PENSIONS POLICY INSTITUTE

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Myths and rules of thumb in retirement income

Executive summary

'Myths and rules of thumb in retirement income' is the second stage of a research project sponsored by State Street Global Advisors. It builds on the findings from the first qualitative research stage that explored how individuals approaching retirement might use their Defined Contribution (DC) pension pots.

This report is part of the PPI's Transitions to Retirement research, a series of major reports exploring how people access pension savings in light of the new pension freedoms. The research series is sponsored by Age UK, The Investment Association, Partnership, The Pensions Advisory Service (TPAS), The Pensions Regulator (TPR), The People's Pension and Fidelity.

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A report by Melissa Echalier and Sarah Luheshi
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Executive summary

This PPI report, ***'Myths and rules of thumb in retirement income'***, is the second stage in a research project sponsored by State Street Global Advisors. It builds on the findings from the first stage, which consisted of qualitative research with individuals approaching retirement exploring their preferences for how they might want to draw their retirement income.

These individuals were selected because they had relatively low levels of Defined Benefits (DB) pensions, and sufficiently large Defined Contribution (DC) pension pots that they might prefer to leave these invested (rather than withdrawing them in their entirety as a cash lump sum). As a result, this group was most likely to be reliant upon DC savings for their retirement income and would be adversely affected if they did not manage them effectively. This earlier research found that while these individuals have made preparations for retirement, they have not thought through their financial position or spending needs in any detail. As a result, they are unlikely to be well placed to make decisions about investments either in the run up to, or during, retirement.

This stage of this research considers how rules of thumb might help retirees to think about and manage their DC pension savings. A round table, hosted by State Street Global Advisors and conducted by the PPI, was attended by representatives from Age UK, Citizens Advice, the Money Advice Service, NEST, The Pensions Advisory Service, The People's Pension, TUC and Which?. This discussed what 'rules of thumb' are, how they differ from received wisdom and how they might support DC savers when setting their strategies for retirement. This report reflects these discussions, along with additional analysis and modelling drawing the following conclusions:

Rules of thumb could help individuals manage their DC pension pots

In the absence of defaults or financial advice there is the risk that, by following what others say or what they perceive to be accepted wisdom, individuals will not always act in their best interests (although they may think they are). In such situations, rules of thumb could be used as a guide (or as a target).

Rules of thumb are not necessarily a way to achieve the optimum outcome for a particular individual. They are not intended to replace financial advice or guidance. What they are, however, is a course of action that is broadly appropriate for most people in a particular group. The central question around the use of rules of thumb is whether, for the group who use them, outcomes are better than if the rule of thumb were not used.

Round table attendees considered the '***five portions of fruit and vegetables a day***' recommendation to be an effective demonstration of a rule of thumb. It is considered easy to understand, is in the general best interests of a person and, even where individuals do not manage to eat five portions, they may take the positive action of increasing their consumption of fruit and vegetables.

There needs to be a clear distinction between a rule of thumb, which offers an appropriate course of action for many people and a received wisdom, which generally does not.

Received wisdom may be true, but not in every case

The two received wisdoms considered in the report ('purchase a buy-to-let property' or 'withdrawing my pension pot to find somewhere better / safer to invest') may be the best course of action for some. However, there are many instances when it will not be the right course.

Whilst the idea of purchasing a buy-to-let property is easy to understand, individuals do not necessarily do better by using their DC savings in this way – factors such as voids and on-going costs lower the yield on property. Other issues for consideration are the risk of investing in ***one single*** asset within ***one single*** asset class, and potential problems where individuals need to access their capital quickly.

Similarly, while some individuals' circumstances may mean that they benefit from withdrawing their entire DC savings at retirement, many do not do better by 'putting them somewhere safer'. Risks include giving up the benefits of some institutional funds (better governance, lower fees) in order to place their savings in potentially costlier retail investments and relying upon themselves to select the correct investment vehicle. They also risk paying a higher amount of tax when they withdraw their entire pension pot in one tax year rather than over a number of tax years.

Rules of thumb need to be carefully phrased and the language needs to make them easy to understand

The round table participants shared the belief that if financial rules of thumb are to be as successful as '***five a day***' these need to be conveyed using language that is both accurate and easy to understand, and financial education and literacy are essential.

Previous PPI research[1] identified a group of 694,000 individuals with low levels of financial education at high risk of using their DC savings in a way that is misaligned with their circumstances.[2] This supports the need for clear language that individuals with low levels of financial education or literacy understand.

[1] PPI (2014)

[2] These were individuals projected to have between £19,400 and £51,300 of DC savings and no DB entitlement at State Pension Age – financial literacy is not generally that high amongst this group of individuals who are likely to depend to a large extent on their DC savings in retirement.

Certain rules of thumb could be helpful to UK individuals under the new pension flexibilities

The two rules of thumb considered in the report (‘4% rule’ and ‘secure a basic income’) are considered to be generally in the best interests of an individual.

The ‘4% rule’ is where an individual could withdraw this amount of their DC pension pot in the first year and, in subsequent years, the same amount indexed by inflation. The rationale behind this rule is that using it should make the fund last their lifetime. This specific rule of thumb could be helpful in the UK, as it addresses a general lack of understanding around life expectancy and awareness of the probability of living until age 90 or 100. Its strength also lies in the fact that it can be used as a guide or as a target. Even if it is not followed to the letter, it provides a reasonable basis for most people in terms of managing their expectations of income from their pension pot.

The ‘secure a basic income to meet essential needs’ rule could also be helpful in the UK as it addresses the risk that UK individuals will be at risk of drawing down their pensions too quickly. In terms of language, it is relatively easy to understand and it can be used as a guide or a target.