



*Managing risk*

**around retirement**

“Retirement at sixty-five is ridiculous. When I was sixty-five I still had pimples.”

George Burns



We believe that a core principle underlying investment in DC plans is that members should take risk only when they have the ability to cope with adverse negative outcomes, either through having the flexibility to contribute more in the future or by adjusting their retirement expectations.

This belief suggests that, in practice, as most members approach retirement a de-risking strategy should be adopted. This is a key element of a lifecycle approach, which is central to many default strategies in DC. What are DC members' objectives at this stage of the journey and what types of protection assets are appropriate in this de-risking period?

In the 'old' world of retirement, there weren't many choices or decisions a member needed to make. Under early DB arrangements, for example, members had a high degree of visibility regarding what their retirement income would be and at what age they would retire. The shift to DC from DB has reduced the level of visibility of future retirement income and increased the decisions a member has to take. Furthermore, shifts in regulation and guidance surrounding retirement have broadened a DC member's choice, with implications for the investment strategy selected. While it is prudent to reduce investment risk as a member approaches retirement, there are various ways to implement this strategy. In this article, we explore the alternatives available to members as they approach retirement and suggest which protection assets may be appropriate. Our findings show that the current practice of building a portfolio of bonds and cash approaching retirement is sound, but product innovation could improve the proposition further.

## How much can you afford to lose?

Historical market performance suggests that equities-dominated strategies tend to maximise returns over many long-term periods. We have previously suggested, however, that DC member investment decisions should be based on balancing risk and return<sup>1</sup>.

As described previously in the glide-path design article, we compare an all-equities strategy against a lifecycle strategy. If an all-equities strategy had been followed, a member could experience a significant decline in the value of their investments close to retirement. Most DC members approaching retirement cannot afford to suffer that kind of decline. A lifecycle approach provides the member with more certainty about their circumstances at retirement, enabling them to plan more effectively. Typically, a lifecycle approach increases exposure to protection assets in the years leading up to retirement. In doing so, the emphasis in asset allocation shifts towards one of matching the likely 'liability structure' at retirement.

In DC, risk is generally defined in relation to variability of retirement income. A member approaching retirement is concerned about protecting the level of retirement income (ignoring for a moment that most members will take an

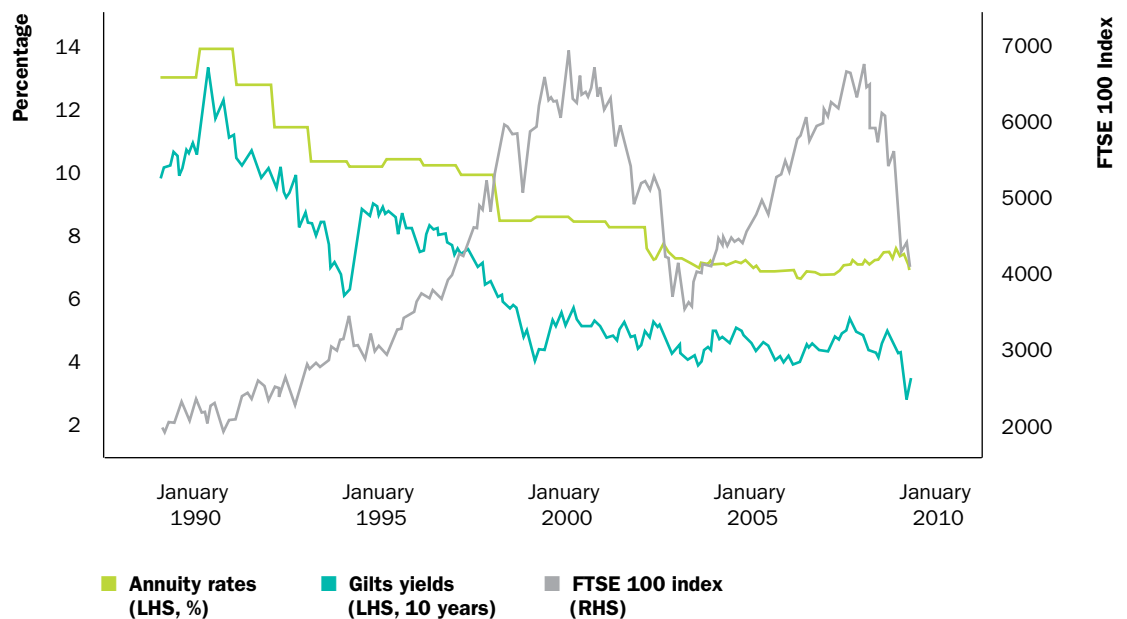
element of their savings account as cash at retirement). This suggests that members should consider hedging against adverse movements in annuity prices, rather than protecting the absolute value of the savings account. It is the purchasing power of the savings account that is important.

## Growth and protection assets

Early in a DC journey, assets will tend to be predominantly invested for growth. Historically, equities have dominated the asset allocation in the early years of a DC journey, but we suggest that growth assets should include the full opportunity set of risky assets, including equities, credit, real estate and alternatives. Protection assets generally include low risk assets such as cash and bonds (both corporate and government). As a member nears the end of his/her DC journey, he/she will typically seek to gradually move out of growth assets and into protection assets. Protection assets would ideally provide a match to his/her future liability, most likely in cash and an annuity purchase.

Investing in cash obviously provides a match to the cash element of the retirement outcome and, to date, the remainder of the savings account has generally been invested in low risk assets such as bonds (both corporate and government) to match the annuity purchase component. **Figure 01** shows

**Figure 01. Comparing annuity rates with gilt yields**



Source: Towers Watson

historic typical market annuity prices and compares these with gilts yields. The correlation is reasonably high, but not perfect.

As the industry and products develop, there may be more scope to include assets such as deferred annuities, swaps and other derivatives. As the protection assets are aiming to act as a proxy for the member's future liabilities, the preferred structure of these assets is partly driven by the intentions of the DC member on approaching retirement. We explore some examples in further detail later in this article.

## Protecting the downside

It is possible to design an investment solution in which the member can retain a higher proportion of growth assets for longer in the DC journey, by incorporating downside protection products. These may be designed to limit the loss of capital, thus creating a floor to the value of the DC investments. Such strategies may be based on the use of put options, for example. However, these strategies only protect the capital in an absolute sense. As an alternative, protection products may be designed to protect retirement provision, taking the form of deferred annuities, for example. To date, the costs of adopting such strategies have tended to be expensive and hence difficult to incorporate effectively into DC investment structures. Switching into a protection assets fund is typically a cheaper alternative to managing risk.

## The typical DC member

The majority of members currently retire at a predetermined age (typically 60 or 65) and take the maximum tax-free cash lump sum available (25 per cent of the accumulated savings account). They then purchase an annuity with the remainder of their account. If the asset structure approaching retirement is seeking to act as a proxy to these 'liabilities', as defined by the DC member's intention, it would appear appropriate that the assets held should be a combination of cash and the type of assets (held by the insurance company) that drive the annuity price.

According to Towers Watson research<sup>2</sup>, most members purchase a level, non-increasing annuity. The assets held by an insurance company in respect of their annuity business are typically a range of bonds, depending on the type of annuity written. Purchasing a level, non-increasing annuity would suggest a protection portfolio of corporate bonds (two-thirds) and conventional gilts (one-third), ideally incorporating some nuances in respect of bond duration to improve the matching ability of the portfolio. If an inflation-linked annuity is likely to be purchased, a more appropriate asset to hold would generally be index-linked gilts.

It should be noted, however, that annuity pricing is not solely driven by prices in these bond markets. In practice, the factors in an insurance company's calculation of their annuity prices are complex. The key drivers include asset yields, default risk, liquidity, longevity, regulatory influences and competitive market positioning. A portfolio of bonds is, therefore, not a perfect proxy, as seen in the recent credit crisis.

“In practice, the factors in an insurance company's calculation of their annuity prices are complex”

## A matter of member priorities

The member's intentions with respect to their cash lump sum will also influence the overall asset structure. There is a trade-off that needs to be considered between protecting the value of the cash lump sum payment and protecting the level of annuity income.

If the member is planning to take the full 25 per cent of their accumulated savings account as tax-free cash at retirement, then it would be reasonable to build up the cash holding to 25 per cent in the period running up to retirement as a matching investment. The 25 per cent cap, however, is based on the market value of the whole DC portfolio at retirement and, therefore, the actual amount of cash available to be taken will be affected by market movements in the non-cash portfolio.

The member, therefore, has a choice to make, depending on their retirement plans:

- If the member has definite plans about how he/she intends to spend the cash sum then he/she may wish to have more certainty around the size of the actual cash lump sum. In this case, it may be appropriate to hold more than 25 per cent of the savings account in cash to better protect the absolute value of the accumulated savings account. Indeed, if absolute certainty is required, then the member's asset allocation towards retirement would need to be 100 per cent cash. However, this strategy would be at the expense of providing any protection to the member in terms of future annuity income that will be received.
- On the other hand, if the member instead wishes to minimise the potential variability of likely retirement annuity income, then it would be appropriate to hold a predominant portion of the DC savings in the bond proxy described previously in order to hedge against adverse annuity price movements. As a consequence, the member would need to accept the potential variability in the actual level of cash lump sum that will be received.

## Improving current practice

A number of market-based and regulatory developments suggest that current practice in pre-retirement investment could be improved for many members going forward. We highlight three examples and expand on them below:

- Introducing flexibility around retirement date.
- Deferring the date of annuity purchase and adopting a drawdown strategy.
- Expansion of annuity-type products becoming available.

The challenge associated with all of these is that the DC member is faced with a new set of decisions to take and more choices in those decisions. We believe that in future, more members (the guided-selectors<sup>1</sup>) need to be encouraged to personalise their investment strategy, albeit within a structured, guidance-based choice/default framework. Enhanced engagement and communication about the options and implications in the years running up to retirement will be critical to success. This places additional pressure on fiduciaries, who will need to decide on the level of guidance and support they wish to provide to their members.

## Trends in annuity prices

There has been a long-term decline in annuity rates since the 1980s, primarily due to increases in life expectancy and reductions in interest rates.

**Figure 02**, below, shows the average annuity rate from the 1950s. The synthetic annuity rate below – an approximation that is derived from historical mortality rates and interest rates – shows how closely annuity rates follow trends in mortality expectations and interest rates.

A retiree today with a fund of £50,000 at retirement would have received an average annuity of around

£3,500, compared to about £7,800 for those retiring in 1980. Based on current estimates, life expectancy will increase further in the future and annuity rates are likely to continue to deteriorate. Moreover, mortality improvements will lead to greater reductions in rates for annuities with any form of guarantee or inflation protection, when compared to level annuities.

This is something members currently do not typically consider in their retirement plans and may require further communication.

**Figure 02. Long-term trends in annuity rates**



Source: Average annuity rates, 1957 to 2002 is quoted from Cannon and Tonks (2004), 2003 onwards from market data. Synthetic annuity rates derived from mortality tables and 10-year bond yields.

### Flexibility in retirement age

Flexibility around retirement date is one option that DC members can use to enable them to take on investment risk and respond to adverse outcomes along their journey. Current practice suggests that it is rarely used, but we believe it may become more influential in time. In a recent survey<sup>3</sup> respondents were asked at what age they wished to retire and when they expected to retire. The results, shown in **Figure 03**, indicate that respondents expect to work longer than they would wish. This suggests that members may be more flexible about their retirement date.

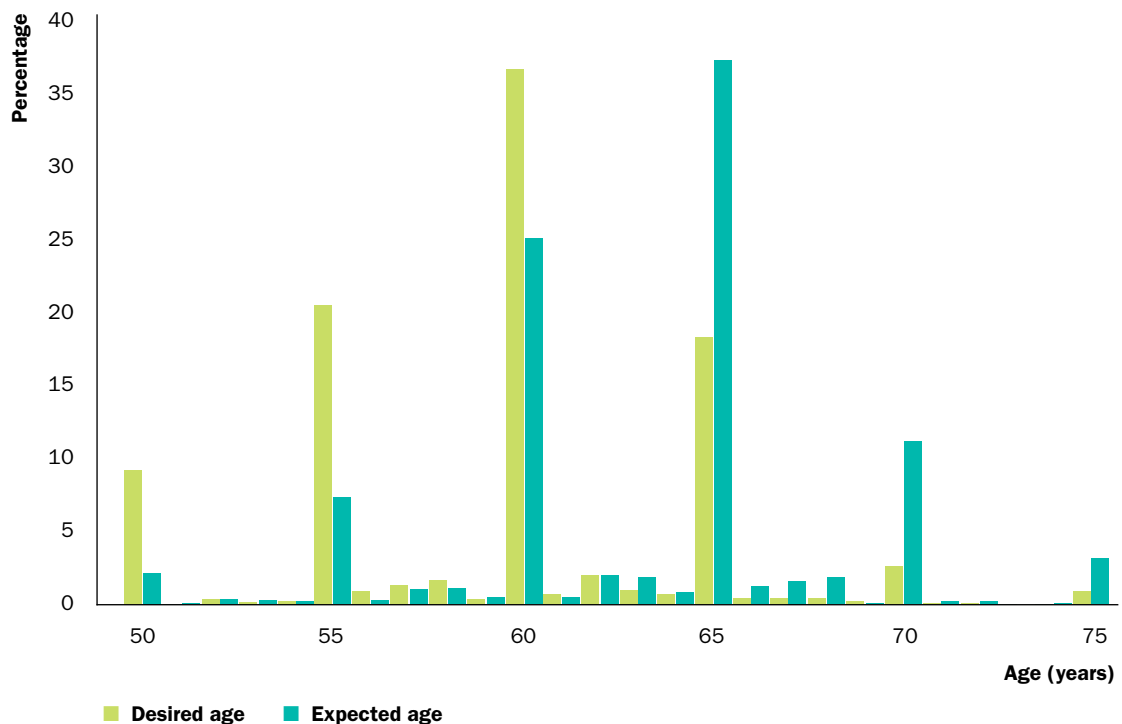
This flexibility is most likely to be used when the member needs to extend the savings period. This may be following a period of adverse market conditions significantly reducing the value of the DC assets or if the level of savings over the journey has been inadequate to meet retirement outcome requirements. Recent research<sup>4</sup> on the effect of the financial crisis on DC member attitudes and retirement savings plans found that approximately one-third of members between the ages of 50 and 64 had decided to delay taking retirement benefits in response to the current economic environment.

In adverse circumstances, a member may consider delaying their transition towards protection assets and retaining their exposure to growth assets for a longer period, in the hope of recovering some of their losses. In general, we would caution against such a strategy, however, as the member may become over-reliant on a market recovery in the short term just at the time when their ability to take investment risk is diminishing. We would instead suggest any additional period of work gained from extending the age of retirement is used to enhance the level of contributions into the DC savings account, whilst de-risking their investment strategy.

### Adopting a drawdown approach

Under current UK legislation, a member is not required to purchase an annuity immediately at retirement. The alternative approach would be to adopt an income drawdown strategy, deferring the annuity purchase until age 75. This provides the member with greater control over their pension assets in the short term, while still being able to benefit from purchasing an annuity later. Members can then adopt a more flexible asset structure towards and into retirement, potentially retaining an exposure to growth assets for a longer period.

**Figure 03. Changing expectations of retirement age**



Adopting an income drawdown strategy is more likely to be beneficial if the size of the DC savings account is significant and the member is not especially dependent on this pool of assets to provide them with their required level of retirement income.

There are also several disadvantages to this strategy:

- Exposure to investment risk continues past the member's retirement date, when their ability to bear investment risk is often small.
- Annuity prices at age 75 are generally relatively worse than at age 65 (due to an effect called 'mortality drag').

- There is a reduced level of security of future income.
- The costs associated with operating an income drawdown strategy can be significant, in particular administration and advice costs.

In summary, whilst not having a fixed annuitisation date in mind can provide members with greater flexibility to take on investment risk, this benefit should be balanced primarily against the need to have income security in retirement. The engagement process also becomes more difficult using this approach, as most fiduciary bodies do not tend to support post-retirement planning programmes.

## Supporting members with their pre- and at-retirement decisions

It is widely accepted that most employees are not financial experts. If they are to successfully navigate the at-retirement market they will need to be provided with help and support.

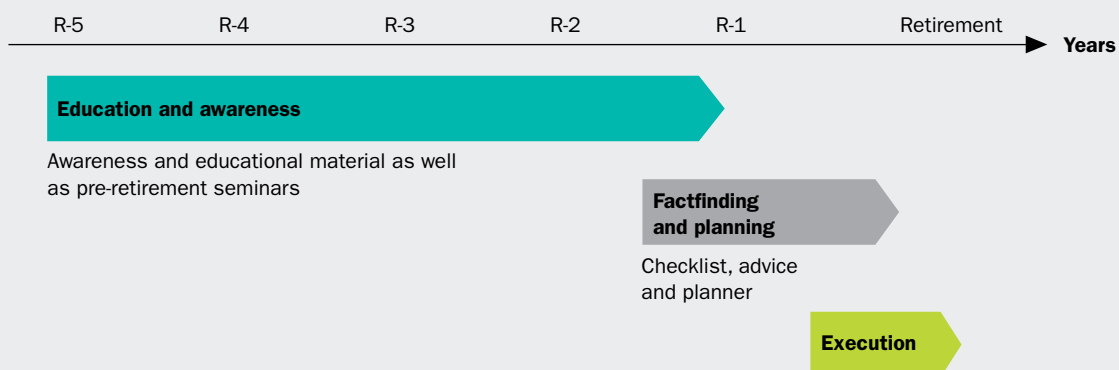
We believe that the timing of support is an essential part of the decumulation process. Assistance should start early enough to enable members to fully consider both their current personal and financial circumstances as well as their future requirements. Only then will they be in a position to start formulating a view on which at-retirement options will be most suitable, enabling the member to make an informed decision.

We therefore suggest that there are three stages to a suitable support framework, as shown in **Figure 04**.

Stage one is the provision of high-level information to raise awareness and educate, starting perhaps five years prior to retirement. Stage two then commences about a year to 18 months before retirement and provides more detailed assistance to members, including access to planning tools and perhaps even advice.

The support in both stages could be provided via a number of different media including online, paper and face-to-face communications. Assuming the first two stages have been effective, the third stage of income execution (for example, purchasing an annuity) should be straightforward.

**Figure 04. Member support framework**



### **Annuity product expansion**

The annuity market is developing quickly, with many new product types becoming available to retiring DC members<sup>5</sup>.

This increasing choice provides more flexibility to the member – albeit at the risk of confusing them – but costs tend to be significant in many of the products. Where the member is able to exercise flexibility, some of these products (for example variable annuities) enable a member to retain an exposure to growth assets for longer in exchange, however, for reduced income security.

“Flexibility around retirement date is one lever that DC members can use to enable them to take on investment risk...”

Given these additional options, member engagement and communication is key. As a result, fiduciaries will need to consider their strategy in this regard and decide on the extent of the support framework that they are prepared to put in place for their members.

### **Looking forward**

We suggest that the hedging/de-risking market in DC is currently under-developed and opportunities exist for product evolution and innovation. There is scope to incorporate, for example, swaps and other derivative-based strategies to replicate a desired future stream of income, thus complementing the annuity products available. Such a strategy could be taken on by the member to provide income from age 65 to 85 years, with a deferred annuity providing income and longevity cover after 85. It would also be possible to extend the period over which members are exposed to growth assets, using specialised annuity products (with-profits annuities and variable annuities for example) or derivative-based products such as annuity proxies. These products would focus on managing member risk as they approach and enter retirement.

Tailoring protection asset funds to better meet a member’s needs through the use of more innovative duration ‘buckets’ could provide members with improved matching of their future anticipated liabilities. The use of such products would, however, tend to be reliant on a nudge engagement programme also being in place<sup>6</sup>.

The potential role of fiduciaries could become more complex in such an environment. We would suggest that this role is focused on the provision of a more sophisticated lifecycle fund coupled with engagement and information which will enable the member to make the decisions necessary.

### **Conclusion**

The structure of the protection assets portfolio and the glide-path switch from growth to protection assets depends on member preferences and intentions towards retirement. The current practice of focusing exposure on a combination of corporate and government bonds and cash provides a reasonable proxy to the typical path at retirement of taking a cash lump sum and annuity purchase. However, there are opportunities to improve this approach which require product innovation in the industry.

### **Notes**

<sup>1</sup> See *Lifecycle strategies: what next?* on page 20.

<sup>2</sup> See Watson Wyatt Pension Research Forum: *Annuitisation and retirement – how can the member experience be improved* (2008).

<sup>3</sup> See Watson Wyatt Pension Research Forum: *The future of UK retirement savings* (2009).

<sup>4</sup> See *Scary markets survey*, Watson Wyatt, 2009.

<sup>5</sup> We note, however, that under Solvency II proposals insurance companies may be less willing to offer annuity products in the future.

<sup>6</sup> For a longer description of nudge see *Lifecycle strategies: what next?* on page 20.