# A guide to income in retirement

Helping you think about getting your finances in shape for retirement

SUCCESSION
GROUP

# Contents

# Introduction

- Retirement means different things to different people these days.
- People are, on average, living longer.
- Compulsory annuity purchase is no longer necessary.
- From April 2015, once you are 55, you can access all or any of your money purchase pensions savings however and whenever you want.
- When the time comes to take some income in retirement it will be essential to take account of all of your savings and investments.

These days, retirement can mean different things to different people. For some it's a traditional retirement with a complete cessation of work. For increasing numbers and for different reasons the journey to complete retirement may be more gradual or a complete retirement may be deferred for a long while or never come. Regardless of the type of retirement you plan or experience you would, of course, like it to be healthy and enjoyable.

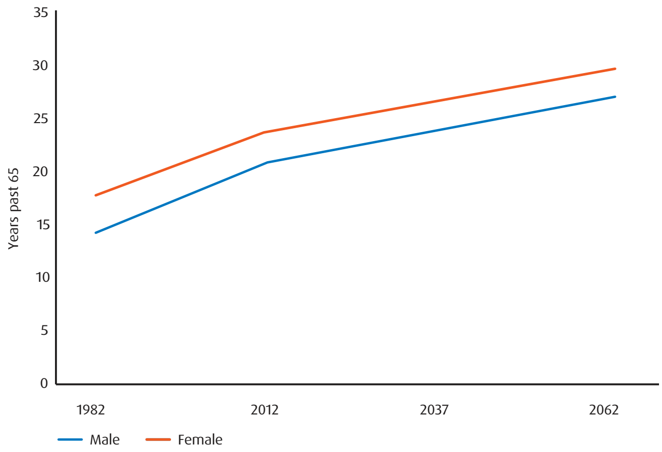
Unfortunately many people fail to achieve this objective. There are lots of reasons for this. Some are to do with failing health. Some are the result of other unforeseen events such as an accident or bereavement. Often though the cause simply is down to poor financial decision making. That may be the result of inadequate saving, poor financial planning in the run up to, and after, retirement (whatever retirement means to you) or both.

For those with savings in pension arrangements – particularly in what are known as defined contribution schemes – the decision on whether, and if so, how and when to convert those savings into income is critical. And it doesn't matter whether those savings have been built up through a workplace pension scheme or through a private or personal pension, the importance of making the right choices at the right time is crucial.

## Living longer

There are many factors that can influence this decision. One is that these days most of us are living longer. According to the Office of National Statistics a man aged 65 can expect to live until he's 86 – that's seven years longer than thirty years ago. A woman aged 65 today can expect to live for nearly twenty four years – that's nearly six years longer than thirty years ago. This is good news. The bad news is that our pension savings have to last much longer.

**Projected life expectancy**




Source: Office for National Statistics 2012

Another important factor is the impact of inflation. For someone retiring at 65 inflation at 3% can reduce the real value of a fixed income by nearly half by the time they are 85. Finding an income that provides protection against the effect of inflation is important but not easy.

## Poor value from annuities

Historically, most people have chosen (and some effectively have been forced) to buy an annuity when faced with the above decision. An annuity provides a safe and regular income. It also ensures that you will never run out of income however long you live. But the income you secure by buying an annuity is substantially dependent on the level of interest rates and life expectancy at the time of purchase. For some years interest rates have been extremely low and longevity expectations have been increasing. As a result the annual income you've been able to secure through an annuity has been much lower than in the past.

"Since April 2015 there have been some big changes to the various ways in which you can take money from your pension pot."

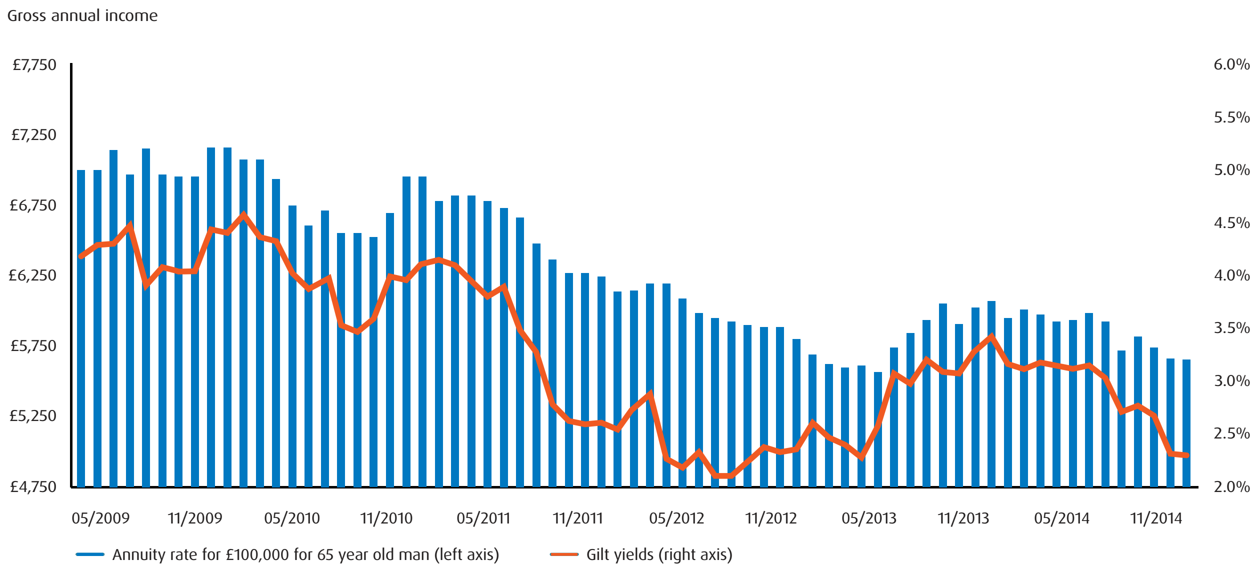
The chart below shows the annual annuity income that could have been secured each month during the period 2009 to 2014 for a man aged 65 with £100,000. For comparison purposes it also shows the relevant gilt yields upon which annuity rates are broadly based.

But this all important decision isn't just about the type and amount of annual income you can secure with an annuity. Equally, or arguably more importantly is whether you should buy an annuity at all – and if so, when is the right time to buy one. These are complex issues which may impact on your spouse or partner if you have one and potentially your other dependants including children and grandchildren. We consider these issues in more detail later in this guide. But the vital thing to remember is that, despite the likelihood that in the future it will be possible to trade (buy and sell) annuities, as the rules stand once you've bought an annuity you cannot change your mind. The money is spent and irrecoverable.

## Pensions get flexible

Starting in April 2015 there are some big changes to the various ways in which you can take money from your pension pot. These are described in the following pages. The new options introduce more choice – and more complexity. Everyone's circumstances are different. You will have your own aspirations for your retirement – and your own priorities. The fundamental principle of these changes though is that once you have reached age 55 you will have the ability to access all or any part of your pension fund albeit taxed, however and whenever you want to.

**Falling annuities rates**




Source: Key Retirement – www.keyrs.co.uk

## State benefits

For many the pension that the State provides will form a key part of their income in retirement. The amount of State Pension you will get usually depends on the National Insurance contributions you have paid. From April 2015 the full Basic State Pension is £115.95 a week. As well as the Basic State Pension, you may get Additional State Pension or Graduated Retirement Benefit, which are based on the amount you earned when working.

The age at which you can claim State Pension is changing. It is currently 65 for men. State Pension Age for women is gradually increasing from 60 and will reach 65 by November 2018. State Pension Age for both men and women will then increase to 66 by October 2020 and then to 67 and eventually 68 by 2046.

And finally, a new flat-rate State Pension which will replace the basic State Pension and is being introduced from 6 April 2016. This will affect people reaching State Pension Age from 6 April 2016 onwards. You can find out more about all of these changes online on the Pension Wise website, or by telephoning the Pensions Advisory Service.

www.pensionwise.gov.uk

0300 123 1047

## The bigger picture

Your defined contribution pension savings may be only part of your accumulated wealth though. You could have money on deposit and investments in all or some of ISAs, collective investments, stocks and shares, insurance based products or even buy to let property, Venture Capital Trusts and Enterprise Investment Schemes – to name but a few!

Self-evidently, the more investment value you have, the greater chance you will have of a financially rewarding retirement. But the more investments you have, the more important it will be to think very carefully about where you take money from when the time comes to take it.

The various investments mentioned all have different tax rules applying to them so having a good understanding of these rules will be essential to good decision making.

In addition to the decision on where to take money from there will be the continuing need to think about the relative importance of certainty of income, access to capital, and preservation of capital for your family as well as the degree of risk you are prepared to take to achieve your required level of return on the investments that remain in your pension fund.

# The 2014 Budget earthquake

From 6 April 2015 you are able to:

- Access your defined contribution pension benefits from age 55 however and whenever you want – as a lump sum or income.
- Any remaining funds on your death can be paid tax free on death before age 75.
- You will have the right to free guidance on your pension choices.

But

- Advice on the course of action that is right for you will be even more necessary.

Since April 2014 we've seen the biggest shake up to pension provison in many years. These changes mainly affect those with defined contribution pensions. Those in workplace defined benefit (or final salary) schemes are largely unaffected. These fundamentally important reforms started with the 2014 Budget and have continued since. Further refinements may be made following the election of the new Government which has already indicated its intention to reduce tax relief for high earners.

Essentially though, there are three key elements to these changes.

### 1. Flexible access to your pension

In his Budget 2014 speech the Chancellor announced sweeping reforms for anyone aged 55 or over looking to access their defined contribution pensions. You will still be able to buy an annuity – and from 6 April 2015 there is more flexibility in the way in which income from annuities can be paid. You can also continue to take usually a quarter of the value of your pensions savings in cash tax free. In addition, from 6 April 2015, you have the option to take some or all of the rest of your pensions savings in cash subject to income tax at your marginal rate(s). And you can drawdown your pensions savings either as a single lump sum or as a series of lump sums at times to suit you. It has led some to conclude that the pension fund, in relation to how it is accessed, will resemble a bank account.

## 2. Changes to the taxation of death benefits

Later in 2014 the Chancellor announced further big changes to the taxation of pension benefits paid on the death of a member of a defined contribution pension scheme – again these new rules take effect from 6 April 2015. Up to now the tax rules for pensions when someone dies have been complicated and depend on how old the person is and whether they have taken any money from their pension.

Under the new rules, someone dying below the age of 75 will be able to pass their pension or its lump sum value on to anyone completely tax free. For someone who has already reached 75 the position is not so straightforward. If their pension is passed on to their beneficiaries as a lump sum it will be liable to a 45% tax charge. Ultimately the government want this type of lump-sum payment to be subject to tax at the beneficiary's marginal rate rather than a 45% flat rate. They hope to introduce this change by April 2016.

If a beneficiary wants to take the deceased's pensions as an income, not a lump sum, and the death was after age 75, the income paid will be taxed at the beneficiary's marginal income tax rate.

These tax changes will also apply to a type of annuity known as a Value Protected Annuity.

## 3. Guaranteed access to impartial guidance

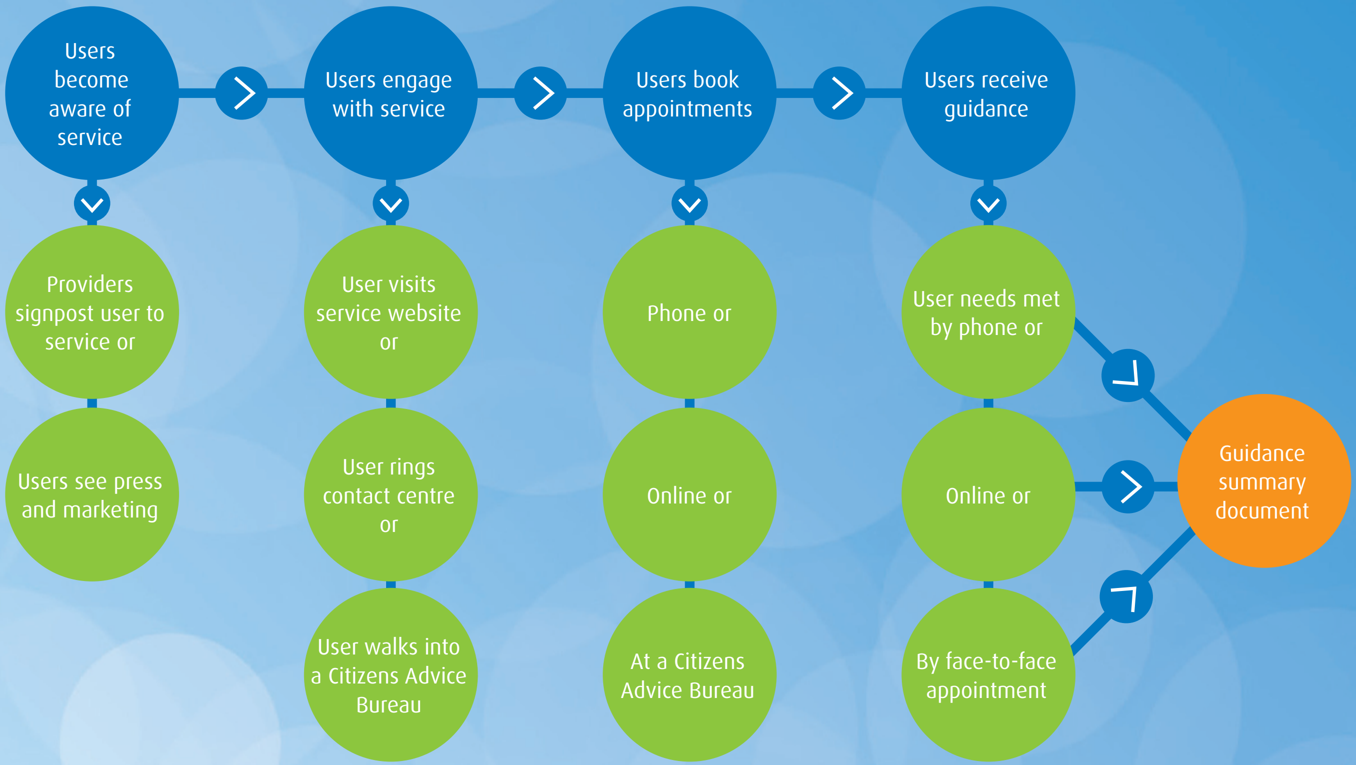
In introducing these changes the government acknowledged that extra flexibility brings with it more choice and the greater risk that inappropriate choices are made leading to less than suitable outcomes. It therefore committed that everyone with a defined contribution pension fund will have access to free high quality impartial guidance as they approached retirement. This commitment was called the Guidance Guarantee. The government believe this will help pension savers understand their options and make confident and informed decisions on how they put their pension savings to best use in retirement.

## Guidance for all

This new service – the Guidance Guarantee – is called 'Pension Wise – Your money. Your choice.' and is backed by the government. Guidance consultations will be available over the telephone, face to face and online. The Pensions Advisory Service (TPAS) delivers the telephone guidance. Specific Citizens Advice Bureaus will provide the face to face guidance service. More details about the service can be found on the Pension Wise website www.pensionwise.gov.uk.

The diagram below, which is taken from the Treasury's guidance note on the Pension Wise service, shows how someone will learn about and can access the new service.

**Pension Wise – getting informed**



If you have an existing defined contribution pension that you are looking to access, your pension provider will have to ask you if you have taken pensions guidance or regulated financial advice, and if not, to encourage you to do so. Remember that guidance is simply that. The Pension Wise service is intended to help those considering accessing their defined contribution pension savings to:

- Ask the right questions, given their individual circumstances and
- To understand their options in order to be able to make an informed next step.

But it is not designed to provide specific advice to individuals on what action would be most suitable for them. For many that next step after receiving guidance should be to seek financial advice.

The new freedoms outlined earlier apply to all existing defined contribution schemes along with new schemes. However it does not follow that all providers of individual and personal pensions will allow or be able to facilitate all the new options. Nor are trustees of workplace pension schemes obliged to provide all the new flexibilities. If you have an existing pension or are in a workplace scheme you will need to check what options are open to you. If you find that the options you require are not available then you may need to consider transferring your pension to a scheme that will allow them. Bear in mind that some providers and schemes may introduce greater flexibility at a later date and transferring will usually carry a cost.

It is also important to appreciate that, just as we've seen with other parts of the pensions landscape, there are no guarantees that these reforms will be free from further political influence in the future.

"Everyone with a defined contribution pension fund will have access to free high quality impartial guidance as they approach retirement."

# New rules in more detail

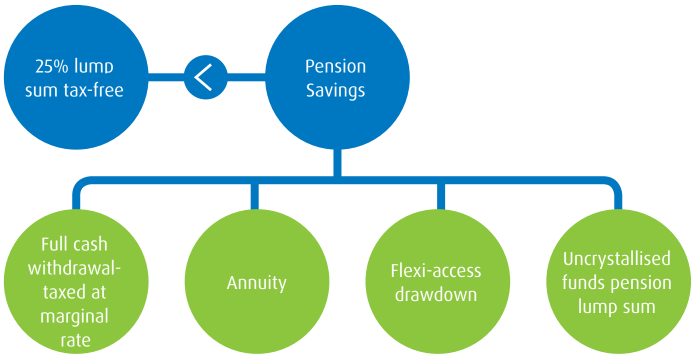
Your post April 2015 choices for taking benefits from your defined contribution pension savings are:

- All in cash; 25% tax free, 75% taxable (full cash withdrawal).
- Gradual withdrawal of funds; partly tax free, partly taxable (flexi-access drawdown) or uncrystallised funds pension lump sum (UFPLS).
- Buying an annuity.

From 6 April 2015 and if you are aged 55 or over and in a defined contribution pension plan you will be able to access your pensions savings in a number of different ways. You should think long and hard when considering these options. It's important to consider not only all your pensions savings – including the state pensions – but also any other savings, investments and other sources of income that you may have such as ISAs, stocks and shares, collective investments, insurance based investments and bank deposits along with any other investments including any properties that you own. In taking any decisions about accessing your savings and how to invest amounts that you do not need to access immediately, you should think about:

- Your current essential income needs such as your day to day living expenses and other known/planned expenditure
- Your lifestyle and other, non-essential expenditure such as holidays, new cars, sports and hobbies, entertainment etc
- Future possible/anticipated living expenses incorporating, possibly, a budget for care
- Unexpected items such as car repairs, home maintenance and health problems
- Gifts – either now or in the future.

**Access options**



## Full cash withdrawal

This is the big change. From 6 April 2015 if you are aged 55 or over with a defined contribution pension plan you will be able to access some or all of your pensions savings at any time and in any amount – assuming your pension provider or scheme permits you to do so. This will allow you to use your pension savings in a variety of ways. You could choose to pay off debt or credit cards, buy a new car, pay for a holiday or perhaps invest in assets that aren't available via your current pension.

It's very important to take into account the income tax that will be payable on these withdrawals – apart from the 25% lump sum that is payable tax free. As explained later in this guide, it will be easy to trigger income tax of 40% or even higher on such withdrawals given the current tax threshold limits.

Name: **Jack**

Age: **64**

Pension pot: **£30,000**

Jack is a widower aged 64. He has just agreed to retire early at the end of May 2015. He is in a workplace defined benefit pension scheme and also has a small private pension currently worth £30,000. Rather than take an early retirement pension from his workplace scheme he decides to take advantage of the new pension flexibilities and use full cash withdrawal from his private pension. He receives £7,500 tax-free and the balance of £22,500 is payable subject to tax at 20% as he has no other income in tax year 2015/16. This provides him with a total income of £25,500 and is sufficient to meet his immediate needs until he starts to receive his defined benefit pension and state pension from 1 May 2016 when he is 65.

## Flexi-access drawdown

This is a new option, available from 6 April 2015, that replaces what previously was known as flexible drawdown. With this option your pension savings are treated as being moved into a new pot. You can withdraw your pension savings from this pot without any limits on the amount or timing of any payments that you choose to take. This is subject to any restrictions that your pension provider or scheme imposes though. The first 25% of your pension savings that you withdraw will be payable tax-free. Thereafter any payments you take will be liable to income tax at your marginal rate(s).

The benefits payable and tax position on death are described elsewhere in this guide.

Name: **Simon**

Age: **60**

Pension pot: **£60,000**

Simon has £60,000 of defined contribution pension savings. He has just turned 60 and he and his wife want to celebrate by visiting South America – a long-time dream. Simon decides to take his tax-free lump sum of £15,000 to fund the trip. At the same time he designates £45,000 to flexi-access drawdown with his current pension provider. As he's still working he decides not to take any income for the time being but he is aware that as soon as he does he will trigger the new £10,000 defined contribution annual allowance – see section 'Beware the tax man' for more details.

## Uncrystallised funds pension lump sum (UFPLS)

This is a brand new way to take income from your pension savings which again is introduced from 6 April 2015. This option is similar to flexi-access drawdown except that for each payment that you withdraw, 25% is treated as tax-free and the other 75% is taxed as income at your marginal rate.

There may be tax planning advantages in using UFPLS rather than flexi-access drawdown. Also if you are in a workplace defined contribution scheme this may only offer UFPLS. In those circumstances if you want to use flexi-access drawdown you will have to transfer your pension to a private pension that allows this option. The benefits payable and tax position on death are described elsewhere in this guide.

Name: **Jane**

Age: **59**

Pension pot: **£170,000**

Jane, 59, is currently a higher rate taxpayer with an income of £50,000 per annum. She has defined contribution savings of £170,000. In June 2015 Jane and her partner decide to build a small extension to their home. They estimate that they will initially need £15,000 to start the project and then a further £2,000 per month for about 9 months. Rather than designate funds to flexi-access drawdown, Jane takes a one off payment from her pension savings of £60,000 which qualifies as an UFPLS.

Jane can receive 25% of this payment – £15,000 – tax-free and the remaining £45,000 is taxed as income at her marginal rate of 40%. Her total income for the year will be £95,000. She will receive an additional monthly income after tax of £2,250 through her UFPLS which should finance the rest of the project. Thereafter the additional income will allow her to consider reducing her work commitments so she can spend more time with her partner.

If you have one or more personal pensions savings pots then you can take up to three of these pots in cash provided each is worth less than £10,000. The rules are different if you have small occupational schemes pension pots valued at less than £10,000, in that you are not restricted to the 'three times' rule. 25% of the cash will be tax-free with the balance taxed as income. In this way you avoid having to use flexi-access drawdown or UFPLS.

## Annuity

For many, the security and certainty offered by an annuity will remain attractive. The budget changes introduced some extra flexibilities for annuities. Providers of annuities can now guarantee that payments will continue for any period that is chosen rather than limit such guarantee periods to ten years which was previously the case. Also the income under annuities in future will be able to rise and fall – either chosen when the annuity is purchased or as a result of a link to investment performance. It is also possible to buy an annuity that provides income for a fixed term – say 5 years – rather than for your lifetime. Typically, at the end of the selected term, a capital sum would be returned and a new decision on investment would be made – depending on the circumstances.

Name: **Mary**

Age: **65**

Pension pot: **£120,000**

Mary, aged 65, has defined contribution pensions savings of £120,000. In May 2015 she decides she wants to buy a lifetime annuity. She can take £30,000 as a lump sum tax-free. The remaining £90,000 is paid to an insurance company to provide her with an income of £4,400 a year. This is added to her other income – she has a part time job – and to her state pension – and is taxed accordingly.

## Thinking of buying an annuity?

There are at least three important points to consider:

**1 Are you getting the best deal?**

Annuity rates vary depending on which provider you choose and, as is the case for many things, some providers are more competitive than others. It's important that you seek the best rate taking into account your state of health.

**2 Are you buying the right type of annuity?**

Should you buy an annuity that increases, providing some protection against inflation? Do you want an annuity that continues to provide income for your spouse or partner in the event of your death?

**3 Is it the right time to buy an annuity?**

As mentioned earlier the income you secure through an annuity will depend on interest rates at the time. It may be that you would be better to delay purchasing an annuity until you are older using a different method of investment to deliver your required income requirements in the meantime. The eventual income you are able to buy via an annuity may improve as a result of higher interest rates. This fact of financial life has led some to conclude, in relation to lifetime annuity purchase, that 75 is the new 65.

You can use more than one of the above options at the same time. For example you might choose to use part of your pensions savings to buy an annuity and use flexi-access drawdown with the rest. You might also decide to defer taking any drawings from your flexi-access drawdown. Alternatively you might take some cash and income using UFPLS for some time and then buy an annuity with your remaining pensions savings at a later date. Which options you select will depend on your personal circumstances and the advice or guidance you receive.

"If you are aged 55 or over with a defined contribution pension plan you will be able to access some or all of your pension savings at any time."

## Your options – considering the pros and cons

| | Pros | Cons |
|---|---|---|
| Full cash withdrawal | • Freedom to spend<br>• No restraint on what you spend it on<br>• 25% tax free | • 75% fully taxable<br>• Removed from tax exempt pension fund<br>• Future income risk if not invested wisely |
| Flexi-access drawdown | • Adaptable to changing circumstances<br>• Allows continued investment returns to be secured in a way that reflects your attitude to risk<br>• Permits a mix of income now and future growth<br>• Funds remaining invested are highly tax efficient<br>• Up to 25% can be taken tax-free<br>• Can take tax-free part and leave rest of funds invested | • Investment risks needs to be considered<br>• Future income/capital values not guaranteed<br>• After tax-free part (25%) remainder of amounts drawn fully taxable as income |
| UFPLS | • Highly flexible/adaptable to personal circumstances<br>• Allows continued investment returns to be secured<br>• 25% of each UFPLS payment is tax free<br>• Funds remaining invested are highly tax efficient | • Investment risks needs to be considered<br>• Future income/capital growth not guaranteed<br>• 75% taxable as income |
| Annuity | • Income secured for life or fixed term<br>• Tax-free cash can be taken (25% of the value of fund) and remainder used to buy an annuity<br>• Inflation proofing can be built in – but at a cost | • All access to funds given up<br>• Flexibility to deal with changes in circumstances given up |

# Leaving a pension legacy

- Your remaining pension fund on death can be left as a lump sum or remain invested in the pension fund to provide income /capital for your dependants or other individuals.
- Funds left on death of an individual who inherits a pension fund (not a lump sum) can be left to others as a lump sum or remain invested.
- Death benefits are tax-free on the death of a person before age 75.
- Tax is payable for benefits inherited from a person who dies after age 75.

As explained earlier, since 6 April 2015 there are new rules for the way in which pension death benefits are taxed. The tax implications are also described earlier. As has been the position for many years, most payments from a pension scheme following a member's death will continue to be free from inheritance tax.

The other important change concerns the beneficiaries who can inherit pensions savings. This applies particularly to those using flexi-access drawdown and some types of annuities. As has been the case up to the point of these changes, a scheme member can nominate one or more individuals as a potential beneficiary to receive their remaining pension savings on their death. From 6 April 2015 the beneficiary can nominate a successor to whom the remaining pensions savings can be passed on their death. That successor can in turn nominate a further successor. So in future it will be possible for pensions savings to be passed down the generations in a very tax efficient manner. There are no restrictions on who can be nominated as a beneficiary or successor.

"In future it will be possible for pension savings to be passed down the generations in a very tax efficient manner."

## The pros and cons of lump sums or inherited funds

| | Pros | Cons |
|---|---|---|
| Lump sum | • Inheritance tax free<br>• Income tax free (death pre 75)<br>• Beneficiary has freedom to spend<br>• Simple<br>• Can pass to a trust to protect from creditors etc | • Loses tax protection of pension fund<br>• If invested, income and gains potentially taxable<br>• Inheritance tax possible on any remaining funds left in estate of the beneficiary |
| Inherited funds | • Remain invested inside tax advantaged pension fund<br>• Nominee or successor can draw regularly, irregularly or just leave<br>• Can be left to the next generation/others<br>• Inheritance tax free | • Potentially subject to income tax on withdrawal dependent on age of deceased<br>• Potentially accessible to creditors etc |

## Beware the tax man

Tax traps related to pensions under the new freedoms include:

- A £10,000 limit on future contributions once income taken under flexi-access drawdown or UFPLS
- Initial payments under flexi-access drawdown or UFPLS may have excess tax deducted that needs to be reclaimed.

## Taxation of payments from defined contribution pension plan schemes

The complicated tax implications of the new freedoms are described earlier in this guide. The actual application of the new tax rules is also complex. This is particularly so for payments made under flexi-access drawdown and UFPLS.

The organisation running your defined contribution pension plan scheme will be responsible for ensuring that the correct tax is deducted from all payments. In practice this will mean that most initial payments will be paid after deduction of tax using an emergency code unless you can provide them with an up-to-date tax code. For some recipients this is likely to mean over deduction of tax (in some cases by significant amounts). In many cases prompt action to get a repayment will be needed. This may be challenging for all involved.

## The impact on further pension contributions

There are measures to ensure that individuals do not exploit the new system to gain unintended tax advantages. The most important is the new £10,000 annual tax allowance for defined contribution pensions savings. This new limit can be triggered in a number of ways including taking income through flexi-access drawdown or through UFPLS. If you trigger the £10,000 annual allowance it will apply immediately to all your future money purchase savings. If you exceed this allowance in relation to contributions made to defined contribution (money purchase) pension arrangements an additional tax charge known as the Annual Allowance charge will apply. This is not an income tax charge but reclaims the tax relief the excess funds would have had automatically applied.

There are many other rules around this new annual tax allowance and if you are in doubt about their application you should seek specialist advice.

## Preventing recycling of income payments

There are already rules in place to prevent tax-free lump sum payments being reinvested in a pension so as to secure more tax relief. This practice is known as pension recycling. These rules will in future apply to any recycling of a tax-free lump sum where the amount exceeds £7,500. Again, if in doubt, seek advice.

## Transfers

As mentioned in the introduction the new freedoms apply only to those with defined contribution pension savings. If you have a defined benefit pension and want to take advantage of the new flexibilities you will need to transfer to a defined contribution pension. In doing so you could lose very valuable benefits and from 6 April 2015 you will have to take appropriate independent advice first. From that date it will no longer be possible to transfer from most public sector pension schemes.

## Other tax traps

There are several other aspects of the new freedoms that could lead to tax charges. These mainly apply to those with larger pensions savings close to the Lifetime Allowance. For further information consult a financial adviser.

“The new freedoms apply only to those with defined contribution pension savings.”

# The investment dilemma

Pension fund investment should:

- reflect the investor's attitude to risk.
- take account of when benefits are likely to be needed and for how long.
- deliver sufficient natural income and capital growth to avoid (as far as possible) capital erosion through drawdown of benefits.
- be with an investment manager who understands the risks associated with, and the investment requirements to manage, drawdown.

The investment strategy that you adopt in the years far ahead of and approaching the point at which you expect to start drawing from your savings should be heavily influenced by the amount and form of benefits that you intend to take. If it is unlikely that you will buy an annuity initially then the investment strategy to be adopted should reflect this. That is likely to mean greater exposure to investment markets to reflect the extended investment horizon. But it may also incorporate some investment that can deliver relative (or even absolute) certainty that a required level of income e.g. to meet known living expenses, will be produced as a minimum. It all depends on what your needs are at the time drawdown commences and what you anticipate those needs to be in the future.

You can then plan a portfolio and investments to reflect those needs and commit to a clear and regular review so that changed circumstances and needs can be reflected. This may mean a re-calibration or more fundamental change to your investment strategy.

### Appropriate strategies

There is no simple or unique formula for most efficiently drawing down money from your savings. And it's perfectly possible to, in effect, segment your overall savings into separate pots for different needs and then invest accordingly. As mentioned earlier it will be important, in designing and monitoring your retirement income strategy, to take into account not just your pensions savings but all the other investments that you might own.

Even though you may identify separate investment pots for different needs and timescales it is important, nevertheless, to establish your personal risk profile based on all your investments and likely needs.

Should you decide to not purchase (or defer the purchase of) an annuity and instead take income using flexi-access drawdown or UFPLS then the right investment approach will be all important. Using flexi-access drawdown or UFPLS is not without risk and it's important that you ensure there is adequate liquidity to meet any short-term cash or income needs. It's also important to appreciate that investment returns in the first two or three years of taking income are especially important. There is inherent risk in setting a strategy of fixed withdrawals from investment. It manifests itself especially if, at the time a fixed withdrawal is made, there is insufficient natural income or capital gain to support the withdrawal and capital is therefore eroded. It is essential to carefully monitor investment values at the time a withdrawal is made to avoid a potentially serious detrimental effect on overall investment wealth.

## Thinking in stages

As we said previously, there is no one size fits all solution to investing defined contribution pensions savings during the transition into retirement and beyond. Needs change and there is a lot to be said for looking at this period in three stages. In the first stage it's likely that more flexibility over drawing of income may be needed. In the second stage income levels are likely to be more stable. And in the third stage income levels may need to increase to cover, for example, care fees. Adopting an investment approach that reflects these changing needs with appropriate levels of security would seem to make sense.

Investing with an investment manager that understands the issues and risks associated with income drawdown is all important. Balancing the potentially conflicting needs of income production and capital preservation is also vital. Equally important is an understanding that personal circumstances change. Income drawdown is not a one way street and because of changing circumstances you may wish to buy an annuity at an earlier – or later – date than you originally envisaged. You need to feel comfortable that your chosen investment manager understands the need for flexibility.

"Investing with an investment manager that understands the issues and risks associated with income drawdown is all important."

# Back to basics

- Investment outcomes between pre and post retirement can differ markedly.
- However, proven investment principles can be applied in both phases.
- Diversification should be considered an integral part of any sensible investment strategy.
- The long-term sustainability of drawdown needs to be carefully assessed.
- Sourcing income naturally can be effective – especially when investing across a range of asset types.

Giving up work – either fully or partially – means that the investment outcomes you are looking to achieve will change markedly from those in the pre-retirement phase. Importantly, it is likely that your investment objectives will also evolve during the course of what hopefully will prove to be a long, healthy and happy retirement.

With annuitisation no longer the pre-determined route to retirement income we all now have to carefully assess the relative merits of a much broader range of options. The appropriateness of each route will be determined by a range of factors that are specific to the individual and professional advice should certainly be considered as you determine the best one for you. Generally speaking, however, there are strong arguments for extending the application of principles commonly employed when investing in the pre-retirement phase.

## Back to basics

Diversification is arguably the most important principle as spreading investments across a range of individual exposures affords a host of benefits. It can help limit losses, dampen volatility and ensure that your portfolio is well placed to capture returns (in the form of income or growth) from a broad range of opportunities.

The graphic shows the discrete annual performance of a range of asset types with each ranked from best to worst in each calendar year. It highlights the marked differentials in absolute and relative returns from year to year. Predicting such moves in advance is notoriously challenging but should you have chosen to diversify your exposure across each asset class a much smoother returns profile would have been achieved.

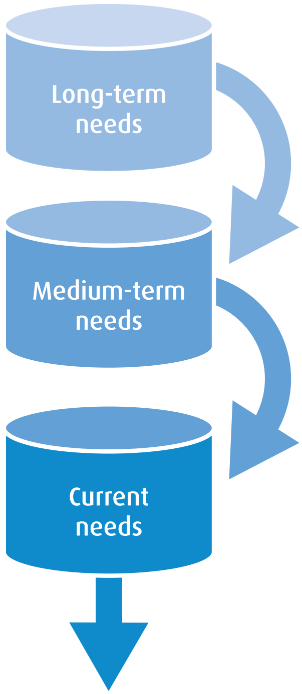
**Diversification provides a smoother ride**

| Returns | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Best | 10.51 | 7.06 | 10.45 | 41.00 | 18.89 | 50.71 | 18.47 | 36.44 | 16.62 | 57.72 | 22.93 | 21.82 | 18.97 | 31.33 | 19.30 |
| | 6.91 | 4.73 | 7.12 | 34.08 | 15.77 | 43.51 | 18.12 | 34.80 | 12.76 | 52.44 | 21.40 | 15.28 | 16.68 | 26.17 | 18.69 |
| | 6.63 | 3.69 | 6.45 | 26.88 | 15.55 | 32.34 | 18.07 | 12.62 | 4.36 | 30.42 | 19.32 | 8.09 | 15.06 | 26.14 | 17.80 |
| | 5.28 | 1.89 | 6.26 | 23.25 | 13.45 | 24.94 | 17.70 | 7.32 | 2.29 | 23.52 | 17.67 | 3.81 | 13.22 | 25.95 | 14.55 |
| | 4.78 | 1.32 | 4.18 | 22.34 | 12.52 | 20.72 | 17.29 | 6.87 | -2.23 | 19.44 | 17.26 | 1.07 | 13.09 | 24.66 | 9.95 |
| | 4.26 | -0.39 | 2.27 | 20.91 | 8.80 | 20.56 | 17.22 | 4.54 | -9.62 | 19.11 | 14.49 | 0.20 | 12.31 | 10.90 | 9.52 |
| | 3.47 | -1.95 | -8.76 | 16.54 | 8.61 | 19.99 | 6.91 | 4.12 | -13.53 | 17.34 | 13.81 | -1.89 | 8.58 | 10.45 | 7.76 |
| | 2.32 | -2.54 | -14.16 | 14.27 | 7.17 | 18.83 | 2.74 | 3.80 | -18.67 | 14.33 | 12.68 | -1.90 | 7.50 | 2.15 | 5.04 |
| | 0.90 | -5.16 | -17.35 | 11.24 | 6.08 | 18.52 | 1.62 | 2.85 | -24.65 | 5.91 | 8.42 | -3.07 | 6.59 | 0.28 | 2.87 |
| | -2.26 | -7.08 | -18.17 | 7.30 | 5.37 | 8.10 | -0.72 | 1.80 | -25.43 | 5.88 | 8.36 | -7.10 | 3.36 | 0.22 | 2.79 |
| | -2.80 | -12.52 | -19.46 | 5.54 | 4.46 | 7.24 | -0.97 | -0.68 | -29.37 | 2.18 | 7.89 | -11.63 | 2.35 | 0.01 | 0.58 |
| | -18.28 | -13.63 | -23.00 | 5.25 | 3.00 | 6.82 | -1.35 | -1.72 | -32.37 | 0.37 | 6.91 | -15.60 | 1.50 | -2.55 | 0.48 |
| | -24.11 | -20.93 | -25.77 | 1.99 | 2.33 | 4.30 | -3.86 | -5.47 | -32.64 | -2.51 | 5.95 | -16.38 | 0.56 | -4.19 | 0.14 |
| Worst | -29.30 | -26.74 | -32.71 | 0.99 | 1.17 | 3.23 | -14.50 | -11.04 | -36.91 | -3.40 | 0.39 | -19.11 | 0.34 | -5.27 | -0.88 |

- IA Asia Pacific Excluding Japan
- IA Global Bonds
- Equally Weighted Portfolio
- IA Europe Excluding UK
- IA North America
- IA UK Gilt
- IA Global Emerging Markets
- IA UK All Companies
- IA UK Index Linked Gilt
- IA Japan
- IA £ Corporate Bond
- IA UK Equity Income
- IA Money Market
- IPD UK All Property

Source: Lipper to 31 December 2014.

Given the array of available asset classes, geographies, investment styles, individual companies and instruments the scope for diversifying a portfolio is seemingly endless. This begs the question, 'what is an appropriate asset mix?' And when looking to answer that due consideration needs to be given to the outcomes you are trying to achieve. It might even be appropriate to consider implementing a suite of asset mixes to meet a range of needs that are likely to include an income now together with a realisation that an element of growth potential remains a priority given the likely duration of the retirement phase.




### Maintaining a range of investment pots

**Long-term pot (10 years+)**

Multiple assets could include:

- Predominantly diversified equity portfolio
- Potential for moderate holdings in other assets such as fixed income

**Medium-term pot (5-10 years)**

Multiple assets could include:

- Fixed income
- Property
- Equity income

**Short-term pot (0-4 years)**

Income from defined benefit schemes/annuities/state benefits, Uncrystallised Funds Pension Lump Sum and/or from:

- Low risk liquid assets
- Short dated government bonds
- Natural income from investments

## The income challenge

Given that retirement means the lack of a regular wage or salary, income generation is likely to be a key investment priority. There are a number of ways of generating income and the merits of all the options need to be carefully considered.

Drawdown is a popular choice and we outlined some of the pros and cons earlier. But what about the broader investment considerations? In the accumulation phase (when you are saving in order to build capital for a future purpose eg retirement) the benefits of saving smaller amounts on a regular basis (often called 'pound cost averaging') are widely appreciated. Save regularly over an extended period of time and it is possible to place yourself in a decent position to grow your capital. Compounding of returns can be powerful and by dripping money into the market a portfolio can often be better placed to iron out the fluctuations that asset markets inevitably suffer.

Apply the same theory in the drawdown phase (when accumulated capital is being used to generate an income), however, and the benefits of pound cost averaging can soon be reversed. Withdraw an 'income' from capital in a falling market and you are only serving to exacerbate the impact of market losses. If the pot of capital is insufficient in size, markets take a prolonged period to recover or investment returns remain below expectations, the likelihood of capital recovering to a desirable level could be significantly diminished. In other words, 'longevity risk' (or in stark terms, your money running out of breath before you do!) can be significant when implementing drawdown.

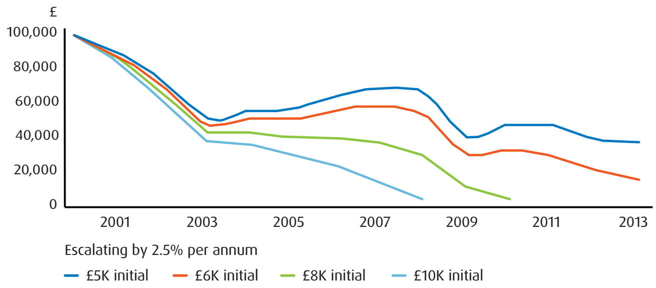
The 'drawdown in falling markets' chart shows capital of £100,000 at outset (1 January 2000) with four annual income levels, each increasing by 2.5% per annum. Based on the performance of the FTSE All-Share Index and by drawing down £5,000 initial income per annum, the capital value will have halved in value by 2003. Had the income taken been £10,000 then capital would have fallen by almost two-thirds over the same period. Perhaps most alarming in this example, is that the total retirement income pot would be exhausted in just 8 years and even in the £5,000 initial income example, it would be worth less than 40% of its initial value in just 13 years.

## Mind the downturn

The 'ups and downs of UK equities' chart below illustrates the performance of the FTSE All-Share Index since 1985. It shows how equity markets can experience prolonged periods of decline from which it can take a significant time to recover. From September 2000 for example, UK equities fell by 42% over a 29 month period and it took until the latter part of 2005 for them to attain a new high.

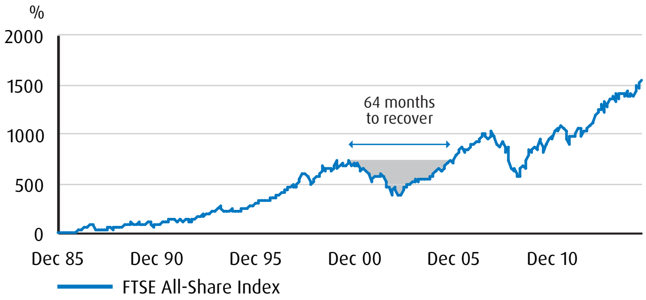
Of course if sufficient financial flexibility exists it may be possible to wait or suspend drawdown when markets are under stress. If personal circumstances don't allow such a pause, or should markets take an extended time to recover, then implementing a drawdown strategy can pose a significant threat to the longevity of capital.

### Drawdown in falling markets




Source: Cazalet Consulting, 'When I'm sixty-four', September 2014.

### Ups and downs of UK equities




Source: Lipper to 31.5.15, FTSE All-Share Index Total Return.

## Natural benefits

Choosing to place greater emphasis on natural income can serve to counter some of the threat posed to capital during downturns. Of course capital values will still be impacted by broader market moves but without the additional burden of capital withdrawal there is greater scope for capital to recover as and when markets resume their upward trajectory. The table illustrates the marked difference between the outcomes of two long-term 'income' strategies. Whilst both generate a broadly comparable level of income the resulting capital is markedly different. The IA Mixed Investment 20-60% Shares sector is used to represent a diversified portfolio of assets typically favoured by more cautiously minded investors. Multi-asset income meanwhile represents a fund from that sector aiming to generate an attractive natural income by investing across a range of assets.

## Basis of example

- Initial investment of £200,000 on the 31 January 2000.
- Natural income on multi-asset income of around 5% per annum. Fund performance reflects income paid out.
- Comparable level of yield (£2,500 per quarter) taken from sector in the form of withdrawal of capital. Sector performance includes dividends reinvested.

### Multi-asset income fund

| Natural income | Capital value |
|---|---|
| £141,872 | £250,542 |

### IA Mixed Investment 20-60% Shares sector

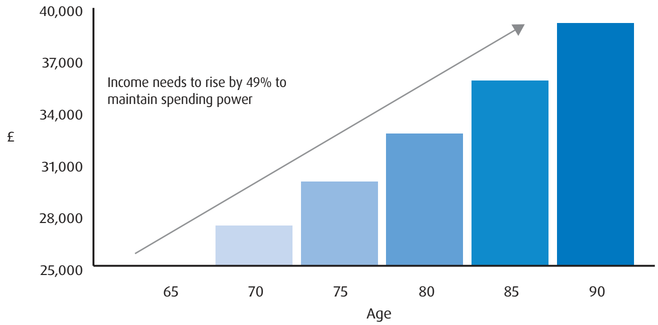
| Drawdown income | Capital value |
|---|---|
| £150,000 | £149,245 |

Source: Lipper and BMO Global Asset Management to 31 January 2015. The illustration was created by BMO Global Asset Management and every effort was made to ensure the accuracy of the methodology. It is however included for illustrative purposes only and is not meant to serve as a recommendation nor should it be taken as advice for investment purposes.

## The cost of living

The impact of inflation also needs to be considered as rising prices can have a meaningful impact on the real value of your retirement income. Retire at 65 on an income of £25,000 and even against a relatively modest backdrop of 1.8% inflation your income will have had to rise to £35,719 by the age of 85 in order to maintain its spending power. Increasing withdrawals to keep pace with inflation can place additional strain on a drawdown strategy.

### Sustaining a real income with 1.8% Inflation

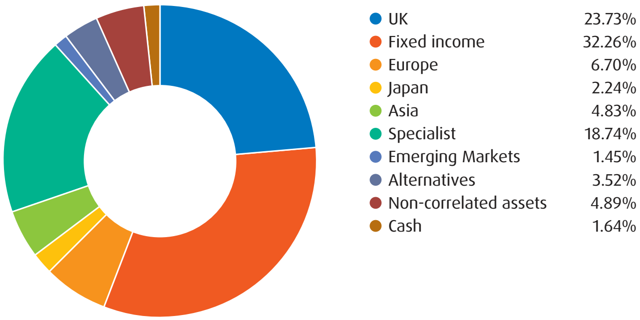



Source: BMO Global Asset Management.

## Income the natural way

Natural income offers a viable alternative or complement to drawdown. By investing in assets capable of generating an attractive and reliable yield it is possible to receive an income whilst placing less pressure on capital. Equities can pay dividends, bonds issue coupons and commercial properties derive income in the form of rent from tenants. There are numerous other options too. Infrastructure funds, for example, offer access to the cashflows generated by assets like toll roads, bridges, hospitals and schools. Importantly, the inclusion of the likes of infrastructure in an income-orientated portfolio increasingly make sense against a backdrop of falling yields in traditional yield-generating areas. The pie chart below shows what a well diversified multi-asset income portfolio might look like.

### Income investing across asset classes

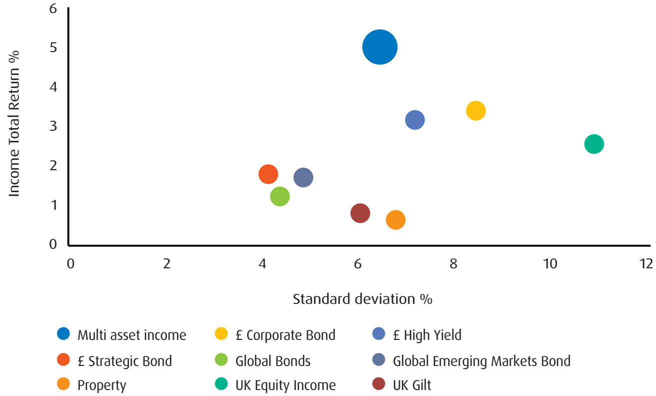



Source: BMO Global Asset Management.

## Multi asset income delivers

Diversification and natural income can prove to be a potent combination. The chart shows the yield and volatility characteristics of a well-diversified income-orientated portfolio compared to more narrowly focused investments.

### An income portfolio investing across asset classes




Source: Lipper to 31 December 2014. Multi asset income represented by the performance of the F&C MM Navigator Distribution Fund (share class A Income). Individual asset class income/standard deviation is represented by the appropriate Investment Association sector eg £ Corporate Bond is IA £ Corporate Bond.

> "By investing in assets capable of generating an attractive and reliable yield it is possible to receive an income whilst placing less pressure on capital."

# The importance of advice

As made clear earlier in this guide, if you have defined contribution pension savings and you are aged over 55 you are entitled to free impartial guidance through the new Pensions Wise service. It is important to appreciate that this is guidance not advice. It may point you in a certain direction but it is unlikely to provide you with all the answers that you need. As you may have gathered, the issues associated with the new pension freedoms and flexibility are complex. What's more unless you choose to convert all of your defined contribution pensions savings it will be important to regularly review your situation and plans in the light of changing personal circumstances, investment market movements and performance and pensions tax and legislative changes.

A wrong decision taken at this point in your life may be irreversible and could certainly seriously impair your future income and capital preservation requirements. That's why, even if you use the Pensions Wise service, we believe that you are likely to benefit from further advice on your specific circumstances – perhaps on a regular basis. This is particularly so if you are already using income drawdown – either flexible drawdown or capped drawdown. There are some additional rules governing these situations which are outside the scope of this guide.

Regardless of whether you are currently taking income from your defined contribution pension, or it is something that you will need to consider in the future, we hope that this guide has made you aware of the implications of the new freedoms. Greater choice is welcome. But it brings with it the need for greater awareness of the risks. The rules are complicated and it's important that you try to avoid mistakes. Seeking advice from a financial adviser should ensure you avoid the traps and pitfalls that lie in wait for the ill-informed.

Contact your Succession Group Planner.

"Greater choice is welcome. But it brings with it the need for greater awareness of the risks."

# Jargon buster

## Understanding some of the more important pensions jargon

**Additional State Pension**: the earnings-related element of the state pension scheme which has replaced the State Earnings Related Pension Scheme to enhance the basic state pension. Also known as the State Second Pension.

**Annuity**: a product that allows you to convert your pension savings into a regular guaranteed income.

**Basic State Pension**: a regular income paid by the government to individuals who have reached State Pension Age.

**Capped drawdown**: previously the most popular form of income drawdown under which there are defined age related limits on the amount of income you can take each year.

**Defined benefit pension**: a pension in which your benefits are normally related to your earnings when leaving the scheme or retiring, and the length of your service. Also known as 'final salary' or 'salary-related' pensions.

**Defined contribution pension**: a pension in which your benefits are determined by the value of the pension savings at retirement. The value of the savings, in turn, is determined by the contributions paid and any investment returns. Also known as a money purchase pension.

**Enhanced annuity**: an annuity under which the income payments are increased if you are suffering from certain medical conditions.

**Final salary pension**: an alternative name for a defined benefit pension.

**Fixed term annuity**: in this case part or all of your pension savings are converted into a guaranteed income for a limited period.

**Flexi-access drawdown**: a new type of income drawdown introduced from April 2015 under which there is greater flexibility over the timing and amounts of income taken.

**Flexible drawdown**: a previous system of drawdown under which there is considerable income flexibility – but only if you can satisfy a minimum level of other income.

**Guidance guarantee**: the government policy to provide everyone who has defined contribution pension savings access to a free and impartial pensions guidance service. Now called Pensions Wise.

**Income drawdown**: a way in which you can take an income from your pension savings whilst they remain invested. Also known as income or pension fund withdrawal.

**Lifetime annuity**: in return for your pension savings you are provided with a secure annual income for life. You can choose to buy a joint life annuity which means that on your death the income will continue to be paid out to your spouse or partner.

**Money purchase pension**: an alternative name for a defined contribution pension.

**Open market option (OMO)**: the open market option allows you to shop around for an annuity so that you do not need to secure your retirement income from your existing pension provider if there is a better option elsewhere.

**Personal pension**: a pension under which you make regular or lump sum payments to your chosen pension provider. If you have an employer they may choose to contribute.

**Private pension**: a pension that is arranged privately between you and your pension provider with no employer involvement.

**State Earnings Related Pension Scheme (SERPS)**: a government arranged pension dependent on the amount an individual was paid whilst he/she was working. SERPS pensions were replaced in 2002 by the State Second Pension.

**State Pension Age**: the earliest age at which someone can draw their basic state pension.

**Value protected annuity**: an annuity that returns a lump sum to your beneficiaries if you die without having received the full value of your pension savings.

**Workplace pension**: a way of saving for your retirement that's arranged by your employer. Some workplace pensions are called 'occupational', 'works', 'company' or 'work-based' pensions.

# About BMO Global Asset Management

BMO Global Asset Management is a worldwide investment group whose first priority is to deliver consistent performance to our investors. Our aim is to be one of the world's most innovative and responsive investment managers, offering you more options, more service and more routes to investment success.

Our worldwide network of investment teams shares a remarkable history of innovation. For example, we can trace our roots back to Foreign & Colonial Investment Trust – the world's first publicly quoted pooled investment vehicle – which we still manage today. We also developed children's savings plans, launched Europe's first ethical fund and the UK's first risk-rated fund range.

We have four regional investment hubs, in London, Toronto, Chicago and Hong Kong. In addition, we have a suite of focused investment boutiques. We currently have 24 offices in 14 countries on 5 continents, giving us local knowledge of major regions and sectors.

Our investors benefit from the backing and resource of a well-funded and fast-growing global organisation with over 1,500 employees around the world and more than £165 billion in assets (as at 31.3.15). Our parent is BMO Group, one of North America's largest banks, with over 46,000 employees worldwide and over £326 billion in assets (as at 31.10.14).

This guide is based on our understanding of legal and tax regulations and practice at the time of writing (June 2015). It has been produced for information only and should not be construed as investment advice. No action must be taken or refrained from being taken based on this guide alone.

BMO Global Asset Management is not authorised to give financial advice. It is essential that you take professional financial advice in relation to any of the areas or planning referenced in this guide.

Past performance is not a guide to future performance. Stock market and currency movements mean the value of investments and the income from them can go down as well as up and you may not get back the original amount invested.

Tax rates and reliefs depend on your individual circumstances and are subject to change.

BMO Global Asset Management