Decumulation Demystified

Is it time to retire the 4% rule?

The 4% drawdown rule forms the basis of many advisers' decumulation propositions. However, the results can often vary significantly depending on when you decide to start saving for your retirement and asset allocation decisions.

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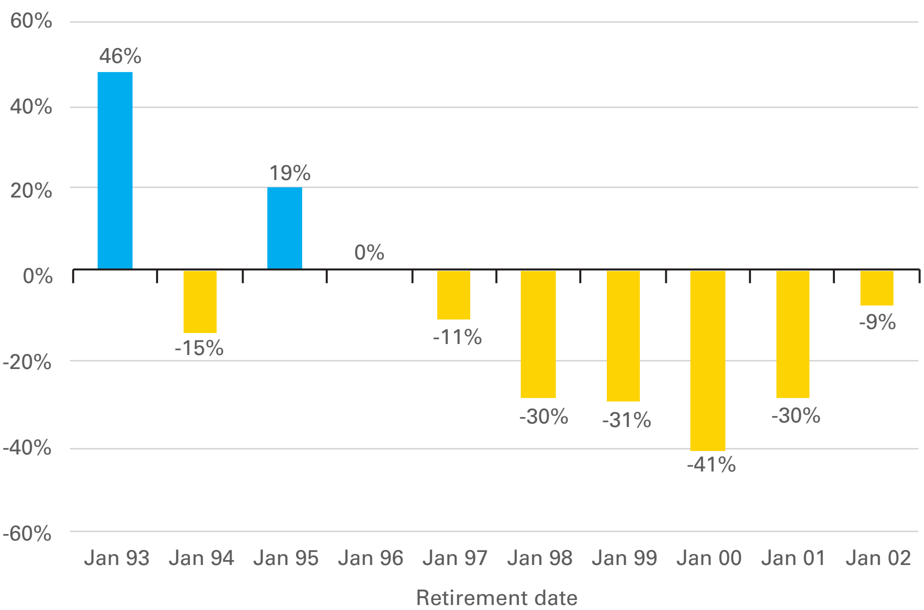
How much can a retired investor draw in income and yet not outlive their savings? This is the crucial question that aeronautical engineer turned financial adviser William 'Bill' Bengen set out to solve in the early 1990s. Known as the 4% rule, Bengen argued that investors could safely set their annual withdrawal rate to 4% of their initial retirement pot and adjust it for inflation without running out of money over a 30-year time horizon[1].

The 4% rule, often referred to as the Bengen rule, is now commonly used by retiring investors and their financial planners. Where there was once complexity - and expensive portfolio analysis - the rule promises simplicity. Set, forget, and spend (if required). But is it as easy as all that?

Figure 1: Change in real value of wealth over 15 years assuming 4% drawdown (UK 'naïve portfolio')



Source: LGIM

TIMING IS EVERYTHING

While it has not yet been 30 years since publication, we can run some 'half-time' analysis. Using Bengen's original parameters, we assumed a static split between domestic equities and bonds. Figure 1 shows the change in the value of a portfolio over discrete 15-year periods for a UK investor if they were drawing down their portfolio by 4% per year.

1 Determining withdrawal rates using historical data, William Bengen

This assumes they are invested in a 'naïve' portfolio that is 50% invested in UK equities and 50% in gilts.

For the lucky retiree who began drawing down in 1993, their capital has gained 46% in real value by 2008. Begin saving a few years later in 1996 or 1997 and the capital has remained static or depreciated only a little. This level of remaining capital should be enough to support another 15 years of income.

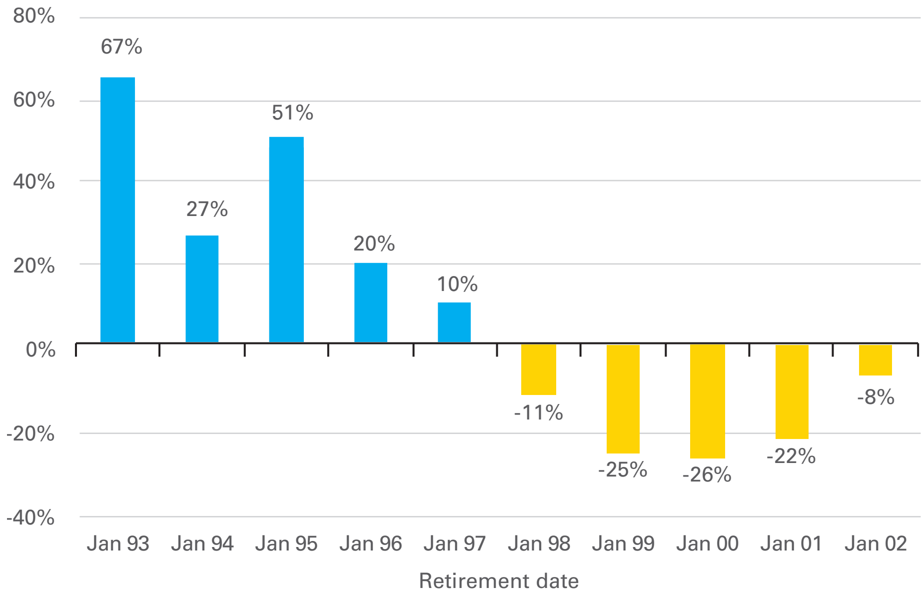
Retirees who start between 1998 and 2001 are instead much less fortunate. In the first half of their 30-year retirement journey, their portfolios have suffered a 30-41% capital loss. The dot-com bubble and the global financial crisis have damaged the fragile starting capital. Where a 4% drawdown seemed like penny-pinching for the 1993 intake, it now looks like an extravagance which the investor can ill afford.

However, Bengen did his research on the basis of a 'naïve' portfolio for the average US investor and the results are broadly comparable. Retiring around the beginning of a bull market, such as 1993, means that retirees could have enjoyed a much higher withdrawal rate.

DYNAMIC, NOT DOGMATIC

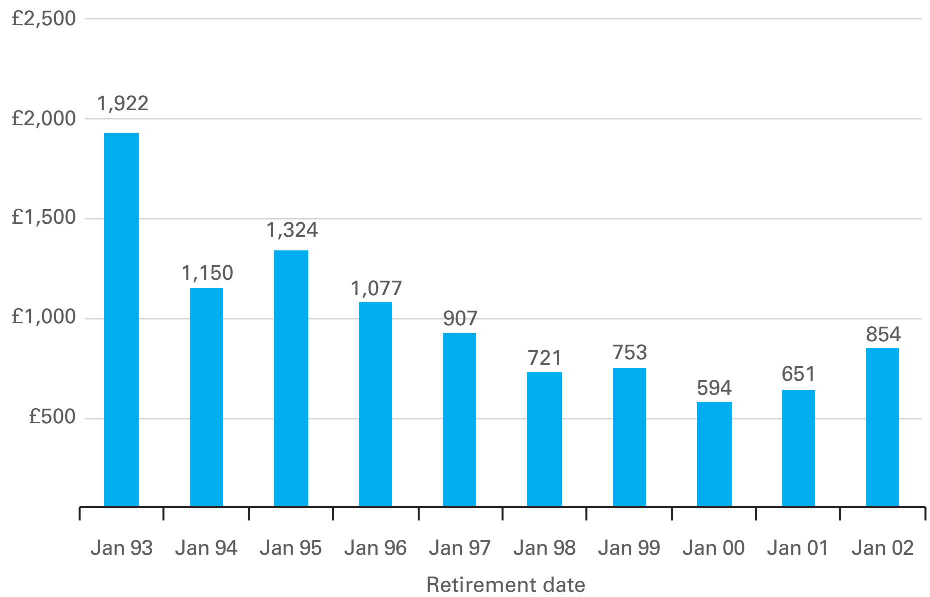
So how serious is this for an investor? A 15-year real value decline of 41% is one thing on a portfolio statement, the effect it has on the potential level of income is quite another.

Figure 2. Change in real value of wealth over 15 years (US 'naïve portfolio')



Source: LGIM

Figure 3: Estimated monthly post-annuitisation payout after 15 years



Source: LGIM, LGR

Imagine a 65 year-old retiree decides she wants to purchase an annuity at age 80, following a 15-year period of 4% drawdown. If she started retirement in 1993, from 2008 onwards she could enjoy monthly payments of around £1900 for the rest of her life. However, if she were to invest from 2000-2015, an annuity would only provide as little as £600 per month[2]. Investors need a more dynamic strategy when it comes to withdrawals at retirement

Bill Bengen has himself returned to the subject, along with others, to perfect and adapt the rule in response to critiques along similar lines as ours on page 2[3]. A key finding is the need for investors to embrace a more dynamic approach to two elements of their retirement journey: the importance of diversification and adjusting the level of income depending on the client requirements. A key finding is the need for investors to embrace a more dynamic approach to the level of distributed income, adjusting it to client requirements, and to diversify the retirement portfolio more broadly.

Bengen's starting point – an equal portfolio split between equities and bonds – is and does not necessarily reflect the standard appetite for risk among retirees. At a specified risk level, spreading investments over different asset classes gives investors a better chance of preserving capital. In addition, understanding the risk appetite for the investor is the most important step for any adviser in both the accumulation and decumulation phases of investment. Suitability remains fundamental to the adviser process. Finding a fund range that can meet a wide range of risk appetites is therefore extremely important. Finally, investors can in certain circumstances now pass on their pension pots to their children without incurring inheritance tax therefore portfolios that are income focused, but not income obsessed, may be more appropriate. Unlike yield-targeting funds, growing clients' capital as part of a total return aim alongside generating a sensible yield can be better aligned to their needs.

There is one final omission from Bengen's original paper – fees. Whilst we cannot guarantee the direction of markets, what we can guarantee is that fees will detract from returns year after year, so it is important for any adviser to meet the objectives of investors in a cost-effective manner.

A FLEXIBLE STRATEGY IS A PRUDENT ONE

Income can play such an important role in an investor's retirement and treating any strategy as dogma would be a mistake. Each investor's situation differs along with their appetite for risk, their retirement spending goals or portfolio capital. Following a 4% withdrawal strategy blindly may lead to particularly volatile results. Indeed Bengen's research did not suggest withdrawing this amount every year – just that it was safe to do so without running out of money.

Often other factors need to be considered in a dynamic withdrawal strategy such as your age, the current level of interest rates and the current size of your pot relative to the future spending requirements.

Protecting against the erosion of capital and the knock-on effect it might have on the future stream of income distributions, should be an integral part of any retirement strategy. Investors should make use of specific tools to navigate their decumulation journey and manage downside risk through strategies including broad diversification. Finally a dynamic withdrawal strategy, more closely linked to the amount of spending necessary per year rather than a fixed portfolio percentage, may significantly improve the investment outcomes. Investors and their financial advisers should constantly evaluate their portfolios to ensure the effectiveness of their chosen strategy.

2 Calculations based on £100,000 investment in a 50% UK equities, 50% UK gilts portfolio and contemporary annuity rates
3 Asset allocation for a lifetime, William Bengen

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