Smoothing the transition from work into retirement

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Retirement Bridge℠:
Providing a Real Choice for Retirees

Most savers in defined contribution (DC) pension schemes buy an annuity when they retire. But changes to life expectancy are undermining the benefits of immediate annuitisation, so is there a better way to deliver an income in retirement?

Some £10 billion in DC retirement funds mature every year in the UK, with over 90% of retirees immediately using their pot of savings to purchase an annuity. Despite this apparent consensus that annuities are the best way to generate an income in retirement, the vast majority provide no protection against inflation or any safety net for those left behind when the buyer dies.

Our research suggests that purchasers act more by default than considered choice, even though there is plenty of evidence that more thought could lead to better retirement outcomes. For example, recent research1 by the National Association of Pension Funds (NAPF) has shown that a majority of DC savers are losing out by not shopping around for annuities.

An even bigger failing is the lack of alternatives. Indeed, with life expectancy for 65-year-olds having nearly doubled in a generation and DC becoming an ever greater part of the UK pension landscape, there is a clear need for the market to evolve in order to provide retirees with better choices for securing income.

But it is not easy to guide DC retirees into making sound choices about what form of retirement income will best serve their needs. The issues involved are extremely difficult to forecast. What will inflation be? How will taxes and regulations evolve? Moreover, each individual’s situation is unique. How long will I live? What health problems will I experience? Given how little can be known with certainty at retirement about the future, these are not easy questions to answer even for the best informed retiree.

AllianceBernstein has been studying how we can deliver better retirement income choices. We have researched how DC savers approach the retirement income problem, how DC arrangements can deliver more choice at a reasonable cost, and how a “Retirement Bridge” approach can both improve retirement decisions and provide more income in most conditions. This paper lays out our conclusions and how we came to them.

Our Consumer Research Suggests Retirees Want Better Choices

We commissioned Compass Research Limited, a consumer and business research company, to help us better understand what DC members thought about securing a retirement income and how their needs could be met. It carried out in-depth interviews with DC pension savers who were in the process of retiring or who had just retired.2 Three key themes emerged from these interviews.

Theme 1: DC savers are very uncertain about retirement and whether they can even afford to retire.

“I’m worried about my pension. I think I need to restructure it and possibly take some more risk to try and make it worth a bit more.”

DC savers often expected to have to continue working past age 65. Some wanted simply to protect what they had; others were ready to accept some risk to maximise their income. Most recognised they faced a number of risks (see Display 1, page 3), including leaving their family in poverty in later life, as well as the impact inflation could have on their incomes—this, remember, is a generation for whom the inflationary 1970s are a real and depressing memory.

The great uncertainty and apprehension of individuals approaching retirement would suggest any early engagement with them is better directed towards guiding their income expectations than making irrevocable decisions about how they take their income.

1Closing the gap: The choices and factors that can affect private pension income in retirement, Pensions Institute sponsored by the NAPF, February 2012.
2Survey involved 22 in-depth interviews and six group discussions with individuals between the ages of 52 and 65 in Birmingham, Leeds, Manchester and Watford in June 2010.
Our DC Credentials

Over the past six years, AllianceBernstein has undertaken a significant amount of research into the issues facing scheme sponsors, providers and, most importantly, savers in a UK retirement saving landscape increasingly dominated by defined contribution pension arrangements.

In 2009, on the back of our research paper Escaping the Pensions Crisis: Building a Better DC Default Fund, we launched our flexible target date fund (TDF) service. For the first time in the UK, this allows pension providers to direct individual savers’ money to a robustly designed and implemented default fund that incorporates age-appropriate diversification and dynamic risk management (see below for an illustrative glide path design).

From a provider’s perspective, we believe the flexible target-date fund means improved governance with much more clearly defined roles and responsibilities for managers, sponsors and/or trustees. For individuals, our approach offers what any saver might reasonably expect: a value-for-money fund that is simple to understand, yet has a sophisticated investment approach that adjusts to the changing needs and risk capacity of savers as they approach and possibly go past their anticipated retirement age.

Because the investment approach is flexible, it continues to adapt seamlessly and cost-effectively as the world changes. Hence we believe that our flexible target-date funds are an important advance in providing better outcomes for DC savers.

Flexible target-date funds have since been adopted by National Employment Savings Trust (NEST), with the state-mandated DC pension provider opting to use them for its all-important default offering. In its rationale for deciding to use TDFs, we agreed with many of the conclusions reached by NEST, which has expended more effort than any other UK organisation on developing good investment governance in DC.

At the end of our 2009 paper, we suggested that flexible target-date funds should be designed to extend past the age of 65 because conventional wisdom on annuitisation is flawed. Rather than annuitising immediately at retirement, we suggested annuitisation should be delayed until an individual reached late seventies, when the most attractive feature of an annuity (protection against the buyer out-living their money) became most valuable. However, at the time of writing, we had not completed our research into the issues involved. This paper aims to fill that gap.

Our Flexible Target Date Funds Can Provide a Well-Governed and Robust Default Fund

The fund’s investment approach changes to match the risk capacity of a typical saver over their lifetime.

<table>
<thead>
<tr>
<th>Life Stage</th>
<th>Young / Adventurous</th>
<th>Mid-Life / Balanced</th>
<th>Pre Retirement / Defensive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund’s Objective</td>
<td>High risk capacity and regular contributions allow the fund to focus on long-term growth</td>
<td>Balance of growth with stability to offset risk of savings shortfall at retirement</td>
<td>Short-term stability to continue building savings while deciding best retirement income option</td>
</tr>
</tbody>
</table>

As the manager of the default fund, we have a responsibility to keep it up to date with market developments, changes in regulations and members’ behaviour. In addition, we manage each target-date fund dynamically on an age-appropriate basis to try smooth the journey for members and ensure that its risk profile remains appropriate for the life stage of those within it.
Theme 2: Savers have little awareness of the process for receiving retirement income.

“I have never really thought about this. I don’t have a clue what type of annuity I have.”

Our research suggested that retirees expected that they would receive advice about how to replace their work income, with the imagined source varying from an independent financial advisor to friends or their employer. While there was some basic knowledge of annuities, there was virtually zero awareness of the open-market option. Meanwhile, of those who had gone into income drawdown, many had highly unrealistic expectations about both the level of income they could sustain and the risks they were taking.

This finding is supported by NAPF research, which found that very few retirees currently use the open-market option for annuities, and those that do may benefit from a pension increased by as much as 20% or more.³

Given the complexity of this problem, it is clear to us that retirees need more time to assess their needs before committing themselves to a decision about their income in retirement.

Theme 3: Retirees tend to default to whatever income option the pension provider recommends.

“I just signed some forms.”

Retirees generally believe that someone, typically their employer, had checked that whatever option was proposed was appropriate for them. Many were unaware they had made any decision about purchasing an annuity, despite filling in the forms. To the extent that members were aware of having bought an annuity, the need to establish an income quickly at retirement dominated their decision making.

Individuals’ propensity to accept whatever is put in front of them places a burden on providers. But, as in the savings phase, it also offers providers the opportunity to greatly improve retirement outcomes for DC savers by creating a default that is appropriate for the majority.

Our research suggested there was a simple way to offer more and better choices for retirees: rather than their being defaulted into an immediate annuity at retirement, they should be given the option of a Retirement Bridge. This approach would mean they took an income directly from their invested funds, using the income drawdown rules, allowing them to defer the purchase of an annuity until later.

Taking this route would not prevent them purchasing an annuity later. Indeed, there may be financial advantages in waiting: for example, between the ages of 65 and 75, the chances that an individual will qualify for an enhanced annuity through ill-health increases substantially. In the mean time, most retirees will value the additional flexibility that drawdown gives, especially in respect of inheritance planning.

“You don’t know what your needs are when you first retire. And you have various pots of money to consider. This would buy time while the dust settles.”

Income Drawdown Is Currently Inaccessible for the Majority

Retirees with large pension pots can already choose income drawdown as an alternative to an annuity. But, sadly, the income drawdown market today is all but inaccessible to the majority of retirees. The primary problem is cost: the fees for advice, administration, distribution and fund management are prohibitive for smaller DC pension pots.

Display 1: Members approaching and entering retirement face a number of difficult-to-quantify risks

<table>
<thead>
<tr>
<th>Risk</th>
<th>Threat</th>
<th>Context</th>
</tr>
</thead>
<tbody>
<tr>
<td>Longevity</td>
<td>That they will outlive their savings</td>
<td>10% probability that a male retiring today will live to over 100</td>
</tr>
<tr>
<td>Mortality</td>
<td>That they will die early, leaving insufficient provision for their family</td>
<td>60% probability that, for a couple retiring today, one will outlive the other by more than 10 years</td>
</tr>
<tr>
<td>Investment</td>
<td>That returns are insufficient or substantial losses are incurred</td>
<td>The last 10 years have seen two bear markets wiping significant value from equity investments.</td>
</tr>
<tr>
<td>Inflation</td>
<td>That the real purchasing power of their savings is diminished</td>
<td>Over a typical 25-year retirement, modest inflation of 3% per annum will destroy 50% of the value of a level pension.</td>
</tr>
<tr>
<td>Legislation</td>
<td>That changes to tax or pension regulation reduce future pension income</td>
<td>Eight major pieces of pension legislation in the last 20 years and 11 secretaries of state</td>
</tr>
</tbody>
</table>

³Treating DC scheme members fairly in retirement?, an NAPF and Pensions Institute research report, February 2012.
Fees vary considerably among providers, but it is not uncommon for even a low-cost provider to charge the equivalent of an annual management fee of 1% per annum, along with a fixed annual payment of £250 for provision of advice, review of income levels, etc. Display 2 shows the impact on drawdown income of these costs and so-called mortality drag (an additional cost which results from delaying annuitisation). Of the two, fees are by far the biggest factor, with those with smaller funds the most heavily penalised.

Our calculations suggest that someone with £25,000—the typical savings pot of a DC retiree today—needs only to achieve an additional return of about 0.5% over annuity-matching bonds to offset the cost of mortality drag. Historically, this would typically be achievable by allocating only 10% of their pot to risky assets such as equities. But for that same person, the additional return required to overcome the drawdown fees likely to be incurred would be nearer 3% a year, requiring an individual to invest an adventurous 70% of his pot in risky assets.

Our research indicates that the income drawdown market is bedevilled by high fees and high-risk investment strategies, with too much money often being drawn too early and with little independent and objective oversight of the advice given. This is an area currently being investigated by the Financial Services Authority. But we believe that because drawdown is currently provided on an individual basis, requiring expensive individual advice it is unattractive for all but the wealthiest of retirees. Moreover, the lack of independent oversight limits its suitability for any but the most knowledgeable of retirees.

These issues need to be addressed if a Retirement Bridge is to be a successful alternative to annuities for a wider audience. We believe that they can be. Indeed, we can show that the costs of income drawdown can be reduced significantly (to an annual management charge of less than 1% all-in) by embedding age-appropriate strategies suitable for most retirees—covering both investment strategy and drawdown rates—in a simple fund. Such an approach would look very like the age-based flexible target-date funds which form the basis of our approach to the savings phase of DC.

**Proposed Features of Our Retirement Bridge**

A range of aged-based funds that would have:

- An income rate that is set and reviewed annually for its sustainability
- A prudent investment strategy with an investment objective aligned with the retiree’s interests—principally, the need to annuitise at some later stage
- An independent expert advisor who assesses the suitability of the product for the retiree—much like an annuity but without the need for expensive individual income drawdown advice
- Simplified drawdown administration
- Single pricing allowing the retiree to invest in the fund for as long or short a period as they like with no financial penalties, thus giving them breathing space to decide their retirement needs

As of 8 March 2012
Based on joint-life annuity and an annuity-matching investment portfolio, with fees charged at £250 per annum for advice, plus 1.0% annual investment management charge
Source: AllianceBernstein and William Burrows
Making the Retirement Bridge Work for the Retiree

To align the investment strategy and drawdown rates of a Retirement Bridge with those of the retiree, the investment objective of the proposed funds needs to take account of:

- The retiree’s age—because the percentage of the fund which can be drawn as sustainable income goes up as the retiree gets older (just like annuity rates which, even after mortality drag, get higher with the age of the purchaser, reflecting the reducing period over which the annuity is expected to be paid. See Display 3).

- The retiree’s future income—because the underlying portfolio must be managed against a benchmark that reflects the cost of the annuity that the retiree is eventually likely to purchase.

- The retiree’s “investment horizon”—because the likelihood that the retiree will surrender and annuitise in the near future needs to be taken into account. This is also age-dependent, as the effects of both rising mortality drag and a shortening investment horizon make the purchase of an annuity increasingly attractive as the retiree gets older.

We believe that a series of age-based funds is the best way to meet these requirements. Individuals of roughly similar age can be grouped in the fund most closely matching the year of their birth. Each fund can then incorporate appropriate objectives to align the interests of the manager (who sets both the investment strategy and the payout rate) with the needs of the retirees. The main features of our proposed Retirement Bridge are outlined below (see “Proposed Features of Our Retirement Bridge” on page 4).

Display 3: Sustainable Income Increases with Age

Joint-Life Annuity Purchased with £100,000

As of March 2012
Source: William Burrows

Retirement Bridge Would Have Outperformed in the Past…

We tested how a simplified version of our proposed strategy might have performed (net of fees) historically through very different markets in each 10-year period from 1920 to 2012.

The results of our research are shown in Display 4.

The bars compare the income that would have been received under the Retirement Bridge with a level, joint-life annuity purchased at the outset at 65. The green

Display 4: A Retirement Bridge Should Have Been Robust in Most Markets

Historical Performance of Retirement Bridge Compared with an Annuity Bought at 65

As of March 2012
bars show the comparison for income between the ages of 65 and 75 (after adjustment for inflation), while the blue show the comparison for the eventual annuity purchased at the age of 75. As well as looking at what happened on average, we also looked at:

The two worst decades:
- The 1930s Depression
- The 2000s Double-Dip Decade

And the two best decades:
- The 1950s Boom
- The 1980s Thatcher Years

Not surprisingly, during the 1930s and the 2000s, our simulations show that the Retirement Bridge would have underperformed a traditional annuity by about 15%, both over the 10 years and on eventual annuitisation at the age of 75. However in favourable decades, such as the 1950s and 1980s, we show that the Retirement Bridge would have done significantly better, outperforming by over 30% by 75. Indeed, on average, over the entire period since 1920, the Retirement Bridge would have left retirees with nearly 20% more income after age 75 and with no loss of income in the 65-to-75 period.

So while the Retirement Bridge approach is no panacea, we would argue that it is much the better option, providing more choice, more flexibility and better outcomes on average than immediate annuitisation.

…and Today’s Market Conditions Could Be the Best in a Generation

Annuity rates today stand at a generational low as a result of increasing longevity expectations and low interest rates. The impact of equalising rates for men and women and new insurance-company solvency rules appear to be only adding to the headwinds facing annuities. Against that background, we believe that our Retirement Bridge could provide a once-in-a-generation opportunity for today’s retirees.

To demonstrate this, we turned to our Capital Markets Engine, the set of analytical tools we use to forecast the likely range of long-term capital-markets returns and thus help guide our strategic asset-allocation decisions. We projected how a Retirement Bridge portfolio might perform against an annuity during the next 10 years, after adjusting for inflation.

Display 5 shows the outcome in bad markets (the 5th percentile, so that the results should be better 95% of the time) and in typical markets (50th percentile). It compares the relative annuitised income after inflation that a 65-year-old retiring in 2012 would be likely to receive at the age of 75 in our Retirement Bridge, with what they might have received from an annuity purchased at the outset.

So, on the basis of current starting conditions, but assuming future markets are bad, we forecast that the Retirement Bridge would result in about the same income as an immediate annuity. However, if markets turn out to be “typical”, we expect the Retirement Bridge to be delivering over 25% more income to retirees by the age of 75 than if they had purchased an annuity immediately.

Conclusion

Current UK defined contribution arrangements focus on the savings phase and overwhelmingly guide retirees to annuitise immediately on retirement. Our research shows that retirees need more choice, more time in which to make their choice and the chance to do better financially.

A Retirement Bridge that gives retirees a period to draw prudently from their savings and annuitise in their late seventies would, in our view, provide more choice, more breathing space and more retirement income on average. Indeed, given today’s low interest-rate environment, the Retirement Bridge could give the current cohort of retirees substantially more income than annuity rates currently offer.
## Retirement Bridge Chimes with Retirees’ Expectations

We explained the Retirement Bridge concept to our consumer panel, with illustrations comparing the potential benefits and outcomes against those from traditional annuities. This table summarises the advantages of our approach and our panel’s reactions.

<table>
<thead>
<tr>
<th>Proposed Benefit</th>
<th>Problem Addressed</th>
<th>What Our Consumers Said</th>
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</thead>
<tbody>
<tr>
<td><strong>Choice</strong> Providing more time</td>
<td>Retirees are often rushed into decisions at retirement in order to achieve an</td>
<td>“I wish I’d known about this. I’m working part-time and could have waited until [annuity] rates were better to tie in my pension…. I just didn’t ask about the other options.”</td>
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<tr>
<td>for engagement with retirement</td>
<td>immediate income. They do this with little knowledge of their needs and the</td>
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<tr>
<td>needs prior to commitment to</td>
<td>retirement market. Retirement Bridge buys them a breathing space to enable them</td>
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<td>an annuity</td>
<td>to make better-informed decisions about both the type of annuity they purchase</td>
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<td></td>
<td>and who they purchase it from.</td>
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<tr>
<td><strong>Flexibility</strong> Ensuring better</td>
<td>Retirees today typically don’t know what their priorities will be in providing</td>
<td>“You’ve saved all your life, and it can’t go to your children. That’s appalling! Yes, I like this if only because the kids would get something.”</td>
</tr>
<tr>
<td>management of decisions</td>
<td>for those around them, or, indeed, who those people will be. Retirement Bridge</td>
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<tr>
<td>about inheritance</td>
<td>provides them with the reassurance that their retirement savings can adapt to</td>
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<td></td>
<td>their changing needs.</td>
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<tr>
<td><strong>Accessibility</strong> Lowering costs</td>
<td>The vast majority of retirees lack the confidence and knowledge to manage their</td>
<td>“Can I just check: they don’t expect me to decide where to put my money, do they? Phew!”</td>
</tr>
<tr>
<td>to allow those with smaller</td>
<td>money themselves, yet often cannot afford individual professional advice, so they</td>
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<tr>
<td>funds to access the benefits of</td>
<td>mostly end up by default in an annuity.</td>
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<td>a professionally managed</td>
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<td>drawdown fund</td>
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<tr>
<td><strong>Potential for Growth</strong> Providing</td>
<td>Our analysis suggests that, historically, our approach would have led to</td>
<td>“I’d rather have the opportunity of some growth in income: the annuity is just going to devalue.”</td>
</tr>
<tr>
<td>the potential for future growth,</td>
<td>better average retirement outcomes, but, starting from where we are today, we</td>
<td></td>
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<tr>
<td>as well as protection from inflation</td>
<td>believe retirees could potentially be substantially better off. Allowing for</td>
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<td></td>
<td>inflation, our research indicates that outcomes were and will likely be far less</td>
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<td>risky than a level annuity.</td>
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A WORD ABOUT RISK

Market Risk The market values of the investments may 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 overseas 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 Currency fluctuations may have a large impact on returns and the value of an investment may be negatively affected when translated into the currency in which the initial investment was made.

Capitalisation Size Risk (Small/Mid) Holdings in smaller companies are often more volatile than holdings in larger ones.