PENSION MATTERS

A guide to YOUR RETIREMENT OPTIONS

Contents

Introduction

This guide is intended to provide a general outline of the various options available to those planning for retirement.

It is of relevance to anyone either still funding for,or approaching, a significant milestone in their lives and is designed to provoke thought and discussion as to the optimum route for your hard earned funds.

It is not intended to be definitive or provide advice but will hopefully help you understand your options and be the next step on your journey towards a happy and fulfilling retirement.

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Conventional annuity

Buying an annuity

The most common way to traditionally take the benefits from a personal pension is to use your pension fund to buy an annuity. This means exchanging your pension fund with an insurance company for a guarantee that it will pay you an income for the rest of your life. Before you buy an annuity you can take a tax free cash lump sum from your pension fund (up to up to 25% of the total fund).

The level of pension income that your annuity will pay you depends on several factors:

Current interest rates

Annuity rates are loosely linked to interest rates so when interest rates are high more pension can be bought because of the potential higher investment return, however when interest rates are low this reduces the amount of pension that can be bought. As we have been in what is perceived as a low interest rate environment for several years now annuity rates have been correspondingly low and are considered by many to be poor value.

However there is nothing to say annuity rates could not fall further. There is an element of gambling with annuity purchase, if you wait and annuity rates rise in the interim you win with a higher income, but if rates fall you are left with a lower income for life than you might have had.

It is worth noting that generally underlying annuity rates have been falling steadily since 1995 and the pension freedoms of April 2015 are likely to reduce the long term demands for annuities even further.

Your age and life expectancy

The older you are when you buy an annuity the fewer years the insurance company will expect to have to pay you so your pension will be higher at age 65 than it would have been at age 60 for the same size fund. The other key factor is increasing longevity; we are all living longer which is good news unless you are in the annuity business! Insurance companies are forever playing catch up because as a population our average life expectancy continues to rise.

This means annuity rates will fall correspondingly as pensions have to be paid for longer. This is something that is bound to continue and it can only have a downward impact on annuity rates, regardless of any other influencing factors.

Health and lifestyle

Increasingly annuities are 'underwritten' to take account of any health factors that may influence your lifespan and if you are in ill health this can result in a higher annuity rate and therefore a greater income in retirement. This can incorporate anything that could potentially reduce your life expectancy from medical conditions, family history, what you do for a living, whether you smoke, even the postcode you live in!

Conventional annuity Continued

The type of pension you want

You have the choice of adding various options to your pension annuity. Your pension can be payable only to you for your lifetime, or it can continue to be paid to your spouse or civil partner when you die. It can stay at the same level each year or you can elect for it to increase at regular intervals.

It may seem a good idea to protect your income against rising prices as the table below demonstrates how inflation can reduce your spending power over time. This does come at a price in that your income will start at a much lower level and will take many years (perhaps 15-20) for your income to get to the level it would have been if you have chosen a level annuity at the start. You have to make a decision whether the lower starting income is worth the benefit of a higher level of income in later years and look at your annuity in relation to your other assets and alongside the state pension which is protected against inflation.

The effect of inflation on £1,000 – reducing your spending power

Source: Prudential

Annual Inflation	Over 5 Years	Over 10 Years	Over 15 Years	Over 25 years
2.25%	£894	£800	£716	£573
4%	£821	£675	£555	£375
6%	£747	£558	£417	£233
8%	£680	£463	£315	£146

You can add a guarantee period to your annuity which means that should you die your pension would continue to be paid at the same level to your dependants for the remainder of the guaranteed period. This is normally for 5 or 10 years. Depending on the options selected at outset your husband or wife may continue to receive a pension or the remainder of the guaranteed instalments may be paid as a lump sum. If they die before you, your pension cannot usually be paid out to anyone else.

Additionally you may now purchase a 'value protected' annuity offering a lump sum death benefit of the annuity purchase price less the pension income paid out to date, this could be for the full amount or a proportion of your fund depending upon what you decide at outset.

All of these different options affect the cost of your annuity and can make a difference to the initial pension you would receive. If you elect to provide for your spouse, want your pension to increase each year or want a guarantee period, these options will reduce the amount of the initial pension you will receive and it could take many years for the pension to increase to the same level it would have been at outset had you elected not to take any of the additional benefits described above.

Conventional annuity Continued

Advantages of a conventional annuity

- Guaranteed income.
- Simplicity.
- No investment risk.
- Security.
- Immediate access to all your tax free cash sum.
- Depending how long you live, you may get back more than you used to buy the annuity.

Disadvantages of a conventional annuity

- You make a decision about your retirement now which you and your family are committed to for the rest of your life – and beyond!
- You may find that you would have been better off waiting – annuity rates may rise.
- Lack of flexibility.
- Your circumstances may change after you have taken the benefits e.g. you may choose to provide benefits for your spouse and they predecease you.
- Inflation may erode the value of your benefits.
- If you die early in retirement the payments received may be less than the amount you invested in the annuity.

The 'open market' option

At this stage I should mention that it is possible to either buy a conventional annuity with the insurance company which holds your pension fund, or if another company is offering higher annuity rates, you may transfer the value of your pension fund to them using what it known as the 'open market' option.

It is rare for the company holding your pension to offer the best annuity rate so we would always recommend investigating your 'open market' option as this will affect your income for the rest of your life. If you need help with this get in touch.

With profits/ unit linked annuity

These are very similar in make up to conventional annuities in that you can choose for the annuity to continue after your death to your spouse and purchase a guaranteed period if you wish.

Unlike conventional annuities though, the level of income is not guaranteed, but is linked to the performance of an investment. As long as a set rate of growth is achieved your income may be higher than under a conventional annuity and can even increase in the future. However, the income could go down if the required growth rate is not achieved. The with profits approach is less volatile than the unit linked option but does not have as great a potential for higher income in the future as the underlying 'with profits' fund will normally have a less aggressive investment strategy.

Advantages of 'unit linked/ with profits' annuity

- You have immediate access to your entire tax free cash sum.
- Depending on how long you live you may get more back than you used to buy the annuity in the first place.
- The income you receive may rise in the future if performance is in excess of the set growth rate for the plan.

Disadvantages of 'unit linked/ with profits' annuity

- If the set growth rate for the plan is not achieved your income level may fall.
- You make a decision about your retirement now which you and your family are committed to for the rest of your life.
- You may find that you would have been better off waiting – annuity rates may rise.
- Your circumstances may change after you have started taking your benefits.
- If you die soon after the plan has started the payments you have received may not represent the amount in the fund.
- Lack of certainty of future income.

Impaired life annuity/ lifestyle annuity

The principles are the same as a conventional annuity.

The difference being that insurance companies may offer higher annuity rates to policyholders with medical problems (impaired life annuities) such as diabetes or heart disease.

Also you may benefit from a higher annuity rate if you were employed in a hazardous occupation, are a smoker or live in what are deemed high risk postcodes (lifestyle annuities) as it is believed these factors could potentially reduce life expectancy.

Variable annuities/ guaranteed drawdown

A recent innovation in the pension planning arena has been the arrival of variable annuities, often referred to as 'guaranteed drawdown'.

It is important to note this new US style variable annuity bears little resemblance to the traditional annuity recognised in the UK. It is best described as a conventional unit-linked investment product, underpinned by different types of guarantee.

For example:

- Your fund is guaranteed not to fall in value regardless of underlying investment conditions.
- Minimum accumulation benefit, where funds are guaranteed to accumulate to a certain amount by a particular point in the future.
- Minimum income benefit. Where from a fixed point in the future, it is guaranteed that regular withdrawals can be made at a specific level, even if the fund itself subsequently runs out of money.
- Minimum death benefit, where a named beneficiary is provided with a specified sum in the event of the insured person dying.

By combining and tweaking these objectives, a plan can be designed that meets your individual needs – and it can give you the flexibility to modify your choices in the future as your circumstances change.

Variable annuities are essentially a 'halfway house' between a conventional annuity and income drawdown potentially offering the best of both worlds, but they are not without constraints.

Variable annuities/ guaranteed drawdown Continued

Advantages of variable annuities

- The guarantee of a fixed level of income/ death benefit/ lump sum.
- Potential for increasing income by sharing in investment growth.
- Flexibility to change your income requirements in the future.
- Avoids 'once in a lifetime' commitment of conventional annuity purchase.
- Potential to leave your fund as a lump sum to beneficiaries other than your spouse.

Disadvantages of variable annuities

- All guarantees come at a cost and have to be paid for explicitly.
- There may also be the 'opportunity cost' of not enjoying the full value of any investment growth due to charges.
- Charges and early surrender values can be prohibitive.
- Variable annuities are relatively new and some designs are complex.
- Your starting income will be lower than a conventional annuity.
- Without growth your income may never reach the level of a conventional annuity.

Uncrystallised pension fund lump sum (UPFLS)

This is a variation on what used to be called 'phased retirement' where you can take your retirement income and tax free cash in stages instead of all at once.

At the start you may decide to take £10,000 out of your pension fund. You immediately receive a tax free cash lump sum of up to 25% (£2,500) and the remainder (£7,500) will be deemed to be income and taxed at your marginal rate.

Your remaining pension fund will stay invested and next year, or month, or indeed anytime you chose you may decide to withdraw a further £10,000, £20,000 or whatever amount you decide and it is taxed on the same basis (25% tax free, 75% taxed). This method will allow you to adapt your income as your circumstances change.

So you may decide to take more of your pension fund during the early years of retirement when you are more active so as to receive another tax free cash sum and increase your income. You can continue doing this until your entire pension fund has been utilised but there is of course the very real danger that you could run out of money early in retirement.

Uncrystallised pension fund lump sum (UPFLS) Continued

Advantages of uncrystallised pension fund lump sum

- Maximum flexibility – if you do not need all of your pension fund straightaway.
- Any pension fund you do not use immediately will remain invested with the potential to grow in a tax free environment so your tax free lump sum could ultimately be larger.
- A 25% tax free cash lump sum can be taken each time you withdraw funds.

Disadvantages of uncrystallised pension fund lump sum

- Money in your pension fund is remains invested and will fall as well as rise.
- You don't maximize all of your tax free cash at outset.
- Your tax free cash amount may be lower than if you has taken the full 25% at outset as a result of falling investment values
- Your income may ultimately be lower than a conventional annuity.

Income drawdown

Income drawdown (or 'flexi access drawdown' as it is now known) works differently to other retirement options.

Up to 25% of your pension fund can be taken as a tax free cash lump sum at outset but instead of purchasing an annuity with the remainder of your pension fund your money remains invested to provide you with an income to drawdown as and when you chose.

You may then take an income directly from your pension fund as often as you wish which is taxed as earned income. The income can be taken without limit so you may chose to take no income or all of your fund at once and any amount between those two extremes. Flexi access drawdown is a high risk strategy as you could run out of money and be left with nothing to live on in the later years of retirement.

Advantages of income drawdown

- Allows you to receive up to 100% of your tax free cash lump sum at outset.
- Income can be increased and decreased within the set income limits which may assist in tax planning.
- Your fund remains invested and with good investment performance your ultimate pension income could be greater than an annuity.
- Purchase of an annuity can be delayed or avoided indefinitely.
- On your death your family can benefit from the full value of your pension fund.

Income drawdown Continued

Disadvantages of income drawdown

- Annuity rates may change making annuity purchase expensive.
- Future investment returns are unknown and the value of funds remaining invested in your pension will fluctuate over time. If the value of your pension fund falls you could receive a lower income in future years.
- You may withdraw too much income in the early years. If your pension fund does not grow sufficiently your income in the future may have to reduce and your fund could be eroded over time leaving you with an ever reducing income.
- There are increased costs involved as ongoing reviews of your plan will be needed to ensure that your retirement needs are being met as your circumstances change.
- If your fund falls you may have to take increasingly uncomfortable levels of investment risk to have any hope of meeting your longer term income needs.
- A combination of high withdrawals and poor investment performance could reduce your fund and income to zero.

What happens when you die?

If you die in drawdown your beneficiaries have three options:

1. Taking a cash lump sum up to the value of the pension fund tax free.
2. Buy an annuity with the remaining fund.
3. Continue to take income drawdown.

If you are over 75 there is a 45% tax charge levied on the fund on death for the tax year 2015/ 2016. Thereafter as with other options the residual pension fund is taxed at your beneficiaries marginal rate.

In conclusion

Pension planning and the numerous options available to you are inevitably complex and if you are like the vast majority of people it is rare to find a case where it is 100% conclusive for any option.

It is usually a case of deciding which option, or combination thereof best suits your longer term financial objectives taking into account your personal circumstances.

The decisions you make will affect the rest of your life so it is important you have as much information as possible before seeking professional advice and deciding upon the optimal course of action for yourself.

Should you want a confidential appraisal of your situation simply complete our enquiry form on our website **www.pensionmatters.net** or please call us.

Alternatively you may wish to contact us via post at the address shown on the back cover of this brochure. Thank you for taking the time to read our guide we hope you found it of value.

If you require further information please contact us on
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