Multi asset income withdrawal in a world of short business cycles

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Executive summary

Simultaneous losses in both stocks and bonds in 2022 coupled with a dramatically increased cost of living is focusing minds on the phenomenon known as sequencing risk. Large withdrawals from a pensions pot when fund values are depressed can significantly reduce the sustainability of income, as recent retirees may discover. Flexible drawdown has only been a feature of the landscape in the UK since universal pensions freedoms in 2015 and this bear market is its first real test.

In this article we demonstrate the importance of managing downside risk during the several recessions and associated bear markets the average person is likely to encounter in the course of their retirement. To do this, we use historical returns to simulate the 20-year experience for cohorts retiring from the mid 1990s onwards. We compare outcomes, assuming fixed annual withdrawals, for a range of investment strategies encompassing cash, global equities, and two multi asset approaches – one a passive strategy focused on natural income; the other an active strategy focused on total return and downside risk management.

Unsurprisingly, we find that keeping your pension pot entirely in cash is unlikely to generate enough return to sustain an income reliably. For the vast majority of the cohorts in our study, both multi asset approaches control sequencing risk better than equities, but the actively managed option is the clear winner with lower peak to trough losses driving superior outcomes. The return of structural inflationary pressure points to shorter business cycles and more frequent bouts of market volatility. In our view the management of downside risk will be as important as the management of return in a successful decumulation solution.

What makes a good decumulation solution?

The asset management industry has had decades of experience designing and managing portfolios for accumulation. However, many providers aren't addressing the distinct investment challenges faced by people withdrawing money from a pension pot to meet their retirement income needs.

In accumulation, the focus is on diversified portfolios that seek to maximise returns for a given level of risk, with risk defined as the volatility of returns. A young saver can afford to take a lot of investment risk, as by far the largest element of their projected pension pot is the future value of contributions they and their employer are yet to make. As they get closer to retirement, it makes sense to reduce risk to preserve capital. All the while, a portfolio with regular inflows is benefiting from 'pound cost averaging' with contributions invested when fund values are depressed showing the greatest long-term gains. As such, short-term volatility isn't entirely a bad thing.

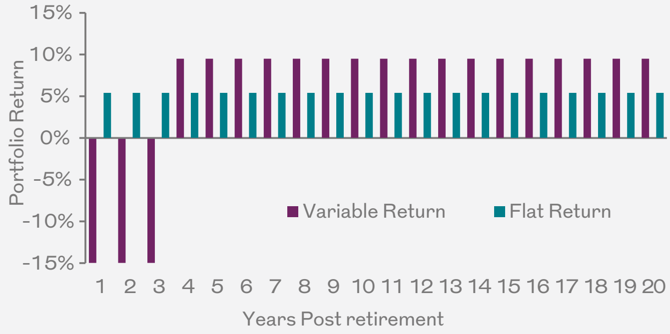
In decumulation, income sustainability is the objective. An investor must keep one eye on returns, as a pension pot replenished by gains will last longer. Unfortunately, real growth-seeking assets like equities, commercial property and commodities exhibit relatively high volatility and volatility is no longer a good thing. In decumulation, 'pound cost averaging' becomes 'pound cost ravaging'. Withdrawals made when fund values are depressed can significantly reduce the future sustainability of income. Investment losses early in retirement when the pension pot is large can be especially damaging, as we illustrate in the simplified example below (Figure 1).

We show two investments with the same long run average return. One has a flat return profile. The other has a variable profile with large losses in the first three years and higher returns later on to make up lost ground. We've set things up so, in either case, a buy and hold strategy would end up in exactly the same place at the end of a 20-year period. When taking an income, the outcomes vary markedly. The pension pot with flat returns still stands at around 30 of its initial value after 20 years of withdrawals. The pension pot with variable returns never recovers from early losses and the pot is completely depleted 12 to 13 years later.

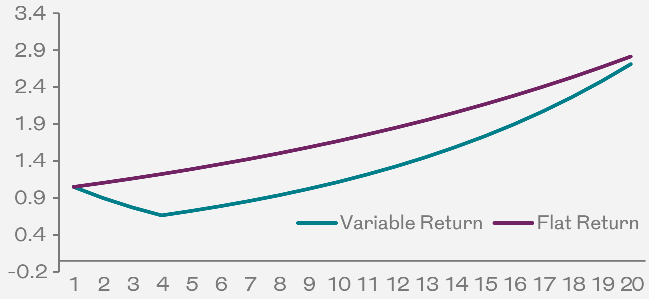
From this example, it is clear that a good decumulation solution needs to achieve an attractive level of return but it must also manage peak to trough losses along the way.

Figure 1: An illustration of sequencing risk in decumulation

Two return profiles over time



Cumulative return profiles over time



- Consider two pension pots of £100,000 looking to fund fixed nominal withdrawals of £7,500 per annum
- The shape of portfolio returns are a significant driver of income sustainability
- The variable return profile experiences significant losses early in retirement that are fully recouped over the remainder of the 20 year period
- None-the-less, sequencing risk means the variable return profile runs out of money in around 12 years while the flat return profile continues to pay out for more than 20 years

Fund value over time given return profiles

Simulated data or historical data are not a guide to future performance. Source: RLAM

Potential pitfalls of a multi asset approach focused on natural income

The first reaction of the asset management industry when pension freedoms were announced was to launch multi asset income funds. The idea was that you could live off the dividends, coupons, rents and interest produced by a diversified portfolio of investments, leaving the capital to grow over time to support future income needs.

In practice, natural income is unlikely to be high enough when interest rates are low. Moreover, the whole idea of a pension for most people is to spend the capital they have accumulated over a working life rather than leaving it in place. Once you are dipping into capital, sequencing risk raises its head.

The risk of losses is particularly acute going into a recession when equities can drop significantly in value, higher yielding bonds can suffer credit losses and apparently unconnected alternatives can suffer from poor liquidity and rising risk aversion. As the saying goes, correlations rise in a crisis.

Active management can reduce sequencing risk

We believe active management can reduce sequencing risk and improve outcomes. Our RL Multi Asset Strategies Fund (MAST) seeks to capture long-term growth in positive market trends while limiting losses during periods of turbulence. There are two elements to the investment process, both well aligned to decumulation needs:

1. **A volatility-capped core portfolio:** An efficient mix of liquid investments to maximise long-term growth at a moderate level of volatility, with exposure to risky assets dialled down during periods of market turbulence to limit peak to trough losses.
2. **An active tactical overlay seeking to add value irrespective of market direction:** A range of active strategies with a low correlation with the assets in the core portfolio and a tendency to add more value going into and out of recessions.

The fund launched in November 2018 but the tactical models at the core of our investment process allow us to simulate historical positioning and returns from the mid-1990s onwards and we can investigate how the approach would have fared in a wide variety of market conditions (Figure 2). We find MAST would have captured about half of the equity market upside in calendar quarters when stocks rose, but only about a tenth of the downside, with lower correlation, when they fell. This is the sort of asymmetric return profile that theory suggests should work well in a decumulation solution.

As you might expect, MAST's downside risk mitigation should work best during bear markets when volatility stays high and tactical opportunities abound. The simulation showed cumulative total returns of around 10% over both the 2001-2003 dot com bust and the 2007-9 Global Financial Crisis. The live MAST fund was also resilient in the bear market of 2022 when compared to passive multi asset funds.

We don't expect volatility management to offer additional protection in the scenario of a sudden shock in a bull market – as illustrated by the 15% drop the fund experienced in 2020 Q1 when Covid-19 first hit – but sequencing risk is less extreme when markets recover quickly, as they did in this instance.

Comparing decumulation outcomes

To compare different investment strategies, we use historical returns to simulate the 20-year experience for cohorts retiring between January 1995 and December 2022. In each case we assume an initial pension pot of £100,000 with fixed annual withdraws of £7,500.

We include four investment strategies encompassing:

1 cash;

2 global equities (unhedged, in sterling terms);

3 a passive multi asset fund focused on natural income*; and

4 an active multi asset fund with downside risk management (MAST).

* a static mix of 60% global equities, 20% sterling investment grade (non-gilts) and 20% global high yield, sterling-hedged.

The risk and return characteristics of each portfolio over the full period from January 1995 to December 2022 are shown below (Figure 3).

Figure 2: MAST shows an asymmetric return profile, falling less during periods of turbulence

1995 Q2 to 2022 Q4	Quarters when stocks rose	Quarters when stocks fell	Average quarter
Time	74%	26%	100%
Global equities (£)	5.8%	-7.8%	2.1%
MAST	2.9%	-0.8%	1.9%
Multi Asset Core	2.3%	-1.3%	1.3%
Tactical overlay	0.7%	0.5%	0.7%
Equity return capture	50%	11%	92%
Correlation	0.7	0.5	0.7

Quarterly returns calculated from Q2 1995 to Q4 2022 comparing MAST to equities (FTSE All World)

Simulated data or historical data are not a guide to future performance. Simulated data is used prior to the inception date of 23rd November 2018, calculated using historical positions generated by RLAM's in-house tactical asset allocation models and signals from the MAST volatility management process. Net of estimated fees and transaction costs. Source: RLAM

The Portfolio Managers make use of a quantitative model that influences their investment decision making process. This analysis uses data from the model prior to fund launch (November 2018) which does not take into account active decisions made by the Portfolio Manager.

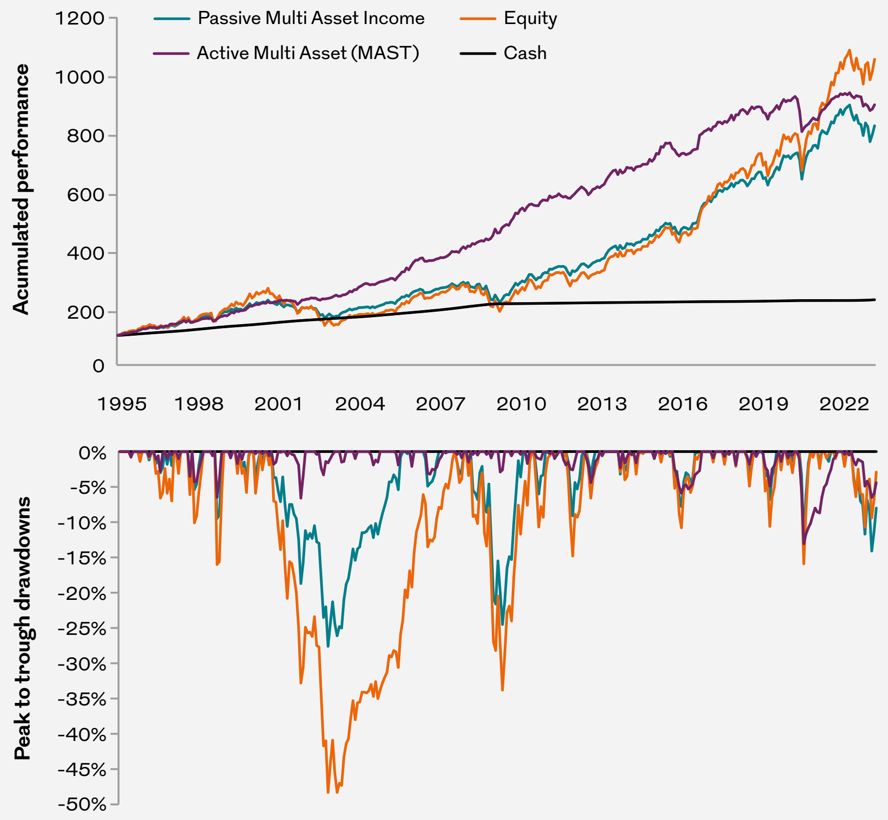
Figure 3: Risk and return characteristics of the four strategies

	Cash	Equity	Passive Multi Asset	Active Multi Asset
Return p.a.	2.9%	8.6%	7.7%	8.1%
Volatility	0.7%	14.5%	10.1%	6.0%
Max peak to trough loss	0.0%	-48.3%	-29.5%	-13.1%
Time to return to high water mark	0 months	81 months	58 months	18 months

Simulated data or historical data are not a guide to future performance. Returns based on JP Morgan 1 month sterling index / Deutsche Bank SONIA Total Return Index for cash; MSCI All Countries World Net Total Return Index for equities; IBOXX £ non-Gilts and ICE BofA BB-B Global Non-Financial High Yield Constrained Index for bonds. Active multi asset returns based on MAST simulated and actual returns. Source: RLAM. Forillustration purposes. Returns shown gross of fees.

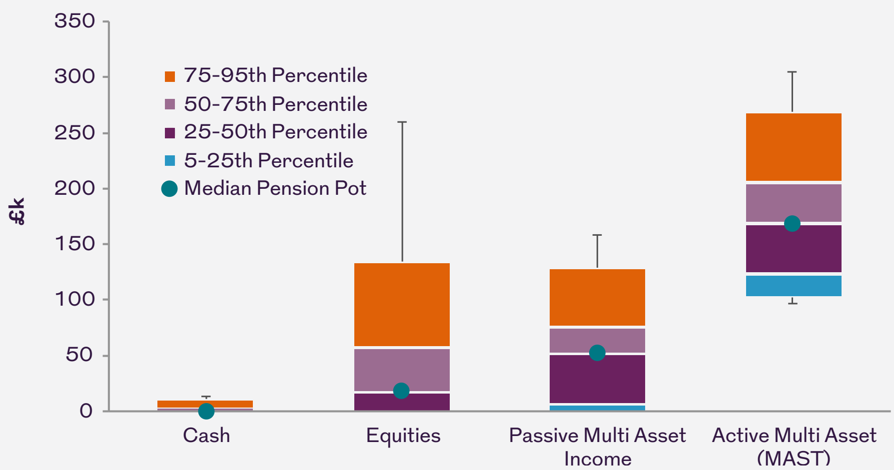
The passive multi asset approach has a similar average return to MAST but higher volatility and greater peak to trough losses in the bear markets (Figure 4). This is because it generates more of its return from market beta and there is no attempt to manage downside risk.

Figure 4: Total returns and peak to trough drawdowns from high water mark



Simulated data or historical data are not a guide to future performance. The chart above shows simulated and live data for the MAST strategy on the same calculation basis as for Figure 2. Source: RLAM as at December 2022.

Figure 5: Distribution of the remaining pension pot for cohorts after 20 years of income withdrawal



Simulated data or historical data are not a guide to future performance. Source: RLAM. Simulated residual fund values for cohorts of retirees taking regular withdrawals of £7,500 per annum over all of the 20-year periods between January 1995 and November 2022 from an initial pension pot of £100,000.

Shape of return matters a lot

There is a high degree of overlap in the data, with all 20-year cohorts including the eight years from 2015 to 2022, but there is still a remarkably wide variation in experience. Those starting to draw income in 1995 experience one recession and associated bear market, while those retiring in March 2000 experience three.

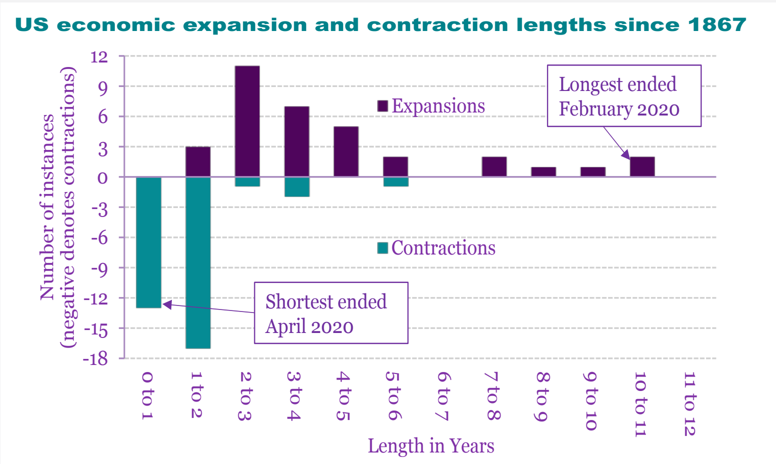
We summarise the results in the 'box and whisker' plots below (Figure 5). Each plot shows bands marking the median outcome across all cohorts along with the 25th and 75th percentile outcomes. The 'whiskers' show the most extreme 5th and 95th percentiles. What is striking is how much of an impact the different shape of returns has on decumulation outcomes, echoing the results of the simplified example in Figure 1.

We make the following observations based on this analysis:

- Unsurprisingly, keeping your pension pot in cash is disastrous with 66% of cohorts running out of money before 20 years had elapsed and other cohorts not far behind.
- Equities offer the strongest average return over the period but high volatility and large peak to trough losses mean 42% of cohorts run out of money. Those happening to retire with £100,000 at the bottom of the dot com bust in September 2002 are an extreme positive outlier, emphasising the lack of consistency in this approach.
- The passive multi asset fund focused on natural income is more consistent, with a much better median outcome than equities and only 20% of cohorts running out of money.
- The active multi asset fund focused on total returns and downside risk management comes out best, with a significantly better median outcome and a sizeable pension pot left at the end of the 20 years for all cohorts.

Given the fact that the two multi asset options have similar average returns over the full period, the superior outcomes with the actively managed approach demonstrate how important the shape of returns is when looking to reduce sequencing risk in decumulation.

Figure 6: Business cycles last an average five years



Source: National Bureau of Economic Research | NBER

> “Practice around decumulation investing is still in its infancy but it is the urgent and unfinished business of pension freedoms.”

The impact of recessions and bear markets on retirement income

The analysis we present here poses a very specific challenge to pension providers. How does your decumulation solution plan to deal with sequencing risk in and around the several recessions that your customers are likely to experience when drawing a retirement income?

We’ve experienced some abnormally long business cycles since 1980, with low inflation allowing central banks to cut interest rates early and hike them late. Structural changes in recent years – including deglobalisation, a chronic underinvestment in commodity capacity, geopolitical risk and populism – make more frequent inflationary overshoots likely. This suggests we will see more frequent recessions, as central banks are forced to step in to create spare capacity in the economy and bring prices down. It’s worth remembering that the average length of a full business cycle, based on US economic data since the 1860s, is about five years, with the average economic expansion lasting only three years (Figure 6).

Business cycles may be getting shorter, but people are taking income earlier and living longer than they used to. According to the Office for National Statistics’ life expectancy calculator, the average 55-year-old is likely to live for around 30 years (Figure 7). They might encounter half a dozen average length business cycles in this time, with the market turbulence linked to each recession potentially threatening the sustainability of their retirement income.

Figure 7: ONS Life Expectancy Calculator at age 55

Source: Office for National Statistics

Lessons for decumulation solution design

Decumulation solutions need to focus on long-term growth and downside risk management in roughly equal measure. Multi asset investing can improve the risk return trade off, limiting the worst outcomes, but passive investing or chasing assets offering high levels of natural income can leave retirees exposed to large losses in recessions. The analysis in this article suggests that an active multi asset approach focused on total returns and downside risk management can produce a much more consistent level of income.

Practice around decumulation investing is still in its infancy but it is the urgent and unfinished business of pension freedoms. If we are in a more inflation prone world, we should expect more years like 2022 with poor or negative stock and bond returns coinciding with increased drawdown needs. Defined Contribution pensions created the freedom to choose your own investment strategy for accumulation, but with freedom comes responsibility. Flexible withdrawals take things one step further, asking retirees to choose both their investment strategy and their income withdrawal strategy in an uncertain world. If the asset management industry can act to minimise sequencing risk, it will make a meaningful contribution to the lives of millions of people who will be drawing down a pension pot to meet their retirement needs.

Investment risks – RL Multi Asset Strategies Fund

Investment Risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative Risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both Fund losses and gains. The impact to the Fund can be greater where they are used in an extensive or complex manner, where the Fund could lose significantly more than the amount invested in derivatives.

EPM Techniques: The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Exchange Rate Risk: Changes in currency exchange rates may affect the value of your investment.

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Emerging Markets Risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

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