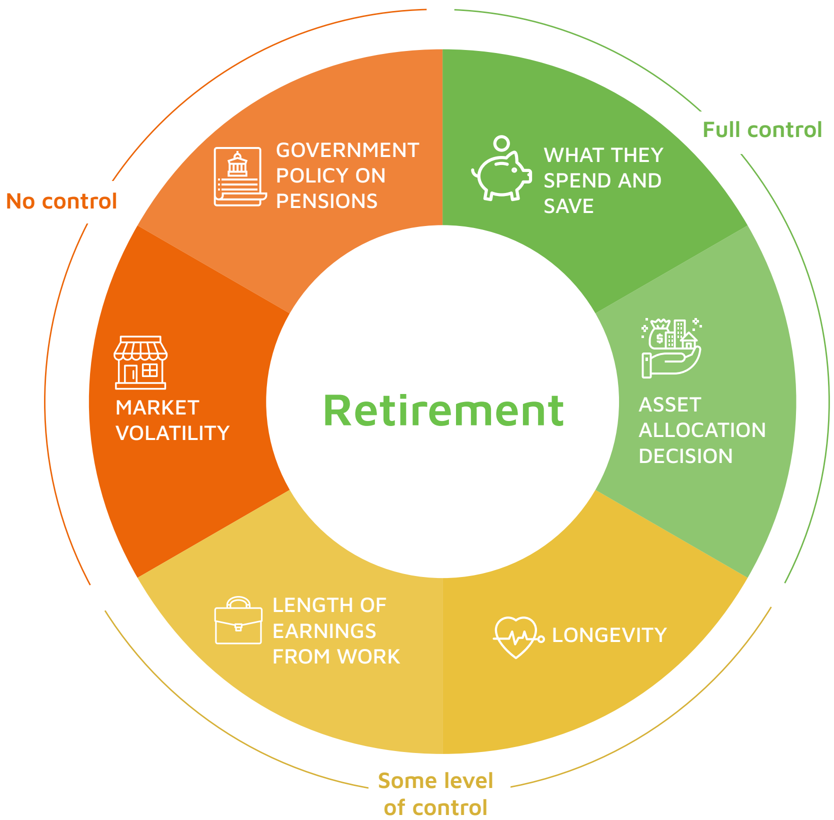
If the sole objective for the client was wealth preservation, then such strategies could still be relevant. However, individuals are exposed to distinctively different risks in retirement, including longevity risk, and many only have finite investable assets to plan with.

Where there are no alternative income sources, such as a final salary/defined benefit (DB) pension, this also poses a problem as clients will come to rely almost exclusively on other pension assets – defined contribution (DC) pensions. With many people undersaving in DC schemes, shortfall risk is going to be a much bigger issue for advisers to deal with, with the sustainability of income inevitably requiring investments with higher returns as many people are now living longer. Ensuring income sustainability over a lengthy period can then prove challenging.

Sequencing risk is the consequence of introducing higher growth strategies into retirement portfolios – most notably, this can be realised in the event of a market fall as clients begin their retirement journeys.

We believe there is a more robust retirement solution that ensures clients can comfortably sustain their income needs in retirement while giving the IFA the ability to balance and manage the risk.

The retirement question for clients



Rethinking risk

As clients' objectives change as they approach retirement, so too does the way they should think about risk.

Risk is no longer centred on changes in the value of their portfolio as it has been in accumulation. Instead, risk is now focused on potential changes to the value of future income. The client's risk is now centred on an immediate outcome.

As such, traditional risk questionnaires built around volatility bands are not suitable for decumulation clients. There is a danger to the adviser that they are still measuring attitudes to the wrong risk in retirement, which not only isn't compliant but leaves advisers exposed to accusations of mis-selling in the future.

The Decumulation Portfolios have been built to work in tandem with our Decumulation Illustrator tool in FE Analytics. The tool helps bring your clients' circumstances to life by demonstrating the different options available in decumulation, helping you ensure they have a diversified and sustainable retirement portfolio, and ultimately, good client outcomes. For this reason, access to the tool via FE Analytics is required when recommending the Decumulation Portfolios to your clients.

Risk is often framed as volatility in accumulation, which illustrates how extreme the movements in the value of their investments may be and, therefore, the possible losses that could occur.

The Decumulation Illustrator tool instead frames risk as the chance of the client running out of money – which we refer to as income viability. It allows financial advisers to discuss income drawdown in a way that is relevant, meaningful and understandable to clients.

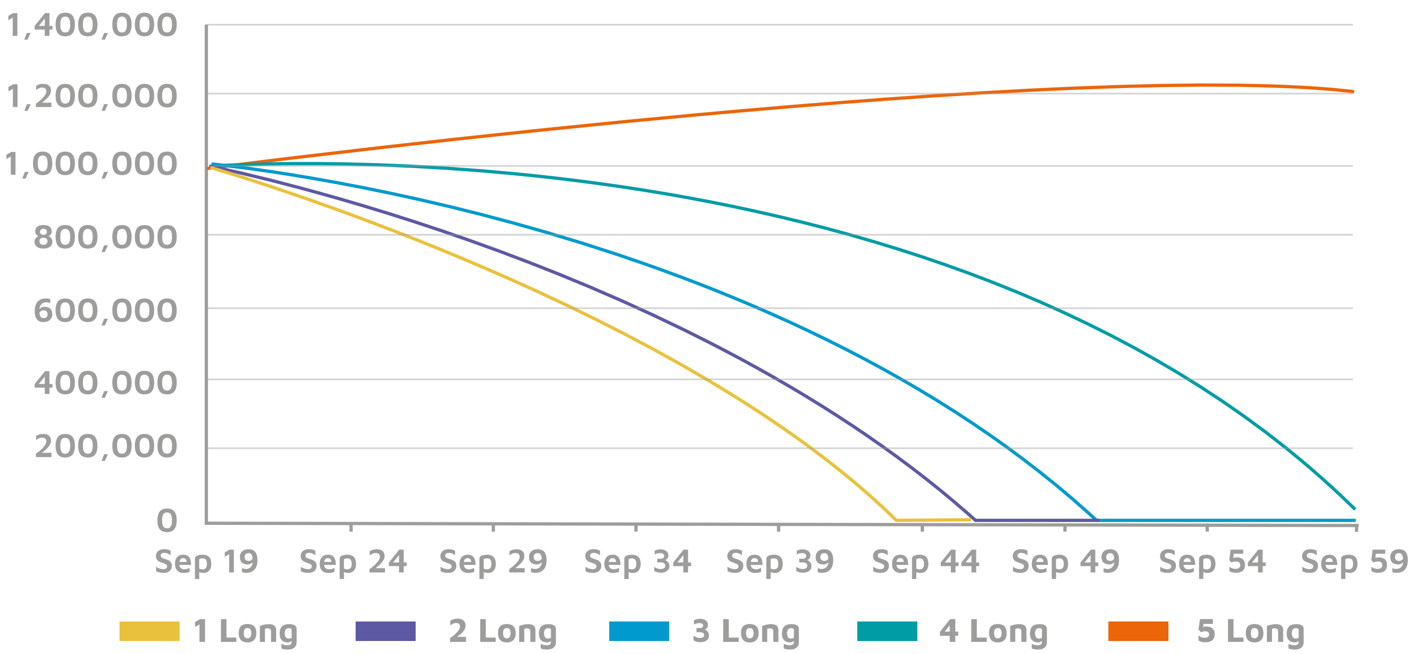
If clients are going to be withdrawing money from their investments, the expected return has to be sustainable given the withdrawal rate. A 4% withdrawal rate could easily increase to 6% once all charges are included. Despite this, it is still common during retirement for investors to stay in low-risk portfolios because this matches their attitude to risk, even though they would have no chance of maintaining a withdrawal rate anywhere near 6%.

For this reason, the Decumulation Illustrator tool places investors in a higher risk portfolio than they may have been invested in during accumulation.

The 4% rule: theory vs practice

This concept is based on the maximum initial withdrawal percentage that is sustainable with a high likelihood of not running out of money. However, the 4% rule is very questionable and it is not guidance on how you can efficiently apply your invested wealth to provide the type of retirement lifestyle clients want. It is worth considering an alternative and dynamic approach that is flexible over time to more effectively use your retirement savings.

40-year projected retirement



Source: EValue Forecast July 2019

Using the latest actuarial forecasts, our illustrator calculates the likelihood that retirees' assets invested in the FE Investments Decumulation Portfolios can deliver on their retirement goals compared to their existing accumulation solution.

How should clients take an income?

We have designed two model portfolios, each specifically made for distinct retirement risks. The Decumulation Illustrator must be used to calculate the relative weighting of the portfolios. Our **Initial Income Portfolio** is designed with defensive positioning which means it takes a reduced level of market risk and insulates against a large market fall, meaning clients can withdraw money from it on a regular basis with relative confidence.

Required income should be withdrawn from this portfolio in the initial instance until the portfolio value is run down to nothing. The growth potential of the portfolio is limited; therefore it is not suitable as a long-term holding as it would not be able to sustain a long-term retirement. This portion of the portfolio provides protection in the event of a market fall, but would act as a drag on performance in a strongly performing market. It therefore only provides a benefit to a minority of retirees, however, as we don't know when a market correction will happen it helps to provide significant peace of mind for all and because this represents a small percentage of a clients' assets it does not significantly harm the prospects for retirees if markets remain strong.

Should markets fall early in retirement the **Initial Income Portfolio** provides time for other high-risk investments to recover, potentially adding a number of years over which the portfolio will be able to pay out an income.

The Decumulation Illustrator tool usually suggests placing the remaining position of the portfolio in our **Long Term Retirement Portfolio**, one of our highest growth portfolios, that is still diversified across multiple asset classes. We believe this offers the best chance for your clients to meet their income needs over the longer term. Retirees need to accept that if they have to stretch their investments a little bit further[1], they will be exposed to market movements and the nature of their requirements means they will need to take a higher level of market risk.

Required income[2]	2.5%	3%	3.5%	4%	4.5%	5%	5.5%	6%	6.5%	7%	7.5%	8%
Initial income (%)	7.84	8.95	9.8	10.4	10.72	11.01	11.22	11.55	11.93	12.39	12.95	13.58
Long-term growth (%)	92.16	91.05	90.2	89.6	89.28	88.99	88.78	88.45	88.07	87.61	87.05	86.42
Average time of Initial Income Portfolio	2y11m	2y10m	2y8m	2y5m	2y3m	2y1m	1y11m	1y10m	1y9m	1y8m	1y7m	1y7m
Model still running at 10 years	100%	100%	100%	100%	99.9%	99.9%	99.6%	98.9%	98%	96.2%	93.1%	89.3%
15 Years	100%	99.9%	99.5%	97.9%	95.3%	90.9%	84.1%	76.3%	66.7%	54.5%	44.4%	34.9%
20 Years	99%	97.2%	92.8%	86.7%	76.9%	67.6%	56.2%	43.4%	32.2%	25%	18.2%	12.7%
25 Years	95.8%	90.3%	81.3%	70.8%	59.2%	46.3%	35.4%	25.5%	18.2%	13.4%	9%	6%
30 Years	90.9%	80.6%	70.3%	67.8%	44.7%	33.9%	24.2%	17.4%	12.4%	8.5%	5.2%	3.6%
35 Years	84.6%	74%	61.4%	47.6%	37%	28%	19.1%	13.8%	9.1%	6.3%	3.9%	2.5%
40 Years	79.4%	68.5%	53.9%	42.2%	32%	23.8%	16.4%	11.8%	7.7%	5.2%	3.2%	2%

1 No other significant assets for retirement available – for example, a DB pension

2 ASSUMPTIONS: For the purposes of this we have assumed charges of 1.5%; these would cover adviser, platform and DFM charges and a level of income that rises by 1% year-on-year – that is, if you were taking 5% of a £1m investment, that would equate to £50,000 in year one and £50,500 in year two.

We have modelled 1,000 different investment outcomes with an economic scenario generator, using a spread of income levels. From this, we determine how sustainable the level of income would be as well as estimating when it is likely to run out. The results of this can be found in the table below.

Over the long term, it is expected that the value of the portfolio will follow a generally upward trajectory and should comfortably outpace inflation, despite some adventures along the way. This long-term growth is ultimately what is needed to support a long retirement.

In order to maximise the long-term potential returns, the majority of the portfolio is invested in equities. Most of these will be blue-chip stocks listed in the major developed markets of the UK, the US, Europe and Japan, but a limited number will derive their growth from higher-risk sectors such as emerging economies and smaller companies.

The FE Investments Decumulation Portfolios

Initial Income Decumulation Portfolio: This portfolio aims to protect an investor from what is called sequencing risk; this is the risk that a large fall in markets early on in retirement significantly devalues investments from which they never recover.

The portfolio is designed with capital preservation as a primary concern and regards any growth as a bonus. The purpose of this portfolio is to have a low correlation to equity markets, which are the highest risk investments, and to be low risk to prevent falls in value.

Long Term Retirement Portfolio: This portfolio aims to protect an investor from what is called shortfall risk – this is the risk that you will run out of money. The portfolio is designed to grow capital aggressively on the understanding this may lead to losses over the short term.

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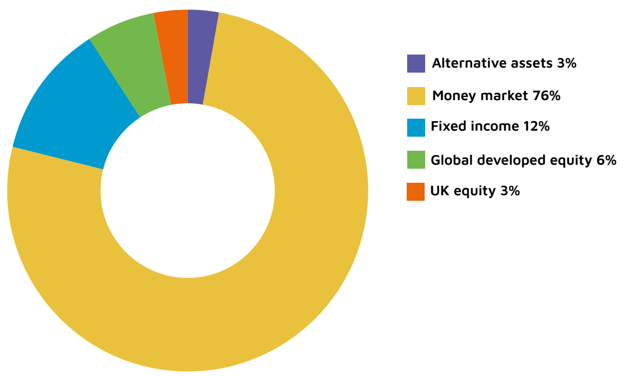
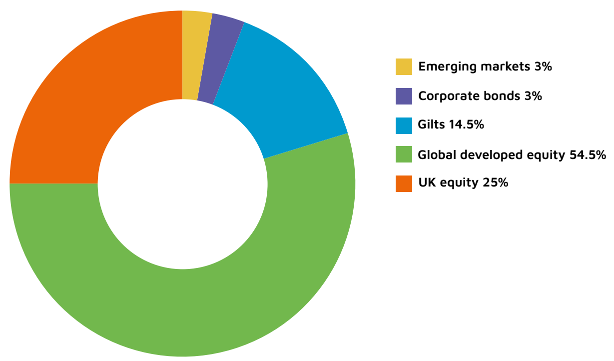
Initial Income Decumulation Portfolio



Long Term Retirement Portfolio



Retirement propositions

Do you have a robust and disciplined approach to managing risks that your clients might be facing in retirement? A unique proposition for retirement, or a centralised retirement proposition (CRP) as it's called, is becoming more commonplace to segmenting clients that are at retirement. As decumulation becomes more important in a changing regulatory environment, having a recurring process in place that assesses your client's income sustainability, built on a strategy using the right tool and investment solutions, not only keeps the regulators happy but benefits your clients and improves your business efficiency.

We have designed a customised retirement investment solution for your clients, in conjunction with tools that are easy to understand and suitable to meet their retirement needs. As you think about segmenting clients in decumulation, creating a structured process that uses our solution, which can be built and applied to your clients in decumulation, can help.

These products have been specifically built to take care of the key retirement risks. To reiterate the point made earlier, accumulation is distinctively different from the decumulation phase. In accumulation, the investment proposition is broadly about clients' investment philosophies and what they believe will deliver on the growth of their assets. In decumulation, clients have to consider a lot of other factors in addition to drawing an income, such as longevity risk. Having that conversation with you, the adviser, about the details of what could go wrong along their retirement journey – which also considers tax planning, protection, income sustainability and so on – is important.

CRP

Building a CRP around the right tool is very important. In addition to the investment strategy, it considers key retirement risks such as longevity. It also deals with capacity for loss and the appropriate retirement withdrawal strategy.

About FE Investments

FE Investments provides discretionary fund management services for financial advisers across the UK. Our investment philosophy focuses on controlling risk and maximising diversification. We combine decades of fund data analysis and sector-leading technology with the expertise of our dedicated investment team to help you achieve your investment goals.

Since launching our discretionary managed portfolios in 2015, we have won multiple awards and been named as one of the fastest-growing discretionary fund managers in the UK, with £4.3 billion of assets under management*.

FE Investments is part of FE fundinfo, which works with thousands of fund managers, fund distributors, financial advisers and channel partners across the globe, helping them to be better connected and better informed. Our industry-leading data, technology, insight and expertise is used by investment professionals to research, distribute, market and invest in funds and model portfolios, leading to more efficient investment decisions.

*As at May 2023

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