Decumulation Demystified

The natural income buffer

Investors' objectives and risks change when they move from saving for retirement to drawing down an income. Due to sequence risk, we have found that the type of income withdrawn matters a great deal to final outcomes.

Andrzej Pioch is a fund manager in the Multi-Asset Funds team with his responsibilities including portfolio management and ongoing development of income strategies.

Justin Onuekwusi is Head of Retail Multi-Asset Funds. Justin moved to Legal & General in 2013 from Aviva Investors, where he was part of the multi-asset team responsible for £70bn of investors' money.

Building a retirement pot can be psychologically difficult – it often requires locking up today's capital in order to save for the future. Yet in many ways it is straightforward as the order in which an investor pursues the accumulation phase does not matter all that much. So long as nothing is withdrawn from the pot until retirement, the sensitivity of the pot's total value to the sequence of events leading up to it, **sequence risk** (often referred to as ***pound-cost ravaging***), is quite low. However, when an investor moves into the decumulation stage – challenges such as taking a regular retirement income, the timing of withdrawals and the level of drawdown matter a great deal, exposing the portfolio to much more sequence risk than before.

40% of investors withdraw the same amount every year regardless of market performance

A retired investor who is drawing down their investments for daily needs is a seller of assets. This can be particularly problematic if they are required to sell assets to meet spending requirements following a fall in asset prices – they are forced to sell at a comparative loss. The sequence risk is subsequently high since it becomes less likely that those losses can be recovered when the market begins expanding. Conversely, an investor withdrawing at the height of the market is in a better position, able to sell assets at a much improved price.

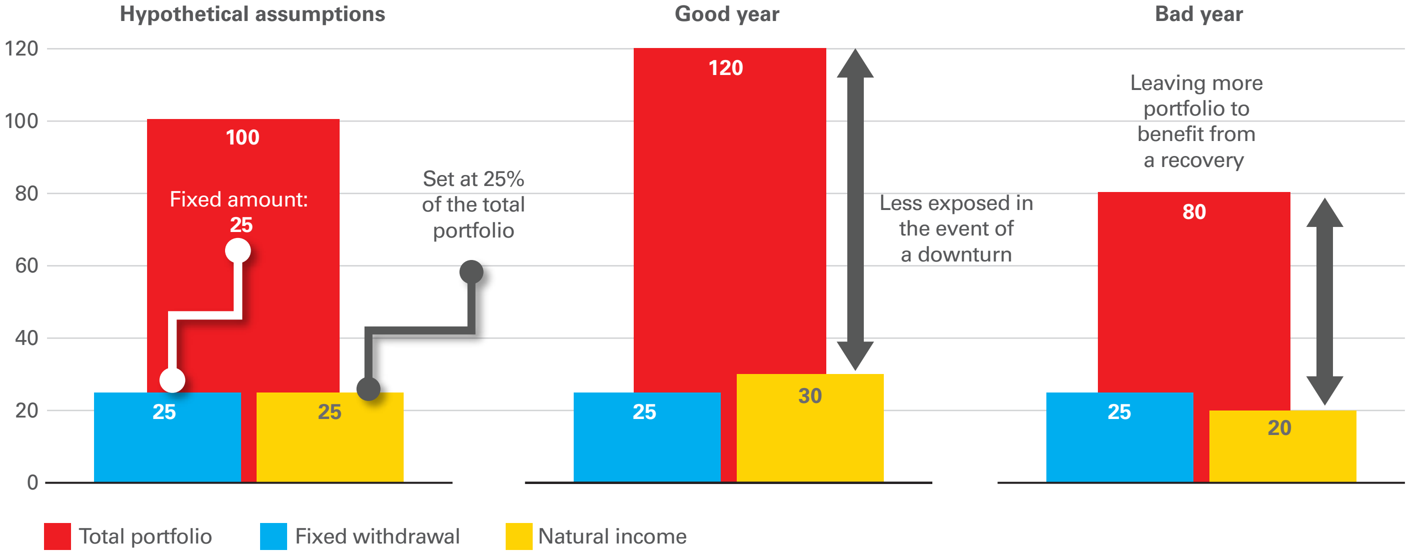
But the investment world rarely allows investors to control the order in which market returns unfold. Even with fairly accurate medium or long-term return forecasts, predicting the path that's going to take us there is much more challenging. Two in five investors withdraw the same absolute amount of cash from their funds year-on-year, regardless of stock market performance, the same percentage of people who receive no financial advice or guidance on the topic[1]. Hence, approaching sequence risk is much more about managing that risk rather than removing it altogether.

NOT ALL INCOME IS CREATED EQUAL

If investors in the decumulation phase are interested in receiving a regular stream of income from their portfolio, they can either opt for fixed withdrawals or natural income distributions.

1. Retirees failing to account for market volatility as they drain funds, Adviser Points of View, July 2018.

Figure 1: Illustrating the impact of different withdrawal scenarios



Source: LGIM, Bloomberg LP. As at 30 April 2018.

In the first case, they would withdraw a fixed amount from their portfolio, for instance a percentage of capital such as 4%, or an absolute figure, say £25,000.

In the second they would only collect whatever income is available in a given period (in terms of dividends or coupons). Interestingly, investment outcomes can be very different under these two scenarios even when the fixed withdrawal is aligned with the average realised yield on the investments over the investment horizon. This is all because of the impact of the sequence of returns.

If investors invest right before the market downturn and keep withdrawing a fixed amount every year, their investment pot shrinks with negative market returns and they may run the risk of drawing down their entire portfolio, giving up any chance of recovery when the market turns. If they opt for natural income distributions, they will effectively collect lower distributions on the way down, protecting the size of their pot, and could be rewarded with higher distributions when the market rallies, effectively participating in the recovery.

This may sound like a sensible risk management mechanism yet some still dismiss it as a purely theoretical concept that doesn't materially affect clients' wealth. However, natural income has another benefit which is harder to quantify and more psychological. Investors have typically favoured income generating assets due to the visibility of the cashflow they can receive and the element of comfort from knowing their investments are paying for their lifestyle.

REVERSING THE SEQUENCE

Using annual returns of the FTSE All Share, we can attempt to assess the impact of the difference in the accumulation and decumulation stages for the investor. Below, we apply the annual returns of the index from 2000-2017 to a £100,000 investment and then reverse the order of the return stream. In the accumulation phase the path varies from year to year but the end outcome for the investor is exactly the same, with the investor ending the 18-year period with exactly the same amount (£238,179) whether they use the actual return stream or reverse it.

However, if we assume a 4% initial withdrawal (£4,000) and assume this amount is continually drawn down each year, taking into account a 3% inflation rate as well, the results are turned on their head somewhat. If invested in the actual return stream, the investor ends up with around £50,000. If we reverse the return stream for the investor something remarkable happens. The pot size is significantly increased leaving the pot slightly above the starting value. In essence this shows the sequence of returns is of utmost importance during drawdown. In this case the negative returns were more detrimental in the actual series as they were experienced earlier on during the drawdown period and made it difficult for the pot to recover.

	Actual	Reversed
2000	-5.90%	13.10%
2001	-13.29%	16.75%
2002	-22.68%	0.98%
2003	20.86%	1.18%
2004	12.84%	20.81%
2005	22.04%	12.30%
2006	16.75%	-3.46%
2007	5.32%	14.51%
2008	-29.93%	30.12%
2009	30.12%	-29.93%
2010	14.51%	5.32%
2011	-3.46%	16.75%
2012	12.30%	22.04%
2013	20.81%	12.84%
2014	1.18%	20.86%
2015	0.98%	-22.68%
2016	16.75%	-13.29%
2017	13.10%	-5.90%

Figure 2: £100,000 in accumulation

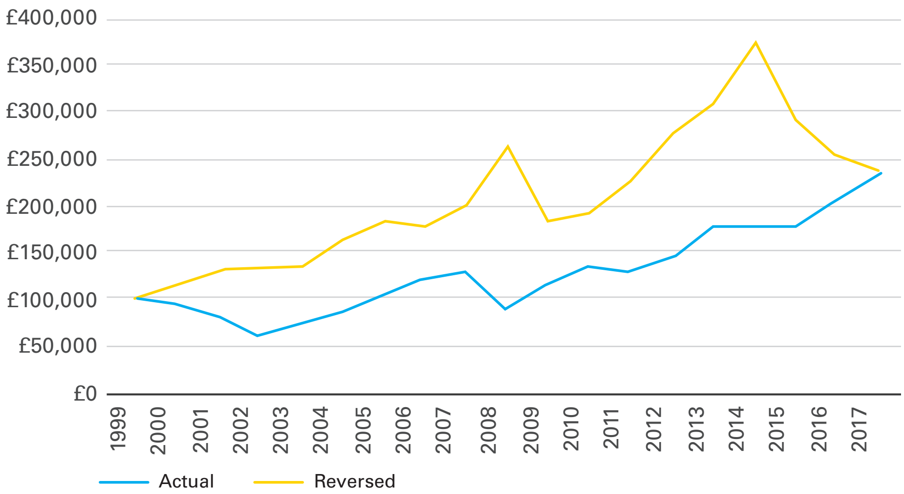
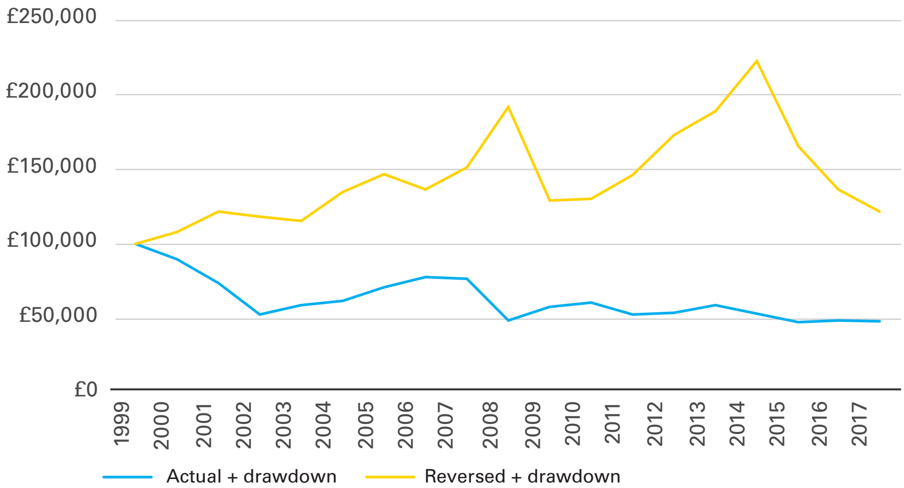


Figure 3: £100,000 in decumulation with annual drawdown



Source: LGIM calculations for illustrative purposes only.

It is worth noting, whilst significant, there are limitations to this simple analysis. Firstly, it uses an annual drawdown assumption – having a small, more frequent drawdown may reduce the gap. Secondly, it is worth noting we have just looked at UK equities in these examples. Indeed, the greater the volatility of the asset class, the greater the sequencing risk. Therefore diversification and investing in a broad set of asset classes can help to mitigate this risk.

NATURAL INCOME FIRST, CAPITAL SECOND

Some investors rely on and may take comfort in knowing that they can receive an absolute level of income from their retirement portfolio.

However, many investors still use funds designed for the accumulation phase through their retirement and use these for drawdown. Where taking a fixed level of income from a growth-focused portfolio often requires the selling of fund units, thereby exposing the portfolio to market movements, taking the majority of the income from natural sources (or a portfolio that is designed for drawdown)[2] and only topping this up with units to meet the desired amount can still act as a minor risk buffer. Whilst it may not eliminate sequence risk, highlighting the risk-management benefits of using natural income alongside other strategies that investors have used in the accumulation phase appears a sensible solution, in our view. By blending the two, our findings show this can still help mitigate the effects of sequence risk for investors.

When investors begin withdrawing from their portfolio, advisers are often faced with two key concerns (1) how much will an investor need to withdraw and (2) where will the income be drawn from within the portfolio. Due to the dangers of sequence risk, we believe income investors should be inspired to think about how portfolios that distribute a natural income can sit within their wider centralised retirement proposition.

2. It is worth noting that some solutions have been developed that are designed for drawdown which are out of scope for this paper

CONTACT US

0345 070 8684* fundsales@lgim.com lgim.com