

# Is de-risking a good idea?

Investment strategy during retirement



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Following significant pension reforms introduced in the 2014 Budget, UK pensioners can now withdraw large cash sums at times of their choosing. In a recent announcement from HMRC, over £10.8 billion has been cashed in by savers accessing their pension pots. In addition to annuity purchases, large numbers are opting to retain exposure to the investment markets during their retirement through 'income drawdown'.

The initial fears that self-managing income drawdown investors might use the proceeds to purchase sports cars or other extravagances have not been borne out.

However these individuals still face several difficult decisions for managing their money through retirement. One key question is whether they should de-risk or re-risk with age. More precisely, should they decrease or increase (or keep the same) the percentage of their portfolio in growth assets such as equities?

Conventional wisdom says that they should de-risk. For instance, one rule of thumb suggests that investors should hold a percentage in equity equal to 100 minus their age, meaning a typical 65 year-old should hold 35% in growth assets whereas an 85 year-old would hold 15% in growth assets. The rest would consist of relatively safe assets such as cash and high-quality bonds. The

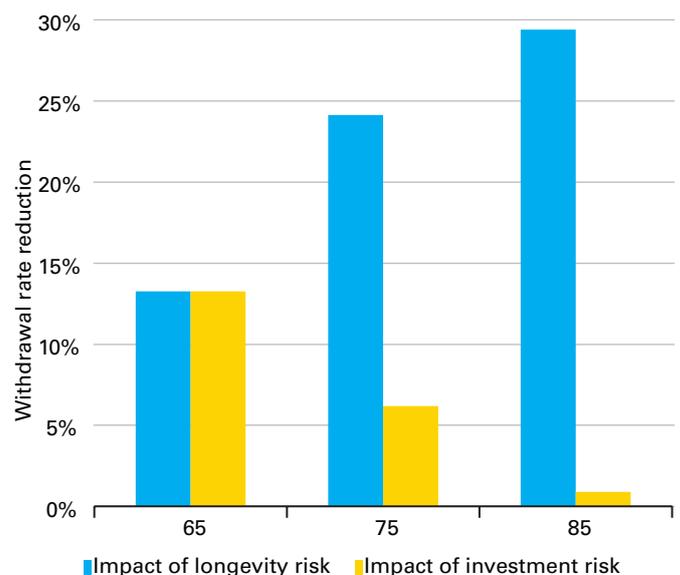
simplicity of this old guideline is appealing, but does it really stack up?

## A SHIFTING BALANCE OF RISKS: INVESTMENT RISK AND LONGEVITY RISK

A good place to start is the risks that retirees face. Retirees are exposed to two key types of risk: investment risk (the risk that returns are lower than expected) and longevity risk (the risk that they outlive their available funds). Both contribute to the overall risk of running out of money.

Our research shows that investment risk matters less as retirees age whereas longevity risk (which drawdown investors cannot 'pool') matters more with age. Eventually longevity risk, rather than investment risk, dominates the overall risk of running out of money. This is shown in Figure 1 as the percentage impacts on 'prudent' withdrawal rates an investor might make as a result of both investment and longevity risk<sup>1</sup>. This prudence acts as 'self-insurance' against that risk, allowing a buffer to build up in case assets perform worse than expected or the pensioner lives for longer than expected. For example, at age 65 an investor might

**Figure 1: How the impact of investment and longevity risk change with age**



Source: LGIM calculations

<sup>1</sup>Further details concerning the calculation can be found here: [http://www.lgim.com/library/knowledge/thought-leadership-content/dc-dynamics/DC\\_Dynamics-is\\_de-risking\\_a\\_good\\_idea-April\\_2017\\_long.pdf](http://www.lgim.com/library/knowledge/thought-leadership-content/dc-dynamics/DC_Dynamics-is_de-risking_a_good_idea-April_2017_long.pdf)

make a 13% reduction to their income to hedge either risk. At age 85, self-insuring against longevity risk might require an almost 30% reduction of their annual income.

**There are two potential consequences of this:**

**First**, the benefits of taking investment risk in old age are small. Whilst so-called 'reckless prudence' (reducing short-term risk at the expense of long term expected returns) can lead to poor outcomes for a highly loss-averse 65 year old, the same is not true for a 95 year old: reckless prudence isn't quite so reckless. This would suggest a de-risking strategy with age.

**Second**, the increasing importance of longevity risk means that annuitisation – where longevity risk (and investment risk) is passed to an insurer – may become more appealing with age. Planning ahead for this purchase may involve de-risking into similar low-risk instruments which are held by insurance companies (such as government bonds and high-grade corporate bonds) so that assets move in line with changes in annuity prices close to the time of purchase.

### SEQUENCE RISK

Sequence risk is the risk that the same returns of different assets (equities, property, corporate bonds etc.) occurring in a different chronological order can lead to a different overall outcome. Post-retirement, consideration of sequence risk discourages overly aggressive de-risking. This is because de-risking following a period of poor investment returns prevents a full recovery if and when markets rebound. This is compounded by any withdrawals taken in this period.

### OTHER FACTORS

There are a range of other factors to consider including other assets held (e.g. properties or a 'defined benefit' pension), the aim of their savings (e.g. mainly to support retirement or mainly as an inheritance vehicle), risk appetite, health and uncertainty over the timing of an eventual annuity purchase if at all. The desire for simplicity is also likely to be a key factor, particularly for older pensioners and it may be simpler to remain in a relatively static strategy. However, monitoring investment performance and making complicated withdrawal decisions is difficult and could become more challenging with age; indeed this is another reason annuities may gradually become more appealing.

### MANAGING THE RETIREMENT JOURNEY

Investment strategy during retirement is clearly a complex topic. Consideration of the shifting balance between investment risk and longevity risk is likely to promote a degree of de-risking. But allowance for so-called 'sequence risk' means that investors should beware of overly aggressive de-risking strategies. The precise journey taken depends on a variety of other factors and an evolving set of individual circumstances. Investors should choose a journey appropriate to their needs and how these are likely to evolve over time.

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