Atkins Bland

Investments • Pensions • Financial Planning

Guide to:

Sustainable Income & Capital Drawdown in Retirement

The reason we have this guide

Ensuring you have adequate income in retirement is one of the most critical aspects of financial planning. Some of that income will come from the state pensions and some might come from other pensions or, for instance, rental profit from real estate.

However, for many of us, some will come from invested capital.

The purpose of this guide is purely to look at that element, and particularly for those who want, or need, to spend some of the capital they have each year, rather than just the income it generates.

The problem this guide seeks to address

As with so many areas of managing money and assets, it is impossible to know in advance exactly how much income will be needed in the future, or exactly how much capital, and in what format, will be required to generate this.

However, those who need to take withdrawals from capital to support their lifestyle do need some guidance on what how much they can do this without risking their future financial security.

As long as essential spending needs are as secure as is practical, it is up to each individual to decide how much risk they are prepared to take of either:

- being forced to reduce their spending later or
- finding they have saved too much and not used their hard-earned savings as well as they could have.

Most of us, by the time we reach retirement, will have first-hand experience of people in both these categories. We will know people who have denied themselves and lived well below their means for no ultimate benefit and others who have overspent in early retirement and paid the price later.

Since no one can accurately predict the future, there is an element of chance with any strategy and almost anyone could fall into one of the above classifications, depending on how fate treats them.

As well as that unknowable issue, there are several other unknown variables which could impact hugely on the question of how much income can be generated from invested capital and how long the capital will last if more than that available income is spent each year.

This paper is, therefore, written against a background of unavoidable uncertainty. It cannot give specific answers but is intended to provide some useful guidance on the issues to consider and what we feel are sensible assumptions to work with.

We have a separate guide which looks at the subject of generating income from capital, available on request, and we recommend that you read this too. The difference between that guide and this guide is that this one is not just looking at the income which capital can generate, but taking this a step further and looking at our recommended method of assessing the overall amount of spending money capital might be able to provide each year in retirement and the pivot points we think should be applied when assessing the risk of the capital being fully eroded away.

We are, therefore, looking here at the position of someone who is happy to spend capital as well as the income it produces, but wants to do their best to ensure they do not do so too quickly and find themselves with inadequate resources later in life.

The core factors to consider

Addressing the factors that need considering for generating sustainable income in retirement

If we want to try to assess the risk of capital being exhausted in our lifetime there are a number of issues we need to look at. The mains ones are:

- The assumed underlying net income available from capital over the medium to long term and the ability for this to rise to combat inflation
- The potential for capital values to increase to combat or exceed inflation, after deducting income yields
- How long someone can be expected to live
- The investment risk someone wishes to expose their capital to and has the capacity to accept
- Lifestyle and preferences on spending patterns

This guide explores each of these factors individually

The assumed underlying income available from capital over the medium to long term and the ability for this to rise to combat inflation

This is assessed in our Guide to Investing for Income and figures are provided in our document titled "Estimated Investment Income Yields"

While conditions inevitably change, we are looking here at longer term income generation throughout retirement, rather than fluctuating income yields driven by shorter term conditions.

We are also looking at income from capital available now. Predicting how much income may be available from capital not yet available to invest, so at the mercy of future asset values compared with income yields, adds a very substantial level of additional uncertainty. This is explored in our ***Guide to the Risks of Future Yield Compression***

The following table sets out what we feel are reasonable assumptions for long term income yields net of basic rate taxes and net of typical investment costs deducted from income yields, from the core investment risk strategies available:

Table 1: Assumed income yield for general planning and potential for this to combat inflation

These are NET of basic rate tax and typical investment costs

Portfolio risk strategy	Fully diversified portfolio	Potential to fully combat inflation	Less diversified portfolio using the highest income options*	Likelihood of the income keeping up with inflation
Very low	1.00%	None	No change	None
Low	2.00%	Remote	No change	Remote
Below average	3.00%	Fair	4.00%	Possible but unlikely
Average	3.00%	Good	4.00%	Fair
Above average	3.00%	Good	4.00%	Good
High	3.00%	Good	4.00%	Good

***This increases the risk due to reduced diversification, might restrict potential capital growth and can also inhibit the ability for income to rise to combat inflation.**

The core factors to consider

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Important notes relating to the previous table

- The figures assume average long-term inflation is in line with the Bank of England (BoE) target of 2% p.a. There will inevitably be periods when inflation is higher, or lower, than the BoE target, but it is longer term averages we are looking at here. When inflation is high, the risk of income yields failing to combat it is naturally increased, but this could be compensated for during periods when inflation is very low.
- The estimates take into account the fact that, as you move up the risk ladder, more capital can be allocated to areas where the income is expected to rise to combat inflation, or potentially at a faster rate than inflation, thus reducing or eliminating the need to use part of the income itself to combat the impact of inflation.
- We do not expect starting income to increase much by moving up the risk ladder, other than from low to below average. This is because the difference in potential return from doing this tends to be in the form of possible capital growth and future income growth, rather than immediate income generation.
- As you move up the risk ladder, you improve the ability for the capital and income to rise to combat inflation over the medium to long term and increase the risks to capital values over the shorter term.
- If you withdraw more income than is being generated and rely on selling investments to make up the difference, you add to the risk since capital values are much more volatile than income generation, and as investments are sold, the income generation is eroded, thus tending to increase the gap to be filled by capital withdrawals in the future.

The potential for capital values to increase to combat or exceed inflation, after deducting income yields

This is possibly the least predictable and reliable of the variable factors, but it is important to take in into consideration to some extent.

As stated earlier, the ability for capital values to rise at or above the rate inflation increases as you move up the risk ladder, along with the risk of capital values falling in the shorter term.

However, any attempt to quantify the possible difference in outcomes between different investment risk strategies is little more than speculation and is not really necessary anyway.

Instead of attempting to do so, we advocate assuming that capital values will combat inflation over the medium to long term in all the risks classifications we use, other than low risk where the prospect of that is minimal, and that the impact of moving up or down the risk ladder does not change the assumption but does change the possibility of actual results underachieving or overachieving the assumption.

The table below sets out our thinking in this respect for the core investment risk classification we work with for an income generating portfolio.

As always, there is the caveat that values may fall instead of rise and these assumptions might prove wildly inaccurate, we feel working with the following is a rational starting point, although they clearly need to be kept under review and absolutely cannot be relied upon.

The core factors to consider

Addressing the factors that need considering for generating sustainable income in retirement

Table 2: Our views on the prospects of capital values combating inflation over the medium to long term from different risk strategies and after natural income has been paid out. Assumes the BoE target for inflation at 2% is achieved on average.

Risk strategy	Likelihood of capital values combating medium to long term inflation	Notes
Low	Remote	Some elements of the portfolio might, but risk control eliminated the option of just using those
Below average	Fair	The portfolio will hold assets where the prospect of capital values to combat inflation is remote, but others where it is good and some where there is a potential for gains to exceed inflation
Average	Good	The majority of assets will have the potential for capital growth to combat inflation, with enough prospect for exceeding this to compensate for those that do not
Above average	Very good	But the expected volatility of values in the shorter term adds significant risk for someone taking more than natural income, so regularly selling shares to cover the shortfall
High	Very good	As above but the very high potential volatility in values means a high risk strategy is not usually suited to someone investing for income above natural yields

Important notes:

- The potential for capital values to increase to combat or exceed inflation is reduced when using a portfolio focussed only on the highest yielding sectors, so with less diversification.
- Inflation rates can vary significantly from one period to another. When inflation is high, the risk of value of a portfolio failing to combat it is naturally increased, but this could be compensated for during periods when inflation is very low.

The core factors to consider

Addressing the factors that need considering for generating

How long someone can be expected to live

Where we are looking at resources which are earmarked for spending rather than leaving as an inheritance for someone, there are two risks-

- Spending it too quickly and seeing it run out while we are still alive and in need of it
- Spending it too slowly and denying ourselves things we could have enjoyed.

To try to address these risks, we need to make a reasonable assumption of how long we will live.

Using national statistics is generally the best starting point for this, but we then need to consider less generalist factors, such as our own health and lifestyle.

However, nobody wants to spend too much time pondering the likely date of their own demise, so it seems sensible to accept this is a complete unknown and work on a reasonable assumption - such as we are unlikely to last much past 105 and, if we do, probably won't want to spend as much on leisure activities in our final years as we do earlier in our retirement.

We therefore work on the basis that if the rate of attrition of capital caused by spending more than natural income should not cause capital to be exhausted before age 105, using the assumptions set out in this guide, then prevailing withdrawals levels should be sustainable for lifetime.

However, we keep this under regular review as we appreciate the assumption we use might not be closely reflected in future reality.

The investment risk someone wishes to expose their capital to and has the capacity to accept

When considering possible capital gains from invested capital, risk exposure is obviously a factor. In essence, the higher you go up the risk ladder, the higher your potential long-term capital gain and the larger your potential shorter term capital losses.

Someone taking more risk may, therefore, be able to withdraw from their capital without it eroding as quickly as it would if they took the same amount but were investing more cautiously. However, if conditions are not good, this can reverse, so increasing risk to facilitate more spending is not a strategy we recommend.

Anyone taking more from capital than is estimated to be supportable for life based on the assumptions we set out in this guide and apply to our advice processes in the hope that their risk strategy will facilitate capital growth ahead of inflation should only do so if they have the discretion to reduce the level of withdrawal in adverse market conditions and are able to accept the consequences of larger falls in the value of their capital during a market crisis as well as the long term consequences of eroding their capital base to the point that it is exhausted and no longer able to contribute to their cost of living.

The position will vary from one person to another but, clearly, taking risks which could cause available resources to be inadequate to cover essential (non-discretionary) spending is very unwise and should be avoided unless it is impossible to do so.

The core factors to consider

Addressing the factors that need considering for generating

Lifestyle and preferences on spending patterns

Many people take the view that they would like to have more to spend in their early retirement than in older age, when infirmity may lead to a more sedentary lifestyle.

This is based on the premise that health and mobility impact on the viability of some activities, and especially holidays.

However, there is the counter-argument that health issues later in retirement may well mean that more income is needed, rather than less, especially if long term care is required.

As mentioned previously, this paper addresses a subject full of uncertainty. This cannot be avoided. It is, therefore, a matter for each individual to decide if they would rather spend more than is sustainable in the early years of their retirement and accept that this might compromise them later or spend less and save for possible increased spending needs in old age, but at the risk of finding they have wasted opportunities for no reason.

The proviso with this is, of course, that spending more in the early years of retirement to the extent that essential spending needs may not be affordable later should be avoided as it is only discretionary rather than essential spending needs which should be risked.

Our approach to assessing sustainable withdrawals from capital resources

The process we use

In the complex and unpredictable world of investment planning, we believe a rational strategy is to avoid adding to that complexity by working with multiple assumptions for factors which can't in reality be predicted at all.

Instead of that, we advocate a simple structure for future assumptions accompanied by regular reviews to test the impact of reality on those assumptions as that reality is revealed by the passage of time.

Reflecting this, our approach is below, with "inflation" referring to changes in the cost of living as measured by the Consumer Prices Index (CPI):

- Assume income yields currently being generated, after all costs, are retained and manage to combat inflation
- Assume future withdrawals from a portfolio do not rise above those needed to combat inflation
- Assume capital values of an income generating portfolio using a below average risk strategy or any strategy further up the risk ladder than that rise to combat inflation over the medium to long term.

This approach, applied in a nice simple and easy to follow way, enables us to assume current withdrawal rates stay the same and any part not covered by the natural income generated, so taken from capital, is withdrawn from a portfolio, with no need for us to add in the extra complication of predicting what inflation rates might be.

In turn, this means we can use a simple spreadsheet to assess when capital will run out, in any situation where withdrawals are above naturally available income, so being funded partly by capital.

We can then test that against our age threshold for need for the income referred to earlier, of age 105.

If our model predicts that capital will not run out prior to age 105 we classify the prevailing level of withdrawal as sustainable for life, albeit with the obvious caveat that we cannot actually know this in advance as it will depend on realistic our assumptions are compared with future reality.

If our model predicts that capital will run out before age 105, we classify the prevailing level of withdrawal as potentially unsustainable. The level of risk that it will not prove sustainable obviously pivots on the age the capital is predicted to run out. If it is over 100, the risk is very low, if it is under 85, the risk is quite high.

So what rate of withdrawal do we feel is sustainable?

This does, of course depend on the rate of natural yield a portfolio is generating and your age at the time the test is carried out.

We can provide specific figures to our clients based on their age at the time and their portfolio strategy on request.

However, the following tables set out examples which might be helpful.

Table 3: Our estimated maximum viable rate of income and capital withdrawal based on living until age 105 and assuming withdrawals increase in line with inflation.

Age	Portfolio income yield after all costs at the time of the assessment		
	3.00%	3.50%	4.00%
	Maximum percentage withdrawal per year, rounded		
	%	%	%
55	3.80%	4.20%	4.60%
60	4.00%	4.40%	4.70%
65	4.20%	4.60%	5.00%
70	4.50%	4.90%	5.20%
75	4.90%	5.30%	5.60%
80	5.50%	5.90%	6.20%
85	6.40%	6.80%	7.10%
90	7.90%	8.20%	8.50%

Table 4: Our estimated sensible maximum level of withdrawal from capital if someone wishes to enjoy a high level of confidence that they can retain this level, after adjustment for inflation, until age 95. *Please note this clearly increases the risk of outliving capital*

Age	Portfolio income yield after all costs at the time of the assessment		
	3.00%	3.50%	4.00%
	Maximum percentage withdrawal per year, rounded		
	£100,000 pension fund		
55	4.20%	4.60%	5.00%
60	4.50%	4.90%	5.20%
65	4.90%	5.30%	5.60%
70	5.50%	5.80%	6.20%
75	6.40%	6.80%	7.10%
80	7.90%	8.20%	8.50%
85	10.80%	11.10%	11.40%

Please note that we have included 4% as this can be relevant for those choosing a very high-income strategy with the increased risk caused by reduced diversification. However, that strategy also negatively impacts the ability of a portfolio income and capital value to combat inflation. This means the columns using 4% carries a

Keeping the outcome under review

Whatever the outcome of our assessment on the sustainability of a prevailing level of withdrawal from an invested portfolio, it is only testing at a moment in time.

It is, therefore, wise to repeat the exercise at portfolio reviews to see if any of the parameters have shifted to the extent that the outcome has changed.

Akins Bland therefore does this, and includes a summary of the check we have carried out in our scheduled portfolio reviews.

Addressing concerns

Where the process described above indicates a risk of the capital being exhausted during someone's lifetime, we will review the impact of this and advise if we feel any action should be taken.

In some cases none will be needed, three of which are:

- Because there is a further source of income due to start at a known date, such as the state pension, so we know the withdrawals will fall to a sustainable level from then anyway
- Because the excess withdrawals are to cover spending for a temporary period and they will be reduced to a sustainable level later in retirement.
- There is other capital available or coming available which will adjust the mathematics and remove the risk of resources running out.

These are just examples, and there could be other reasons why taking withdrawals from capital at a rate that risks resources being exhausted does not give undue cause for concern, but if there is cause for concern, Atkins Bland will explain this and try to suggest changes that remove or at least mitigate the risks being taken.

We do, of course, recognise that all we can do is advise, and that no one is under any obligation to accept and act on our advice, but we will always do our best to ensure a client taking risks with their own future financial security or that of a dependent is aware of the danger and any options available to address it.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates

Past investment performance is not a reliable guide to the future

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted

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Atkins Bland

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The value of investments will fall as well as rise, as can any income generated. An investor may, therefore, get back less than invested.

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