

PENSIONS

HOW TO INVEST IN A

# DRAWDOWN PENSION





Independent Financial Advisers - Financial Life Planners



## **PENSIONS**

# HOW TO INVEST IN A **DRAWDOWN PENSION**

## **CONTENTS**

Introduction	4
The Drawdown Mix	5
Income	6
Risks	7
Where To Invest	10
About Us	14
Compliance Statement	16
Contact Us	16

## Introduction

When you come to draw upon your pension you have three basic options. They are: withdraw your whole pension pot in one go; buy an annuity; retain the money within the pension and use 'Drawdown' to take an income.

This guide is not about these choices and which one is right for you. It is not about the technical nature of drawdown. If you need help determining whether drawdown is the correct option for you, then please contact us for help.

This is about how to invest in a drawdown plan assuming you have reached this stage, where you need to consider this. It is suitable for you, if:

- You are considering using drawdown as an option for your pension, in the near future
- You are about to start drawing on your pension, using the drawdown option
- You are already in a drawdown arrangement

The purpose of this guide is to explain some of the particular aspects of investing within a drawdown arrangement.

Drawdown allows you to take control of your retirement income, giving you the flexibility to choose your own investments and strategy.

The income level is not going to be secure nor will it be guaranteed. The investments you use to provide or generate this income are, in likelihood, going to be risky – at least to some extent – and could fall in value.

Great care needs to be taken in terms of which investments to use, the income level you choose, the strategy you pursue and how this is managed on an ongoing basis.

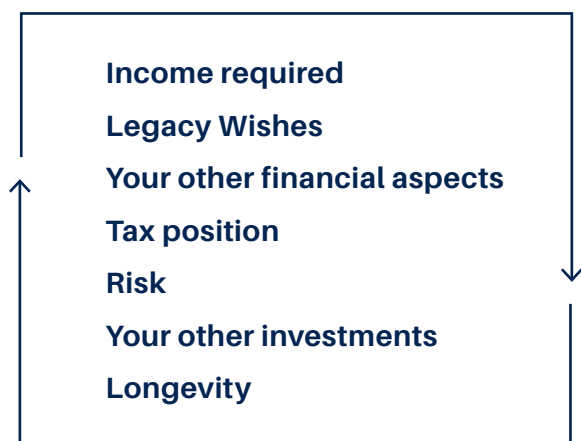
## The Drawdown Mix

Drawdown is inherently complicated by a potent mix of combining different requirements and considerations against one another. These requirements will probably be both within and without the Drawdown plan.

Factors you will need to weigh up and be wary of, which sit outside your drawdown plan include:

- Your wider finances and investments;
- Your tax position;
- Your wider family position.

### The mix of things that need to be considered:



For example, you may well have strong wishes around how you want to provide for beneficiaries. In this respect the Pension Freedom legislation makes the death tax position on pensions, in certain circumstances, quite favourable.

This could be influential in wanting to run a drawdown plan instead of an annuity, for example.

As we mentioned above, this guide is not about this type of consideration.

It is mentioned here simply to stress the complexities of the drawdown position, because these “outer” considerations can have a direct effect on how you structure a drawdown plan and therefore your investment approach.

Suffice to say, the position outside of the drawdown plan will have an impact. “Inside” the drawdown plan, there are other complexities which also apply.

This is the focus of the rest of this guide, how you approach the investment factors.

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TO BE SECURE OR GUARANTEED.  
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## Income

It is probable your approach, to a large extent, will be dictated by your income needs or desires.

It is an irony, and in the current market a nice feature, of drawdown that you have considerable, almost unlimited, flexibility over the income level you might select. The irony this leads to is that you could run a drawdown plan with no income taken at all.

This is not as strange as it may seem because there could be many situations where this makes sense. For example, you could take income for a few years of, say, 4% per year and then stop because other sources of income arise which mean you do not need to take any income from your drawdown plan in the year that follows.

Drawdown allows you to vary the income level as needed. To determine your income level you can choose different methods or strategies.

### Three common options are:

1. You select a percentage figure
2. You select a monetary amount
3. You take the 'natural' income level generated by your investments

The first option is where you choose a percentage figure, for example 4% per year, and then withdraw this as you go. You will need to select how often to take this (monthly, quarterly etc.) and whether to increase this by a bit year on year to keep up with the cost of living.

The second option is very similar, except in this case you choose a fixed amount, for example £10,000 per year, and then withdraw this, again how often and whether you increase this year on year are added aspects to consider.

The third option is different, in this case you would choose to take the income produced naturally by the investments you use. If you were investing into a mixed basket of different investment types, but ones that produce a yield of some sort, then you would opt to receive the yield from that basket. This yield could vary from year to year and could even fall at times. However by taking the natural yield theoretically you are putting less stress on the investments (see below for more).

There may be other options or variations – drawdown is always a personal circumstance led arrangement, so you will be able to find the method which best suits you. It is worth reiterating that the flexible nature of drawdown means that you can vary your approach over the years, so your strategy is not set in stone.

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## Risks

One of the most important aspects of running a drawdown plan is to understand the risks that apply. These are not necessarily obvious.

At the time of writing, March 2018, we need to make it clear that some of the most prevalent risks have not seen the light of day since drawdown grew in popularity after the introduction of the new Pension Freedom legislation in 2015.

The prevailing economic and investment climate that has largely existed for the period 2008-2017 has been one of low inflation, record low interest rates, benign asset markets, all favourable market conditions for drawdown investors.

We cannot emphasise strongly enough how important it is to recognise this.

The future investment and market conditions could be very different. The most important risks that threaten drawdown investors could easily come about. Investors must manage their situations to cater for these risks.

There are three risks to focus on and these need to be broken down somewhat, but here they are in their headings:

- Inflation risk
- Investment risk
- Longevity risk

The inflation risk is around losses you could incur in the true value of your capital or income from your drawdown plan over years as a result of inflation. This is a hidden factor. You could actually see rises in your capital values or income, but still be worse off because of inflation.

Imagine a scenario where you have a drawdown value of £220,000 and you are drawing £10,000 per year income. The value of the income is level for the next five years and the value of the pot increases from £220,000 to £225,000. That doesn't look too bad a result?

However, now look at the true value of these figures five years later, assuming different inflation rates;

(The true value is assessed to be the spending value in today's terms)

Inflation Rate (Over 5 Years)	£225,000 Pot "True Value" (£)	£10,000 Income "True Value" (£)
@2% p.a.	201,600	8,960
@4% p.a.	176,265	7,834
@6% p.a.	148,905	6,618

This is just an illustration over five years, the longer you stretch this and the higher inflation rate the more dramatic the impact – and potentially the loss.

For example over 20 years £10,000 falls in value to a true value figure of £4,563 assuming a 4% inflation rate per year.

There is a "behavioural science" aspect to this. Many investors would consider an actual loss (in pounds and pence terms) of the sort illustrated by these true value figures as unacceptable, but don't view the inflation affected loss in the same way. Inflation is a true risk and one that must be factored into planning and the strategy used.

**Even seemingly small rates of inflation will compound over time to reduce the true value of income and capital. Inflation, whilst hidden, is a real threat to drawdown investors who need to factor this into their planning.**

The investment risk is the simple tangible risk of actually losing money as a result of market falls or choosing an investment that performs badly.

This is a huge consideration for drawdown investors.

Losses which can be absorbed or accepted during the accumulation years, when saving for retirement is the aim, may not be acceptable or tolerated in the drawdown years. This is because there may not be the time to make up the losses or because the income required simply pours fuel on the fire of the capital losses.

Losses in drawdown are far more damaging, generally speaking, than losses when accumulating.

The income element is prevalent here. If you were to lose 10% of capital value in any particular year and you are drawing 5% income (basically against the capital value), your pot value falls 15%, if this happens for two or three years on the trot, you can soon run into trouble.

Trouble meaning you might have to forego income, change tact to protect the rest of your pot (and therefore have no chance of recovering your former pot value) or carry on 'as is' risking running out of money entirely.

The investment risk side is much nuanced in drawdown. For example, there is something known as sequence risk which entails the risk of early year losses (soon after you start drawdown) which can have a magnified negative effect on your experience and outcome.

Managing your investments to limit losses is incredibly important.

Finally you have longevity risk. This is somewhat different to the two other risks, because this is about the duration of the time you need to generate an income.

### **You have to weigh up the question, what happens if you live for a very long time?**

Assume you retire at 63 and start taking an income using drawdown. You may well consult a life expectancy table to see how long you can expect to live! Well don't, is the answer and here's why:

The life expectancy table may tell you that your life expectancy is 83.

The first thing to note (and not a lot of people know this) is that is NOT your most likely age at death.

Your most likely age at death is going to be later than that. So straight away the life expectancy table has misled you.

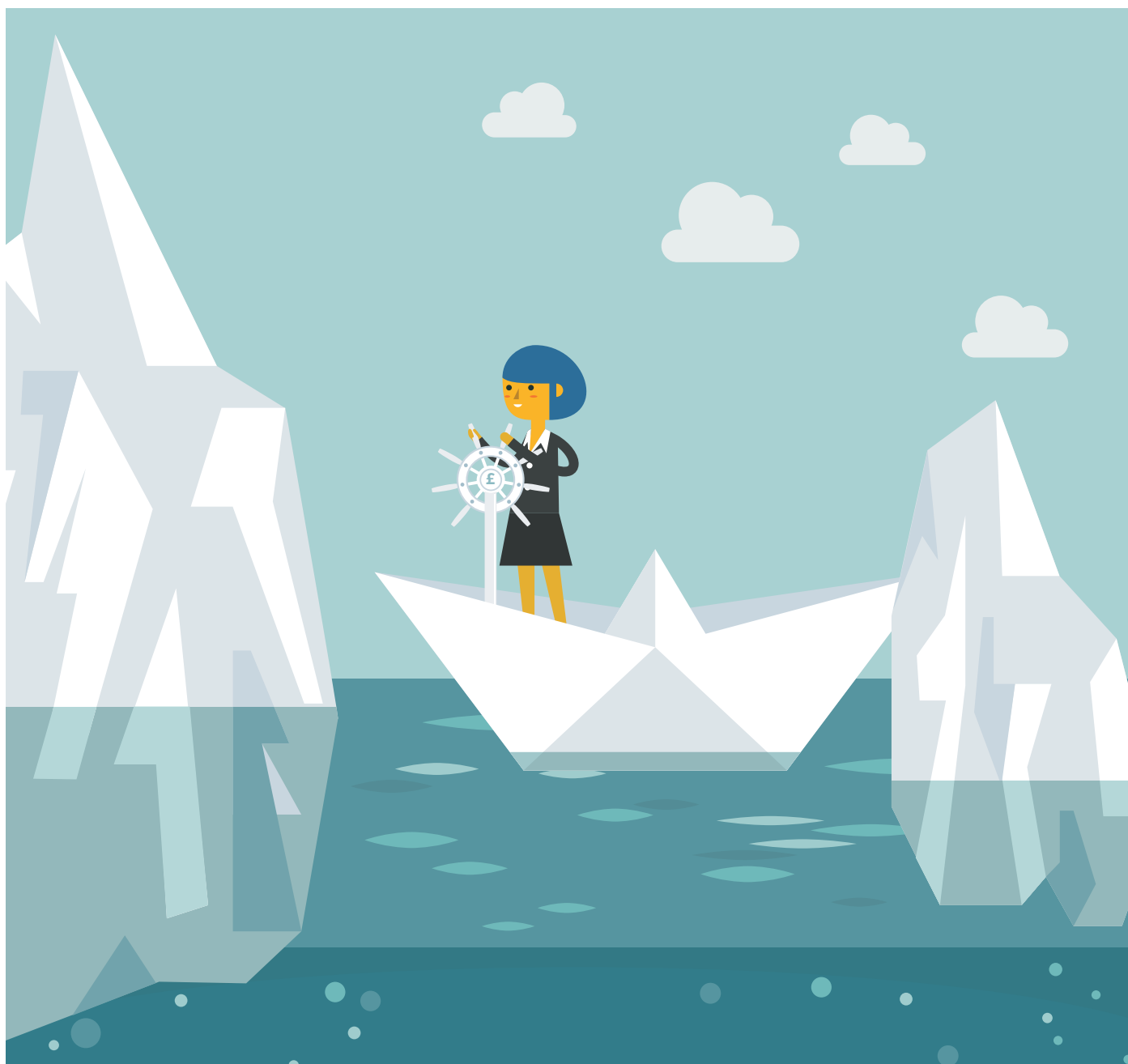
Second, even assuming you have worked out your most likely age of death is 86 or 87. Now what? Do you plan so that your income covers you until that age? No.

You might live longer than that, these are only averages and mean expectations. You do not have to be much of an outlier to live to 90, or even 95. You could be a true outlier and live to 105.

For individuals their life expectancy is almost totally irrelevant. It is useful for insurance companies calculating life assurance rates or annuity rates. But for an individual if anything it is deceptive, as they have no interest in the average date of death. Their chances of living much longer than the life expectancy are so high they must plan for a long life.

The longevity risk is that you manage your drawdown in such a way that you have no 'insurance' against being a longer life individual. If you assume normal life duration (as assumed by those averages and means) you could easily find that those final years, which could be many – you run out of money.





### **The risks in combination**

Strangely the first two risks, inflation and investment risks, are in a way a factor of the third risk, longevity risk. Inflation is not really a problem if you don't live very long after starting your drawdown and investment risk is also less, because the less time you are in your plan the less chance of hitting troubled times.

It is really the combination of these risks which make drawdown such a delicate arrangement and one that requires maximum respect for due diligence in this regard.

Anyone entering into drawdown must have a proper risk management approach as a result.

## Where to Invest

The ultimate decision where to allocate your funds within a drawdown plan is completely personal and circumstantial. There is no 'one-size-fits-all' approach and two very different-looking strategies used in different cases could be equally valid.

There are though certain key factors which need to be born in mind and are likely to be true for most drawdown investors:

- As indicated in the previous sections, the risk position and your income requirements will be highly influential. As will other financial arrangements, outside of your drawdown plan. Your other investments and wider requirements will need to be considered.
- As with any investing of this sort – and because of the point made in the paragraph above – diversification will probably be of great importance in your approach. Diversification remains the best way to manage and mitigate risk.
- The strategy you use and the investments selected will probably need to change over time. This is because the economic climate and market conditions will be changing. You may also wish to consider rebalancing, which is a way of keeping the assets you use in line with your attitude to risk, over time, as the asset values fluctuate.

The challenge faced by drawdown investors and their advisers is to get the balance right between the need for growth and income, against the risks taken.

This guide has not gone into any technical aspects of drawdown nor compared it to other alternatives. However in considering the investment position and your options, it is worth mentioning annuities, for a very specific reason.

One of the main alternatives to using drawdown is an annuity (although it is worth stating there is nothing stopping you from using both if you have enough money). An annuity will allow you to convert your pension pot into a secure lifetime income. You exchange the pot for a level of income, the annuity rate, which then pays out for life.

Annuity rates – as of March 2018 – happen to be low, based on historical levels, making annuities less attractive than they have been in the past. As of 1st March 2018 for a 65 year old an annuity rate for an escalating income (escalating at 3% per year) with a 50% spouse's pension attached, but with no other guarantee is £3,486 per year per £100,000 of pension fund value exchanged. (Source: [Sharingpensions.co.uk](https://www.sharingpensions.co.uk) annuity tables see note at end of the guide)

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### Imagine this scenario:

You get to the point where you wish to draw upon your pension and you have a plan value of £100,000 to produce income (we assume you have taken any cash entitlement tax free first).

That £100,000 can buy an annuity of £3,486 per year, which is payable for the rest of your life. It increases by 3% each year and pays out at a 50% level to your spouse after your death.

You decide you don't like this rate of income and want to use drawdown instead.

There are various reasons why drawdown might be preferable, but it is the investment position we are covering here.

To compare to the annuity you need to invest into drawdown and generate an income of at least 3.5% per year.

Where's that income going to come from?

Cash – won't produce anywhere near that level of income, nor will it provide any capital growth to protect against inflation.

Fixed Interest areas – such as government bonds, corporate bonds. These might – in the right combination – get close to this level of income but the higher the income sought, the greater the risk. For example very low risk government bonds might produce 2.5% income, corporate bonds 4.5%

income and if you combine the two, you might average out at 3.5%. Again though, will that income grow? Plus the corporate bonds hold much higher risk (relatively than cash or government bonds).

Property – you could use property funds or even direct commercial property investments, these may yield income higher than 3.5% but there is risk on both the income level, the capital value of the property and also there are other risks around difficulties with tenants, void periods and so on.

Shares – you could use shares or share-based funds and these may well produce an income through dividends and the yield from these could be around 3-4%, so comparable to the annuity option. But again the income is not secure, could fall, as could the capital value of the shares.

The problem that this highlights is that to improve upon the certain income for life of an annuity, which is easily the best comparison to make, you need to start ratcheting up the risk.

The more you wish to take the return up beyond the annuity level, the greater the risk.

This is why the past 10 years have generally worked for drawdown investors, because the market conditions for fixed interest, property and shares have been good. This has made the comparison with the annuity option favourable. The risk has paid off.

To beat the safe and certain income rate of an annuity, the drawdown investor needs to take some risk. The risk is higher the greater the out-performance targeted. This creates a difficult scenario, because the higher risks can derail a drawdown plan entirely, if they come to fruition. This is the delicate balance a drawdown investor needs to manage. One where skilled help can prove invaluable.

The drawdown investor's task is to look forward and envisage how they can make their strategy work if conditions are not so favourable in the future and this requires a very skilled application and strategy applied.

We can help you with your investment strategy and have the experience and the software facilities to help you in this area.

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DRAWDOWN PLAN ENTIRELY,  
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## Notes

The annuity figure quoted from [sharingpensions.co.uk](https://www.sharingpensions.co.uk): Annuity rates based on a central London postcode (other locations such as Peterborough or Liverpool could be up to 4% higher or Dundee and Newcastle could be 5% higher) using a purchase price of £100,000 - this assumes an original pension fund of £133,333 and after the tax free lump sum of £33,333 has been taken. Income is gross per year (before deduction of tax) and payable monthly in advance for the whole of the annuitant's life. No medical enhancements are included in these annuities. The pension annuity table is only a guide as annuities change frequently. Figures shown have been adjusted for Unisex annuity rates on a gender neutral basis and joint life rates assume both are the same age.

All other figures through this guide are for illustrative purposes only, they are examples to highlight broader points being made. They should not be used as guidance or construed as advice.

With drawdown, any decisions taken, either to the suitability of drawdown or in context of any investments chosen or income taken should only be made after appropriate independent advice has been received.

Investment values can fall and it is possible that a drawdown investment may not produce the income required and can even run out of money in an individual's lifetime.

The guide was written in March 2018. Please note that rules and regulations are subject to change and at the time of reading could be different to when this guide was written.

Interface Financial Planning cannot be held responsible for any decisions taken by readers of this guide based solely on the contents of this guide.



## History, structure, and expertise

Interface Financial Planning started providing independent financial advice in 1992. From the beginning it had the aim of providing professional advice and quality service to people with modest income and wealth.

Its key value was putting people before profit, and contribution before reward. This mission statement has been our torch to light the path ahead and has been the reason that we have endured for over 24 years.

Alan has lead the company with his personal values of: Integrity, Compassion, Respect, & Loyalty, and he is proud that over the years he has worked with clients who share similar values. Like him they want to help others and make the world a little better.

Client care and service is important and he is proud that his first two clients from January 1990 remain his clients today.

We believe that every client should have access to highly qualified advice and expertise.

Technology is used to the full to maximise efficiency and engage expertise from throughout the UK. The business has been paperless for 10 years and for over 5 years has been 'cloud' based. This structure reduces costs and allows support staff to operate anywhere - from Colchester to Honiton to Leicester and elsewhere.

Clients are encouraged to access their online account where they can exchange messages and documents securely. They can view their investments and reports, and they have immediate access to their paper file. Clients love the transparency and openness of being able to view and print paperwork going back for years and many clients use it as a source of reference.



**Owner, Director  
Interface Financial Planning**

Alan Moran is one of the most highly qualified advisers in the UK. He became a Certified Financial Planner in 1995 and he was one of the first Chartered Financial Planners in 2005.

He is a Chartered FCSI, a holder of the IMC certificate and member of CFA UK. His expertise has been called upon by The CII, The IFP, The Kinder Institute, and others, where he has trained and examined other financial advisers.

**Alan Moran B.Sc. M.Soc.Sc. Cert.Ed. FPFS FSWW IMC  
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Readers should not rely on, or take any action or steps, based on anything written in this guide without first taking appropriate advice. Interface Financial Planning Ltd cannot be held responsible for any decisions based on the wording in this guide where such advice has not been sought or taken.

The information contained in this guide is based on legislation as of the date of preparation and this may be subject to change.

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