OCM Wealth Management

• Chartered Financial Planners • Discretionary Asset Managers • Stockbrokers • Tax Advisers

KEY GUIDE

Investing for income when you retire

Planning the longest holiday of your life

There comes a time when you stop working for your money and put your money to work for you. For most people, that is retirement. The decisions you make then could have repercussions for the rest of your life, and recently there have been some major changes to the choices you can make with your pensions. Your retirement could turn out to last considerably longer than you think, as the table below shows.

How long will your retirement be?

	Men		Women	
Age now	Life expectancy	Chance of reaching age 100	Life expectancy	Chance of reaching age 100
60	86	8.1%	88.0	12.3%
65	86	7.2%	89	11.1%

Source: DWP 2012-based cohort expectation of life, 1981-2060, Principal Projection, United Kingdom and DWP 2012-based period q(x), 1981-2060, Principal Projection, United Kingdom Based on age in 2016

Action point

Make a list of all your pensions and other investments and find out what they are worth.

You probably have a number of different investments and other assets that can provide income in your retirement and perhaps also leave an inheritance for your family. There could be different pensions from different sources. You are likely to have a state pension and other pension entitlements that have built up over the years, perhaps from several employers. You may also have capital you have accumulated from savings or inheritances over your working life. You probably also own your home, which may now be larger than you really need and you could possibly use some of its value to boost your retirement income.

Your income needs may also evolve as you grow older. For example, in the early years of retirement you may be happy to continue working part-time and so may need to draw less than the full potential income from your pensions and other investments for a while. But your income needs could start relatively high and then reduce as you get older, before rising again. This could happen if you have an active but non-working early retirement with relatively high income needs, which then fall as you get out and about less, before increasing again if it turns out that you need care. The decisions you make when you retire should take these possibilities into account. You might also want to consider how to minimise the inheritance tax on your estate.

Some decisions you take for your retirement may be permanent, for example if you decide to buy an annuity. Others, like the investment of a retirement lump sum, may need to be regularly reviewed.

Making the right investment choices at retirement is so important that you owe it to yourself and your family to take professional advice. It is best to start at least six months before your intended retirement date, because gathering all the relevant information and weighing the various options can be a slow process.

Key planning issues at retirement

Investment planning when you retire can be more complicated than sorting out your finances at other times.

- Your investment goals may be evolving, with the emphasis moving from growth to income.
- Your attitude to investment risk and your ability to absorb losses will probably change once you have no earnings coming in with which to make good any investment losses.
- Your marginal rate of tax could fall when you stop work, as your full time earnings come to a halt.
- You may not be certain about the level of your future income if, for example, you are planning to undertake some part-time consultancy work.
- You may want to pay more attention to inheritance planning than you have before.
- Your spending patterns are likely to change with no travel to work, and more leisure.
- You could have a large one-off investment to make, such as a pension scheme lump sum. And you may well need to keep your pension fund invested to generate a long term income.

A good starting point is to estimate what net income you will need in retirement by undertaking a long term cash flow planning exercise. This cash flow planning exercise will take into account how long you may live, based on average lifespans and also your own health and family history.

Action point

Estimate how much income you will need throughout your retirement.

Pensions decisions

There are basically two types of pension you may hold.

A defined contribution (DC) pension typically comes either from a scheme set up by an employer or from a personal or stakeholder pension you set up yourself. The DC scheme has a fund, part of which you can draw as a tax-free lump sum. The remainder is taxable, whether taken as income or as lump sums.

A defined benefit (DB) scheme will provide you with a pension that your employer guarantees and which is based on your earnings and how long you worked for the employer. It could also pay you a tax-free lump sum. Most DB schemes are from public sector employers and a few large private companies.

Defined contribution pensions

The fund built up in your pension plan effectively gives you a pot of money. You can use this to provide either:

- A tax-free lump sum, usually up to 25% of the total fund, and a taxable pension income. The income can be provided by an annuity or by withdrawals (often known as income drawdown) from your pension fund; or
- A lump sum, 25% of which is tax-free.

Where the first option is chosen, most people decide to draw the maximum tax-free lump sum either all at once or through a series of payments. The income choice is often more complicated.

The decision about whether to buy an annuity or to take pension income drawdown deserves careful thought. It is worth taking some time to consider the choices; some people are likely to be better off buying an annuity and others should draw their income directly from their pension fund. In some cases, it may be worth starting with pension income drawdown and buying an annuity some years later.

So how is an annuity different from income drawdown?

Annuity

An annuity is simply a lifetime income that you can buy with your accumulated pension fund from an insurance company. There are two key choices you have to make if you buy an annuity.

- **The form of annuity.** Your annuity income could stay at the same level for the rest of your life or you could opt for a lower starting income that increases each year to protect you against the effects of inflation. You could also choose for income to be paid to your spouse, partner or anyone else you choose, perhaps at a lower level than your pension, if you die before them. If you are under age 75 when you die, and their income starts on or after 6 April 2015, it is tax free.
- **The annuity provider.** Don't automatically buy the annuity offered by your current pension provider – the chances are that you could do better. There are substantial differences in annuity rates offered by the top and bottom companies and they change frequently. You may also qualify for an enhanced annuity because of your health or other circumstances.

Remember, this should be treated as a decision for life. While the government plans to allow the re-sale of annuities, you are unlikely to get nearly as much back as the annuity cost. There is no substitute for skilled advice from an expert who can check the whole market for you.

Action point

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The advantage of an annuity is that it is simple and guaranteed to last for the rest of your life – and your spouse or partner's life as well if you buy an annuity that includes them. The main drawback of an annuity arrangement is that it is not flexible.

Example – comparing annuities

Helen is age 65 and has a pension fund of £400,000. She plans to take £100,000 as a tax-free pension commencement lump sum and use the rest to buy an annuity. Her pension provider offers her an annuity of £1,200 a month. Helen consults a financial adviser, who considers all her circumstances and agrees that an annuity is likely to be the best option. However, having researched the market, and taking into account that Helen smokes 20 cigarettes a day and has high blood pressure, her financial adviser is able to arrange an annuity of £1,600 a month with a different company – a third higher than the original offer.

Pension income drawdown

Under pension income drawdown, you draw your income directly from your pension fund.

This is much more flexible, but there are no guarantees that the fund will be able to pay out an income for the rest of your life. In general, the death benefits tend to be better than those provided by annuities. Pension drawdown is generally more complicated and costly to administer than annuities and carries additional risks, so it is not suitable for everyone.

There is complete flexibility about how much you can draw from your pension fund once you have decided to take drawdown, including not drawing any of your fund but leaving it in the more-or-less tax-free environment to accumulate. You also have the ability to take the whole fund in a single payment, though that could result in high tax charges. Drawing income will restrict future payments to DC pensions without tax changes to £10,000 a year, except for 'capped' drawdown arrangements started before 6 April 2015.

Any fund left over when you die can be used to provide a pension for a dependant or someone else nominated by you, or paid out as a lump sum. In either case, payments are tax free if you die before age 75, but taxable if you are 75 or over.

Whatever you do, you should consider the tax consequences. Drawing down a very substantial amount from your fund could cause more of your income to be subject to higher rates of tax than if you drew smaller amounts each year. Or you might be able to plan your income so that you can take a substantial amount from your pension without an especially high tax charge.

There are variants of income drawdown that can provide some extra security. Variable annuities guarantee a minimum income level, at a cost, while fixed term annuities allow you to secure income for a number of years and leave a pot of money at the end for future income.

Fund withdrawal

Action point

Think whether it is more important to you to have a guaranteed income or to have flexibility, but with the risk your income could fall or even run out.

An 'uncrystallised funds pension lump sum' (UFPLS) allows you to withdraw money from your pension, up to its full value, without needing to access drawdown or an annuity. With a UFPLS, 25% will be tax free, with the remainder taxed as income. The money can then be invested outside the pension to provide future income. While this option may seem attractive, withdrawing the full amount could take you into a higher income tax bracket, and so may not be beneficial. It will also restrict future payments to DC pensions without tax charges to £10,000 a year. It is important to get advice if you consider this option.

Timing

Most personal pensions, and some other DC pensions, allow you to phase in taking your benefits, not linked to when you stop work. This means you can use part of your fund to provide a tax free lump sum and an annuity or drawdown and then leave the rest to start drawing on later. However, you cannot start taking your benefits before age 55, which will increase to 57 in 2028.

Defined benefit pensions

In most DB schemes outside the public sector you will have one simple choice to make about your main benefits: do you want to exchange some of your taxable pension for tax free cash?

Example – fund withdrawals

Derek is age 58 and has a pension fund of £800,000 in a self-invested personal pension (SIPP). He requires a lump sum of £100,000 to pay off his mortgage and fund his daughter's wedding. He is continuing to work, earning £60,000 a year, so does not require any income, and wants to continue his £2,000 a month contribution to his SIPP. Derek is thinking about taking a UFPLS fund withdrawal, but after considering all Derek's circumstances his financial adviser recommends that he immediately takes £100,000 as a tax-free pension commencement lump sum, with £300,000 moving to income drawdown. This means he has no immediate tax liability, though income from drawdown will be taxable when he takes it. He is also able to continue his £2,000 a month contribution without adverse tax consequences, because he has only taken pension commencement lump sum and not drawdown income.

In most defined benefit pension schemes outside the public sector you will have one simple choice to make about your main benefits: do you want to exchange some of your taxable pension for tax free cash?

Put that way, the answer might seem obvious, but in practice cash might well not be the better option. The terms on which you will be able to exchange some of your pension for cash are often far from generous and may more than offset the tax exemption. In public sector schemes, cash is often a fixed part of the overall benefits, although usually you will be able to commute a small part of your pension for extra cash.

If you have made additional voluntary contributions to the scheme (other than those that buy 'added years' of service), you will also have to decide how these are dealt with. The options will usually be similar to those for DC occupational schemes, described below.

Some people consider transferring out of a DB pension to take advantage of the flexibilities of DC pensions, but this involves giving up a guaranteed income for one that is subject to investment risk. It should not be done without professional advice, and in any case is not legally possible from most public sector schemes.

Investment income

Having some investment income could make the difference between just getting by and enjoying a comfortable retirement. However, that does not mean that you should always opt for the investments offering the highest possible income when you retire. As a general rule, the higher the initial income you receive from an investment, the less scope there will be for future income and capital growth. Higher income could also mean paying more tax.

Broadly speaking, there are three ways in which you can take income from investments.

- You could just take the natural income. For example, some income funds can make regular payments by distributing dividend income. The hope would be that the dividends would rise in future and provide an increased income and even some capital gains. Of course this is not guaranteed and income and capital values could drop.

- You could regard the total return from your investments as your income. In that case you would regard both the income and capital gains as your spendable income. Clearly this is a higher risk strategy because you cannot count on making gains on a regular basis, and there may be years when there are losses. It also reduces the potential inflation protection for the portfolio of investments.
- You could consciously aim to eat into the capital as well as drawing the income and gains. Clearly this is the highest risk, because at some time the capital will run out – possibly while you are still living.

Gone are the days when you could rely on bank and building society deposits to pay a meaningful rate of interest, even if the buying power of your underlying capital was being eaten away by inflation. If you are looking for income now, there are three main areas to consider – both in the UK and overseas.

- **Fixed interest securities**, which cover a wide area of investments from government bonds (gilts) to corporate bonds. Income yields vary considerably between different securities with, unsurprisingly, the highest yields from the riskiest bonds.
- **Shares**, which in the UK and many other countries now yield more than short-term deposits. Over the long-term, dividend income from shares has been less volatile than share prices.
- **Commercial property** is an often forgotten source of income. This can provide a good level of income, as well as the possibility of growth in value, though there will be ongoing costs as well.

Action point

The three main investment sectors can be accessed through a wide range of investment funds. You can hold them directly or through investment 'wrappers', such as ISAs and investment bonds.

Past performance is not a guide to future performance. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

ISAs and other tax wrappers The three main investment sectors can be accessed through a wide range of investment funds. You can hold them directly or through investment 'wrappers', such as ISAs and investment bonds. ISAs can be particularly useful in generating income because:

- Within an ISA, there is no capital growth, interest or dividend payments, although corporation tax already paid by companies cannot be reclaimed.
- You have no tax pay and nothing to report to HM Revenue & Customs (HMRC)
- On your death, your ISAs can pass to your spouse or civil partner and provide an income for them.

From tax year 2016/17, there is a **personal savings allowance** of up to £1,000 a year for income received as interest – the exact allowance depends on your overall tax position. Everyone also has a dividend allowance of £5,000. These will make the tax position on income the same as for ISAs up to the level of the allowances.

The choice of investments, the appropriate wrappers and who should own what investments are all areas to explore with your financial adviser in the run up to retirement. After that you should review your investments with your adviser regularly – usually once a year – to make sure that your objectives are still being met and to make any necessary amendments.

Using your home in retirement

Planning for retirement should also take your home into account. Increasingly these days many people still have an outstanding mortgage when they retire, and paying it off may be a priority. However, you may also wish to use the value of your home to supplement your retirement income. This could be by downsizing and moving to a smaller, less expensive house, or you could consider a number of different options which may be available to you.

How we can help

Preparing for your retirement is complicated, with many different things to take into account. We can help you with your planning and, in particular, we provide advice on:

- Cash flow planning.
- Choosing between annuity and income drawdown, and finding the best annuity rate if relevant.
- The best provider, investment strategy and income levels for drawdown.
- Managing your investments, including the pension lump sum, in a tax-efficient way that meets your needs.
- Inheritance tax and estate planning.

Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

Past performance is not a guide to future performance. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

Levels and basis of, and reliefs from, taxation are subject to change and depend on your individual circumstances.

The Financial Conduct Authority does not regulate tax and estate planning.

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