AllianceBernstein

Do UK DC Pension Savers Need a Lifetime Income Default?

Providing Professional Help Through the Retirement Journey

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The "Freedom and Choice" reforms of 2015 empowered UK Defined Contribution (DC) pension savers to access their pension benefits with more flexibility than ever before. While these new freedoms were a great step forward, they also created huge personal responsibility for individual DC plan members, who now face numerous options and complicated investment issues as they seek to create a reliable retirement income stream from their pension savings.

Now, eight years on, our research indicates DC members mostly remain ill-equipped to cope with the complexities of pension investing. We think the majority of DC savers—particularly those currently invested in default solutions—need help with their investments in retirement. And we believe that, for the bulk of UK DC retirees, the most promising solution will probably be a single default retirement journey from accumulation through decumulation.

What Our UK DC Member Surveys Tell Us

Most DC members are not financial experts and need help at all stages of their pension journey.

Many members only start to understand their retirement needs as they approach—or even after—their retirement date. They need investment solutions that allow them time to think things through.

Members also value the flexibility to keep their options open rather than immediately locking into a retirement product for life.

All members want value for money, and competitive fees are particularly important for those with smaller pots.

Now inflation is once more above target, investment solutions that can provide growth and help preserve purchasing power are more important than ever.

Source: AB's four UK DC member surveys carried out in 2014, 2016, 2018 and 2020 [next survey due 2023]. Respondents over these years ranged from over 1,000 to over 4,000.

The Retirement Income Challenge

Turning a DC pension pot into an income stream for life can be very challenging. DC retirees mostly have very limited insights about their remaining lifespan and have modest financial knowledge—but must navigate an array of complex unknowns:

Five Risks to Consider

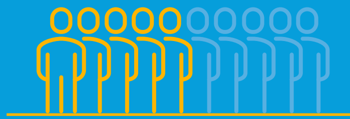
- **Longevity Risk**
  Unless I annuitize, will my money run out before I die?
- **Mortality Risk**
  If I annuitize, will I die early and waste part of my pot?
- **Growth Opportunity Cost Risk**
  If I allocate to primarily low-risk investments, how much investment gain from growth assets could I forego?
- **Market Risk**
  If I invest significantly into growth assets (e.g. stock markets), how much could I lose?
- **Inflation Risk**
  How much will inflation erode my retirement income's purchasing power over the years?

DC retirees also need to grapple with consequential factors such as costs and charges (some transparent, others opaque) and the ability to access capital for emergencies or if their needs change. So, how well prepared are DC savers to make crucial retirement decisions? The fact that around 96% of DC master trust scheme members in the UK are invested in default solutions* for the savings phase should give us a clue. In our regular survey of US pension plan members, we asked a revealing question...

What do you consider a realistic withdrawal rate in your retirement years?

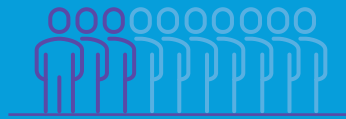
* Source: Pensions Policy Institute - The DC Future Book 2022

What Did US Plan Members Tell Us?



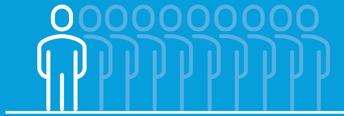
Nearly half (45%)
of US respondents thought that they could sustainably withdraw 7% or more annually

7%
or more



Over one-quarter (28%)
of US respondents thought that they could sustainably withdraw 10% or more annually

10%
or more



A further 12%
didn't know how much they could withdraw

For illustrative purposes only
AB research: Inside the Minds of Plan Participants fielded April, 2023 (1,200 respondents)
Source: AB

DC Retirees Need Help

More than half (57%) of participants thought they could withdraw 7% or more annually (or didn't know how much they could withdraw), with over one-quarter (28%) responding that a withdrawal rate of 10% or more was sustainable. But, based on our capital market forecasts, we think a realistic withdrawal rate could be closer to just 3%—less than half the median response. We believe UK DC savers are likely to have a limited understanding of withdrawal rates too, and risk exhausting their pension savings early if their choices are too optimistic.

High withdrawal rates will likely deplete savings quickly. We estimate that a UK DC saver aged 65 could expect the following outcomes:

10%	7%	3.4%
withdrawal rate – savings last around 10 years	withdrawal rate – savings last around 15 years	withdrawal rate – savings last around 35 years

This assumes a return in line with the current 10-year UK nominal gilt yield of 4.3% and an inflation experience in line with the historical average (3.3%).

For illustrative purposes only. There can be no assurance that any investment objectives will be achieved.

Economist and Nobel laureate William Sharpe referred to decumulation—the process of drawing down wealth to fund retirement spending needs—as "*the nastiest, hardest problem in finance*". In our view, that problem is about to get even nastier and harder.

The benign macroeconomic background that drove decades of strong market gains has stalled and is likely set to reverse. While inflation is currently retreating from recent peaks, powerful secular forces such as deglobalization, ageing populations, and the demands of environmental and social spending will likely keep inflation higher than in the pre-pandemic era for decades to come. At the same time, stock- and bond-market returns will probably be much lower than in the boom years and, because of lower correlations, investing exclusively in stocks and bonds will likely create more volatile portfolios than DC members expect.

It's clear to us that DC retirees in both the US and UK need help to navigate these daunting challenges—now.

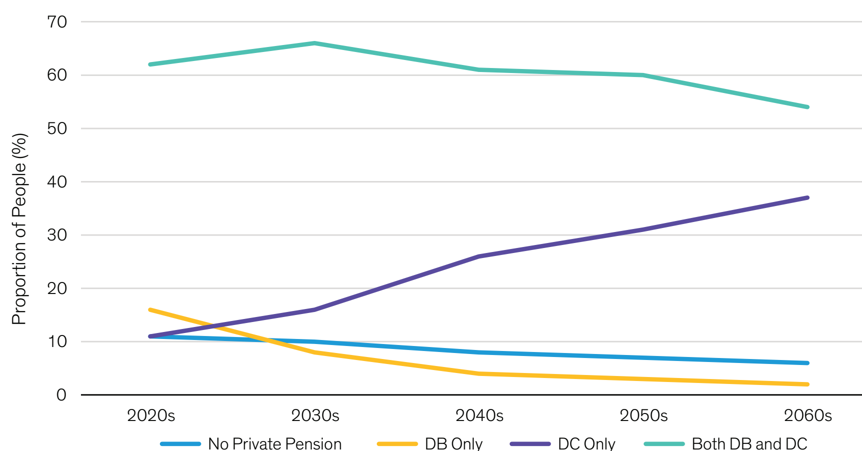
No Time to Lose Providing New UK Solutions

Many UK pension savers are still entitled to final salary pensions from defined benefit (DB) schemes, as either part or all of their pension provisions. These final salary-related benefits effectively provide an annuity that is either wholly or partly inflation-linked. DB is a valuable component in a pension savings strategy. By creating a guaranteed income stream, it provides a low-volatility anchor that enables pension savers to invest more for longer in growth assets, a strategy which over time will likely generate higher returns. For that reason, an insured or guaranteed component is common to many pension systems around the developed world.

The value of an investment can go down as well as up and investors may not get back the full amount they invested.

But for an important part of the UK pensions market, the numbers shown in the *Display below* are not as rosy as they seem.

DISPLAY 1: PROPORTION OF WORKING AGE PEOPLE IN UK HOUSEHOLDS WITH EACH PRIVATE PENSION TYPE (BY COHORT)



Historical analyses do not guarantee future results.
Cohort refers to the decade in which individuals will reach state pension age. Based on data presented in "Analysis of Future Pension Incomes" on 3 March 2023 by the Department for Work and Pensions (DWP).
Source: DWP and AB.

According to the Department for Work and Pensions (DWP), 62% of UK pension savers currently have a mix of DB and DC assets in their household, with only around 11% relying exclusively on DC. And even by 2060, over half (54%) of households are still expected to have a DB component in their retirement savings.

However, those statistics are heavily influenced by the large number of public sector workers who are still enrolled in DB schemes. Focusing just on the private sector, we would expect a considerably greater reliance on DC savings. Pension fiduciaries need to recognize the scale of the challenge that's already confronting this significant constituency, in terms of relying exclusively on DC for their pension savings and needing to manage those savings effectively.

What Could a Lifetime Income Default Solution Look Like?

As we've seen, the security and predictability of an annuity is valuable. But typically the cost of annuitization is relatively high, particularly for inflation-linked products. So, in principle, our research suggests that for most DC savers the best value is likely to be found by combining insurance products with other investment products in their retirement income strategy.

In the US, this is easier to put into practice, as there already exists a well-developed insurance market that can provide both deferred annuities and guaranteed income wrappers for securities portfolios (known as guaranteed lifetime withdrawal benefits or GLWBs).

The deferred annuity enables DC savers to allocate part of their pension pot to buying a guaranteed income that kicks in later in life—say, aged 80. It provides lifetime income protection to guard against both longevity risk and another, less-recognized risk, cognitive decline that can cloud investors' judgement as they age.

The GLWB provides a guaranteed minimum level of income for DC savers. If savers follow drawdown amount stipulations and the value of their pot falls such that they are no longer able to withdraw the insured minimum level (due to negative market movements or savers living beyond their expected lifespans), the GLWB product kicks in and tops-up the retirees' income to the minimum level.

For many DC savers, a lifetime income solution combining a GWLB with a multi-asset target date fund (TDF) will in our view represent the most appropriate balance between maximizing portfolio growth (and hence income) and guarding against longevity risk. The insurance component can help individual DC savers eliminate the longevity risk that they can't diversify, and in our analysis can help significantly improve sustainable withdrawal rates.

A Practical Solution for UK DC Savers

Unfortunately for UK DC retirees, the UK insurance market currently lacks the variety of individual insurance-based products that are common in the US. So, for instance, a DC member in the UK could delay the purchase of an annuity as part of their retirement strategy but would likely be unable to buy a deferred annuity outright. GLWB products are also unavailable here.

Even so, it's possible to create practical solutions for UK DC retirees that can address the risks that they face and provide effective default vehicles through retirement. For instance, multi-asset funds can be geared to providing a reliable, managed retirement income through to a specified target age (say, 75 or 95). By choosing an investment-led solution, retirees can have complete access to their capital and retain the option to make changes in the later stage of retirement—for example, use their remaining pot either to annuitize or to invest in a product or strategy that can meet day-to-day living expenses, provide rainy day funds or an inheritance fund.

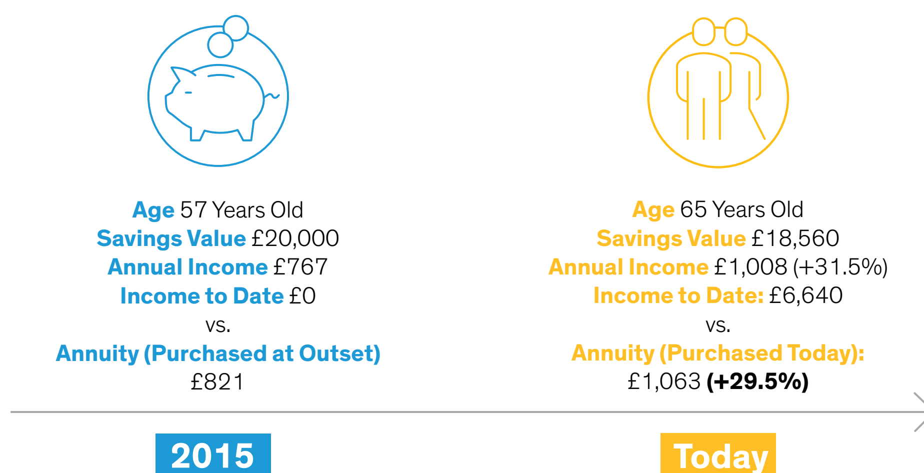
AB's own UK DC retirement income strategy, Retirement Bridge, comprises a range of dynamically managed multi-asset funds that pay a regular income to DC retirees and target an age of 75—when we expect retirees to secure an income via an annuity, or leave capital invested for legacy reasons. Just as DC members can invest in one of a series of TDFs based on their expected retirement age, so investors in our Retirement Bridge strategy can invest in one of a series of Retirement Bridge Funds according to their year of birth (for example the "Retirement Bridge Fund 1959"). And so, just as in AB's regular TDF ranges, DC members' Retirement Bridge savings are actively managed across a mix of equities, bonds, commodities and other diversifying investments, with a defined end date, and with a specific objective: in this case, maintaining a high and sustainable income alongside minimizing the chance that retirees will suffer a fall in income when they eventually use their retirement savings to annuitize.

Consistent with our regular accumulation TDF ranges, we measure the success of our Retirement Bridge funds against a range of relevant benchmarks. But the acid test for this product is whether it has outperformed a comparable annuity since purchase. Specifically, it aims to increase the total income payout by age 75 to more than 20% above that of a traditional non-escalating joint-life annuity.

In the *Displays* below we show how the Retirement Bridge strategy has outperformed an annuity for a notional 65-year-old investing in 2015, and has paid attractive levels of income relative to both inflation and DB limited price indexation (LPI) since inception.

DISPLAY 2: RETIREMENT BRIDGE HAS MET ITS OBJECTIVES

Indicative Retiree Journey

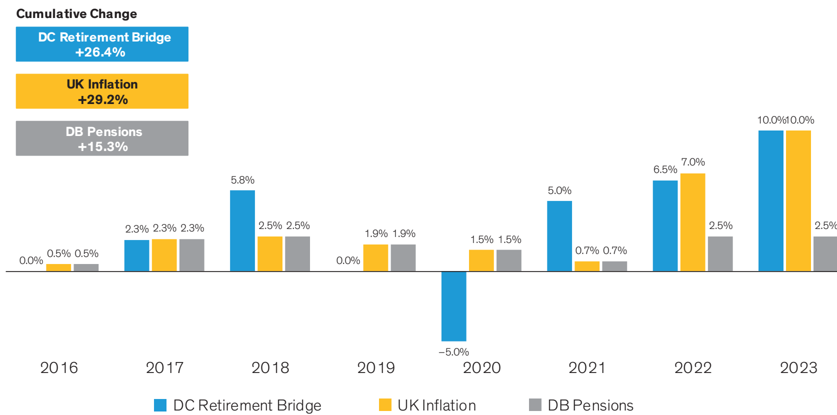


Past performance does not guarantee future results. There can be no assurance that any investment objectives will be achieved.

Illustrative 65-year-old experience assumes investment in Retirement Bridge Fund 1958 at inception on 29 March 2015 allows for the agreed 2023 payout increase, effective from 1 July 2023. Experience also assumes an annual fee deduction of 0.75%. The reference annuity is for a healthy non-smoker with a Chelmsford (Essex) postcode; with a joint-life annuity (50% reversionary on first death) with a partner with the same birth date; no guarantee. As at 31 March 2023.
Source: MoneyHelper and AB

DISPLAY 3: RESULTS OF ANNUAL INCOME PAYOUT REVIEWS

Since Inception Percentages



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Annual Retirement Bridge payout change shown is an equally weighted average of all vintages. Inflation measure shown is change in UK CPI inflation. DB Benefit increases shown are the current statutory requirement for payments to be increased by the lower of UK RPI and 2.5%. Retirement Bridge payouts are reviewed and fixed annually as at 31 March, with the new payout effective from 1 July. As at 31 March 2023.

Source: ONS and AB

This type of strategy aims to meet some of the most important needs that DC members face, based on responses to our UK member surveys:

Time to Choose

Providing more time for DC savers to consider their retirement needs before committing to a fixed-term strategy or annuity

Flexibility

Keeping DC savers' options open, for instance allowing them to retain their capital for rainy-day or inheritance purposes

Accessibility

Offering an institutional-priced solution to improve value for money and to allow DC savers with smaller pots to access the benefits of a professionally managed drawdown fund

Growth Potential

Creating the opportunity for future growth as well as countering the impact of inflation

Consequently, we think this type of approach can provide a flexible, practical solution to the problems an increasing number of pension savers are facing, and we are leveraging our experience here in the UK to launch a seamless Whole of Life default solution in 2023/24.

What Does the Future Hold?

In the long term, we hope that a greater variety of insured options will become available in the UK. These could greatly improve product design and so help lift sustainable withdrawal rates for DC savers.

In the shorter term, we expect that fiduciaries and asset managers will become increasingly aware of the importance of helping DC savers manage their investments not just to the point of retirement, but through the point of retirement and into old age. In practical terms, this would involve a switch from default accumulation to default income strategies at the point of retirement.

At AB, we have almost a decade of experience in delivering retirement income solutions to UK clients and their members through Retirement Bridge. As we apply this experience to create a Whole of Life default solution, we're also paving the way for a framework that could—if required—support Collective DC (CDC) in a fair and transparent way.

We believe these developments could represent a win-win for DC pensions. We would expect not only better individual investment outcomes on average, but also improved peace of mind—for DC members and fiduciaries.

About AllianceBernstein

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Some of the principal risks of investing in Target Date Funds include:

Market Risk: The market values of the Fund's holdings rise and fall from day to day, so investments may lose value. **Interest Rate Risk:** Bonds may lose value if interest rates rise or fall—long-duration bonds tend to rise and fall more than short-duration bonds. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or capital—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Allocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign Risk:** Investing in non-UK assets may be more volatile because of political, regulatory, market and economic uncertainties associated with them. These risks are magnified in assets of emerging or developing markets. **Currency Risk:** If a non-UK asset's trading currency weakens versus sterling, its value may be negatively affected when translated back into sterling terms. **Reinsurance Risk:** The underlying fund(s) is accessed via another insurance provider, also known as a reinsurance arrangement; creating a direct counterparty exposure. In the event of default by an insurance provider, the value of the assets will likely fall, which will be reflected in the value of our Fund price.

Target Date Retirement Funds (TDFs) are designed for a typical pension fund saver intending to retire in or around the years stated in the name of the Fund. As the Funds are intended to be default pension saving vehicles which seek to meet the requirements of a broad range of persons, they do not take into account an individual's personal circumstances and may not be suitable for a particular individual or group of individuals with complex financial or personal circumstances.

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