The Biggest Risk to Pension Drawdown Investors

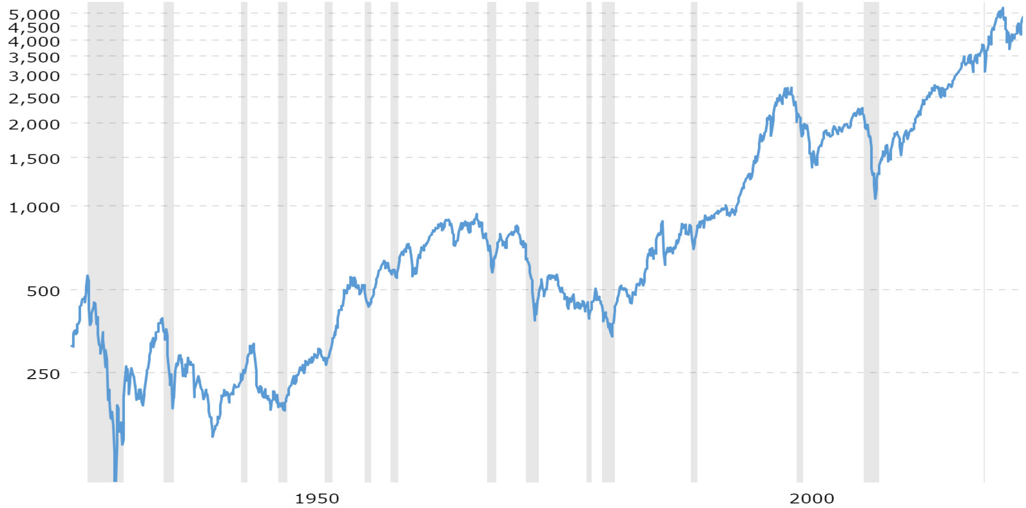
2024

Tideway

Pension Drawdown's Biggest Risk

An investment into the stock market is generally recognised as the most effective long-term route to earning a better return than you can get from a cash deposit and history tells us that over the long term, shares have delivered better returns than bonds and property.

In the last 90 years investing in the S&P 500 has delivered an average compound return of just over 7% p.a., shown below.



Source: Macrotrends - The S&P 500 index since the 1920s on a logarithmic scale and showing periods of economic recession (grey vertical lines)

However, investing in the stock market when drawing an income creates the biggest risk for those opting for pension drawdown. This is known as **return sequencing risk**.

The chart above is not a straight line and historic stock market data since 1947 shows 14 bear markets, one every 5 years on average, where there has been a stock market correction with a drop in value of more than 20%.

The timing of such market corrections is notoriously hard to predict. They can coincide with recessions but as the chart above shows, not always because most often they are prompted by unforeseen and unexpected events.

As the chart above shows, over the last 90 years, patience eventually provided those premium long-term returns, but investors, who started investing just before a bear market event have often had to wait quite a few years to make a profit from the stock market.

The way these market downturns impact those drawing an income from their pension accounts is known as **return sequencing risk** and it is one of the biggest risks to drawdown pensions. Whether you are about to embark on drawdown, or are already in drawdown, if your drawdown account is invested in the stock market and you haven't considered **return sequencing risk** you may be taking much more risk than you realise or need to take.

Introduction To Pension Drawdown

The income provided by annuities, the traditional way to generate pension income, has increased as Government bond yields increased significantly after the end of quantitative easing in 2022.

As of December 2023, annuities can generate lifetime income from between 4% and 7% for a 60 year old, depending on the rate of annual increases they want in their income to combat the impact of inflation.

However, investors with more than £200,000 in pension accounts generally find the features of pension drawdown a more attractive option than buying an annuity largely due to the flexibility and potential family legacy value.

Even though the price of annuities has come down, annuities still:

- Require you to give up your pension capital in an irreversible one off transaction
- Lock you in to a fixed level of income for life which cannot be changed.
- Lock you in to long-term government bond yields and preclude you from investing for a better return

The amount of income you can receive from an annuity depends on how long you live - the longer you live as an annuity owner, the better return from the annuity you get. This means annuities will be particularly poor value for money for those who do not live into their 90's.

The alternative to an annuity purchase is to use pension drawdown.

You keep your pension funds invested and draw an income as and when you need it and at an amount entirely at your discretion.

This has become very popular amongst pension holders with accounts worth more than £200,000, but of course comes with the big risk of running out of money too soon in retirement.

This risk is massively increased when investing in the stock market and making withdrawals. You might calculate your withdrawal plan based on a long-term return forecast from the stock market investments but due to **return sequencing risk** you may never make those forecast returns and your plan can go badly wrong.

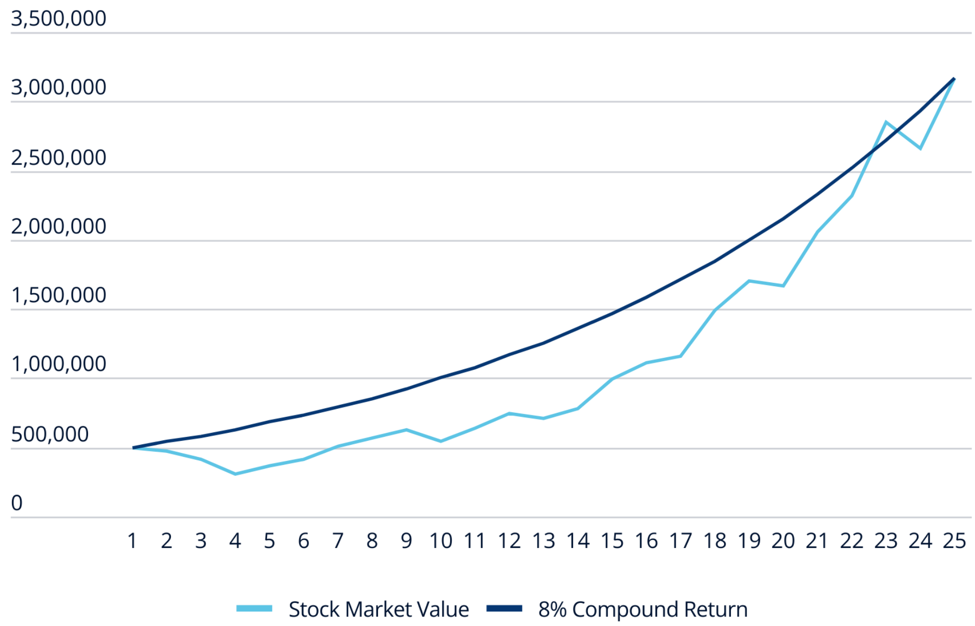
Return Sequencing Risk Explained

To see how return sequencing impacts drawdown investors let's look at returns for different investors in the same hypothetical stock market.

The charts below show a hypothetical future stock market return exhibiting similar returns and volatility to historic stock markets and its impact on first a lump sum investor, then regular savers and finally drawdown investors highlighting the impact of return sequencing risk.

Chart 1 Lump Sum Investors:

Shows a classic stock market return delivering 8% compound return over 25 years and shows how much it would increase a lump sum investment of £500,000 over that period. The lump sum investor reaps the average long-term compound return.



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As typifies stock market returns, the returns are not smooth, with above average returns in some years and negative returns in others.

Trying to avoid such corrections by timing investments in and out of the stock market is notoriously difficult and carries the significant risk of missing out on above average return periods. In 2023 the stock market rose by almost 10% in just 2 months, it would have been easy to miss this return trying to time investments in and out of markets.

Chart 2 Regular Savers:

Shows a regular saver saving £20,000 per year into the exact same hypothetical stock market In this example the regular saver reaps an average return that is higher than the long-term average return of the market making 46% overall more than an investor saving into a smoothed return of 8% p.a.

The regular saver makes an average long-term return of 10.6% p.a. and 2.6% more each year than the lump sum investor.

The stock market downturns have acted as a tail wind increasing the return to the regular saver.

This happens because as the market falls the regular saver gets to buy shares at a cheaper price and acquire more shares than had the market grown in a steady line.

It's the secret of many a successful investor including Warren Buffet, who rarely sell shares and when the market dips buys more!

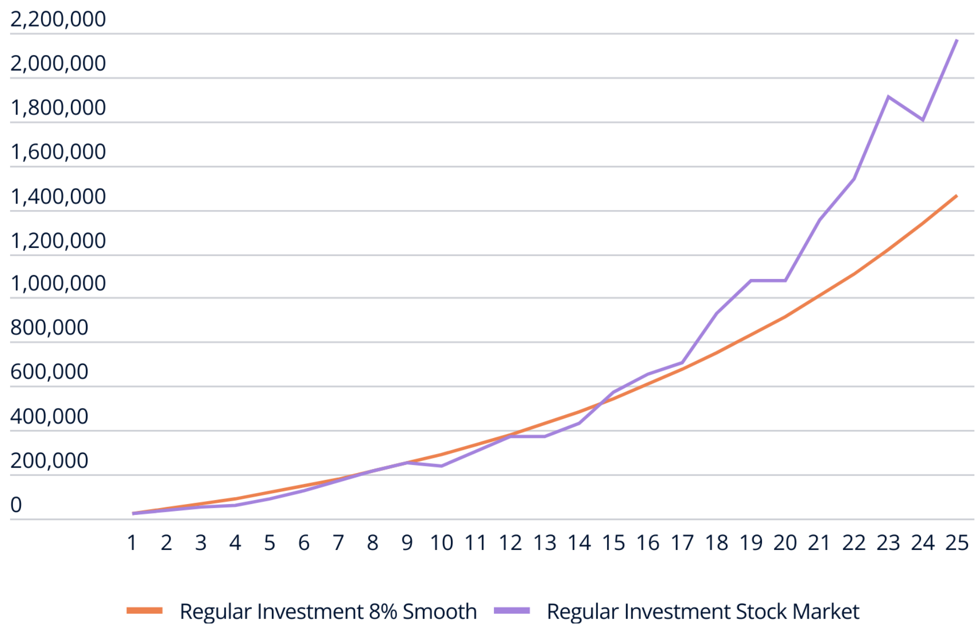

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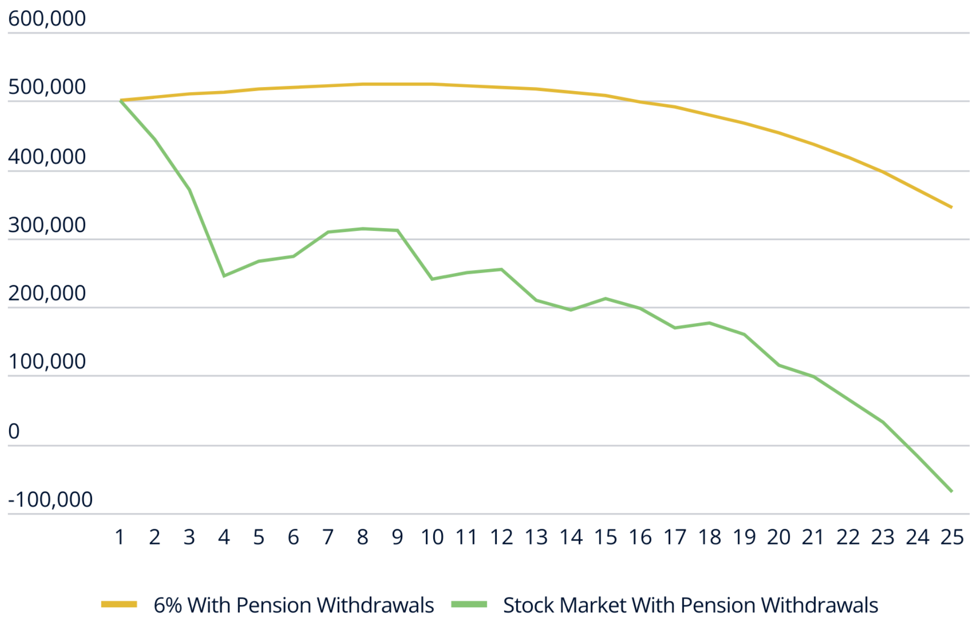
Chart 3 Drawdown Investors:

However, when you start to make regular withdrawals, the exact opposite happens.

Chart 3 below shows someone starting with an initial investment of £500,000 into the exact same hypothetical stock market and drawing £25,000 per year in income escalating by 3% a year to keep pace with inflation.



In this example the drawdown investor almost completely exhausts their account in 24 years and does considerably worse than somebody earning a smooth return of 6%, 2% less than the average stock market return.

The drawdown investor only makes a long-term average return of 3.9% p.a., 4.1% less each year compared to the lump sum investor and 6.7% less each year than the regular saver.

This happens because as stock market corrections occur shares have to be sold at a loss to fund income withdrawals and a disproportionate number of shares have to be sold at lower values to sustain the income.

Three investors investing in the exact same stock market over the same period make very different returns simply down to stock market volatility and how they put money in and take money out of the market.

The regular saver gets the best return, the regular withdrawer the worst return. This is how return sequencing has the power to do irreversible damage to your drawdown account and withdrawal plans.

Managing Return Sequencing Risk

A quick glance around the internet will show that whilst return sequencing risk has been well understood by investment managers and financial advisors for some time, there are not many practical ways around it.

Solutions we have seen include:

- Suspending or reducing withdrawals on your account whilst waiting for profits to emerge, which may not be practical.
- Diversifying your investments will also help to an extent. However, there are plenty of historic examples where traditional diversification into a balanced or 60/40 mixed equity bond portfolio did not reduce the overall account volatility sufficiently to afford protection.

The only way to substantially reduce the impact of return sequencing risk whilst still investing your account into the stock market, is wherever possible to avoid selling stock market linked investments to fund withdrawals in market downturns.

This will allow time for a recovery and generate greater returns in the long-term return.

This is easy to say but quite hard to deliver in practice.

To do it you need a drawdown account and investment process that facilitates:

- The ability to separate out long-term volatile stock market investments from short-term investments that don't have the same price volatility.
- A decision making process for allocating between short-term and long-term investments based on your likely withdrawal plans in conjunction with your attitude to risk. This will need to be kept under review from year to year.
- An encashment process to fund income withdrawals that takes account of the return on your long-term investments and takes withdrawals from the less volatile short-term investments if long-term investment values are in a downturn.
- A profit taking process that will restock your short-term investments as needed from profits from the long-term returns.

If this is done well, the results can be impressive.

Chart 4: Two-Account Drawdown

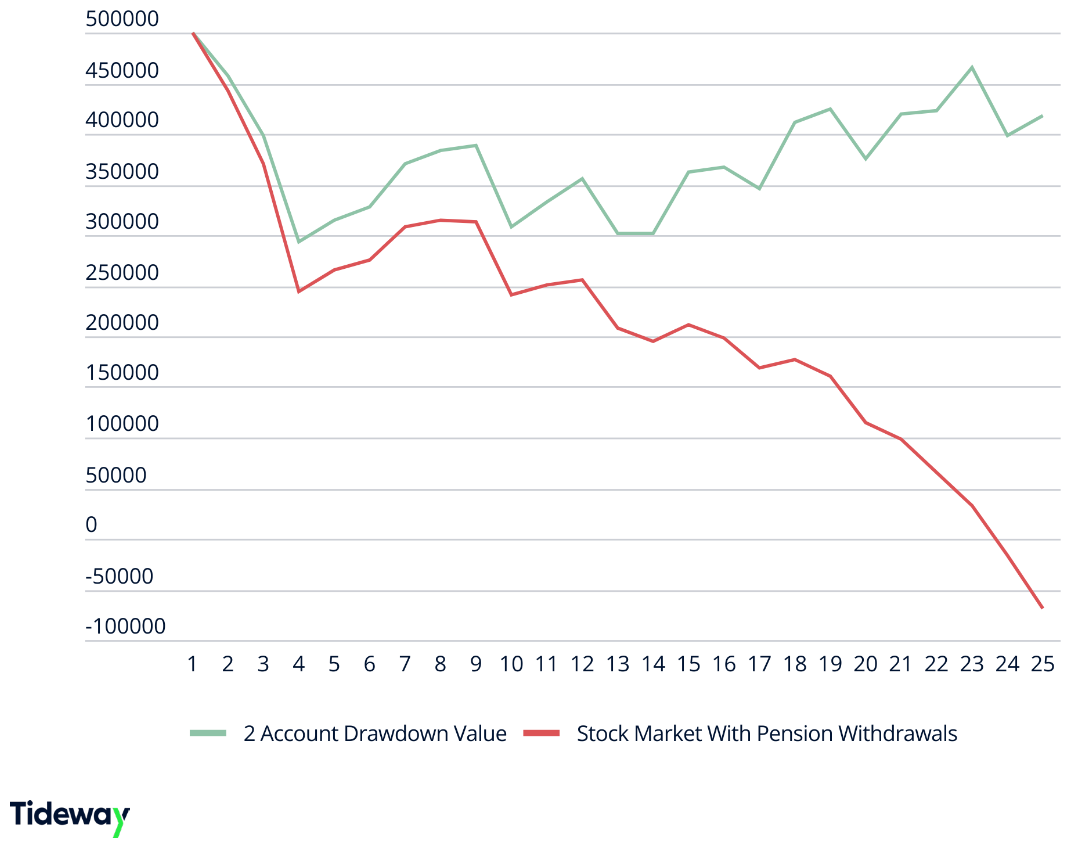
The chart below shows the same £500,000 starting value and income withdrawals as above and compares a single drawdown account invested in the hypothetical stock market with a two account drawdown plan.

The two-account drawdown plan is made up of:

- Account No 1 - has a balance of approximately 5 years' income needs, or 25% of the overall plan value and is invested in short-term, less volatile investments seeking a smoothed lower return: in this case 5% per year return.

- Account No 2 - the balance of the plan is invested in the exact same hypothetical stock market.

By taking income withdrawals from profits in the long-term No. 2 account and from the short-term No. 1 account when the stock market takes a down-turn, a significant return improvement can be made.



There is a £487,000 improvement in the overall balance of the two account drawdown plan after 25 years. The two-account process does not completely insulate drawdown investors from the stock market volatility, and does not get to the same return as the lump sum invest or regular saver, but it does significantly increase the plan return and gives a much better outcome for the drawdown investor.

In this example the two-account drawdown investor makes an average return over the 25 years of 6.3% a year, it is 2.4% a year better than investing 100% in the stock market, which makes a massive difference to the end result.

It's important to note this improvement is achieved not by making better investment returns or reducing fees but simply by managing the return sequencing risk by actually investing less in the stock market and more in lower risk less volatile investments earning lower returns.

To compare this end result with an annuity purchase. If you were to buy the same £25,000 of escalating income it would cost a 60 year old around £550,000 at current rates. This of course would require giving up access to all your pension capital and would mean your pension plan having no value at age 85 versus the c£420,000 shown in chart 4 after 25 years.

Conclusions For Drawdown Investors

Drawdown investors need to:

- Be fully aware of the impact of market volatility and return sequencing risks before planning withdrawals
- Understand that a smoothed return investment is more valuable to them than a volatile stock market investment **unless** return sequencing risks are managed
- Make sure they have the proper drawdown plan infrastructure to manage return sequencing risk
- Be wary of investing 100% in the stock market if withdrawals are planned
- Make sure they have an encashment process to fund withdrawals that takes account of stock market volatility

Using Tideway's two account drawdown service will manage all these issues for you.

Check If You Are Exposed to Return Sequencing Risk

Here is a quick check list of questions:

- Have you or your adviser worked out your withdrawal needs for the next 5 years?
- Can you meet your income requirement from your investment yield only? Keeping the capital intact and untouched to fund withdrawals?
- Do you have an amount invested in less volatile short term investments to cover the shortfall between the withdrawals needed and the income generated?

If the answer to any of 3 questions above is NO **- you are very likely exposed to return sequencing risk.**

- Are you invested more than 80% in the stock market or stock market funds with plans to withdraw in the coming 5 years?
- Are you invested in only one investment fund and plan to make withdrawals in the next 5 years?
- Are your withdrawals funded by selling proportionally across multiple funds?

If the answer to any of these 3 questions is YES - **you are very likely exposed to return sequencing risk.**

If you don't know the answer to these 6 questions you may well be exposed to return sequencing risk.

About Tideway

Tideway's senior management team's investment and advice experience goes back to the 1980's. We are an independently owned business without ties to any financial institution and we advise on around £450m of private client money for 650 customers with portfolios ranging from £200,000 to £40m.

Whilst we advise an increasing number of young adults from the families we look after, our core clients trust us with their hard earned and largely irreplaceable capital with a view to giving them the income they need first and foremost and then to pass wealth to the next generation.

We pride ourselves in hard work, an intelligent and global investment approach, thorough research into every investment we make for our clients and forward-thinking proactive advice.

For more information about Tideway Wealth visit our website or if you have a particular enquiry reach out to one of our experts. Follow us on LinkedIn.

- The content of this document is for information purposes only and should not be construed as financial advice
- Please be aware that the value of investments, and the income you may receive from them, cannot be guaranteed and may fall as well as rise
- We always recommend that you seek professional regulated financial advice before investing

“Tideway specialises in advising clients planning for retirement or living off their investment income”

We recognise that we are often dealing with irreplaceable capital. With this in mind, here are things we focus on:

- Generating inflation beating returns
- Generating portfolio income
- Investing globally
- Hiring the best investment talent
- Lowering costs
- Being tax efficient
- Avoiding large permanent losses
- Not betting the ranch on one strategy
- Avoiding price bubbles
- Avoiding esoteric or illiquid investments

Tideway’s leadership has over 35 years of investment advisory experience. We believe in hard work, thorough research and strong due diligence.

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