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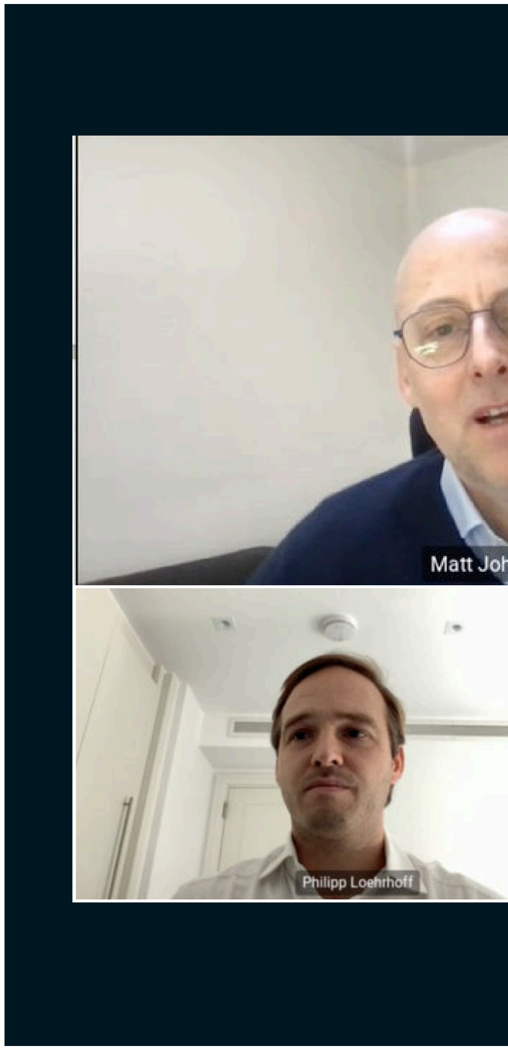
The Decumulation Dilemma

Innovation, investment solutions & member engagement is needed to address the thorny challenges

[Watch the round table recording]



Defined Contribution is increasingly becoming the leading pension source for members. As members age, a lot more attention must turn to decumulation.

In our Panel, we discussed this critical, yet complex phase of the retirement journey and considered what the industry is doing to provide a roadmap for tackling the challenges with a mix of innovative strategies and member-centric solutions.

The Decumulation Landscape: Members' Complex and Diverse Needs

Opening the discussion, Mark Jaffray, Partner and Investment Consultant at Hymans Robertson set the stage by highlighting the sheer diversity of members'

Click the image to watch the webinar
Top row: Matt Johnston, Esther Hawley
Bottom row: Philipp Loehrhoff, Mark Jaffray, Hugh Cutler

In Brief

1.
Decumulation is challenging: The transition from saving to drawing income is complex, but diversified, income-producing strategies can offer stability and flexibility for members.

2.
Protected equity combines growth with protection: This strategy keeps investment risk on the table in a measured way, limiting losses during downturns while capturing the lion's share of market upswings.

3.
Knowledge is power: Tools and education are critical for empowering members to make informed decisions about balancing essential expenses with discretionary spending.

circumstances. Some are lucky enough to have DB benefits and other savings, others may be more reliant on DC pots and the State Pension. Some are financially educated, other's not.

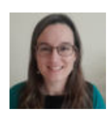
Drawing on data from the Financial Conduct Authority, it was stark that many members have small DC pots, and these are often withdrawn as cash. "Decumulation requires a range of solutions tailored to address members' varying circumstances and aspirations" Jaffray explained. Given this heterogeneity, it's evident, a "one size fits all" approach will not cut the mustard in decumulation.

He pointed to longevity pooling mechanisms, such as Collective Defined Contribution (CDC) schemes, as an example of how innovative approaches could significantly boost retirement incomes.

The Panel

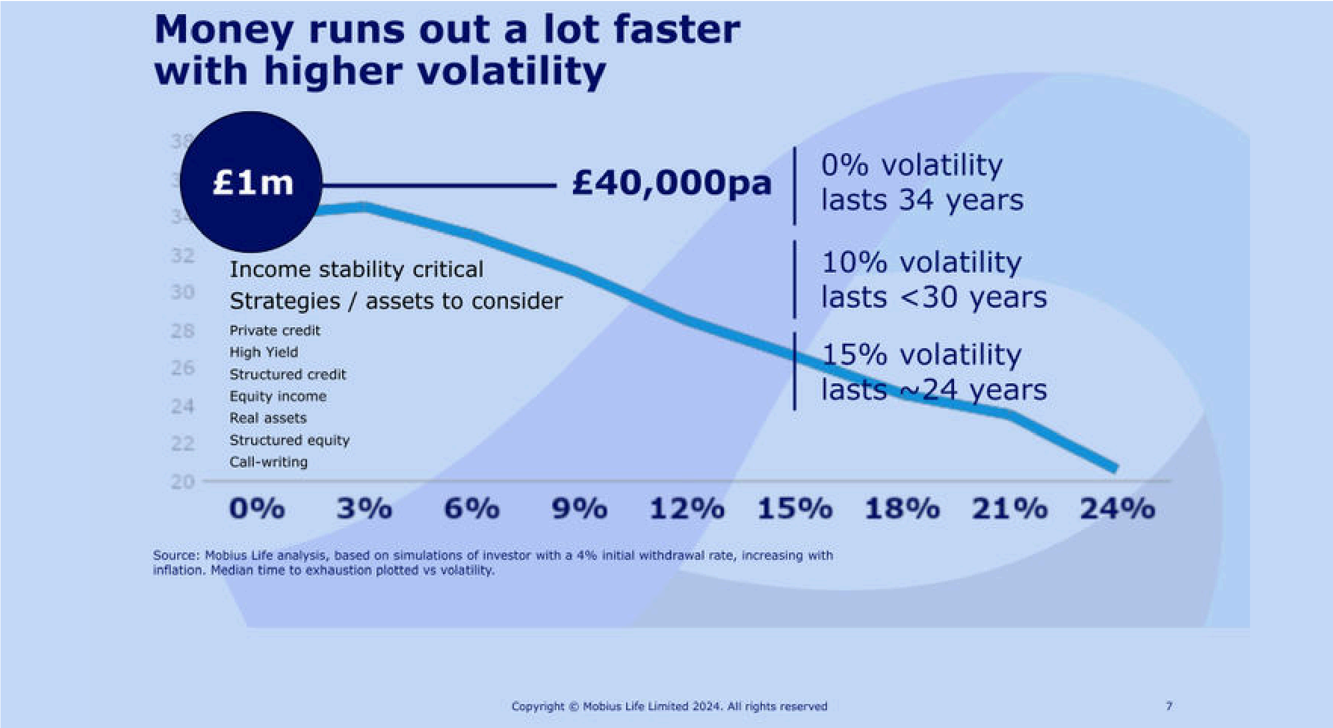
Philipp Loehrhoff
Head of Multi-Asset Solutions, Berenberg

Mark Jaffray
Partner,
Hymans Robertson



Esther Hawley
Head of Retirement Proposition,
Standard Life

Hugh Cutler
Chief Commercial Officer,
Mobius Life



Money can run out a lot faster in volatilie market conditions

CDCs, he noted, combine the benefits of higher growth asset allocations with pooled longevity risks, potentially delivering up to 50% more income compared to traditional drawdown methods. However, regulatory complexities and a lack of member understanding can hinder their adoption.

Sequencing Risk: Market volatility can be a member's enemy in retirement

Another key concern for retirees is sequencing risk, the erosion of savings caused by withdrawing funds during market downturns.

This risk can devastate retirement plans, and in worse case scenarios, simply running out of money, long before the retirement finishing line.

Referencing Nobel Prize for Economics thought leader, Bill Sharpe, Hugh Cutler of Mobius Life described the decumulation challenge as "one of the hardest and nastiest problems in finance!"

Hugh set out a couple of instructive scenarios leading up to retirement. Retire at the wrong time, for example shortly after the GFC or 9/11 and a member's pot could be exhausted in 10 years. Retire in more favourable market circumstances, despite taking a healthy annual income, the DC pot could still be full many years into retirement.

The problem is there are so many unknowns, not just on financial conditions, but on life expectancy, the need for care, for other unexpected living costs and so forth.

Resilient portfolios are needed and diversification is critical, he argued, with assets such as private credit, income-generating real estate, structured equity solutions to name a few helping to control volatility whilst maintain growth potential.

How not to run out of money.... quickly, or qlowly !

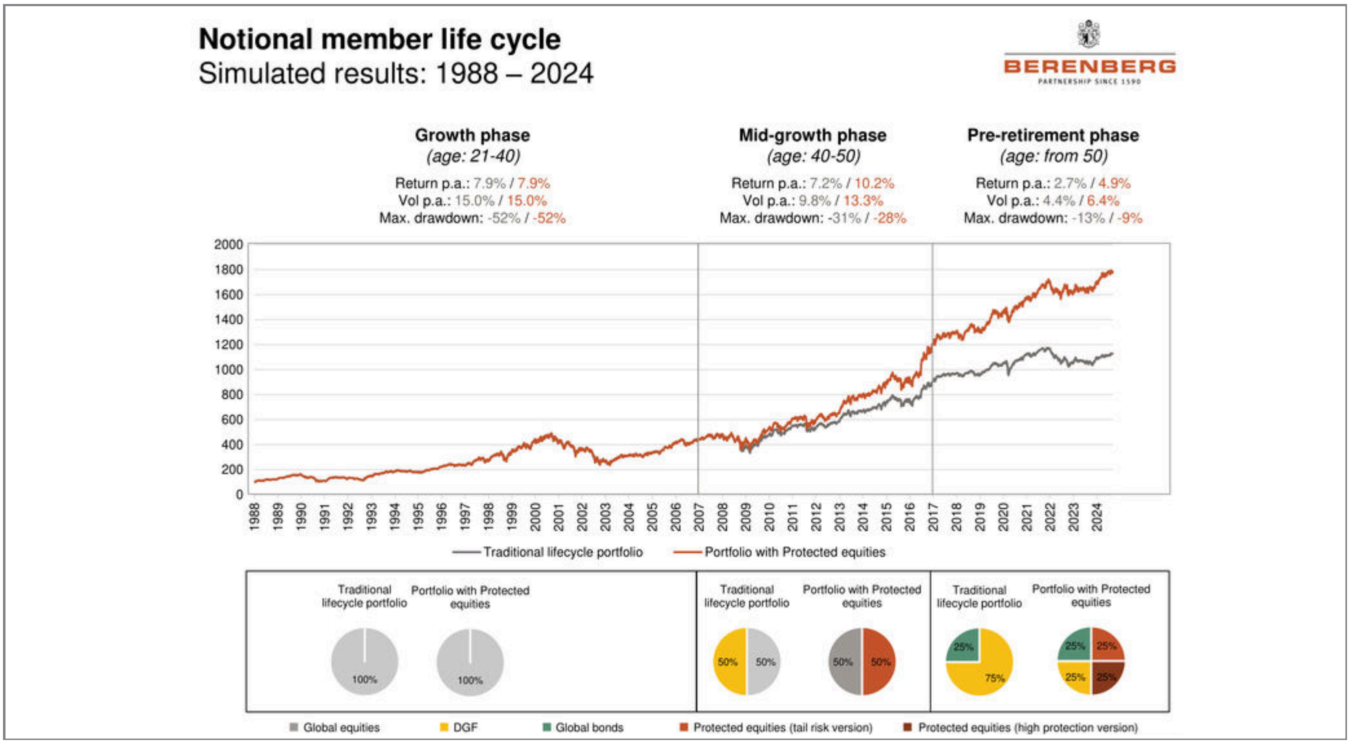
Philipp Loehrhoff, Multi Asset Solutions leader at Berenberg took the baton from Hugh setting out how Berenberg's protected equity strategy can help with the challenges of decumulation.

Philipp echoed Hugh's concerns on sequencing risk. Drawdowns in market sell-offs can deplete pot sizes quickly. But running out of money slowly due to insufficient growth, whilst less drastic, is also a major investment problem that needs attention.

"When markets decline early in retirement, the combination of withdrawals and losses can quickly erode savings," he explained. Members drawing from a reduced pot may find it impossible to recover, jeopardising their ability to sustain income in later years.

The result can be an inclination to be overly-conservative in investment strategies in the decumulation phase.

This brings its own problems: Significantly de-risked investment approaches may avoid short-term losses, but can leave members vulnerable to running out of money slowly. "If investments don't grow, members risk seeing their savings dwindle slowly, unable to support their lifestyle over the long term," he warned.



Adding Protected Equities can boost pension pots in a risk controlled manner

Introducing Protected Equities

Berenberg's protected equity strategy aims to keep equity risk on the table, but in a risk balanced way, Philipp advised. The strategy manages drawdown risk by using options to cap losses during market downturns. By limiting this downside, members' savings are shielded from the worst of equity market turbulence.

Protection comes with a cost, and this shaves off some of the potential upside in equity market growth. In Philipp's view, this is a price worth paying. Having risk-balanced exposure allows members to allocate to equity markets in larger quantity for longer, a vital consideration when many retirements could span 20 to 30 years.

Philipp wrapped up his presentation setting out modelling that demonstrates how an allocation to protected equity investments running up to and in decumulation delivers stronger risk-adjusted returns than traditional life-cycle models, in particular those utilising diversified growth funds which have often delivered disappointing investment performance.

Member Engagement: The Role of Tools and Education

While innovative investment strategies are vital, they must be paired with strong member engagement to drive better outcomes. Esther Hawley, Head of Retirement Proposition at Standard Life brought this point to the fore, noting that many members lack the knowledge needed to make informed decisions about decumulation. "Helping members understand their retirement options is critical, especially as more people rely solely on DC pots," Esther said. Many members wont have the resources, nor the inclination to take advice, so its incumbent on providers to help. It is complex, but paring things down to some key principles is desirable.

Focusing the mind on essential spending such as food and heating your home is fundamental, as is ensuring the inflationary impact on these costs is addressed.

Once the member is clear in their mind that these essential costs are covered, they may be prepared to hold more flexible return-seeking investments to enhance the potential for discretionary spending in retirement.

Understanding what members have, and where should not be under-estimated.

Standard Life's are working on a tool that aims to bridge the knowledge gap and provide members with a consolidated view of their pensions, state entitlements, and savings. This enables them to assess whether they have enough income to cover essentials and plan for discretionary spending.

Partner Insight

The Decumulation Dilemma

Addressing the challenge with Protected Equities

By Philipp Loehrhoff
Head of Multi Asset Solutions

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__Important Considerations__: It is crucial for investors to carefully consider their individual circumstances, risk tolerance, and long-term financial goals when making investment decisions, and to seek professional advice as needed. The strategy may not be suitable for all investors, and past performance is not indicative of future results.It is crucial to understand that investing in the strategy involves risks, including the potential loss of invested capital.

As Defined Contribution (DC) pensions continue to grow in prominence in the UK, a significant challenge has emerged in the later stages of the traditional life cycle model: the need to balance growth and risk management to ensure adequate retirement income. This article explores how protected equities, an investment approach that utilises options with the aim of reducing downside risk while seeking to participate in market upside, may offer a solution to this decumulation challenge.

The conventional lifecycle approach to pension investing dictates a shift from equities to bonds as individuals approach retirement, aiming to protect their accumulated wealth. However, this often leads to insufficient returns, potentially jeopardising retirees' financial security. Retirees face a profound dilemma: maintaining higher equity allocations risks significant losses that could deplete their capital, while overly conservative investing may result in prematurely running out of money, especially in periods of elevated inflation.

Most retirees have a low risk tolerance, making it difficult to maintain the equity exposure needed to generate sustainable returns over the remaining life expectancy, often a 20-to-30-year time horizon. They must delicately balance the risk of major losses against the risk of inadequate portfolio growth.

An environment of elevated inflation further complicates the situation, as conservative portfolios are more likely to be depleted early when living costs increase. Navigating this complex landscape requires a nuanced approach that can provide both growth potential and downside protection.

Introducing protected equities to the DC mix

In response to these challenges, Berenberg has launched its Protected Equities Strategy, specifically tailored for DC pensions. The strategy combines equities and exchange-listed options to build a portfolio aiming for long-term growth with reduced risk. By using options to hedge part of the equity risk, the strategy aims to effectively limit losses during market downturns while still allowing meaningful participation in upside moves. This can enable pension investors to maintain higher equity allocations without significantly altering the overall risk profile of their portfolios, providing the growth potential needed to sustain a long and comfortable retirement.

The Protected Equities Strategy offers flexibility, allowing it to be adapted to different risk tolerances and lifecycle stages.This adaptability makes it potentially suitable for the evolving needs of pension savers over time.

One of the key objectives of the strategy is to help address sequencing risk - the risk that the timing of withdrawals will negatively impact portfolio returns - which can be a significant concern for retirees.

Addressing the Decumulation Challenge with Protected Equities

Berenberg has designed the Protected Equities Strategy to meet the specific needs and constraints of the cost-sensitive DC pensions market. It aims to provide good value for money, offers daily pricing & liquidity, and can be integrated into existing DC schemes via various investment platforms.

Moreover, the strategy fully satisfies all DC regulatory reporting requirements, ensuring a smooth adoption process for pension providers.

As the UK DC pensions landscape continues to evolve, the need to balance growth and risk management is becoming increasingly critical, particularly in the vulnerable later years of the investment lifecycle.

Berenberg's innovative Protected Equities Strategy, by deftly combining downside protection with growth potential, can provide an elegant and compelling solution to the complex challenges retirees face in securing a comfortable retirement.

Navigating this complex landscape requires a nuanced approach that seeks to balance the competing objectives of growth and risk management.

As the UK DC pensions landscape continues to evolve, the need to balance growth and risk management is becoming increasingly critical