Planning for your retirement

Managing income in retirement

FundsNetwork

THE CHANGING SHAPE OF RETIREMENT

In this guide we set out some of the key things you need to think about when deciding on a retirement income plan.

- **How long might you need to make your money last?** This could be longer than you think.
- **What costs will you have and how will these increase with inflation?** Fixed income sources such as annuities may leave you struggling to cover costs in later life.
- **How should you invest in retirement?** Staying invested can bring many benefits, but you also need to understand the risks.
- **What about loved ones?** How do you best provide for them when you're gone?

Putting all this together, we aim to show you how a successful retirement income plan will often involve combining multiple sources of income to meet your needs.

Retirement has evolved rapidly in recent years. We are living longer, can enjoy more active lifestyles in retirement and, following the 2014 Budget announcement, can now take advantage of a shake-up in how we use our retirement savings.

Changes announced in the 2014 Budget will, if enacted, mean that from April 2015, you will no longer need to secure a lifetime income with your pension savings at retirement. This is set to revolutionise the way people use their retirement savings, allowing those over the age of 55 to take what they want, when they want. Some will still want to generate a regular income from their savings, but others may choose to dip into them on a more ad-hoc basis.

Some may find they're better off cashing in their pension and paying off debt. There's even an opportunity to get more from the State Pension.

This is balanced by a greater shift in responsibility for funding older age from the State and employers to the individual. You are likely to receive fewer guaranteed income sources to rely on in later life and need to plan for fluctuating investment markets and low interest rates.

Retirement will continue to evolve and present new opportunities to people, but you will need to prepare financially to ensure you are comfortable in what might possibly be decades of retirement.

By looking ahead you can make sure that you make the most of your pension and other investments, and that you are prepared for the new era of retirement that is allowing pensioners greater freedom in the way they use their money to enjoy the lifestyle they want.

To understand what retirement income options might be best for you, speak to your adviser and they will be able to assist you.

Lifespans can be longer than expected

	65-year-old man	65-year-old woman	65-year-old couple*
50% chance	89 yrs.	90 yrs.	93 yrs.
25% chance	95 yrs.	96 yrs.	99 yrs.

*At least one surviving individual
Source: Annuitant mortality data as provided by the UK Actuarial Profession's Continuous Mortality Investigation.
Figures assume you are in good health. For illustrative purposes only.

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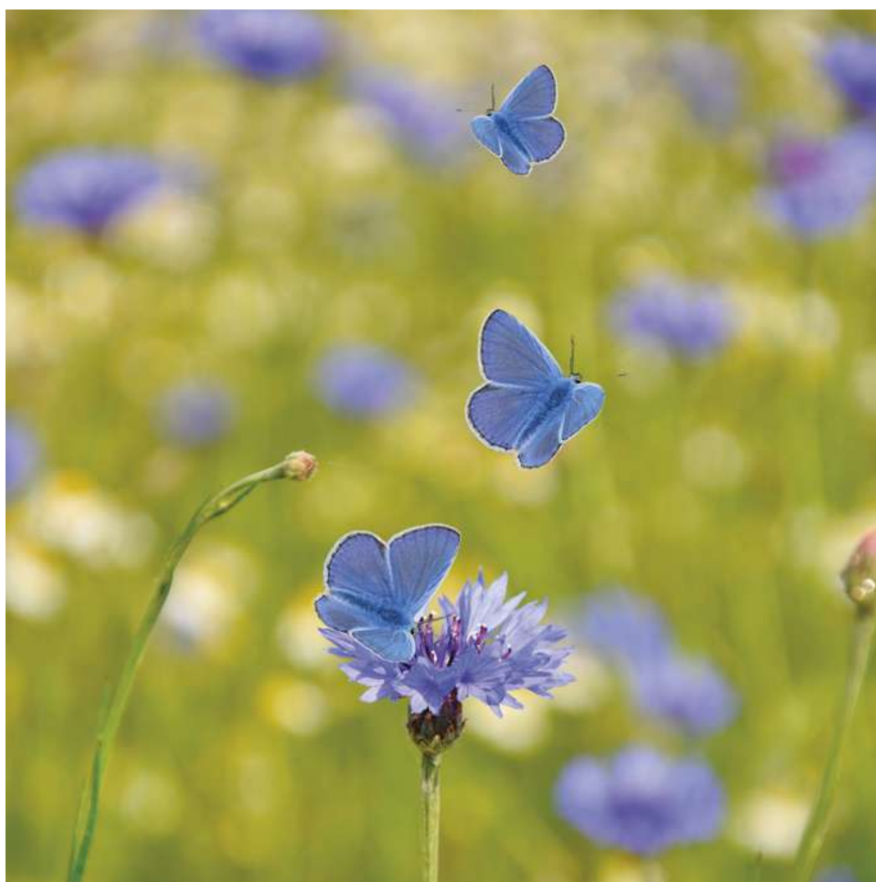
> "BY BEING REALISTIC ABOUT JUST HOW LONG YOUR MONEY MAY HAVE TO LAST, YOU WILL ENSURE YOU DO NOT FALL FOUL OF 'LONGEVITY RISK' OR, IN PLAIN LANGUAGE, THE RISK OF OUTLIVING YOUR MONEY."

Living longer

The fact that Britons are living longer lives should be celebrated but it also means individuals will have to fund increasingly longer retirements with less help from the State and their employers.

Unfortunately too many people underestimate just how long they will live in retirement which is why planning ahead is so important. By being realistic about just how long your money may have to last, you will ensure you do not fall foul of 'longevity risk' or, in plain language, the risk of outliving your money.

Thinking about how long you will live and just how much money you will need to enjoy your retirement is the first step towards ensuring that you will you have the secure and happy old age you want.



For those who want to continue working beyond their State Pension Age there is the option to defer taking the State Pension. By deferring your State Pension you are entitled to extra money each week which makes up for not taking it straight away.

Those deferring before April 2016 will see their State Pension increase 1% for every five weeks they put off claiming. This represents an increase of 10.4% each year and so is certainly worth considering as an alternative to other income products if you are eligible and in good health. Those reaching State Pension Age after April 2016 will not receive such generous terms so may be less likely to benefit.

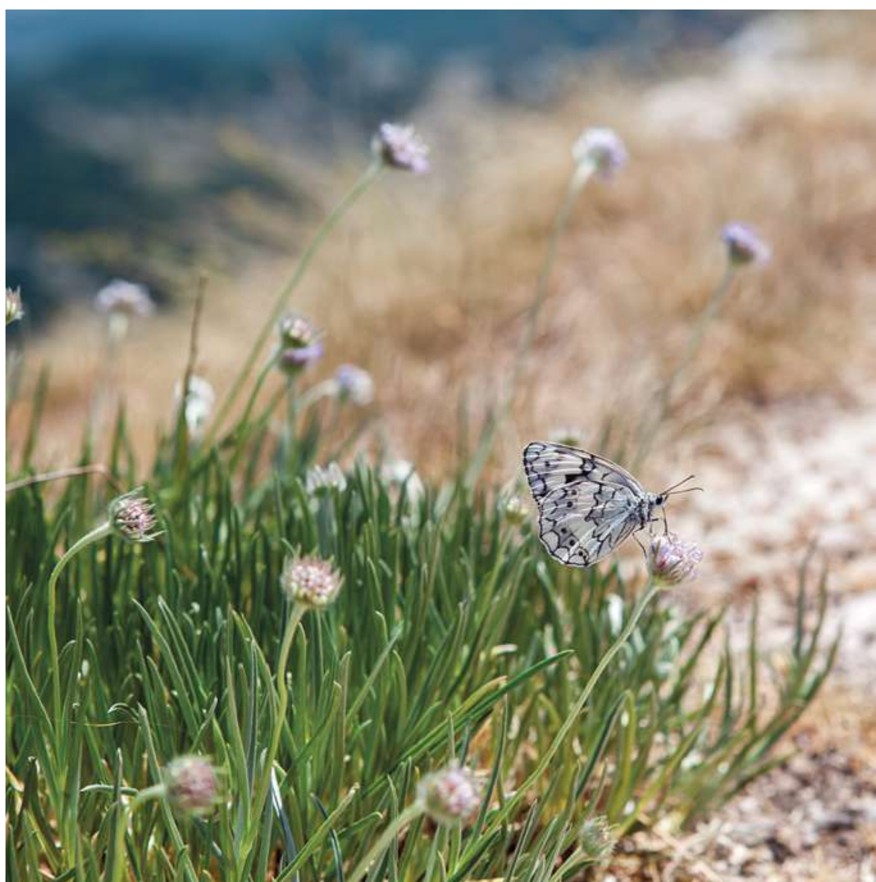
Working longer

Improved health and the need to fund a longer retirement means many have taken the opportunity to keep working either full-time or part-time after their normal retirement age.

The Office of National Statistics shows the proportion of people aged 65 and over who are still working has almost doubled in the past ten years from 8.7% to 16%.

Working past traditional retirement ages enables individuals to boost their pension pots and many people are choosing to remain in their jobs part-time or take on consultancy roles before taking the leap to full retirement.

The government has responded to improving longevity by increasing the age at which you receive the State Pension. It will rise to 66 in 2020 for men and women, then to 67 between 2026 and 2028 and keep on rising to 68 by 2046. So for many of us, working beyond age 65 will be a necessity not just an option.



Budgeting for expenses and rainy days

We've established that you're probably going to live for a long time in retirement and your money has to stretch further so your first step is to work out just what that money has to cover.

By drawing up a realistic budget of fixed spending, such as bills and food shopping, as well as the cost of some luxuries such as holidays, you should be able to work out what income you will need to continue living comfortably.

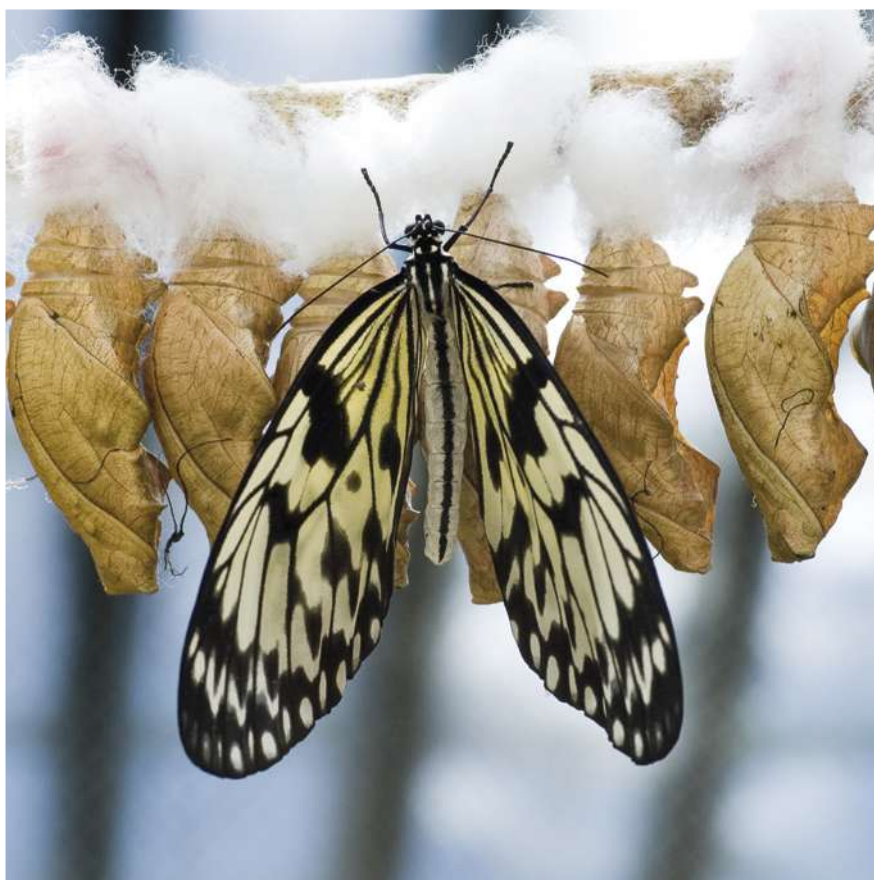
Once you have established what your essential expenses are, we strongly suggest making sure you have enough forms of secure income to cover these. Secure income includes State Pensions, final salary or defined benefit pensions and annuities.

To the extent that you don't have enough secure income to meet essential expenses, you may wish to secure an income from your pension to cover these costs for the rest of your life. You can do this in several ways. You can put part of your pension pot towards buying an annuity that will provide this income, although you should keep in mind that your needs will change and that prices will rise over time with inflation.

Alternatively, you can look at deferring the State Pension, which will increase the amount of inflation-linked income you will get.

On top of day-to-day expenses don't forget to make provision for a rainy day fund to cope with unexpected costs such as the boiler breaking down. Many people forget to make provision for such events at the outset and have difficulty funding them later in retirement.

A growing issue is the need to consider whether you might need care in later life. Some thought will need to be given as to how to cover this. That may involve setting aside some money now or accepting the need to utilise assets such as your home to fund this should the need arise. Alternatively, you might consider insurance to meet the costs.



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Impact of inflation

Inflation is a silent assassin that erodes the value of your money and limits your spending power if you do not protect yourself against it.

Inflation is a huge risk to your savings and failing to take its impact into account can have a detrimental effect on your standard of living. When investing your money and planning for retirement, you should speak to your adviser about the impact of inflation on your investments, and how best to protect yourself against this.

Investing in assets that are likely to keep up with inflation, such as stocks and shares, can help protect the purchasing power of your income, but you will need to consider the extent to which you are prepared to accept investment risk.

If investment values fall then this may mean you need to reduce the income you take or run the risk that your money will run out sooner than expected.

You can buy annuities that allow for cost of living increases, but these are generally quite expensive as the guarantees are costly for the insurance company to provide. Presently, providing full inflation protection under an annuity can mean a reduction in your initial income of over 40%.

Investing for retirement income

Once you have covered your day-to-day expenses with a secure income you will be in a position to consider how to invest your remaining pension savings. Some people will prefer to be certain of what they'll have in retirement, but others will be prepared to take some risk with a view to growing their retirement savings, even if they decide to buy an annuity later in life. In particular, the effect of inflation may mean that the perceived safety of the annuity's fixed payments is ill-founded as its purchasing power will be eroded over time. Your adviser will be able to help you decide what an appropriate level of risk to take on is to achieve your desired outcomes.

The most common way to continue to invest while drawing an income in retirement is through 'pension drawdown'. Other products that allow you to grow assets include investment-linked annuities and variable annuities. These products also include some level of guarantee, but this will typically come at a cost.

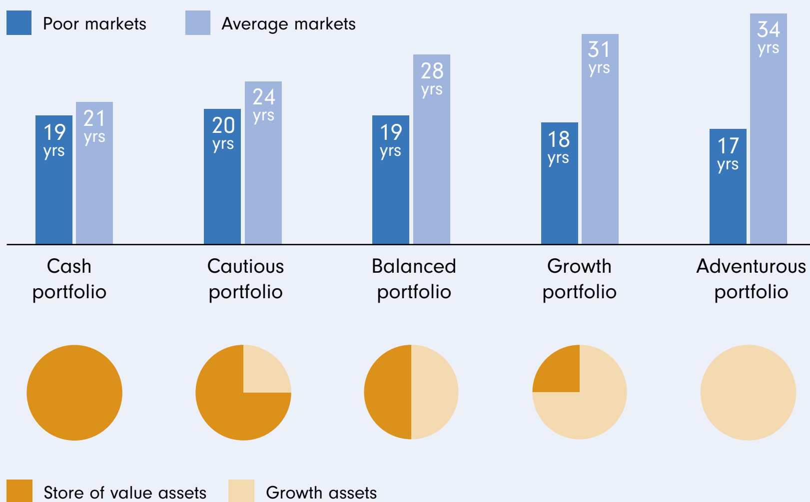
How prices can change

Price comparison 1999 – 2014			
Item	**Price in 1999**	**Price in 2014**	**% change**
Milk (pint)	34p	49p	44%
Loaf of white sliced bread (800g)	51p	£1.40	175%
Draught lager (pint)	£1.93	£3.00	55%
Unleaded petrol (litre)	63.6p	£1.31	104%
Bottle of wine	£3.55	£6.50	83%

Source: Tesco, Pintprice.com, AA, Numbeo.com. July 2014

Asset allocation: See how long different portfolios may have lasted

Maintaining a diverse mix of asset types can help your money last. Look how asset mix affects the longevity of a hypothetical portfolio with a 6% withdrawal rate, adjusted annually for inflation.



Source: Fidelity, July 2014. Store of value assets include Global Bonds and Cash. Growth assets include UK Equities, World Equities, Commodities and Property.

Asset allocation

Depending on the investments you choose – your asset allocation – you may be able to mitigate the impact of inflation and continue to grow your savings.

Investors should look at using a mixture of fixed-income investments like gilts and bonds to provide a stable income, equity investments with the aim of providing capital growth, and cash deposits for immediate income needs.

The amount you hold in each type of asset will depend on when you need the money and your attitude to risk.

Generally, you should look to hold money that you will need in the next few years in safer assets, such as fixed interest and cash, while investing the balance in assets that are expected to deliver higher returns, but these may be more volatile.

You need to make sure you are not taking an overly cautious or an overly aggressive attitude to your investment risk as both strategies could see your savings run out quicker than you would like.

A cautious investment strategy may not generate sufficient returns to deliver the income you need over your retirement.

More aggressive strategies increase the likelihood of making your money last longer on average but also mean that if things go wrong you could quickly run out of money.

Investment market volatility can have a significant impact on the success of your income planning. The need to draw income can make the effects of falling markets even more pronounced.

Managing market volatility

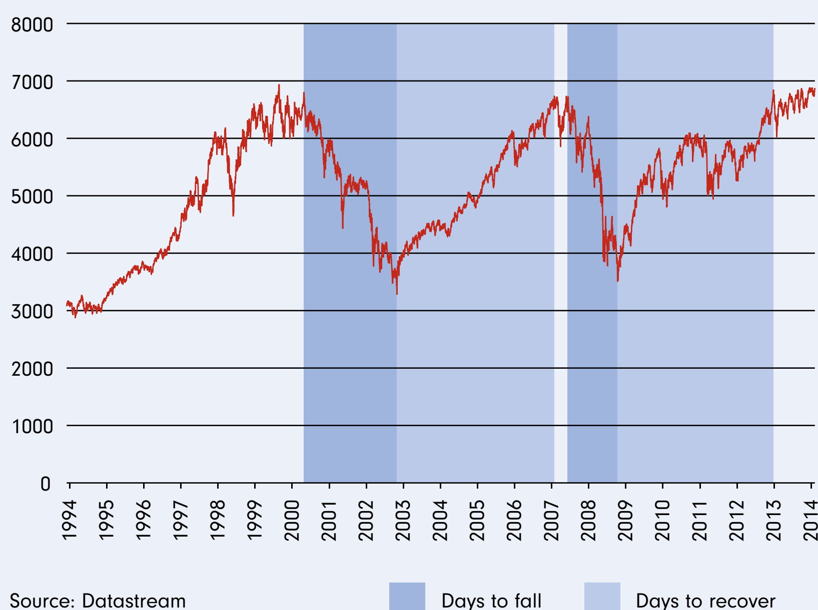
Investing in retirement involves taking risk in order to grow your income. This can be particularly useful when trying to mitigate the impact of inflation. But planning your investments in retirement from the start is particularly important, because when you are taking income any falls you suffer will hit you much harder, especially if they happen early on in your retirement. Markets can fall quickly but may take a much longer time to recover.

If you suffer negative returns your portfolio is affected in two ways; the portfolio value falls because the stock market has fallen and is then reduced further by withdrawals you take.

This means that you have a smaller amount to support future income payments and on which to earn potential future growth.

A fall in the value of your portfolio may be a signal to reduce the level of income you're taking, although some people may find this hard if they have become accustomed to a certain lifestyle. Covering your essential expenses with secure sources of income allows you more freedom over how you invest as a need to reduce income won't result in you not being able to meet essential expenses.

Market volatility in the FTSE 100 Index
The chart shows the daily level of the FTSE 100 Index (excluding dividends) from April 1994 to April 2014.



Source: Datastream

An effective investment strategy will aim to make sure that you do not expose money that you will need in the short to medium term to too much risk. By doing this you can reduce the chances of market volatility throwing you off track.

Beware the taxman

Pension income is not tax-free. You receive tax relief on contributions on the way in, but the government taxes your pension at your marginal rate of income tax when you take it out, although everyone is entitled to take a 25% lump sum absolutely tax-free from their pension pot.

Before you start taking large amounts of money out of your pension, make sure you speak to your adviser about the tax implications. You could find yourself paying 40% or 45% income tax depending on how much of your savings you take. And if you take too much you may even lose your personal allowance meaning you pay an effective income tax rate of 60% on some income.

You should also look at your pension income in the context of other income you may be receiving from part-time work, other investments or property and draw your pension as tax-efficiently as possible. You should also consider the income of a spouse or partner.

The tax implications on your retirement savings in the event of your death should also be considered. A tax of 55% is currently levied on pension pots in drawdown although the pot does fall outside of a person's estate for Inheritance Tax purposes. This rate of tax is being reviewed by the Government and may change in the future.

Looking after loved ones

When planning for retirement it is likely that a spouse, partner or other family members will have to be taken into consideration.

Unfortunately, many people overlook the need to provide for their loved ones when they take out annuities, opting for a single-life annuity rather than a joint-life annuity. As the name suggests, a single-life annuity pays out until you die but a joint-life annuity will pay out to a spouse or partner after you die. You can select the amount of income you wish a spouse or partner to receive on your death. It can be any percentage of your annuity income up to 100%.

Although the cost of a joint-life annuity may be higher, as it may have to pay out for longer, it is worth discussing with your adviser, particularly if your partner or spouse does not have their own savings and/or pension to rely on.

If you are using pension drawdown then, on your death, your spouse or partner can continue to draw an income or buy an annuity. This would be subject to income tax. Alternatively, they can take the remaining fund as a lump sum, though this would be subject to a tax charge. This charge is currently 55%, but this is being reviewed by the government and may change in the future.

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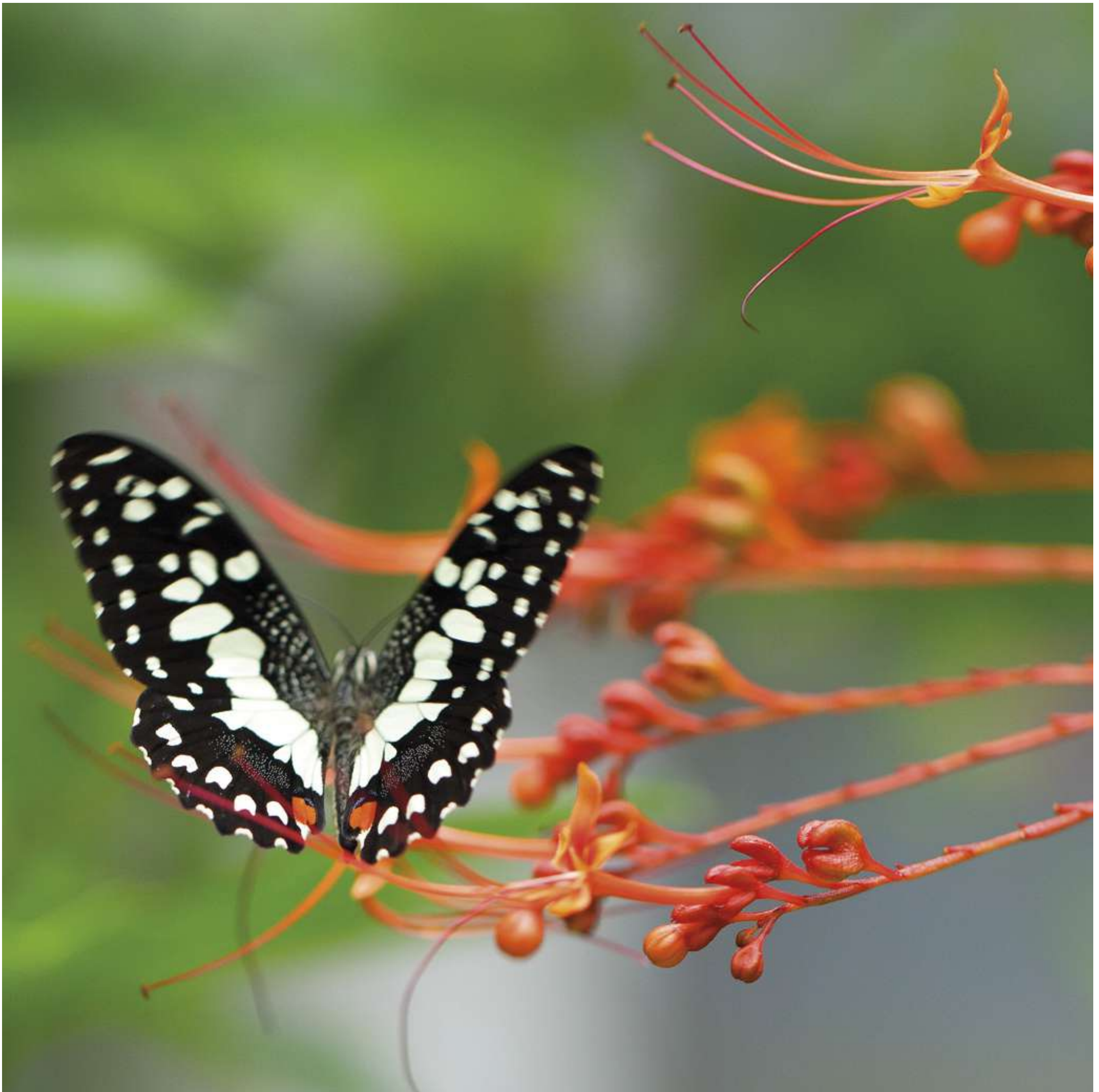

The best solution for you

The key to planning for retirement is to combine different income streams to ensure that you can live the life you want to lead. Speak to your adviser for help finding the best solution for you.

By diversifying the ways in which you receive income, you can work out the best ways to reduce the effects of inflation, longevity, market volatility and tax. For many people combining a variety of income sources will be the best solution as the table below shows. We have also included a case study so you can see how this works in practice.

Pension drawdown allows you to benefit from potential growth in your investment and to change the income you take to suit you. However your savings will be at risk of a market downturn and of running out of money earlier than expected.

Forms of secure income such as State Pensions and defined benefit pensions will be the bedrock of your retirement plan to cover essential expenses. Annuities also provide a secure income so you know that your bills are covered but they generally do not offer flexibility or a chance to grow your money.

Other savings and investments should also be considered in your retirement plan. These may include cash deposits, ISAs, stocks and shares and so on. As with pension drawdown investing, you will need to consider how much risk you want to take with these savings. Are they to meet specific needs, generate an income or just there as rainy day funds?

The sooner you expect to access them, the less investment risk you should normally take on.

There is no right answer to retirement planning or a one-size-fits-all solution. Every retiree will have different priorities and expectations but everyone will need to look at their finances holistically to work out the best way to fund their retirement.

Your adviser will provide you with the support you need to understand the choices you have to make, review each option and help you to select the solution that is best suited to your needs.

Consider how various income sources align with your objectives

✓ (red) Strong alignment
✓ (black) Moderate alignment

Income sources	Potential for income growth to keep up with **inflation**	Lifetime income that will not run out due to **longevity**	Predictable income to provide protection from **market volatility**	Flexibility to meet changing needs and **uncertainties**	Ability to leave benefits for your **loved ones**
Drawdown pension investment portfolio with systematic withdrawals	✓ (strong)		✓ (moderate)	✓ (strong)	✓ (strong)
Non-pension investment portfolio with systematic withdrawals (for example ISAs)	✓ (strong)		✓ (moderate)	✓ (strong)	✓ (strong)
Variable annuity contract held via pension	✓ (moderate)	✓ (strong)	✓ (moderate)	✓ (moderate)	✓ (strong)
Fixed annuity with annual increases	✓ (moderate)	✓ (strong)	✓ (strong)		✓ (moderate)
Defined benefit pension	✓ (moderate)	✓ (strong)	✓ (strong)		✓ (moderate)
State Pension	✓ (strong)	✓ (strong)	✓ (strong)		
Combined income sources	✓ (strong)	✓ (strong)	✓ (strong)	✓ (strong)	✓ (strong)

CASE STUDY:
DAVID WANTS TO BALANCE RISK AND REWARD

"I WILL BE 65 YEARS OLD THIS MONTH AND WANT TO RETIRE THEN. I'M ENTITLED TO £6,000 A YEAR STATE PENSION AND ALSO HAVE A FINAL SALARY COMPANY PENSION OF £10,000 A YEAR THAT GOES UP WITH INFLATION. I HAVE A PERSONAL PENSION POT OF £300,000 AND AN OUTSTANDING MORTGAGE OF £50,000. I ESTIMATE THAT I WILL NEED JUST UNDER £18,000 A YEAR BEFORE TAX TO COVER MY BASIC LIVING EXPENSES. WHAT CAN I DO?"

First things first – look at clearing debt
David is entitled to take 25% of his personal pension fund as tax-free cash giving him £75,000 at retirement. In most cases it will make sense to take this cash and as David still has a mortgage of £50,000 he can clear that with part of his tax-free cash. This avoids the need to meet interest and capital repayments out of his taxed income.

Covering basic expenses – options
David has a solid base of guaranteed income from the State Pension and his defined benefit plan. Both will go up in line with inflation so he's well protected there. But he hasn't quite got enough to cover his basic expenses. What should he do?

OPTIONS

Defer State Pension and live off his pension savings for a short period	For each year that David defers taking his State Pension it will be increased by 10.4%. So by deferring it for three years he will increase it by 31.2% to £7,872 (plus whatever the State Pension has been increased by because of inflation over that period). Together with his defined benefit pension he will then have more or less what he needs to cover his basic expenses and it will be protected from inflation for the rest of his life. He will need to cover excess expenses of £8,000 a year over the three-year period. Assuming inflation is 2% a year this will take around £24,500 from his personal pension savings.
Buy an inflation-proofed annuity of £1,872 a year	Inflation protection on annuities is an expensive option. The cost of buying an inflation-linked annuity of £1,872 a year (what David would get by deferring State Pension for three years) is just over £54,000.[1] This is over twice what he would need had he chosen State Pension deferral.
Take additional income from his personal pension using pension drawdown	This is another good option and David certainly has plenty of money to cover this. But it's not guaranteed and so David could find more of his money has to go on covering basic expenses than he intended, particularly if inflation is high.

Overall, it seems David will be better off deferring his State Pension for three years. He has £25,000 of tax-free cash left after paying off his mortgage and so can use that to bridge the gap for the three years. As he needs certainty of income he holds it on deposit with the bank but can increase his interest by locking it away until he needs it.

INVESTING FOR INCOME

David has £225,000 left over from his personal pension. What can he do with this?

Use a drawdown pension to stay invested and generate income	David can invest his remaining fund in a drawdown pension arrangement and access his savings as and when he needs to. Assuming he wants to draw a steady income, then, depending on how certain he wanted to be of his money lasting a lifetime, he could look at a starting income of between 4% and 6% of his portfolio which would generate between £9,000 and £13,500 a year. By investing in growth-oriented assets he could reasonably expect to increase this income over time to help mitigate the impact of inflation. This is not risk-free and if his investments perform poorly he might have to reduce the income he takes or accept the risk of running out of money sooner than expected.
Buy an annuity	Alternatively David could buy an annuity. With his remaining fund of £225,000 he could buy a flat-rate annuity of around £13,300[2] a year. An inflation-linked annuity would only give him a starting income of £7,600[3] a year.

As David already has his basic expenses covered he is happy to take some risk in order to grow his retirement income. He invests in a pension drawdown arrangement taking a modest income of £8,000 and investing reasonably adventurously with the aim of growing his income over time and keeping his options open for the future.

1 Source: Assureweb. Based on a male aged 65 with no health issues and a non-smoker. Annuity purchase price, after tax-free cash has been taken, of £54,036 based on single life, RPI-linked annuity with a ten-year guarantee payable monthly in advance. Figures correct as at July 2014.

2 Source: Assureweb. Based on a male aged 65 with no health issues and a non-smoker. Annuity purchase price, after tax-free cash has been taken, of £225,000 based on single life, level annuity with a ten-year guarantee payable monthly in advance. Figures correct as at July 2014.

3 Source: Assureweb. Based on a male aged 65 with no health issues and a non-smoker. Annuity purchase price, after tax-free cash has been taken, of £225,000 based on single life, RPI-linked annuity with a ten-year guarantee payable monthly in advance. Figures correct as at July 2014.

CASE STUDY:
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OTHER CONSIDERATIONS

Benefits on death	Under a drawdown arrangement any funds remaining on death can be used to provide income for loved ones or withdrawn as a lump sum subject to a tax charge (currently 55%). If David had bought an annuity he could have chosen to have his pension continue to be paid to his wife on death although that would have reduced his income further.
Flexibility	Annuities once established can generally not be changed. If David's circumstances changed, say his health deteriorated quickly or he needed to fund unexpected expenses, he would almost certainly not be able to change an annuity contract. Drawdown pension would give him the flexibility to change his plans although this might have consequences later on. For example, taking a significant additional withdrawal could reduce the future income he could take.
Management	A drawdown pension arrangement needs to be reviewed regularly to ensure it remains on track to deliver against expectations. This involves reviewing and adjusting investments and perhaps income levels on a reasonably regular basis. David may be happy doing this himself or may prefer to get the help of a specialist adviser to take care of this for him. In contrast, annuities generally need little maintenance once they are established.

This example shows that a mix of different income sources is often needed to achieve the best outcome. David used the State Pension, a defined benefit pension and drawdown to get the result he needed. For other people, different solutions might be better. It's important to look at all the options and consider which ones are best for you.

IMPORTANT INFORMATION

The value of investments can go down as well as up and you may get back less than you invest. Past performance is not a guide to what may happen in the future.

Tax savings and eligibility to invest in a pension or an ISA depend on personal circumstances and all tax rules may change in the future. Please note, you cannot access the money held in a pension until the age of 55.

If you are using pension drawdown, you and your adviser control, and must review how your pension is invested, taking into account your attitude to risk, and the level of income you take. Market volatility or high income withdrawals, may result in your pension pot reducing in value, leaving you with less income than you need in future.

The information contained in this guide must not be deemed as advice, and any advice you do receive must be provided by your adviser.

Contact your financial adviser to help you get in shape financially for your retirement.

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