Helping people manage their retirement income

More and more people are now relying on defined contribution pensions to provide their income in retirement. According to the FCA retirement income survey in 2018/19, almost three times as many people choose to draw their income from their pension pot than buy an annuity. This decision then leaves them with the difficult task of managing their pot over the rest of their lifetime.

The same survey also found that 48% of people did so without taking any regulated advice or guidance. This finding may be because people are put off from taking advice by the cost, but it may also be that many people are not entirely comfortable with financial matters and figures in particular.

A recent report by PensionBee entitled “Drawdown Doldrums” (2020) also emphasised the need for simple investment and communication pathways to help savers manage this process.

It is therefore clear that there is a real need for tools that people can use themselves to help them to successfully manage their retirement income. This article looks at one possible approach using the ‘risk bowtie’ framework which provides a logical and visual tool to help them do this.

For the purposes of this article I have assumed that the pensions pot is the main source of income in retirement and that a decision to purchase an annuity has already been excluded. In practice people may have other savings or income which means that they can take more risk with their pot than they would do otherwise, in the knowledge that they can rely on this other money if needed.

Alternatively, they may be in receipt of state benefits and their entitlement, often means tested, can be adversely affected by decisions made at retirement. It is essential that these wider considerations are taken into account but for the purpose of this article, I have assumed that there is no entitlement to state benefits.

The next section describes the risk bowtie framework in more detail.

Using a risk bowtie to help manage your income

When a person first retires, they need to make decisions about the level of risk they are willing to take in the management of their pension pot in order to provide a durable level of income. In this context ‘risk’ is the chance of not having enough money to provide an income for life.

Over time, unexpected events will inevitably occur (such as changes in investment markets or changes in personal circumstances) and so people need a way of revisiting the level of risk that was initially acceptable and adjusting it accordingly.

The risk bowtie is a risk management tool that brings together the various actions that can be used to manage this risk in a logical and visual manner.

In the risk bowtie framework, there are two steps:

- The first step involves deciding on the actions that need to be taken in order to set the level the of risk that a person can accommodate (preventative actions).
- The second step involves revising these actions, as events unfold, to adjust the level of risk being taken (corrective actions).

Diagrammatically this might be summarised as:

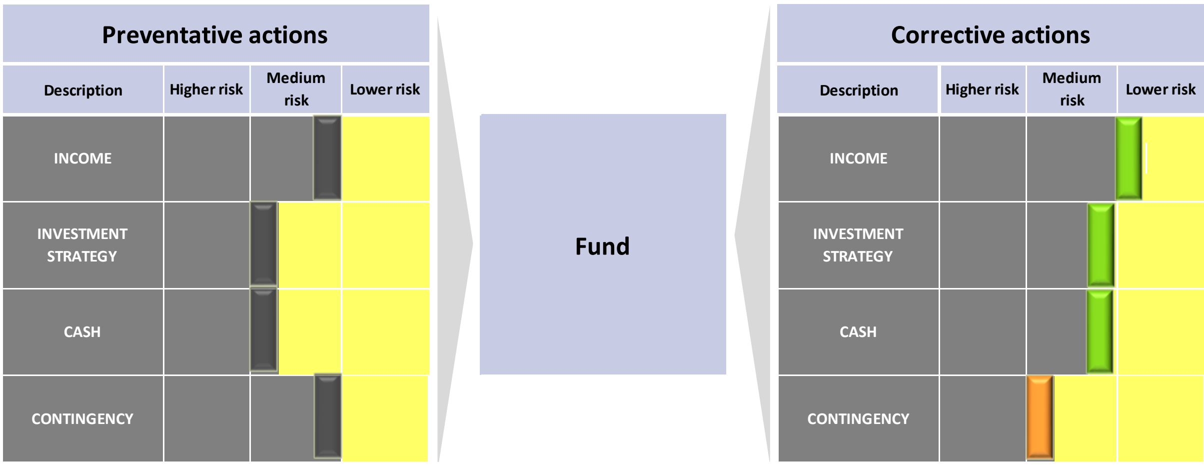
Events –> Preventative actions –> Fund –> Corrective actions –> Income durability.

Actions and presentation

Set out below is an example of how this approach can be used to help manage a person's retirement income. In the example, I have shown the following four key actions, but others could easily be included:

- The level of income being drawn – drawing a lower level of income increases the chance that there will be enough money left for later.
- The investment strategy – investing in low risk assets will potentially reduce the volatility of the investments and reduce the chance of running out of money later.
- The level of cash held – investing in cash will provide protection from falls in investment markets at the point when the money is needed although too much invested in cash will reduce the ability to offset the impact of inflation.
- The level of the contingency fund – holding a contingency fund, which can be invested in a range of low risk assets, can be used to top up income if the main fund falls, without needing to encash other assets at the wrong time.

These four actions are presented on the diagram below, which also shows three broad risk settings – high, medium, and low risk.



The area shaded yellow therefore gives a visual representation of the person's 'risk profile' which in this case are all in the 'medium risk' category. By giving these risk settings, the person is able to see their overall level of risk and where these risks are being taken.

On the right-hand side, increases to the level of risk are coloured amber and reductions, green.

A worked example

In this example the individual had a total pension pot at retirement of £250,000.

They decided to hold cash worth 2 years of income and set aside a contingency fund of 12% of the total pot to cover unexpected events, leaving £220,000 to support their ongoing income.

They chose to invest 40% of their pot in low risk assets leaving 60% in higher risk/growth assets, and to draw a supportable income of £8,800pa (or 4% of their pot, excluding the contingency fund). This information is shown on the left-hand side of the bowtie below:

Preventative actions

Description	Higer risk setting	Medium risk setting	Lower risk setting
INCOME	8%	5%	2%
INVESTMENT STRATEGY	20%	50%	80%
CASH	1 yrs	2.5 yrs	4 yrs
CONTINGENCY	4%	10%	16%

Fund

	Last time		This time	
	Fund	Income	Fund	Income
Income supporting fund	£220,000	£8,800	-	-
Contingency fund	£30,000	£0	-	-
Total Fund	£250,000	£8,800	-	-

At the next review things had improved. The person’s pot had increased to £275,000 and the supportable income to £9,200pa.

One approach to these changed circumstances would be to increase the pension being drawn from £8,800pa to £9,200pa and to leave the other actions unchanged.

However, another option would be to keep the pension being drawn at £8,800pa, and to use the improvement in the level of the pot to reduce the overall level of risk.

In this case the person decided to ‘bank’ these investment gains and use them to reduce the level of investment risk and increase the level of cash held. They were then able to reduce the level of their contingency fund to reflect the lower level of risk being run.

Fund

	Last time		This time	
	Fund	Income	Fund	Income
Income supporting fund	£220,000	£8,800	£253,000	£8,800
Contingency fund	£30,000	£0	£22,000	£0
Total Fund	£250,000	£8,800	£275,000	£8,800

Corrective actions

Description	Higer risk setting	Medium risk setting	Lower risk setting
INCOME	8%	5%	2%
INVESTMENT STRATEGY	20%	50%	80%
CASH	1 yrs	2.5 yr	4 yrs
CONTINGENCY	4%	10%	16%

If their pot had fallen since the review, they could have decided whether to reduce their income, leave everything unchanged, or perhaps draw on their contingency fund until the next review.

The completed bowtie diagram, which is set out below, neatly summarises on one diagram all of the information above, and how the person's risk profile changed in response to the changing circumstances.

Preventative actions

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Conclusion

With more and more people having to rely on defined contribution pensions in their retirement, there is an increasing need for new ways to help them make sensible choices about managing their retirement income.

I hope the idea presented here, could provide a way of helping people to visualise the risks associated with income drawdown, and so help them to successfully manage their future income.

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