



Making Good Retirement Choices

An Investment Special Report

Autumn 2014



Contents

Section 1

Foreword	3
----------	---

Section 2

Historic comparison of income drawdown and annuities	4
Our analysis	5
The Retirees of 1999	6
The Retirees of 2004	9
The Retirees of 2009	12

Section 3

Recommendations	15
-----------------	----



Foreword

Clive Bolton, managing director retirement solutions, Aviva

'Freedom and Choice', the Government's new pension rules for the over-55s is due to start in April next year, as consumers take even more personal responsibility for funding their retirement. Along with this increased choice comes a new challenge for consumers. How can they make the most of their money without finding themselves cashless in their later years? And importantly, how does government, the regulators and the financial services industry support consumers as they navigate their way towards their retirement years?

In this special report, we examine how someone who retired in 1999, 2004 or 2009 could be financially positioned today had they chosen an annuity or an income drawdown option 15, 10 or five years ago, respectively.

The historic analysis we present is more relevant today than ever before, with people about to be given unprecedented levels of choice over their retirement savings. How best to balance practical retirement planning with greater freedom of choice is likely to be an area of continuing focus over the coming years as we see how the 'first' retirees in 2015 begin to adapt to this new world.

Consumer reaction to the changes will be important to monitor over time. Following the Budget on 19th March 2014, Aviva commissioned a consumer survey from ICM Research to gauge reaction to the recently announced retirement changes:

- Two thirds of people (72% male, 60% female) were aware of the changes with highest awareness of 84% and 86% in the 55-64 and over-65 age groups.
- Nearly two-thirds of people agreed with the statement "having control over how you spend your pension pot is a good thing" with only 6% disagreeing.

Based on this early research, people's initial reaction was to view these Budget changes positively. However, on a cautionary note, 61% said that as the pension rules were loosened, people would need to show greater restraint in coming years to avoid running out of money.

Much has been said in the period since the Budget about the opportunities for consumers to choose retirement options other than annuities. Our analysis seeks to provide a more objective view of the annuity and drawdown choice. Our aim is not to show one solution is better than another, but to demonstrate that every retiree must consider carefully how best to fund their retirement and that there is no simple answer to which 'retirement choice' will perform the best.

Our analysis covers a turbulent economic period from 1999 to 2014, and this context is important when looking at the performance of retirement products. Overall the economy is now improving and we are currently experiencing relatively benign conditions. However, anyone considering their retirement finance options should do so with a long-term view. History tells us that continued economic turbulence over a period of two or three decades is a likelihood and any retirement plan should be robust and diverse enough to manage these ups and downs.



Historic comparison of income drawdown and annuities

In this report we analyse the financial outcomes for three groups of retirees making different financial choices in each of the years - 1999, 2004 or 2009. We have analysed the outcomes based on the customers choosing an annuity on the assumptions below, or choosing each of three different drawdown portfolios.

This is set at 6th April in each year to tie in with the start of the tax year and is also the date when changes to the pension tax rules normally take place.

The new choices

Most people who have pension savings above the trivial thresholds currently face two choices under the current rules:

1. Buy an annuity.
2. Take income withdrawals from their pension fund.

The new system will simply add a third option - take their entire pension as a lump sum.

However, the principle of this third option will be similar to income drawdown under the new rules, but with a different tax treatment. So, our analysis is also relevant to those taking income withdrawals from non-pension savings.

Annuity assumptions

The purchase price is £50,000.

We have used actual annuity rates available on 6th April in each of the relevant years.

We have used male rates at age 65 (sex-based rates were in use at the time that these cohorts reached retirement) and assumed that the annuity is set up on a level basis.

Importantly, we have tried to make the annuity as similar to drawdown as possible by building in a 100% spouse's pension (female assumed age 62), because any residual drawdown fund can be inherited by the spouse.

Drawdown assumptions

The amount invested is £50,000.

For income drawdown we created three portfolios from investment indices:

Portfolio 1 – 100% equity tracking the FTSE All-Share Index with income reinvested (Source: Lipper).

Portfolio 2 – 100% fixed interest tracking the FTSE British Government All Stocks Index (all UK gilts) again with income reinvested (Source: Lipper).

Portfolio 3 – 50% equity, 30% fixed interest (using the same indices as Portfolios 1 & 2) and 20% cash using the Bank of England Base Rate (Source: Bank of England).

For all drawdown portfolios, we have assumed a total charge of 1%. Although modern index-tracking drawdown plans are available today for less than 0.5%, the charges on drawdown plans at the assumed retirement ages in this analysis would have been higher. Additional charges have been included to cover the role of financial advice, which would normally take the total charge above 1%.

The amount taken as a withdrawal from the drawdown portfolio matches the monthly income paid by the annuity.

Limitations such as the Government Actuary maximum withdrawal limits have been excluded from the analysis as we are seeking to create forward-looking analysis relevant to the new (post-April 2015) retirement rules, but using historic data.

Our Analysis

Our analysis focuses on the performance of annuities and income drawdown at three points in time, 1999, 2004 and 2009. We then fast-forward to 2014 to look at how the residual money could be used by savers.

Summary For Each Year:

1999

Retiring in 1999 and using drawdown as the income solution would not have proved to have been a good decision, regardless of whether the retiree invested in equities or bonds. There are of course investment strategies which might have mitigated the effect, and timely switching from one asset class to another would almost certainly have resulted in a better outcome. However, timing the market is notoriously difficult.

2004

Retiring in 2004 also favours the annuity option. Only by investing in 100% equity would the drawdown option have outperformed the annuity. This however would have been a brave route as the period since 2004 witnessed sharp falls in equity prices as a result of the global financial crisis. The fixed interest and mixed investment drawdown route would now underperform the annuity option by £60 and £15 a month, respectively.

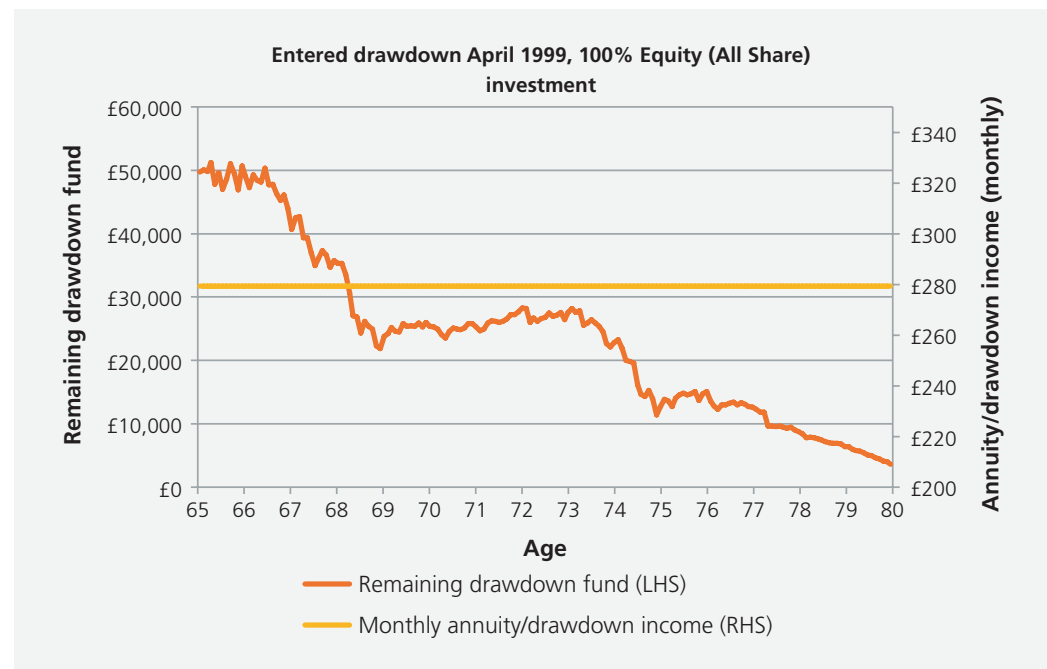
2009

Retiring in 2009 favours the income drawdown option. Only with the cautious use of fixed interest investments in the drawdown option would it fail to outperform the annuity. The relatively low base of the equity market in 2009 and its subsequent strong performance delivers outperformance from the drawdown in both the 100% equity and mixed investment options, of £115 and £20 a month, respectively.

The retirees of 1999

Annuity: In this first case study, our retirees would have had the choice of buying an annuity with income of £279.31 a month (equivalent to a rate of 6.7%) or investing in a drawdown portfolio.

Portfolio 1 - the first analysis assumes **100% equity investment**.



In April 2014 our 1999 retirees would be approaching age 80 years, and their spouses 77 years.

The annuity income of £279.31 would remain in payment to the last survivor of the couple whilst the drawdown fund is now worth £3,614.

At annuity rates available on 6th April 2014 for a couple aged 80 and 77, the remaining drawdown fund is enough to purchase an annuity of only £16.91 per month.

What is immediately obvious is that the drawdown fund has depleted close to zero (£3,614 by age 80). Bearing in mind that the average life expectancy for an insured male is 86 years, this shows the danger of relying solely on a drawdown pot.

A saver in this situation faces the remainder of retirement in poverty unless they have other sources of income which are enough to meet their expenditure needs.

1999 at a glance

Gloomy retail sales in Christmas 1998 and a decline in manufacturing exports led to some predictions that the UK economy would shrink in 1999. By April of that year however, commentators were saying that the UK had escaped a recession. As the country moved toward the new century celebrations, there was significant focus on the completion of the millennium dome and the possible impact of the so-called Y2K computer glitches.

- Prime Minister – Tony Blair
- Aggregated conventional long gilt yield 4.47%
- CPI Inflation 1.54%

News

January 1st – the Euro currency is established

March 24th – NATO launches air strikes against the Federal Republic of Yugoslavia, the first time NATO has attacked a sovereign country.

March 24th – A fire in the Mont Blanc Tunnel kills 39 people.

April 5th – Two Libyans accused of the bombing of Pan Am flight 103 in 1988 are handed over to the Scottish authorities for eventual trial in The Netherlands.

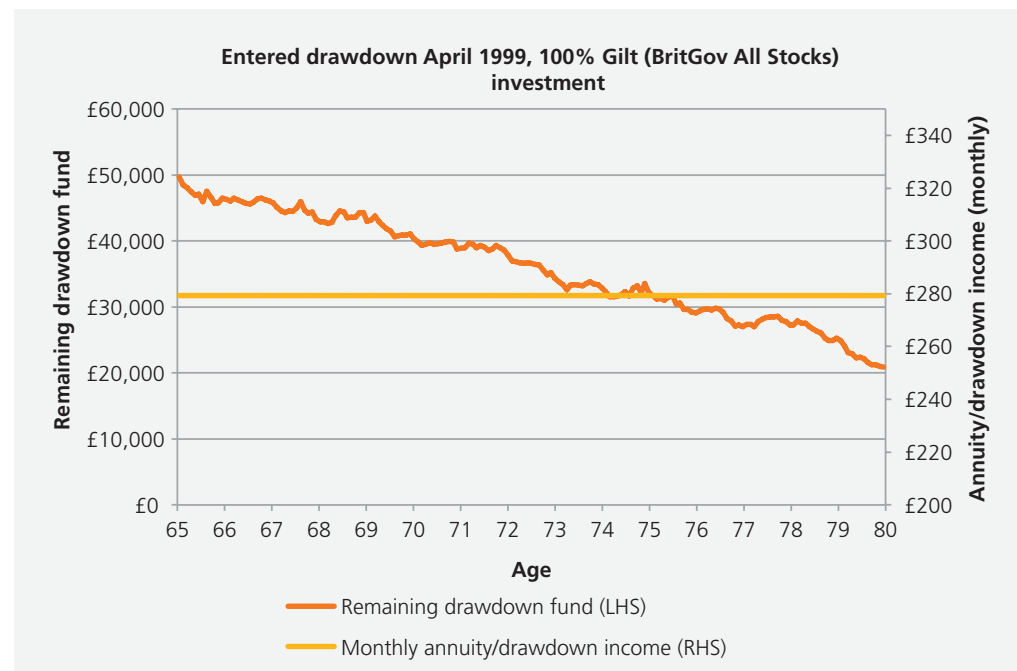
April 20th – Columbine High School massacre in the US.

May 6th – Elections are held in Scotland and Wales for the new Scottish Parliament and National Assembly for Wales.

August 17th – A 7.6 Richter Scale earthquake hits Izmit in North Western Turkey, killing 17,000 and injuring 44,000.

The retirees of 1999

Portfolio 2 - the second analysis uses **100% fixed interest**.



In this analysis, the drawdown fund has performed better than the 100% equity and is worth £20,883 after monthly withdrawals over 15 years.

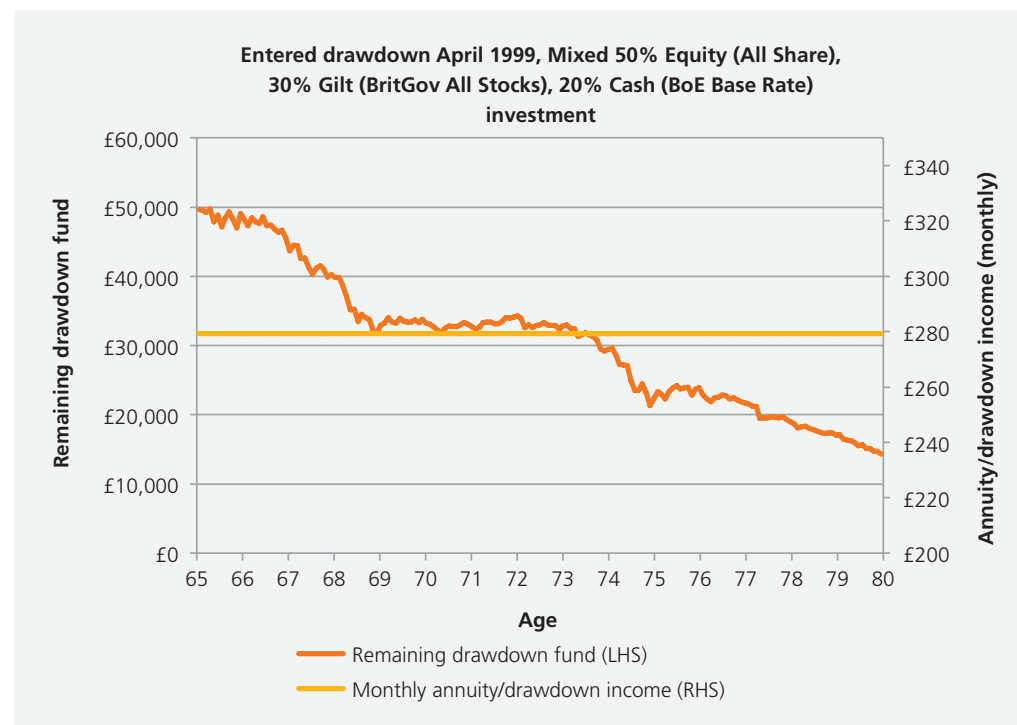
At current annuity rates, this would buy an income of £119.29 a month, which is about £160 a month less than the monthly income from an annuity bought back in 1999.

The residual funds from the fixed interest pot (£20,883) is substantially better than the 100% equity example, and may still be enough to sustain income through to the average life expectancy of 86 years. However, it is unlikely to last until the median age of death for men (88 to 89) and if the saver is one of the 30% of men who live longer than the median age, poverty in retirement is a real prospect.

The alternative is locking into a much reduced level of income of £119.29 at age 80, which would at least be guaranteed for life.

The retirees of 1999

Portfolio 3 - the third and final analysis for the retirees of 1999 uses **the mixed investment portfolio**.



In this example, the remaining drawdown fund is £14,309, enough to buy an annuity today of £77.40 per month, compared to £279.31 had an annuity been bought originally.

If the saver remains in drawdown and continues to withdraw income in line with the annuity income originally available, the fund is likely to last another four to five years, which is still less than average life expectancy for males.

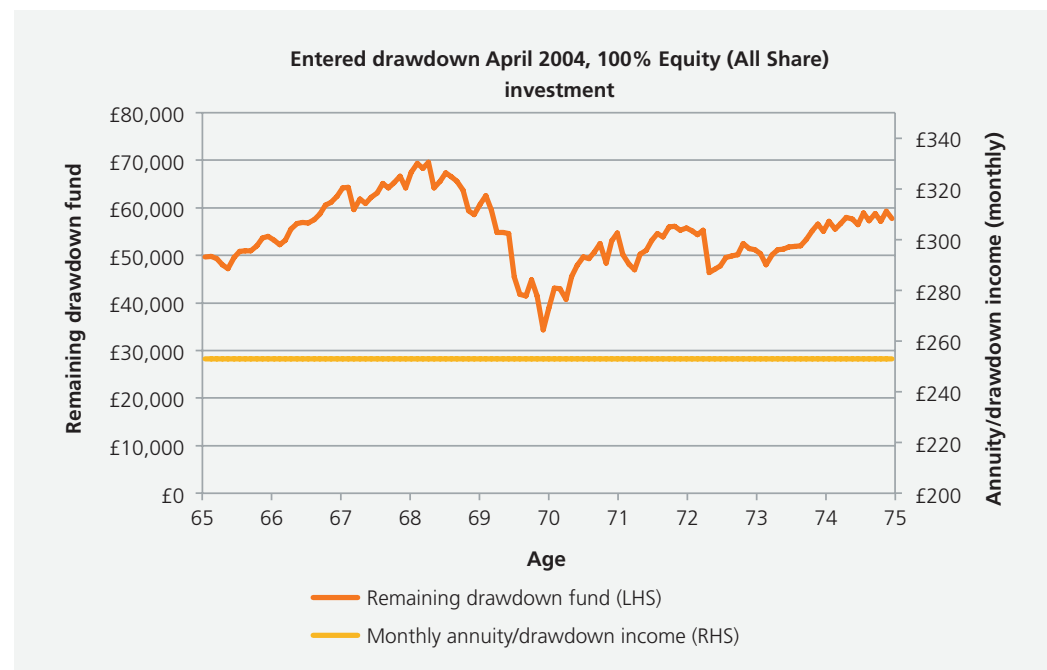
Therefore, retiring in 1999, using drawdown as the income solution and failing to adjust the investment portfolios used in this analysis would not have proved to have been a good decision. There are of course investment strategies which might have mitigated the effect and timely switching from one asset class to another would almost certainly have resulted in a better outcome. However, timing the market is notoriously difficult.

The retirees of 2004

Annuity: Our retirees would have had the choice of buying an annuity with income of £252.97 or investing in a drawdown portfolio.

These retirees are aged 75 years in 2014, and their spouses aged 73 years, with a life expectancy of up to another 15 years.

Portfolio 1 – **100% equity.**



The residual drawdown fund in 2014 of £57,780 is enough to buy a monthly annuity of £291.11, about £40 a month more than had they bought an annuity originally at age 65 (£252.97).

Over this period, drawdown has done much better than for people entering retirement in 1999, despite the significant fall in value between 2007 and 2009 following the credit crisis. However, it is likely that such a sharp fall in value may have caused savers using this particular strategy a great deal of worry, and this is often the reason people often switch out of volatile investments at the bottom of the market.

2004 at a glance

The UK economy grew by an estimated 3.1% in 2004 after accelerating in the last quarter of the year, figures from the Office for National Statistics (ONS) show. The rise came despite a decline in production output and a terrible Christmas for retailers. Growth in the final three months of 2004 marked the 50th consecutive quarter of growth.

- Prime Minister - Tony Blair
- Aggregated conventional long gilt yield 4.76%
- CPI Inflation 1.01%

News

February 4th – Facebook launches.

March 25th – UK Prime Minister Tony Blair visits Libyan leader, Colonel Muammar Gaddafi.

May 1st – The largest expansion of the European Union to date with 10 new member states: Poland, Lithuania, Latvia, Estonia, Czech Republic, Slovakia, Slovenia, Hungary, Malta and Cyprus.

August 13-29th – Summer Olympics in Athens, Greece.

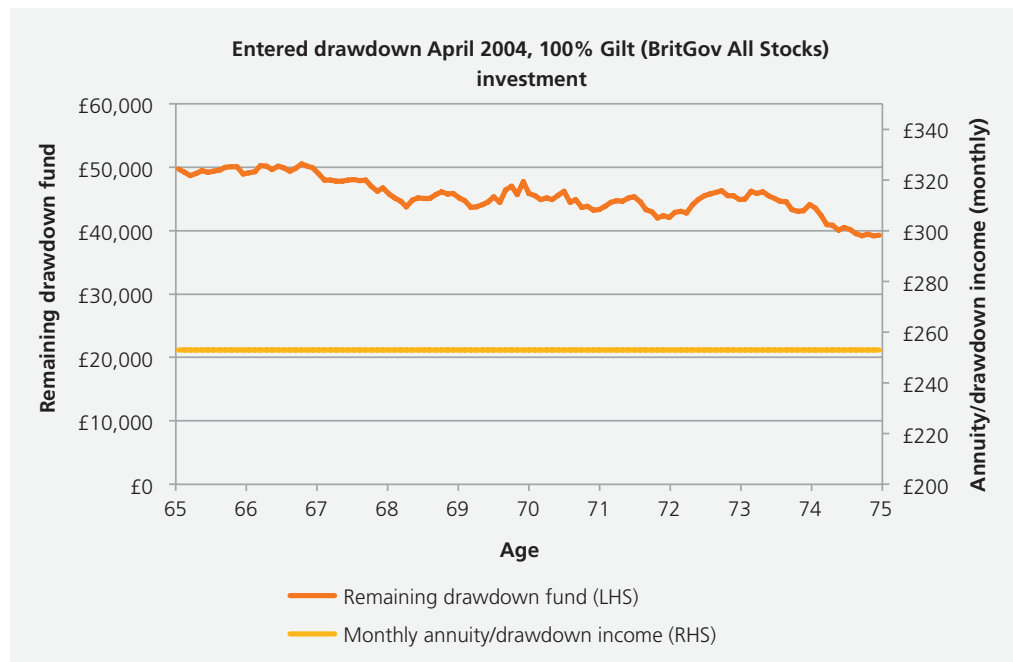
September 1st – Chechen terrorists take between 1000 and 1500 people hostage at a school in Beslan, Northern Ossetia. The siege ends two days later with 334 dead and more than 700 people injured

October 29th – In Rome, European heads of state sign the Treaty and Final Act, establishing the first European Constitution.

December 26th – An earthquake measuring 9.3 on the Richter Scale hits the Indian Ocean, generating a massive tsunami and killing more than 180,000 people.

The retirees of 2004

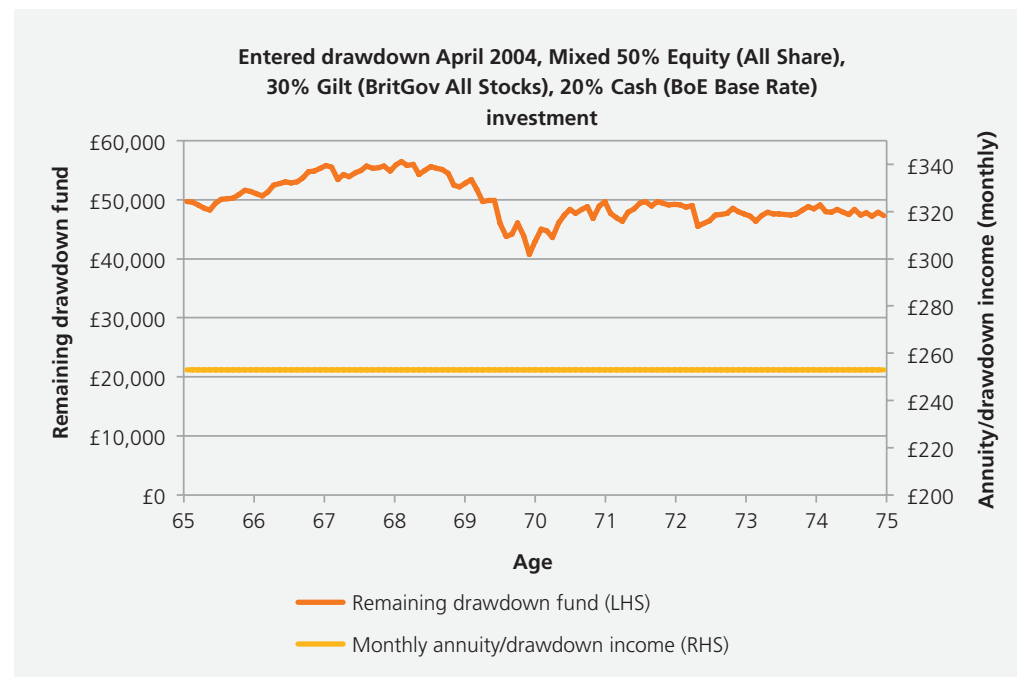
Portfolio 2 – 100% fixed interest



The residual drawdown fund in 2014 of £39,246 is enough to buy a monthly annuity of £194.90 a month, just under £60 a month less than had an annuity been bought originally at age 65 (£252.97). So, despite lower volatility, fixed interest has not provided as good a return as equities over this period.

The retirees of 2004

Portfolio 3 – mixed investment



In 2014, the residual drawdown fund of £47,263 is enough to buy a monthly annuity of £237.64, about £15 a month less than had an annuity been bought originally at age 65 (£252.97).

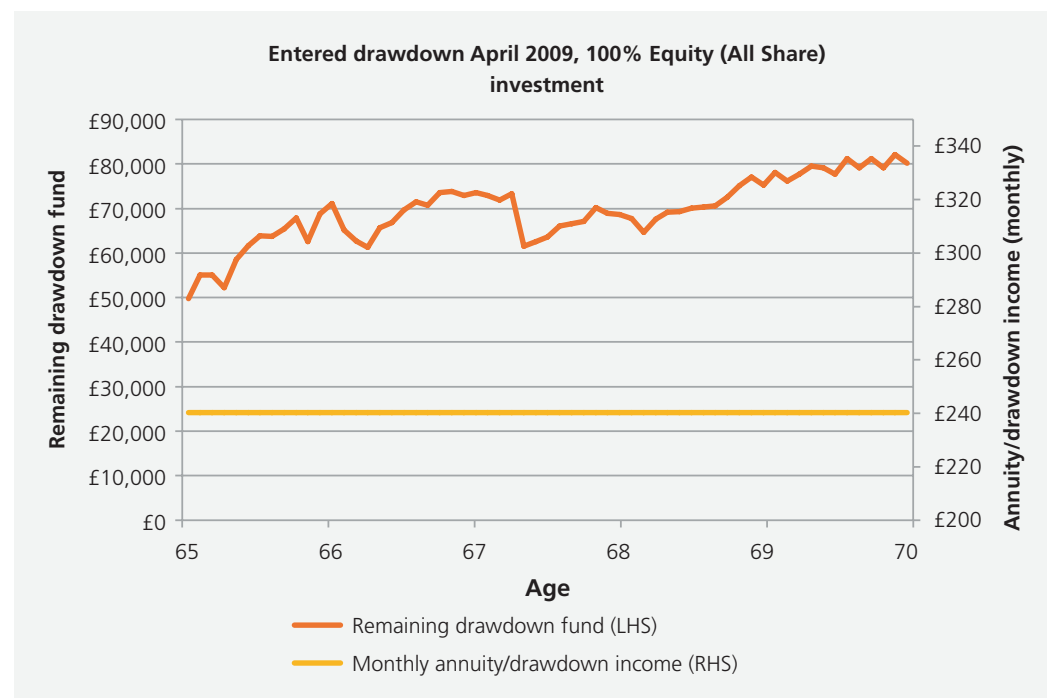
The mixed portfolio has in this case provided a reasonably good return whilst reducing the volatility associated with the equity portfolio. This approach would have provided more comfort during the equity market downturn that followed the credit crisis.

The retirees of 2009

Annuity: Our retirees would have had the choice of buying an annuity with income of £240.29 or investing in a drawdown portfolio.

These 2009 retirees are aged 70 in 2014 and have an average life expectancy of up to another 20 years.

Portfolio 1 – 100% equity



The residual drawdown fund of £80,183 is enough to buy a monthly annuity of £355.63, about £115 a month more than had an annuity been bought originally at age 65 (£240.29).

This particular period and investment choice shows the best outcome for drawdown in our analysis. The return for taking risk and investing at the bottom of the market is clearly evident. However, it would have taken a brave investor to allocate all of their retirement savings to equity investment in the early months of 2009.

2009 at a glance

With the British economy in the longest recession on record, government figures showed a 0.4% drop in GDP in the third quarter of the year. Hopes remained for a return to growth by the end of the year despite the UK facing the worst global financial crisis and recession in 60 years.

- Prime Minister - Gordon Brown
- Aggregated conventional long gilt yield 4.38%
- CPI Inflation 2.32%

News

Jan 20th - Barack Obama is inaugurated as the 44th President of the United States of America

February 7th – The deadliest bush fires in Australian history begin, killing 173 people, injuring more than 500 and leaving 7,500 people homeless.

April 2nd – The second G-20 summit involving heads of state, rather than the usual finance ministers, meets in London. Top of the agenda is the ongoing global financial crisis.

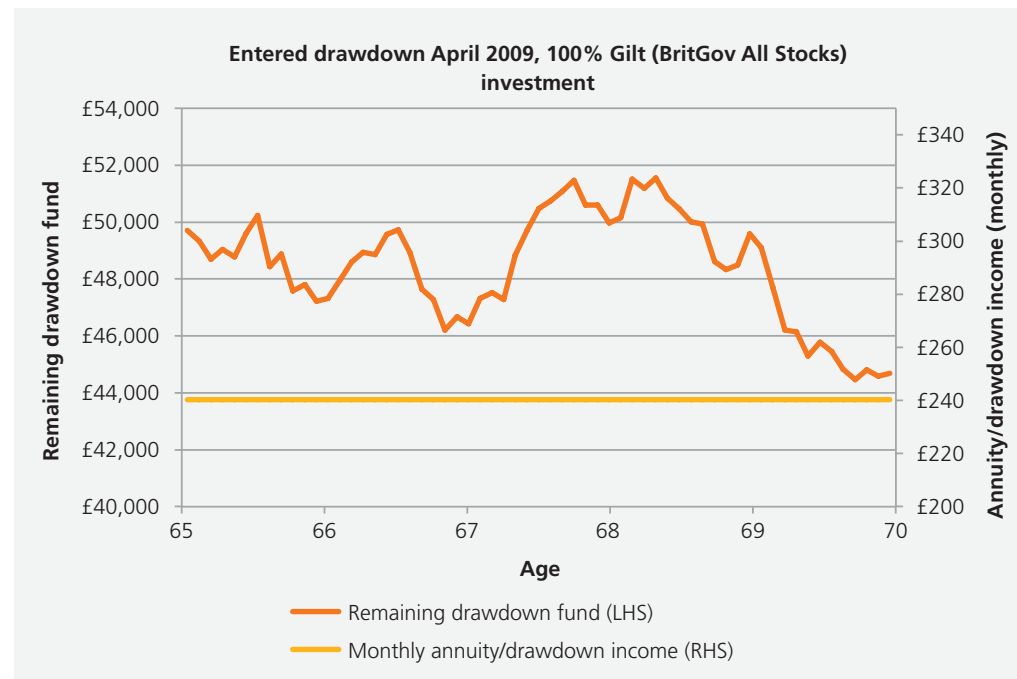
June 1st – Air France Flight 447, en route from Rio de Janeiro in Brazil to Paris, France crashes into the Atlantic Ocean killing all 228 people on board.

June 11th – The outbreak of the H1N1 influenza strain, commonly referred to as “swine flu” is deemed a global pandemic.

August 12th - New figures show UK unemployment stood at 2,440,000, the highest level for almost 15 years.

The retirees of 2009

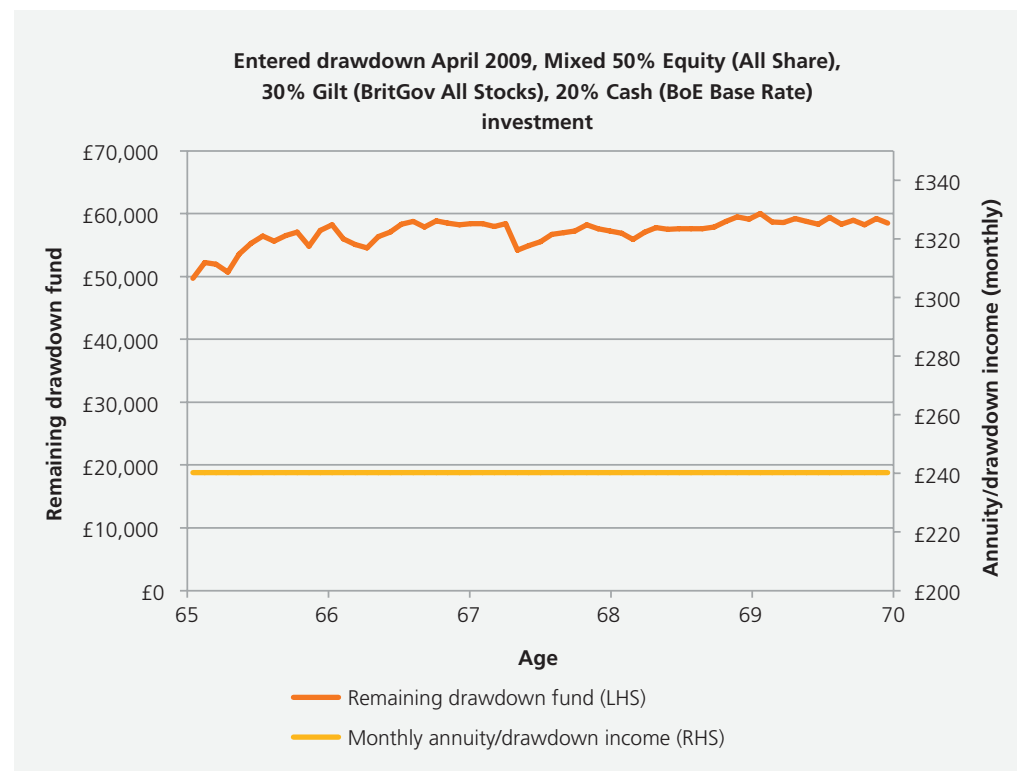
Portfolio 2 – 100% fixed interest



The residual drawdown fund of £44,679 is enough to buy a monthly annuity of £198.37, just under £42 a month less than had an annuity been bought originally at age 65 (£240.29).

The retirees of 2009

Portfolio 3 – mixed investment



The residual drawdown fund of £58,483 is enough to buy a monthly annuity of £260.65, just over £20 a month more than had an annuity been bought originally at age 65 (£240.29).

Conclusions

This analysis has shown the extreme risk and reward that drawdown can involve, particularly the 1999 and 2009 equity investment examples with the 1999 retirees penalised and the 2009 equity investors rewarded.

As might have been expected, mixed investment strategies both reduce volatility and avoid the extremes involved in taking a single asset class bet.

However, no investment strategy is fool-proof as the 1999 examples make clear. Investors in any of the portfolios examined would not have done particularly well. This underscores the need for a different approach towards drawdown investing, where delivery of an income is the most important consideration. Strategies that focus on that outcome are therefore more likely to be successful.

Another approach would be to mix guaranteed lifetime income with drawdown. This would mitigate the risk of running out of money altogether, allowing enough income to meet regular fixed expenditure via an annuity and perhaps using drawdown income as discretionary spend. This approach also allows withdrawals from the discretionary portion to be reduced during periods of investment volatility and allow the fund to recover before drawing income at a higher rate once again.

Recommendations

This investment special has looked to the past to examine the possible outcomes that await the 2015 'Freedom and Choice' retirees.

We can see there are no easy answers and that the risk that people may run out of money is a real one.

The future remains an unknown, so for people retiring today, a balanced approach that mixes annuity and drawdown (whether from a pension fund or other investments), may present the best balance of risk management with potential reward.

It is clear by looking at those living off drawdown longest (1999) that the chance of someone outliving their savings is a real one. The income rates we have used vary from 5.7% for the 2009 cohort to 6.7% for the 1999 cohort. Whilst most drawdown funds have performed reasonably well, and in our examples we have taken income from the drawdown funds that match level annuity rates available with the same starting fund, drawdown needs to be managed more conservatively and a sustainable withdrawal rate may be nearer 3% or 4% for those in normal health.

Freedom and choice will allow people to take their whole pension fund as cash but that cash will still have to support them during their retirement whether used as cash withdrawals, used to buy tranches of income or invested into drawdown. Ultimately the new options are little different from drawdown other than in tax treatment.

What should consumers do as they plan for retirement?

- ✓ If the amount of money you have saved for your retirement is, together with other sources of income such as state pension, only just enough to cover core expenditure then an annuity offers the least-risk choice in ensuring you don't outlive your savings.
- ✓ Drawdown is a viable alternative to those whose savings are capable of providing income above their core expenditure needs. A safety margin is essential if using drawdown as the sole source of income.
- ✓ Drawdown works best when the funds that the pension pot is invested in are rising and when the income withdrawals are not excessive. If choosing drawdown, be realistic about the level of income withdrawal you choose.
- ✓ Consider reducing or stopping income withdrawals from drawdown portfolios when the value of the drawdown investments are falling.
- ✓ Consider mixing annuity and drawdown income, with annuity income covering core expenditure needs and drawdown income covering discretionary spending.
- ✓ Before taking your pension pot as cash, consider the tax consequences. A cash pot is very similar to a drawdown pot as a way of providing income. Therefore you should choose the tax wrapper that is most tax efficient.
- ✓ Taking advice would be prudent if you are not confident about your financial choices.

