

Article

Managing opportunities

July/August Edition

Q1 - How are retirees looking to utilise income drawdown as part of their retirement planning strategy? How has it evolved as a result of the current economic turbulence?

The income drawdown market has evolved in many ways over the last 14 years. The benefits that attracted people to it remain true today, control of the underlying pension fund income, timing of annuity purchase and death benefits. The events of the last 14 years mean we now understand how this particular vehicle behaves in all kinds of market conditions. It has been the subject of regular regulatory scrutiny and guidance so we have a clear picture of the nature of the risks that need to be understood by the client.

More than ever, clients are using income drawdown as part of an overall retirement strategy. The market is driven almost entirely by clients under the guidance of an IFA. Strategies for how you invest and draw income are common. Clients will know whether their pension plan is likely to be their primary source of income. They will be provided with information to outline the overall resources that they will have and need in retirement. They must consider the rate at which income is likely to be taken from the fund allowing for market conditions, the likely investment performance of the portfolio and the charges levied by the product provider.

The current market conditions highlight why it is important for clients to understand the behaviour of the product and nature of the risks involved.

Q2 - What do you think are the biggest misconceptions people hold about income drawdown and what can the industry do to overcome them?

I am not convinced the problem today is about misconceptions, it is more about concerns that come from the reality of the risks. Volatile market conditions make recognising the risks real.

Previous regulatory work highlighted concerns because it was difficult to determine whether clients were being provided with a satisfactory explanation of the inherent risks of opting for income drawdown rather than the other options available. It was suggested that the risks were often described superficially and in terms the investor would not have been likely to understand. Particular areas highlighted:

- High income withdrawals may not be sustainable during the deferral period.
- Taking income withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is taken. This could result in a lower income when the annuity is eventually purchased.
- The investment returns achieved may be less than those shown in the illustrations.
- Annuity rates may be at a lower level when the annuity purchase takes place.

As an industry, we are now better at explaining what these risks mean to the end client. Ultimately, we can't influence annuity rates but we can influence the other three areas. Managing expectations is crucial, we can adjust income levels and we can decide on the appropriate acceptable level of risk alongside a sensibly structured investment strategy with regular reviews.

Q3 - Where do you see product innovation occurring in the income drawdown market?

Two important areas of change involve the nature of charges and allowing for the ever-changing nature of the underlying investments and markets.

Over the last fourteen years you will have come across products with bid offer spreads, policy fees, up front allocation percentages, single charges, multiple charges, the list is endless. Products of choice today will clearly disclose the nature, impact and timing of any charges.

Looking at charges, some may question the logic of SIPPs applying a charge when a client takes income at retirement. To understand whether this represents good value you must first identify the cost of the SIPP wrapper. Using Sippcentre as an example, the SIPP wrapper has a cost measured by a reduction in yield (RIY) of 0.17% p.a. In essence, it is structured so that the client is only paying for benefits and features as they use them. In traditional products, you could argue the cost is smoothed across all clients irrespective of whether you use this feature.

A simple example shows the historical scale of change and varying investments trends. The most popular funds by sales over the last ten years have covered sectors that include technology, North America, healthcare, commodities, UK income, property and absolute return. In the early years of the income drawdown market, such was the impact of Equitable Life that with profits was one of the most popular investment choices. Investment strategies are evolving beyond the use of more traditional external fund links to include things like exchange traded funds and discretionary investment managers.

A constantly evolving investment proposition that meets the changing needs of the client and the market is now accepted as a crucial ingredient for success.

SIPPs provide the re-assurance of being able to allow for all of the above.

Q4 - How do you think recent developments in the variable annuity market will affect income drawdown going forward?

Two areas worth considering here are longevity risk and the impact of a guarantee. From a product manufacturer's view, the risk and potential cost, if you get it wrong, is huge. Globally, this is why history shows that for every successful product there are many that have proved to be financial suicide for the provider.

The problem with longevity is few of us are in a position to predict our lifespan. The longevity risks in income drawdown are all about what happens to the residual fund if I die early and what is the chance of exhausting my fund if I live to a ripe old age. Variable annuity products tend to market the benefits of a guaranteed minimum income, guaranteed income for life and protection against market falls. If this is the case, longevity is often the enemy of the provider.

Over recent years I have been approached by many organisations willing to provide the underlying mechanism for guaranteed income, a key ingredient in a variable annuity. Few, if any, have been willing to carry the financial implications attached to the longevity risk. You have to ask why?

Many products will market the potential for upside alongside a guarantee. In understanding the potential for upside you must consider the impact of the cost of the guarantee. For every product that can clearly display a track record for delivering upside in all market conditions, you will have many that can't.

Variable annuities will be attractive to some but will remain niche solutions when compared to income drawdown.

END

Please note this document is intended for trade and national press individuals.

Notes for Editors

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A J Bell is the UK's largest privately owned SIPP provider and is continuing to grow rapidly in challenging capital markets. Invesco Perpetual and Midas Capital own 23% and 15% respectively of the share capital, the remainder being owned by Andy Bell and the management team.

Established in 1995, A J Bell specialises in providing administration, trustee and actuarial services for SIPP and SSAS.

A J Bell is now one of the largest SIPP trustee and administrators in the UK with in excess of 32,000* individual SIPPs and assets under administration exceeding £8bn*. It provides third party SIPP administration services for Barclays Stockbrokers, Halifax Share Dealing, Skandia and E*Trade.

Recent research by CoreData Research placed Sippcentre as one of the two most preferred SIPPs.

A J Bell has won an array of prestigious industry awards recognising our reputation for leading products and services. A J Bell products include Sippcentre, Sippdeal, Sippdealxtra, A J Bell Platinum and A J Bell Securities.

*As at 30th September 2008.



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