Planning for your retirement

Generating an income in retirement

Fidelity™
WORLDWIDE INVESTMENT

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PLANNING YOUR RETIREMENT INCOME

When you retire, one of the most important things you'll need to consider is how you are going to generate an income for the rest of your life. Of course, most retirees will receive a pension from the government, although many people choose to retire before the State retirement age and so can't rely on this income immediately. In any case, the State Pension is seldom enough to sustain the lifestyle you dream of and so you may well have to rely on income generated from other sources in order to live comfortably.

If you are lucky enough to be a member of a defined benefit pension scheme, your employer (or scheme provider) will normally pay you an income for the rest of your life. However, if you hold a defined contribution pension, you will need to generate an income from your pension fund. The good news is, from April 2015, it is expected that you will have more choice and flexibility than ever before.

Full pension freedom

As you may have heard, some radical reforms to pensions were announced in the March 2014 Budget. The changes mean that from age 55, depending on the choices you make, you will be able to take as much of your defined contribution pension savings as you like – when you like. It means a much more flexible retirement plan can be designed for you and your family. From April 2015, your options include:

- Purchasing an annuity – a product which pays you a guaranteed income for life
- Entering into pension drawdown – a more flexible way of generating an income directly from your pension fund
- Taking all your pensions as cash (please note that this may well have tax implications) – you will be able to spend this as you see fit although this could drastically affect the level of income you receive over the rest of your life.

PLANNING YOUR RETIREMENT INCOME

Whatever option you choose, you have the ability to take on average a 25% tax-free cash lump sum from your pensions which you can spend or invest.

Income from other investments

Of course, you can also generate an income from any other investments you hold outside of your pension plans. ISAs, for instance, can be particularly useful because they can deliver a tax-free income (pension income is taxable). Investments held outside of 'tax wrappers' also have a big part to play, especially as you may be able to utilise a range of allowances to keep the tax you pay low.

Don't forget about capital growth

While income will probably be your priority in retirement, you also need to think about how your capital keeps pace with inflation. If this is eaten away by the cost of living, then the income generated by your savings will also be worth less in real terms. One way to counter this is to hold some growth-producing investments alongside those which provide an income.

Choosing your investments

Many types of investment have the potential to pay an income and in this guide we look at some of those you may consider within income drawdown (or for your non-pension income requirements): cash, bonds, shares, property and multi-asset investments.

With the exception of cash, where most put their money into bank and building society savings accounts, it generally makes sense to access these other investments through funds, collective investment vehicles that pool your money with other investors savings and invest according to a specified set of objectives. These provide a relatively low-cost way of holding a diversified mix of investments and you also enjoy the benefit of expert management as the fund will often be supported by both a fund manager and a team of investment specialists . So, while we explain the workings of the underlying investments in the pages that follow, most investors should consider an investment fund as a way to gain exposure to the market.

And, as ever, please remember the value of your investments and any income from them can rise and fall and you may not get back the amount you invest. Eligibility to invest into an SIPP depends on personal circumstances and all tax rules may change. The value of tax savings will depend on your individual circumstances and all tax rules may change in the future.

The value of advice

As you may have gathered from the considerations we've listed here, generating an income in retirement is far from straightforward. Therefore, the need for financial advice at retirement is probably more important than at any other stage of your life.

We therefore strongly recommend that you seek the help of an adviser before you make any decisions about the choices you face at retirement. An adviser will consider your goals and objectives and then recommend a course of action which is right for you.

CASH

For the latest on savings and cash rates, you can use comparison websites such as moneyfacts.co.uk

Safe, but will it deliver?

Cash is usually the first stop for the income investor. However, with the low interest rates we've seen over the last few years, the relative security of a deposit account has come at a cost. Many cash accounts have offered interest rates below the rate of inflation, which has meant that savers have become worse off in real terms (especially if tax has been paid on the interest). In other words, cash savings have been unable to keep pace with the increasing cost of living. Cash interest rates remain at historic lows and, although many commentators are predicting that these may rise in the next year or so, any increases are likely to be quite small.

Even banks can fail and, although investor protection schemes have ensured no UK savers lost their money, little has been done to restore lost confidence in the banking system. So, while cash remains the safest and most accessible investment choice, other alternatives can offer better income for those prepared to accept more risk.

BONDS

As with any investment, various degrees of risk and reward can be found in the bond market.

A spectrum of risk

Bonds are a common source of retirement income. They are issued by governments and companies as a way of raising money. In fact, the government's spending is in part financed by debt in the form of the bonds it issues.

Like any lender, the holder of the bond (the investor) can expect eventual repayment of the loan at maturity and receives a fixed rate of interest known as a coupon. It is the fixed rate of interest that gives the asset class its name: fixed interest or fixed income.

The risk of bonds is largely related to the financial strength of the issuer, whether that's a company or a government. At one end of the scale, a government is unlikely to fail to pay a coupon or repay its debt at maturity so these are generally the safest investments.

In fixed-income jargon, failure to pay investors is known as "default". Of course, the British government is less likely than, say, an emerging market government to default. This means an investor might reasonably expect a lower interest rate for the lower-risk investment. However, over the last few years there have been frequent references to the possibility of some European governments, such as Greece, Italy and Spain, defaulting. These governments have been forced to offer a higher coupon to investors to encourage them to buy their debt as the risk associated with an investment in these countries has increased.

High-quality, well-established companies which generate lots of cash are considered to be the safest corporate bond issuers and their bonds are classified as "investment grade". Utility companies, pharmaceuticals, big food retailers and major oil corporations are among the companies that dominate this sector.

High yield bonds are issued by companies that are judged more likely to default. They are known as "sub-investment grade" bonds and, to attract investors and to compensate them for the higher risk, a higher coupon rate is offered.

Here's how it works:

Imagine making a £100 investment into a single bond paying a 10% coupon. You will receive £10 a year interest from the bond issuer. You sell that bond for £110 and the new holder still only receives the same £10 a year interest having paid £110.

This is a yield of 9.09% on their £110 investment (£10/£110 = 9.09%).

The rising price causes the yield to fall. The same happens in reverse when prices fall.

The risk of default is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may therefore vary between different government issuers as well as between different corporate issuers.

Supply, demand and yield

Once issued, bonds are freely traded and can therefore fluctuate in price according to the ebb and flow of supply and demand. In 2011, for example, investors' fear of the financial crisis meant demand was high for the safest government bonds (including those of the UK, known as gilts) and their prices rose due to this heightened level of demand.

Rising prices are usually welcomed by investors but, in the case of bonds, they can spell bad news for new investors. Remember, the income from a bond is fixed as a percentage of the issue price. So, investors who buy after the bond has been issued will receive a lower yield than the original investors if the price of the bond has risen.

These investors will also only receive the face value amount at maturity rather than the price they actually paid.

The value of bonds is influenced by movements in interest rates, changes in the credit rating of bond issuers, and other factors such as inflation and market dynamics. In general, as interest rates rise the price of a bond will fall. The risk of default is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may, therefore, vary between different government issuers as well as between different corporate issuers.

BONDS

The place for bonds in an income portfolio

Bonds can play an important part in a retiree's income portfolio. Bond investments are usually lower risk and less volatile than shares and property, so generally offer a smoother ride (although, at times, bond markets can be volatile too). Generally, bond prices are sensitive to interest rates, inflation and other economic influences as well as corporate revenue and profit (in the case of corporate bonds). Because of this, bonds offer an effective way to diversify your portfolio when mixed with other investments.

Most bond funds pay regular interest so they can help to generate an income. You also have the option to reinvest the income to help boost the overall return.

Selecting a bond fund

A professional fund manager will analyse the bond market and make a careful selection of corporate bonds to avoid companies at risk of default, provide income and even generate a capital gain. However, it is important to understand the fund manager's investment approach and where on the risk spectrum they are investing. Are you comfortable with the balance of risk compared with the potential return? Your adviser will be able to help select one which is right for you.

If you see a promotion for a bond fund, you are likely to see at least two yields quoted. The distribution yield gives you a simple idea of what your returns might be over the next 12 months. It takes account of the fluctuating bond price and ongoing yield, but not the purchase price's impact at maturity. The underlying yield gives an indication of returns after expenses, inclusive of all interest payments and any capital gain or loss made at maturity. The underlying yield is therefore a more accurate reflection of the overall potential return.

When choosing a bond fund, make sure you find out whether the fund manager's charges are taken from the capital of the fund or from the income it generates. Charges taken from income will reduce the income returned to investors but will allow the capital to grow, while charges taken from the fund's capital will maintain quoted income levels but will reduce the capital value of the fund which will affect future performance. Your adviser will be able to tell you whether the fund manager's charges are taken from the capital of the fund or from the income it generates.

SHARES (EQUITIES)

The importance of dividends

Many companies choose to reward their shareholders by paying them a dividend. It is normally funded from the company's profits and will be paid for each share in issue. So, if a company declares a dividend of 5p per share and you hold 1,000 shares, you'll receive a dividend payment of £50 (normally in cash).

One of the most attractive things about dividends is that they can be more predictable than share prices because companies will usually continue paying dividends even if their profits fall temporarily. In fact, some company directors tend to view the dividend as a sign of corporate strength. Some companies pride themselves on never cutting their dividend. This is particularly true of companies that attract investors because they are a good source of dividend income.

Investors can take dividends as cash to spend today or reinvest them to buy more shares in the company. If you reinvest the income, you help the capital value of your investment to grow. Over the long term, a critical component of the total return from shares has been reinvested dividends.

For example, if you had invested £100 in the UK market 25 years ago and spent the dividends you received your investment would have risen in value to £310 by July 2014. However, if you had reinvested your dividends the value of your investment would have risen to £760. By reinvesting dividends, you would have made an average gain each year of 8.45%, rather than just 4.63%, by taking the income.

The chart below shows the difference reinvesting dividends has made to UK investors over the past decade.

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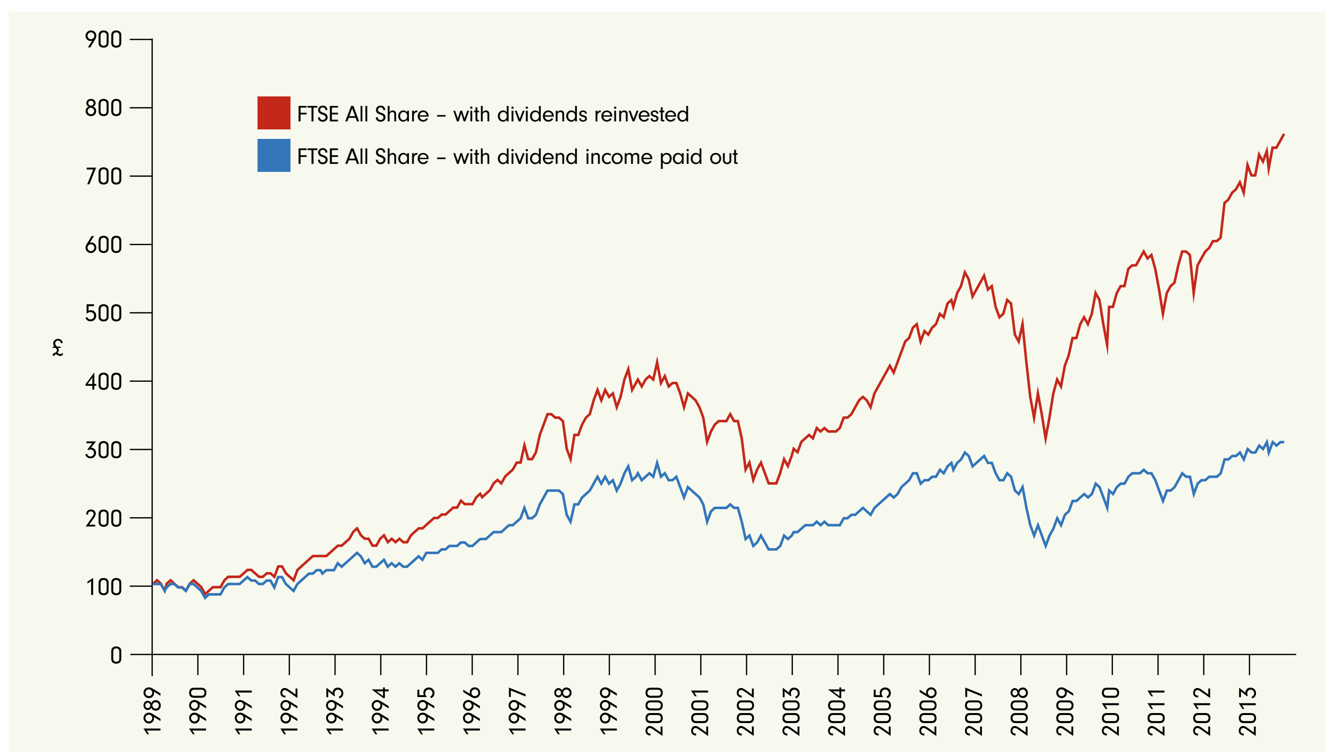
SHARES (EQUITIES)

Over two decades of the FTSE All Share Index – dividends matter



Source: Datastream, FTSE All Share Index as at 01.05.14. Fidelity has been licensed by FTSE International Limited to use the name FTSE All-Share Index. Please note these figures are to May 2014, for the most recent performance contact your adviser. Past performance is not a guide to what may happen in the future.

The dividend yield

The yield from a share can be calculated by dividing the dividend by the share price. So if the dividend is 5p per share and the share price is 150p, then the yield is 3.33%. The same inverse relationship between yield and price exists with shares as with bonds. So, as a share price falls, its yield increases as long as the company maintains its dividend.

If you invest in equity funds, you will usually find the net yield is calculated simply by dividing the annual net (after tax) dividend income per share paid by the fund over the previous year divided by its current price. Most fund providers will let you choose to have your dividends automatically reinvested into the fund.

Making the right investment decisions

Professional fund managers will look for companies that are able to remain profitable and maintain their dividends, which in turn is good for income investors. Selecting the right companies and avoiding the worst is crucial to achieving good returns. To make the most of equity income, investors should find a fund manager they believe can identify the strongest and most reliable companies – those most likely to maintain their dividend. Your adviser can help find the right fund for you.

PROPERTY

Property investment funds make it easy for an average investor to access this asset class. A professional fund manager can aim to diversify risk, achieve a respectable yield and offer the potential for capital gain.

For centuries, property has been used to generate income and it remains one of the most popular investment classes. Although there have been times of boom and bust in property prices, as with other income investments, the inverse relationship between price and yield means falling prices can help investors.

When considering an investment in the commercial and residential property market, it is important to remember that the long-term gains from property investments are as much from the collection of rental yield as from an increase in capital value. Property is also one of the most illiquid investments so it may be difficult to redeem your money at short notice. And remember that if you are a home-owner, you probably already have a large part of your overall wealth tied up in the property market. Also, another thing to bear in mind is that the value of property is generally a matter of a valuer's opinion rather than fact.

A practical way to invest in property is through an investment fund from which you can receive income payments and potentially capital growth as well. Some funds in the property sector invest directly in property and land. These can be difficult to sell so you may not be able to cash in this investment when you want to. There may be long delays in acting on your instructions to sell your investment. Other property funds invest in the shares of property companies and so these are more liquid investments (although they can be more volatile than those that invest in property directly).

MULTI-ASSET INCOME INVESTMENTS

The benefits of diversification are as powerful in the search for income as when investing for growth. Investing across a broader set of investment types enables you to achieve a more stable and sustainable income.

Instead of investing in just one particular type of investment, you can choose to spread your money across a wide variety of different investment types. Maintaining a diversified spread of investments is normally a wise strategy. Holding several different investments together in a portfolio means that you are not putting all your eggs in one basket. If one investment performs poorly, then you still have others to fall back on. In other words, diversification reduces risk.

The benefits of diversification are often referred to when investing for growth. However, the principle is just as valid when investing for income. What's more, by investing across a broader set of investment types – or asset classes – it is possible to achieve a more stable and sustainable income, one which is able to keep pace with inflation.

One of the best ways to hold a spread of income assets is through a multi-asset income fund. These typically invest in a wide range of income assets such as cash, government and investment grade corporate bonds. They will also normally hold a small proportion of assets which provide both an income and the potential for capital growth. These include shares, property, infrastructure investments and high-yield bonds. A multi-asset fund also benefits from the expertise of a professional manager, who can decide upon the best mix of assets to hold at any given time.

DRAWING AN INCOME

Deciding upon how much to withdraw from your retirement savings each year is very important. If you withdraw too much – and your investments do not grow quickly enough to compensate for these withdrawals – you might find that your money runs out before you die. This is obviously not an ideal situation as you will still need to support yourself and perhaps your family.

When you do come to plan your retirement income, you might have a cash figure in mind or you may just want to withdraw a percentage of your investments each year. However, it might be useful to remember that, when you do retire, your expenses may change as much as your income does.

Establishing how much income you should take from your pensions and investments is an area where your adviser can help. They can work with you to establish a prudent withdrawal rate so that there is a good chance that your money outlasts you.

Income drawdown

From April 2015, the rules currently under consultation state that if you enter into an income drawdown arrangement, you will be able to withdraw as much money as you like each year from your pension fund (you can withdraw the whole amount in one go if you so choose). However, the income you withdraw will be taxable.

Most income drawdown schemes allow you to choose how frequently you receive income payments. This could be monthly, quarterly, half yearly or annually. You may also have the ability to request one-off payments.

Income from other investments

How you take your income is also a consideration with your non-pension investments. Do you need the money monthly, quarterly or as and when required? Income funds will pay their income on regular cycles so you can match these to your needs. However, you should remember that there can be different tax implications depending on how you choose to take an income from your investments.

Many investment companies, understand the need for you to take an income, offer regular withdrawal facilities. They work by paying a specified amount from your investment accounts and transferring the money directly to your bank account. If the yield on your investments is not sufficient to pay you the amount you need, the withdrawal facility will sell investments to make up the difference. This way you know you will have a regular income come what may. Remember, however, that this may reduce the capital over time if the fund's growth does not compensate for the withdrawals.

Pension drawdown income is not secure. You, and your adviser, control and must review how your pension is invested and how much income you draw within the applicable limits. Poor investment performance and excessive income withdrawals can deplete your fund leaving you with less income than you require

Annuities

Instead of entering into income drawdown, many people use their pension pot to purchase an annuity. These pay a secure and guaranteed income for life. There are a wide range of annuities available in the UK with lots of different options. For example, some make the same level payments to you for the rest of your life while others make increasing index-linked payments. You can also choose to have an income paid to your partner, or another dependant, in the event of your death. Your adviser can help you decide if an annuity is right for you and help select the best option for your circumstances.

When you purchase an annuity, your capital cannot be passed on to your dependants when you die. Only any guaranteed benefits or a dependant's income included as part of the annuity contract can be passed on.

MAXIMISING YOUR INCOME

The eligibility to invest in an ISA and how much the tax savings are worth depends on individual circumstances and all tax rules may change in the future.

Income and tax

When you retire you will still have a range of tax allowances available to you – including your personal allowance – and so through sound planning you will be able to maximise the income you receive. ISAs, for instance, can be particularly valuable to retirees as there is no income tax to pay on your returns. You can invest up to £15,000 in a NISA in 2014/15 and so over the years you can build up a sizeable sum in these tax-advantaged accounts.

The Capital Gains Tax (CGT) allowance can also be a very useful allowance if you have a sizeable portfolio of "non-tax wrapped" investments. An individual can realise gains of £11,000 in 2014/15 without incurring CGT, which can then be spent or reinvested as appropriate. Of course, selling an investment is a repayment of capital rather than an income payment but it can be a tax-efficient way of generating extra funds.

Tax planning in retirement is a complex business and so we recommend that you seek professional financial advice in this area. A good adviser can put together a tax-efficient retirement income plan for you which should mean the amount of tax you pay each year is minimised. We believe that, through skilfully planning, an adviser can help you achieve a much more prosperous retirement.

THE IMPORTANCE OF ADVICE

Fidelity has a long history of helping people meet their financial goals. We have a reputation for developing innovative investment products and we pride ourselves on providing clear information to help you and your adviser make informed investment decisions.

As an independent company, we are free to concentrate on the best interests of our investors. And throughout our more than 40-year history, we have focused single-mindedly on delivering superior investment returns for our clients. We can't advise you on what investments would suit your particular circumstances, so please consult your financial adviser.

If you would like any further information on Fidelity's income generating investment options, please contact your financial adviser.

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