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Myths and rules of thumb in retirement income

'Myths and rules of thumb in retirement income' is the second stage of a research project sponsored by State Street Global Advisors. It builds on the findings from the first qualitative research stage that explored how individuals approaching retirement might use their Defined Contribution (DC) pension pots.

This report is part of the PPI's Transitions to Retirement research, a series of major reports exploring how people access pension savings in light of the new pension freedoms. The research series is sponsored by Age UK, The Investment Association, Partnership, The Pensions Advisory Service (TPAS), The Pensions Regulator (TPR), The People's Pension and Fidelity.

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Myths and rules of thumb in retirement income

Executive summary

This PPI report, *'Myths and rules of thumb in retirement income'*, is the second stage in a research project sponsored by State Street Global Advisors. It builds on the findings from the first stage, which consisted of qualitative research with individuals approaching retirement exploring their preferences for how they might want to draw their retirement income.

These individuals were selected because they had relatively low levels of Defined Benefits (DB) pensions, and sufficiently large Defined Contribution (DC) pension pots that they might prefer to leave these invested (rather than withdrawing them in their entirety as a cash lump sum). As a result, this group was most likely to be reliant upon DC savings for their retirement income and would be adversely affected if they did not manage them effectively. This earlier research found that while these individuals have made preparations for retirement, they have not thought through their financial position or spending needs in any detail. As a result, they are unlikely to be well placed to make decisions about investments either in the run up to, or during, retirement.

This stage of this research considers how rules of thumb might help retirees to think about and manage their DC pension savings. A round table, hosted by State Street Global Advisors and conducted by the PPI, was attended by representatives from Age UK, Citizens Advice, the Money Advice Service, NEST, The Pensions Advisory Service, The People's Pension, TUC and Which?. This discussed what 'rules of thumb' are, how they differ from received wisdom and how they might support DC savers when setting their strategies for retirement. This report reflects these discussions, along with additional analysis and modelling drawing the following conclusions:

Rules of thumb could help individuals manage their DC pension pots
In the absence of defaults or financial advice there is the risk that, by following what others say or what they perceive to be accepted wisdom, individuals will not always act in their best interests (although they may think they are). In such situations, rules of thumb could be used as a guide (or as a target).

Rules of thumb are not necessarily a way to achieve the optimum outcome for a particular individual. They are not intended to replace financial advice or guidance. What they are, however, is a course of action that is broadly appropriate for most people in a particular group. The central question around the use of rules of thumb is whether, for the group who use them, outcomes are better than if the rule of thumb were not used.

Round table attendees considered the '*five portions of fruit and vegetables a day*' recommendation to be an effective demonstration of a rule of thumb. It is considered easy to understand, is in the general best interests of a person and, even where individuals do not manage to eat five portions, they may take the positive action of increasing their consumption of fruit and vegetables.

There needs to be a clear distinction between a rule of thumb, which offers an appropriate course of action for many people and a received wisdom, which generally does not.

Received wisdom may be true, but not in every case

The two received wisdoms considered in the report ('purchase a buy-to-let property' or 'withdrawing my pension pot to find somewhere better / safer to invest') may be the best course of action for some. However, there are many instances when it will not be the right course.

Whilst the idea of purchasing a buy-to-let property is easy to understand, individuals do not necessarily do better by using their DC savings in this way – factors such as voids and on-going costs lower the yield on property. Other issues for consideration are the risk of investing in *one single* asset within *one single* asset class, and potential problems where individuals need to access their capital quickly.

Similarly, while some individuals' circumstances may mean that they benefit from withdrawing their entire DC savings at retirement, many do not do better by 'putting them somewhere safer'. Risks include giving up the benefits of some institutional funds (better governance, lower fees) in order to place their savings in potentially costlier retail investments and relying upon themselves to select the correct investment vehicle. They also risk paying a higher amount of tax when they withdraw their entire pension pot in one tax year rather than over a number of tax years.

Rules of thumb need to be carefully phrased and the language needs to make them easy to understand

The round table participants shared the belief that if financial rules of thumb are to be as successful as '*five a day*' these need to be conveyed using language that is both accurate and easy to understand, and financial education and literacy are essential.

Previous PPI research[1] identified a group of 694,000 individuals with low levels of financial education at high risk of using their DC savings in a way that is misaligned with their circumstances.[2] This supports the need for clear language that individuals with low levels of financial education or literacy understand.

[1] PPI (2014)

[2] These were individuals projected to have between £19,400 and £51,300 of DC savings and no DB entitlement at State Pension Age – financial literacy is not generally that high amongst this group of individuals who are likely to depend to a large extent on their DC savings in retirement.

Certain rules of thumb could be helpful to UK individuals under the new pension flexibilities

The two rules of thumb considered in the report ('4% rule' and 'secure a basic income') are considered to be generally in the best interests of an individual.

The '4% rule' is where an individual could withdraw this amount of their DC pension pot in the first year and, in subsequent years, the same amount indexed by inflation. The rationale behind this rule is that using it should make the fund last their lifetime. This specific rule of thumb could be helpful in the UK, as it addresses a general lack of understanding around life expectancy and awareness of the probability of living until age 90 or 100. Its strength also lies in the fact that it can be used as a guide or as a target. Even if it is not followed to the letter, it provides a reasonable basis for most people in terms of managing their expectations of income from their pension pot.

The 'secure a basic income to meet essential needs' rule could also be helpful in the UK as it addresses the risk that UK individuals will be at risk of drawing down their pensions too quickly. In terms of language, it is relatively easy to understand and it can be used as a guide or a target.

Introduction

In light of the changes announced at Budget 2014, the PPI has embarked on a series of major research reports on *Transitions to Retirement* exploring developments in how people might convert their workplace Defined Contribution (DC) pension savings into retirement income, and the associated risks and opportunities around the new freedoms and flexibilities.

'*Myths and rules of thumb in retirement income*' is the second stage of a research project sponsored by State Street Global Advisors. It builds on the findings from the first qualitative research stage of the project that explored how individuals approaching retirement might use their DC pension pots. The individuals selected to take part in the research had sufficiently large pension pots that they might prefer to leave these invested (rather than withdrawing them in their entirety as a cash lump sum). As a result, the findings should not be taken to be representative for all DC savers.

In addition, these individuals had relatively low levels of Defined Benefit (DB) pensions and, as a result, were most likely to be reliant upon DC savings for their retirement income. They would, consequently, be adversely affected if they did not manage their DC savings effectively in retirement.

The earlier research found that while these individuals have made preparations for retirement, they have not thought through their financial position or their spending needs in any detail. This group is unlikely to be well placed to make decisions about investments either in the run up to, or during, retirement.

A round table, hosted by State Street Global Advisors and conducted by the PPI, was attended by representatives from Age UK, Citizens Advice, the Money Advice Service, NEST, The Pensions Advisory Service, The People's Pension, TUC and Which?. This discussed what 'rules of thumb' are, how they differ from received wisdom, and how they might support DC savers when setting their strategies for retirement. This report builds on these discussions, supplemented with additional analysis and modelling around some common statements around retirement, drawing conclusions around the role and use of rules of thumb.

The first chapter of this report provides an overview of the definition of a rule of thumb, and its possible application in retirement. The second chapter provides an overview and assessment of two specific rules of thumb.

The third chapter considers some of the received wisdoms that may prevent an individual making the most of their retirement income.

The fourth chapter uses the findings to draw some conclusions from this research for the pensions industry.

Chapter one: what is a rule of thumb?

A rule of thumb is defined as:

'A guideline that provides simplified advice regarding a particular subject. A rule of thumb is a general principle that provides practical instructions for accomplishing or approaching a certain task. Typically, rules of thumb develop as a result of practice and experience rather than scientific research or theory'.[3]

Although a rule of thumb may be appropriate for most people, it may not apply to every individual and their specific set of circumstances. Generally, however, it should help individuals decide upon a course of action, without having to analyse their own current and future circumstances in detail.

Well-known financial rules of thumb include:
- Paying off your highest-interest credit cards first.
- Keeping an emergency fund equal to at least three to six months' worth of household expenses.

For the purposes of this report rules of thumb:
- Are not being suggested as a replacement for individuals to seek financial advice and / or guidance.
- Differ from a default in that an external body, such as a government or institution, generally applies a default while an individual selects and applies a rule of thumb.

The round table attendees considered the '*five portions of fruit and vegetables a day*' recommendation an effective demonstration of a rule of thumb. It is widely recognised that individuals should eat more than five portions but the objective of five is seen as realistic and not overwhelming.

This rule of thumb is a useful example because it has the following attributes:
- It is easy to understand.
- Is in the general best interests of a person. In this instance, it reflects the underlying assumption that individuals do not eat enough fruit and vegetables.
- Individuals are not likely to face any negative consequences by adopting this rule of thumb. There are relatively few individuals who would not benefit from increasing their consumption of fruit and vegetables.
- Even where individuals do not manage to eat five portions, they may take the positive action of increasing their consumption of fruit and vegetables.
- The existence of this rule is likely to have led to media coverage, which may in turn have increased awareness of the need to eat fruit and vegetables.

[3] http://www.investopedia.com/terms/r/rule-of-thumb.asp

Table 1 shows what a rule of thumb applied to income in retirement is, and is not, in the context of this report.

Table 1

Rules of thumbs for the withdrawal of income from pension savings

They <u>are a tool that</u>:

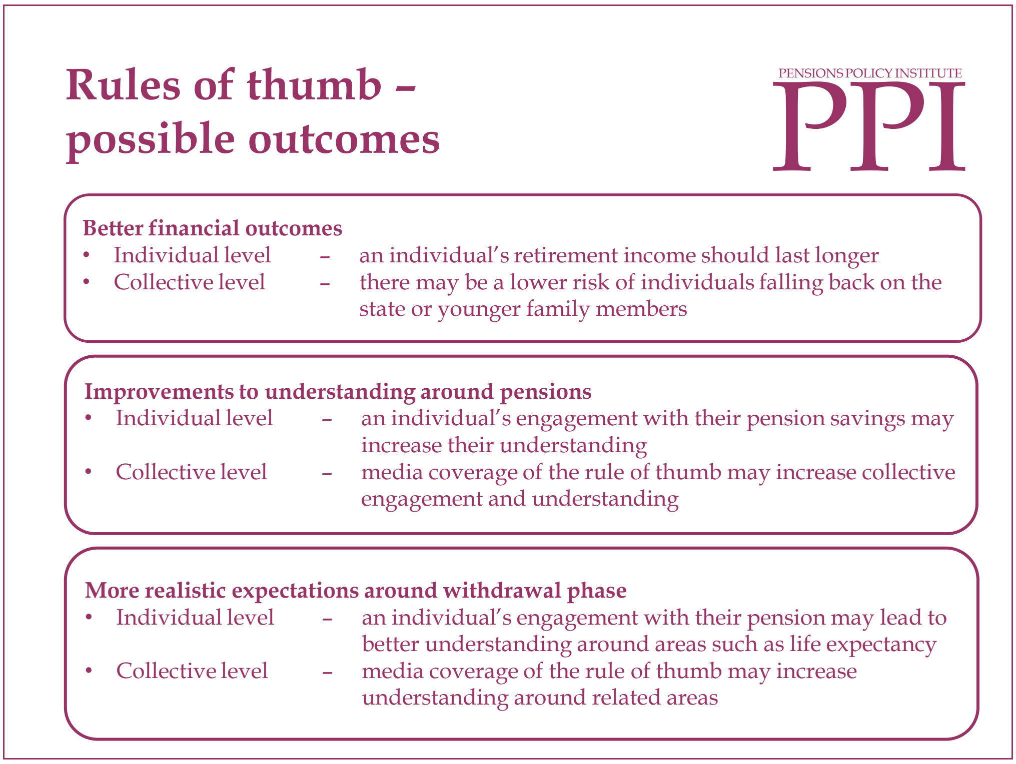
- Addresses a specific situation. For example, many individuals underestimate how long their retirement income will need to last;
- Is relatively easy to understand and follow;
- Can be used as a guide or as a target that individuals can aim for;
- Offers a better course of action than not following it.

They <u>are not</u>:

- Perfect – they will not suit everyone for every situation;
- The way to achieve the <u>optimum</u> outcome for that particular individual;
- A 'once and done' approach. Such decisions should be revisited on regular occasions.[4]

There may also be other advantages brought about by the communication or use of a rule of thumb, such as a more general increase in interest in or understanding around a particular issue, such as pensions (Chart 1).

Chart 1



[4] http://monevator.com/asset-allocation-strategy-rules-of-thumb/

Language used to describe any rules of thumb is central to their value

A key conclusion of the attendees at the round table was the need to use language that is both accurate and easy to understand. PPI research found that financial literacy is not generally high amongst those who are most reliant upon their DC pensions in retirement.[5] This highlights the need for clear language that individuals with low levels of financial education or literacy understand.

There were discussions around rules that use percentages, such as the '4% withdrawal' rule of thumb used in the United States being difficult to understand. A number of alternatives were suggested but none really met the 'easy to understand' criteria.

Chapter two considers the extent to which two rules of thumb, in particular, might help individuals to manage their retirement income, to assess the extent to which they might be helpful, especially the question around whether outcomes are better than if the rule of thumb was not used.

[5] PPI (2014)

Chapter two: examples of rules of thumb

Under the new pension flexibilities one risk is that an individual will draw down their Defined Contribution (DC) pension fund too quickly and will run out of money. This chapter considers the extent to which two specific rules of thumb might help individuals to manage their retirement income under the new pension flexibilities.

Rule 1: '4% withdrawal'
Rule 2: 'secure a basic income to meet essential needs'

Rule 1: 4% withdrawal

'4% withdrawal' could help individuals with DC savings to manage their retirement income
'4% withdrawal' has been widely debated by financial advisors in the United States (US) where annuitisation has not been the norm and, consequently, individuals have to make decisions around the rate at which they withdraw their DC pension pot. Box 1 shows the underlying rationale for the 4% rule.

Box 1

4% withdrawal

- Individuals withdraw 4% of the value of their DC pension pot in the first year of retirement
- In subsequent years, they withdraw this amount indexed by inflation
- Using this approach should make the fund last their lifetime

Discussion in the US has been mainly around whether 4% is a sustainable percentage rather than a critique of the rule itself. In contrast, this chapter first assesses the extent to which this type of rule of thumb may be helpful under the UK pension flexibilities, including the extent to which 4% might be a sustainable percentage in the UK.

Chart 2 considers the 4% rule against the definition of a rule of thumb outlined in Chapter one. The extent to which this rule meets these criteria is then considered in detail.

Chart 2

Comparison of 4% withdrawal against the definition of a rule of thumb

Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Yes	• International experience suggests that individuals are at risk of drawing down their pension savings too quickly • Deals specifically with how much it may be possible to withdraw each year
Relatively easy to understand and apply	Partly	• May need to be framed differently • Individuals may need a tool / formulae to help them calculate the amount of income
Tool that can work in variety of ways	Yes	• It can helpfully act as a guide or target.
Offers a better course of action than not following it	Generally	• For the majority of individuals this would be a reasonable course of action

A '4% *type*' rule of thumb could be helpful to UK individuals under the new pension flexibilities

Addresses a specific situation
This deals with the very specific question of how much of their DC savings pot an individual can withdraw each year.

Other countries' experiences suggest that where UK individuals use drawdown products they will be at risk of drawing down their pensions too quickly, with the risk of a negative impact on their quality of life. In Australia, 25% of people aged 55 deplete their balances by the age of 70.[6] Similar concerns have been expressed in the US and Ireland. This suggests that a need in the UK for an approach, such as the 4% rule of thumb, to prevent individuals from running out of money in retirement.

Similarly, UK analysis, conducted by Age UK, finds that where an individual with a £29,000 pension pot withdraws £3,000 (around 10%) per year from the age of 65, they will run out of money by age 75. Age UK suggests that, even where individuals make modest withdrawals, they risk spending their later retirement without any income from private pensions.[7]

[6] Murray, D. (2014)
[7] http://www.ageuk.org.uk/latest-news/pension-reforms-could-leave-many-older-people-out-of-money/

Relatively easy to understand and to apply
This rule of thumb may be difficult to understand where individuals are not able to calculate percentages. Therefore, this rule may need to be framed in language that is easier for individuals to understand. Similarly, individuals may need help to calculate the initial amount of income. Both of these may be partly addressed by the provision of on-line tools to help individuals calculate their withdrawal.

Tools that can work in a variety of ways
The 4% rule can be used as a guide or a target. When used in the US, many retirees do not stick to 4%; instead they monitor their portfolio and alter their withdrawal amount in line with changes to the market and their needs.[8]

Offers a better course of action than not following it
UK individuals may not stick to 4%, but may also withdraw a lower amount per year than they would have done without the rule.

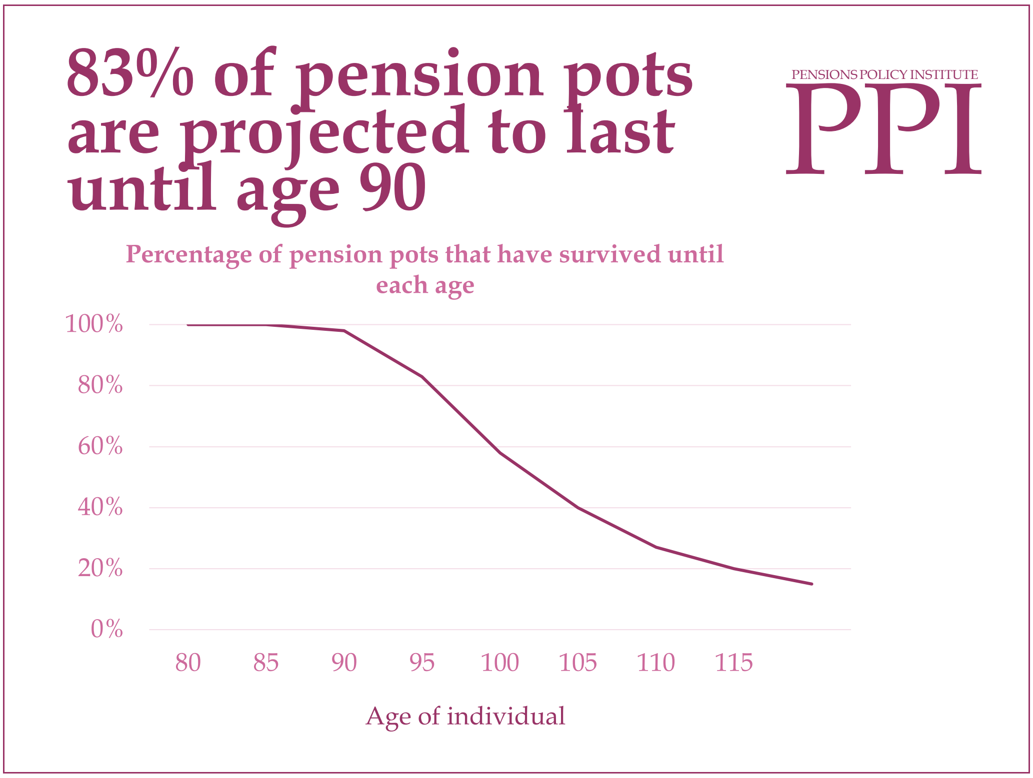
The 4% rule may alter individuals' expectations around a sustainable level of withdrawal. If the stock market performs poorly, they may then understand the need to modify their withdrawal rate so as to sustain the income over a longer period.

4% appears to be a reasonable starting point for UK DC savers
As part of the consideration as to whether following the 4% withdrawal rule offers a better route than not doing so we modelled the possible outcomes for a median 65 year old male whose fund is invested 60% in equities and the remainder in gilts. The PPI's Individual Model takes into account 1,000 different scenarios, stochastically considering multiple factors including equity and gilt returns. More information about the modelling approach is available in a separate appendix on the PPI website. While the first stage of this research targeted individuals with relatively large pension pots, these modelling results would apply regardless of the size of pension pot (provided that fees are calculated as a percentage of the pot).

The modelling assumed that individuals withdraw their DC pension pot from age 65. In this year, the individual withdraws 4% of their initial pot. In subsequent years they withdraw this initial amount uprated by the Consumer Price Index. On this basis, the median male has a very high probability of his DC savings lasting until age 84, which is the average life expectancy for such a 65-year-old UK male (Chart 3).

[8] Vanguard (2012)

Chart 3[9]

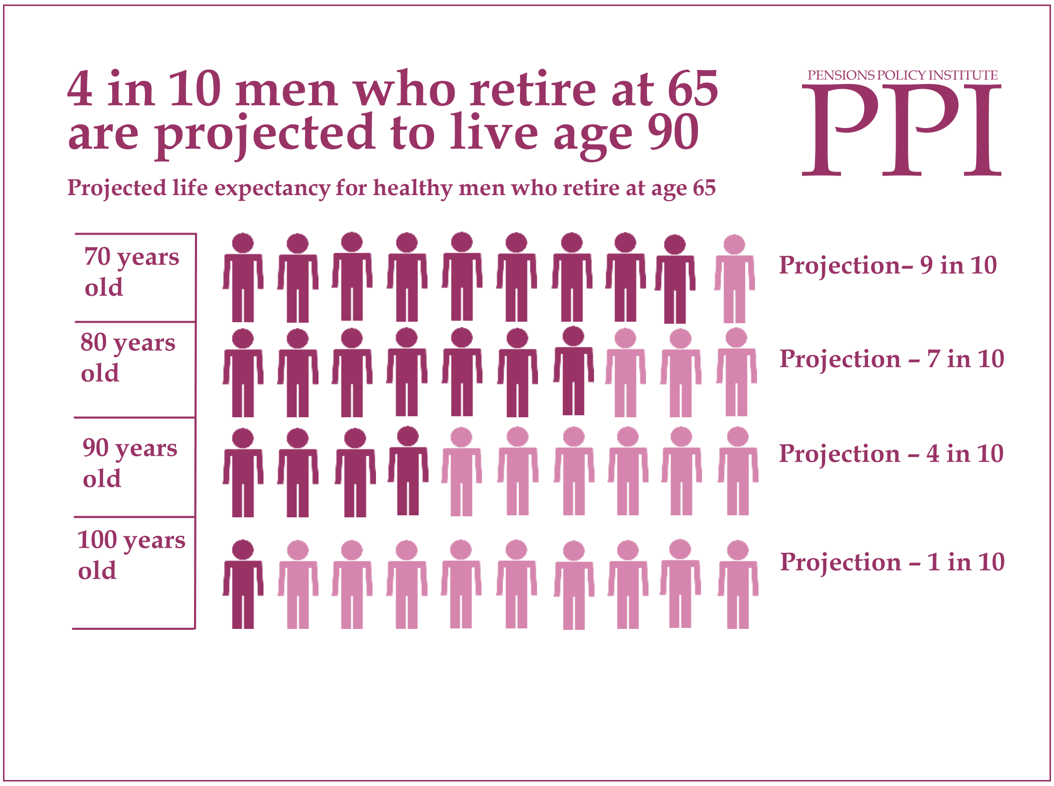


Comparing the length of time a pot may potentially last, with an individual's life expectancy (for a male aged 65) highlights:

- A 65-year old male has a **9 in 10** chance of living until age 70. There is a **very high (higher than 9 in 10)** projected probability that his DC savings will last until this age.
- He has a **7 in 10** chance of living until age 80. There is a **very high (higher than 9 in 10)** projected probability that his DC savings will last until this age.
- He has a **4 in 10** chance of living until age 90. There is an **8 in 10** projected probability that his DC savings will last until this age.
- He has just under a **1 in 10** chance of living until age 100. There is a **4 in 10** projected probability that his DC savings will last until this age.

[9] Assumptions; an individual withdraws 4% of pension pot at age 65. Each subsequent year he withdraws this initial amount uprated by the Consumer Price Index. The pension pot is invested in 60% equities and the remainder in gilts. There is a 0.75% charge on drawdown.

Chart 4



These findings have different interpretations depending on an individual's attitude to risk and expectations around their own longevity. Chart 4 shows the projected life expectancy for healthy men who retire at age 65. Considering the individual who lives until age 90, there is a 2 in 10 probability that they will have run out of money at 90 if they apply the 4% rule. While this may seem high to risk-averse individuals, it may be lower than their probability of running out of money if they had not applied a rule of thumb.

Overall, the figures suggest that a 4% withdrawal rate might be a reasonable starting point. Further analysis of other levels of withdrawal would be required in order to reach firmer conclusions as well as consideration of the following:

- The whole pot would be exhausted without the maintenance of any capital;
- No allowance for the individual's wish to pass on an inheritance;
- What happens if the individual exhausts their DC pension pot? If they have other sources of capital, running out of money may not be such a problem. However, if they rely on the state pension or benefits only, exhausting their DC savings may be problematic;
- This approach does not necessarily guarantee the *optimum* outcome as it is not seeking to replace the need for financial advice or guidance;
- The steady stream of income may not match the profile of an individuals cost in retirement; a 'typical' pattern for costs has been noted as a u-shape consumption curve where individuals have a higher spend in early retirement, this decreases in the middle years due to a reduction in mobility.

Finally it increases again at around age 85 due to disability-related expenditure;[10]
- These projections assume fees of 0.75% per year; however, outcomes would be different where fees are charged at a different rate. Which? Recently surveyed drawdown providers and found that an individual with a £50,000 pension pot could be £3,000 better off after ten years where they used the least expensive provider rather than the most expensive.[11]
- Individuals are likely to review these arrangements on a regular basis, even where they adopt the rule of thumb, and modify their withdrawals based on a number of factors. This is particularly important where individuals' health status changes and a different approach may be appropriate.

Rule 2: 'Secure a basic income to meet essential needs'

Securing a basic income to cover essential needs should be a priority for individuals over other concerns, such as leaving an inheritance
Round table participants suggested that a relevant rule of thumb would be for individuals to '*secure a basic income in order to meet essential needs*' in retirement. There was particular reference to examples of individuals choosing to pass on their DC savings to their children ahead of securing their own basic income. In this report, 'securing a basic income' refers to the idea of an individual securing a level of income for life.

The previous stage of the research asked individuals to assess their essential needs in retirement.[12] Many were realistic about what they would require (Box 2) but underestimated how long they would need it for.

Box 2: Findings from the first stage of this research – interviews and focus groups with DC savers aged 50 and over

- When taken through a task which required them to consider their spending pattern in detail in retirement most individuals estimated that they would need around £10,000 - £15,000 for the early years of retirement, dropping to around £10,000 for the later years.
- At the same time, participants underestimated their life expectancy, thereby underestimating how long their pension pot might be required to last.

This finding is supported by research conducted by NEST that finds that the threshold for a 'comfortable' retirement is around £15,000 per year.[13] While individuals' definitions of a basic or comfortable income may vary,

[10] PPI (2009)
[11] http://www.which.co.uk/news/2015/07/the-true-cost-of-pension-freedom-409249/
[12] PPI (2015)
[13] NEST (2014)

this supports the argument for individuals to identify a 'floor' at which they want to secure a regular income.

A 'secure your basic income' rule could be helpful to UK individuals under the new pension flexibilities but it does not fully address issues around the tendency to underestimate longevity
Chart 5 considers 'secure your basic income' against the definition of a rule of thumb outlined in Chapter one.

Chart 5

Comparison of secure your basic income against the definition of a rule of thumb

Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Partly	• While the rule may help individuals to think about their essential expenses, it may not address their tendency to underestimate their life expectancy
Relatively easy to understand and apply	Partly	• This rule is relatively easy for individuals to understand, as they should be used to budgeting • It may be more difficult to assess for how long they will need to secure their basic needs
Tool that can work in variety of ways	Partly	• It can helpfully act as a guide or target but isn't prescriptive enough in terms of what a basic income might be to totally meet the criteria
Offers a better course of action than not following it	Yes	• Enables individuals to consider what their pension pot is for and how their priorities interact

Addresses a specific situation
As with the 4% rule of thumb, this rule responds to the fact that UK individuals will be at risk of drawing down their pensions too quickly (or using these pots for discretionary or luxury spending without securing a basic income), with the risk of a negative impact on their quality of life.

However, where individuals underestimate their own life expectancy they also underestimate how long the pot will need to last. This means that, where they think that they have secured a level of income for the rest of their life, they may still exhaust their pension pot prematurely because they underestimate the number of years for which it needs to last.

Where individuals qualify for the maximum amount of Basic and State Second Pension, they could receive £14,350 per year, which would cover many basic income needs without significant additional funding. However, under the New State Pension the annual income is currently estimated to be £8,060 per year.

Individuals may therefore need to find between £2,000 and £7,000 per year in order to secure a 'basic income'.

Relatively easy to understand and to apply
This rule of thumb is relatively easy to understand. However, individuals may not fully understand the extent of their consumption needs in retirement and may underestimate their costs. In addition, while individuals may feel able to assess their likely basic needs in the early years, this is more challenging for later retirement. Where these assessments are inaccurate, individuals may retain insufficient savings to meet their basic needs in later retirement.

This suggests that it would be helpful to explore supplementing this approach with the concept of replacement rates, which may still have a role in helping individuals to calculate their consumption needs in retirement. Replacement rates calculate the level of income that individuals may need in retirement to replicate their standard of living in working life.

Individuals who use this approach may also benefit from combining this with a regular review of their financial situation.

Tools that can work in a variety of ways
The 'Secure your basic income' rule can be used as a guide or a target or even followed to the letter. In all cases, it may dissuade individuals from some discretionary or luxury spending once they understand that they need to maintain their savings in order to ensure that they have sufficient income in future years.

Offers a better course of action than not following it
Ensuring that an individual has considered their minimum requirements has to be better than not, although it may generate more questions than it is possible to answer. For example, if their pension pot is insufficient to cover their basic needs for any length of time, what can they do?

More importantly, is the timing of people asking themselves this specific question (as to what their basic income needs are). If they can be encouraged to do this well before retirement, this may enable them to make up at least some of any potential shortfall in their pension pot.

Chapter three considers what is a received wisdom and discusses a couple of examples for pension decumulation.

Chapter three: received wisdoms

The round table participants discussed other rules of thumbs. However, when these were assessed against the criteria identified in Chapter two these rules of thumb failed to meet them. It was felt that these fell into the category of a 'received wisdom'; that is:

'A judgment that has been accepted as true or worthy, especially without firsthand corroboration'.[14]

The participants felt that the key criterion that a received wisdom typically failed upon was 'offering a better course of action than not following it'. Two such wisdoms in particular emerged from the first stage of this research project:[15]

Wisdom 1: 'Better returns can be achieved by investing in property'
Wisdom 2: 'I can find somewhere 'better' or 'safer' for my money'

This chapter reflects findings from a review of literature and the round table discussion around these wisdoms.

Wisdom 1: Better returns can be achieved by investing in property

While property was popular amongst participants in the first stage of this research, few had considered the costs associated with such an investment, or the risks involved.

Box 3: Findings from the first stage of this research – interviews and focus groups with DC savers aged 50 and over

Accepted wisdom amongst this group was that they believed better returns could be achieved by investing in property

- It was common for respondents to discuss accessing funds to invest in a buy-to-let property, with most talking about buying a property outright
- Property remained popular even when individuals considered the risk of investing in *one single* asset
- Individuals had not typically considered costs (except the purchase price) in their calculations, suggesting that any views on rental yield may be over-optimistic

[14] http://www.thefreedictionary.com/received
[15] PPI (2015)

Research conducted by the ONS supports these findings; an ONS survey found that 42% of people were considering investing in property for their retirement.[16] Similarly, 28% respondents considered property to be the safest way to save for retirement.[17]

While the preferences expressed by individuals in the first stage of this research will not necessarily translate into action, the received wisdom among many members from this research was that better returns could be achieved by investing in a buy-to-let property. This finding was particularly striking because individuals in this group typically described themselves as risk-averse, yet they were not averse to the risk of investing in one single property.

This preference was despite the fact that the average pension pot will not be sufficient to purchase a property, particularly in the South East. The Pension Advisory Service's (TPAS) experience suggests that an individual may be attracted to the idea of having a tangible asset, such as a property, without necessarily having the means to achieve it.

The rest of this section assumes that individuals purchase their property outright; however, where they wish to purchase the property with a mortgage this will have an additional impact on their level of return. Factors such as the availability of mortgages to older people and changes to tax relief on mortgage interest would also have an impact on outcomes for those wishing to purchase a buy-to-let property.

Chart 6 considers the purchase of a buy-to-let property against the definition of a rule of thumb, based on criteria used to assess the effectiveness of rules of thumb in Chapter two.

16 http://on.ft.com/1H4QTDt
17 ONS (2015)

Chart 6

Assessment of purchase of a buy-to-let property against the definition of a rule of thumb

Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Yes	• Deals specifically with the issue of generating a retirement income
Relatively easy to understand and apply	Yes	• UK individuals are familiar with and generally positive towards the idea of purchasing a buy-to-let property
Tool that can work in variety of ways	No	• Typically, individuals purchase a whole buy-to-let property
Offers a better course of action than not following it	Not always	• It does not guarantee better returns than other forms of investments • There are particular risks around investing in property

Received wisdom may not always be true: While the idea of purchasing a buy-to-let property is easy to understand, it does not always generate a better return

Addresses a specific situation
The purchase of a buy-to-let property at retirement addresses a very specific issue of generating a retirement income.

Relatively easy to understand and apply
During the first stage of this research individuals made the suggestion of purchasing a buy-to-let property to provide retirement income. This demonstrates how individuals understand the concept of a buy-to-let property and would be willing or confident to go ahead and purchase such a property.

Tool that can work in a variety of ways
Unlike the rules of thumb considered in Chapter 2, it is not possible to apply this approach in a variety of ways; typically individuals purchase a whole buy-to-let property.

Offers a better course of action than not following it
While investing in property may be a suitable course of action for some individuals, it does not guarantee better returns than other forms of investments. In addition, there are particular risks around investing in property, such as:

- **There is no risk diversification**
  Where money is invested in a vehicle such as a pension, the investment manager invests this across a number of different types of assets (asset classes), such as equities and bonds. In addition, within particular asset types, funds can be invested across a range of assets, e.g. they may be invested in different companies' shares. This approach aims to diversify risk so that an individual will not be disproportionately affected if the value of one particular type of asset falls.

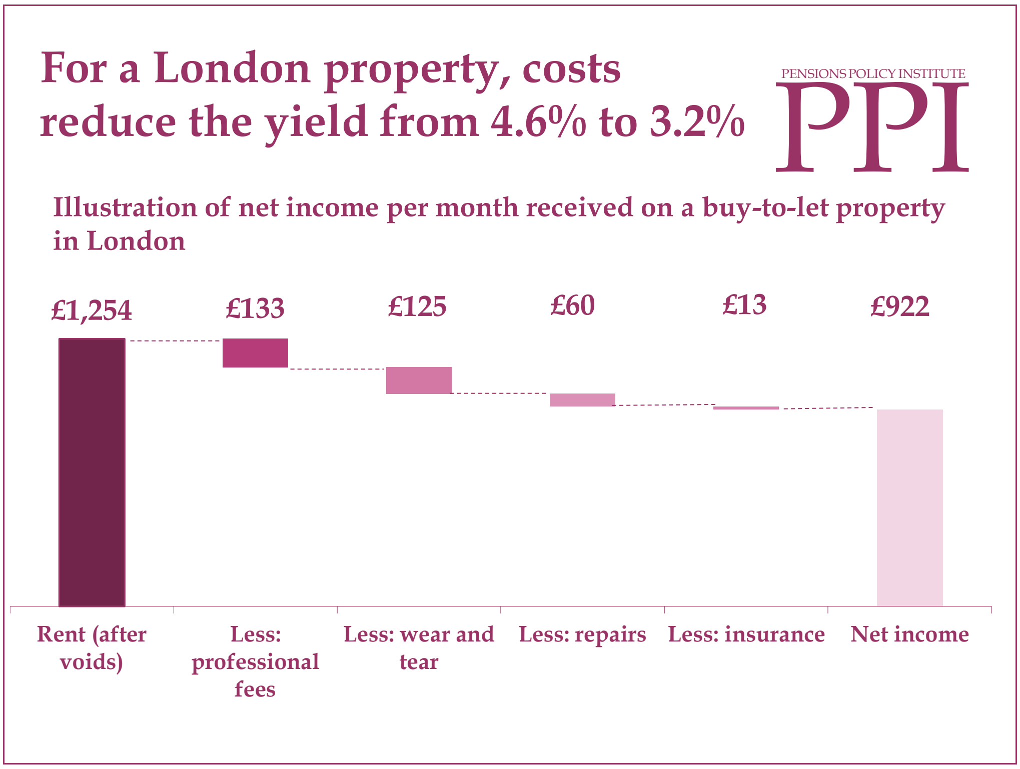
  Buying a property entails investment in *one* asset within *one* asset class, meaning that individuals could be disproportionately affected by changes in the value of this asset. Risk arises from various factors; for example, the impact of a fall in property prices on capital and the impact of a bad tenant or lengthy void periods on income. Both of these are explored further in the following sections.

- **Investing money in a buy-to-let property means it is difficult to access this money quickly**[18]
  The purchase of property means that individuals may not be able to access their money easily or quickly.[19] This can be particularly problematic where house prices fall and individuals are required to crystallise any losses.

- **Individuals can under-estimate costs associated with a buy-to-let property and, as a result, over-estimate rental yields**
  Along with the cost of purchasing a property, there are on-going costs associated with the renting of a property such as repairs, agents' fees, insurance and administrative costs, (e.g. tenancy deposit scheme fees). Void periods also have an impact on income - it is estimated that average void periods amount to 2.7 weeks per year.[20] All these factors have an impact on the levels of rental yield achieved by an individual, as does the location of the property. Charts 7 and 8 contain illustrations that compare the impact of these types of costs on rental yield for one property in London and another in Wales. These illustrations have been used for comparison because they were the areas with the lowest and highest rental yields in 2013.[21] In both of these illustrations, the yield is reduced by around a third by the impact of costs.

[18] https://www.capitaemployeebenefits.co.uk/en/current-news/2014/04/could-a-buy-to-let-investment-replace-your-pension#sthash.k1isSsJD.dpuf
[19] Which? (2015)
[20] www.propertywire.com (2014)
[21] Countrywide.co.uk (2013)

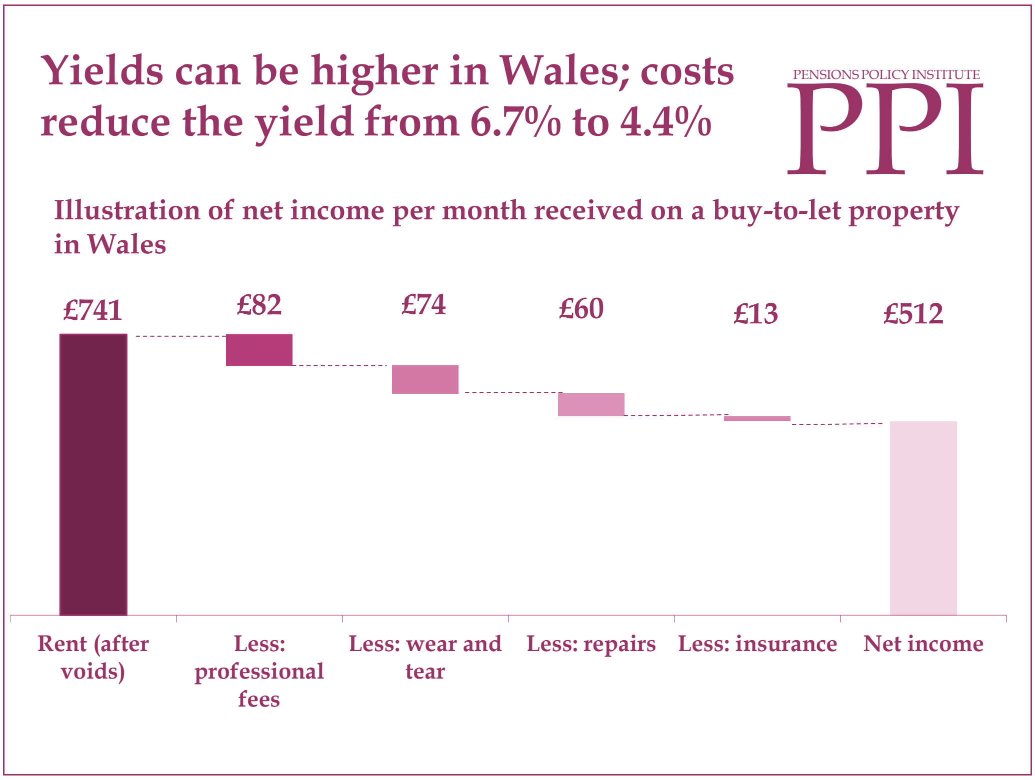
Chart 7[22]



Both of these illustrations assume that an individual does not take out a mortgage. The yield would reduce further with this cost.

[22] Data sources include: Nationwide Building Society, Countrywide.co.uk (2013) www.propertywire.com (2014) www.lcplc.co.uk, Lloyds Banking Group (2014), Property Investment Project (2015), British Gas (2014), twww.rla.org.uk (2015)

Chart 8



In addition, many individuals do not factor a further reduction in yield due to income tax being payable on rental income. However, individuals would also pay income tax on other sources of income, such as withdrawals from a DC pension.

It is important to take account of the impact of income tax on a pension pot withdrawal and capital gains tax on the sale of any second property

There are two types of tax, in particular, to take into account in this scenario:[23]

- Income tax that is to be paid on withdrawals from a DC pension in order to purchase the property;
- Capital gains tax on sale of the property.

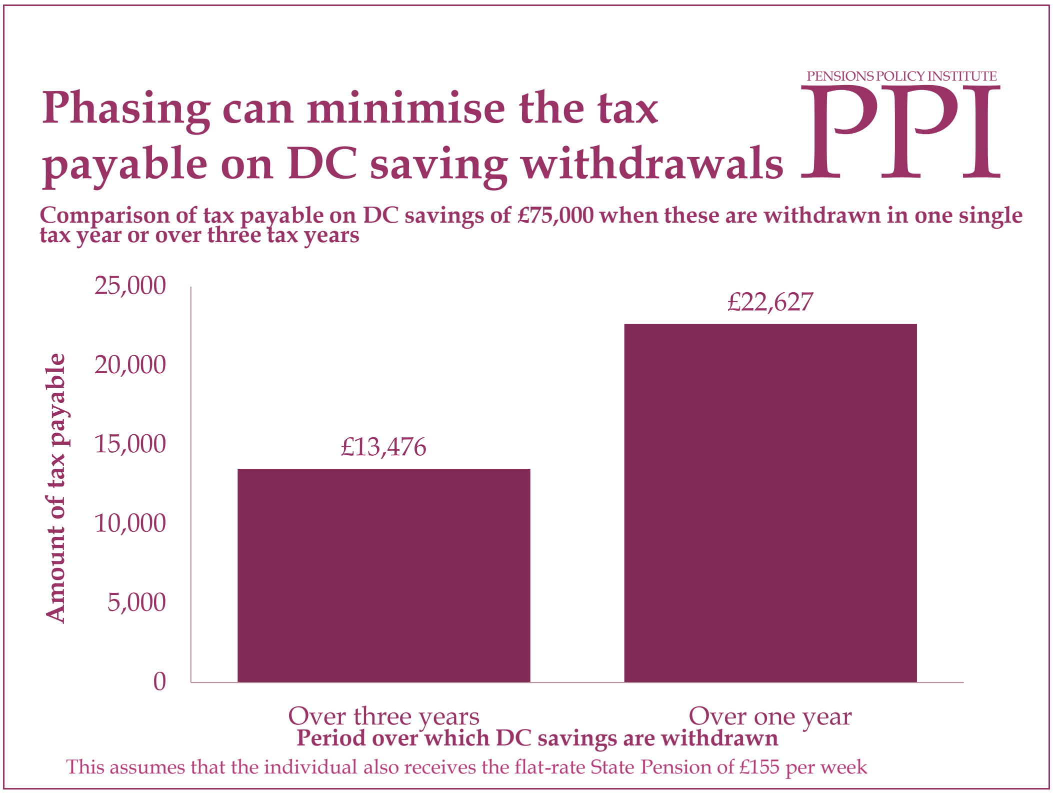
These interact to influence an individual's tax position, making a decision around whether to withdraw money from a pension pot a complicated one. Findings from the first stage of this research suggest that some individuals may not be aware of the tax treatment of withdrawals from their pension pot. Several participants were very surprised to learn that their plans to purchase a buy-to-let property could lead to a 40% tax payment.

Individuals pay income tax on withdrawals from DC pensions in line with their normal tiered tax rates. Where an individual withdraws their entire DC pension pot at one time in order to purchase a property it may cross a tax threshold. As a result of this they would pay a higher rate of tax on a proportion of this than if

[23] Individuals are also liable for income tax on rental income

they had accessed this gradually over a number of years. Chart 9 compares the withdrawal of an entire pension pot of £75,000 (after the withdrawal of a 25% tax-free lump sum from a £100,000 pension pot) in one year versus phased withdrawals over three years.

Chart 9



Unlike an individual's main residence, capital gains tax is due on the sale of a buy-to-let property. If an individual does not have capital gains from other sources and their gain on a buy-to-let property is less than the annual capital gains tax-free allowance of £11,100, capital gains tax is not of concern.

As individuals age they may be less willing or able to manage a buy-to-let property

Even where a property is managed by an agent, individuals may be required to undertake particular tasks such as the approval of tenants, management of the agents and completion of tax returns. This could be a particular concern where an individual experiences cognitive decline as they age.

Wisdom 2: 'I can find somewhere 'better' or 'safer' for my money'

Individuals in the previous stage of this research expressed their preference for taking their money out of their pension to put into 'safer' or 'better' investments[24]

Box 4 highlights findings during the first stage of this research suggesting that participants were risk adverse. However, many had little understanding of how investment choices, and factors such as inflation, would impact upon their savings.

Box 4: Findings from the first stage of this research – interviews and focus groups with DC savers aged 50 and over

Received wisdom amongst this group was that their money could be either 'safer' or they could achieve better returns if they took their money out of their pension and invested it themselves

- Many mentioned taking money out of the pension to put into 'safer' or 'better' investments – which often meant cash based investments
- There was little understanding of how investment choices and rates of return would impact on how long their pension savings would be likely to last
- There was evidence that the tax implications of drawing down all of a pot at once had been missed by some participants

Chart 10 considers the withdrawal by an individual of their entire DC savings against the definition of a rule of thumbs, based on criteria used to assess the effectiveness of rules of thumb in Chapter two.

[24] PPI (2015)

Chart 10

Assessment of withdrawal by an individual of their entire DC savings against the definition of a rule of thumb

Criteria	Meets the criteria?	Commentary
Addresses a specific situation	Yes	• Deals specifically with the question of what to do with DC savings
Relatively easy to understand and apply	Yes	• Individuals understand the idea of accessing their DC savings and, in particular, putting this in cash savings
Tool that can work in variety of ways	No	• According to this received wisdom, individuals withdraw their entire DC savings
Offers a better course of action than not following it	No	• It does not guarantee better returns and cash investments in particular may not offer acceptable returns

Received wisdom may not always be true: While the idea of withdrawing entire DC savings is easy to understand it does not always generate a better return

Addresses a specific situation
The withdrawal by an individual of their entire DC savings deals specifically with the question of what to do with DC savings.

Relatively easy to understand and apply
During the previous stage of this research individuals made the suggestion of accessing their DC savings and putting them somewhere 'safer' or 'better'.

Tool that can work in a variety of ways
Unlike the rules of thumb considered in Chapter two, it is not possible to apply this approach in a variety of ways; this approach refers to individuals withdrawing their entire DC savings.

Offers a better course of action than not following it
While some individuals' circumstances mean that they may benefit from withdrawing their entire DC savings at retirement, many will not necessarily do better by withdrawing such savings and putting them somewhere 'safer'.

The following factors should be taken into account by individuals thinking about withdrawing their DC pension pots to place these in 'safer' or 'better' investments.

- **Interest rates are relatively low and, over the long-term are unlikely to offer an acceptable level of return to individuals**
  Some risk might be required to deliver investment returns that provide individuals with an acceptable level of income and, in particular, protect them against inflation. Individuals who took part in the previous stage of this research initially wanted to place their DC savings in 'safer' investments. However, once they understood the possible consequences and the type of trade-offs that might be required, they indicated that they would be prepared to take some risk.

- **Individuals may end up purchasing directly from asset management companies ('retail funds') which can be more expensive than funds provided as part of their pension arrangements ('institutional funds')**
  Fees for retail funds can be higher than for equivalent institutional funds. Retail funds do not generally benefit from the same economies of scale available to an institutional investor. It has been reported that annual management charges on these types of funds can be 1.5% for a fund investing in equities and that these charges can include an advisor commission and a platform administration fee.[25]

  Individuals risk withdrawing their pension pot and investing it in a more expensive product having lost the pension wrapper around it and potentially incurring income tax.

- **It may be more difficult for individuals to stick to a particular level of withdrawal where funds are held in an easy to access bank account**
  Where individuals are easily able to access their pension funds, they may not stick to a particular level of withdrawal compared to products where they are required to apply to make a withdrawal.

- **It is important to take account of the impact of tax – particularly where the individual may not be expecting to pay tax**
  Individuals pay income tax on withdrawals from DC pensions in line with their normal tiered tax rates. Where an individual withdraws their entire DC pension pot at one time it may cross a tax threshold. As a result they would pay a higher rate of tax on a proportion of this than if they had accessed this gradually over a number of years.

[25] http://www.thisismoney.co.uk/money/diyinvesting/article-2594308/How-decode-confusing-investment-fund-names.html

- **In their search for better investment returns, individuals may be tempted by pension scams**
  The introduction of pension flexibilities has led to heightened concerns around pension scams, with The Pensions Regulator (TPR) pointing out that the tactics used by pension scammers are constantly in flux.[26] Many DC savers' lack of understanding around a realistic level of return, along with their conviction that they can get better returns outside of pensions, may lead to them being particularly vulnerable to scams. Round table attendees suggested that individuals should question investments where returns in excess of 8% are promised. This is in line with TPR literature that suggests that a tactic used by scammers is the distribution of marketing materials that promise returns of over 8%. Those individuals who are swayed by this level of return may have already explored the level of annuity that they are able to purchase and are disappointed by this rate.

  The TPR highlights tactics as offering free pension reviews, health checks and promises of better returns on savings.

  The Pensions Advisory Service (TPAS) suggests the following as possible indicators that an offer may be a scam:[27]
  - Individuals approached out of the blue
  - Particular phrases like 'one-off investment opportunity'
  - Money to be transferred overseas
  - Individuals encouraged to speed up transfers of money
  - No documentation being made available
  - The 'special offer' will only be available for a short period of time and the proposed investment is often an unusual one (such as land or property developments)

[26] http://www.thepensionsregulator.gov.uk/regulate-and-enforce/pension-scams.aspx
[27] http://www.pensionsadvisoryservice.org.uk/pension-problems/making-a-complaint/common-concerns/pension-scams

Conclusion:

Rules of thumb could help individuals manage their DC pension pots
Without effective defaults or financial advice there is the risk that DC savers will not always act in their best interests (although they may think they are) by following what others say or what they perceive to be accepted wisdoms and facts. In such situations, rules of thumb can help by providing a guide or as a target that individuals can aim for.

Rules of thumb needs to be carefully phrased and the language used needs to make them easy to understand and easy to apply
A key conclusion of the attendees at the round table was the need to use clear, accurate language to convey a rule of thumb.

The 4% rule of thumb could act as a realistic starting point for UK DC savers
The 4% rule of thumb could be helpful in the UK, as it addresses a general lack of understanding around life expectancy. Its strength also lies in the fact that it can be used as a guide or as a target, and it helps to manage expectations around levels of income from pension pots.

PPI modelling suggests that, if an individual were to adopt the 4% rule, he has a very high probability of his DC savings lasting until age 84 (the average life expectancy for a male).[28] However, the 4% rule is not a guarantee and in some instances, the pot will run out if the individual continues with that specific course of action.

Received wisdom is not always true; individuals do not necessarily do better by withdrawing their DC pension pots to invest in a buy-to-let property or somewhere 'safer'
There is a tendency for individuals to say that they will withdraw their DC pension pots and put the money elsewhere,[29] including in buy-to-let properties or 'safer' investments. This is of particular concern where individuals indicate that they will withdraw their entire pot in the first instance without understanding the consequences.

These individuals risk giving up the benefits of some institutional funds (better governance, lower fees) in order to place their savings in potentially costlier investments. They also risk paying a higher amount of tax when they withdraw their entire pension pot in one tax year rather than over a number of tax years.

A question remains around how to promote rules of thumb, and how individuals can be influenced to question received wisdoms
It is difficult for DC savers to assess the helpfulness of different sources of guidance and information. In order to address this, the use of rules of thumb could be part of the discussion that Pension Wise has with individuals.

[28] This calculation assumes that a healthy 65 –year old male starts to withdraw his DC savings at age 65
[29] PPI (2015)

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