Briefing

How should I invest my drawdown fund?

While investment strategies need tailoring to your particular needs and risk profile, there are a few key concepts to bear in mind. We highlight some of the questions you, and we strongly suggest a financial adviser, may consider when constructing and reviewing an investment portfolio.

What am I trying to achieve?

Starting out with your objectives is vital. Planning is much easier when we know the destination and stopping points. If you would like to see some common aims, have a look at our briefing note "How long does my drawdown fund need to last?" At this stage of setting an agenda for your portfolio, it is worth bearing in mind that your circumstances are susceptible to change, and that some significant life changes often take place in our retirement years. However, a well-constructed and regularly-reviewed framework could help in a variety of conditions.

Why am I in drawdown?

Your initial motivation for selecting drawdown is likely to provide many of the answers for how to shape your portfolio's investments. For instance, those who are looking to their drawdown fund to provide their main income in retirement are likely to be less willing to take on risk than those who also receive income from a defined benefit pension. If you have access to other financial resources, that too will affect what you need from your drawdown investments.

How might inflation influence my outcomes?

The rate of inflation is important as it poses a stealth threat to spending power over time. Even moderate levels of inflation chip away at the real value of savings and investment returns. A common aim of drawdown portfolios is to increase, or at least maintain, long-term purchasing power. Therefore, asking whether your strategy expects to produce returns in excess of inflation makes sense.

It is only once investment returns exceed the rate of inflation that the strategy increases real purchasing power.

> A 1.5% return in a 3% inflation environment is the equivalent of a -1.5% return when adjusted for inflation.

What are my investment choices?

The world of pension scheme investments can appear very complicated, with a multitude of different assets available to invest in and a host of different managers offering subtly different approaches - and in many ways it is very complicated. But when you distil it all down, we believe there is a simpler theme underlying it all.

Essentially, there are only three ways of making money from investments, albeit with a huge range of potential choices:

Equity
Owning a part of something that earns income (e.g. shares, property)

Debt
Lending money in exchange for interest (e.g. corporate bonds, gilts)

Skill
Buying something and selling it on for a profit (e.g. active management)

All asset classes are actually one (or more) of these in disguise.

The extent to which you use some or all of these methods will depend on your desired outcomes and risk appetite. Understanding what risks you are willing to take is something that an adviser can discuss with you, providing a valuable rationale for how you use the above ways of making money within your portfolio.

> There is evidence that making good decisions on how to allocate your drawdown fund between different asset types can have a materially beneficial effect on returns, (a process often referred to as 'asset allocation').

In general, the asset type you allocate funds to has a larger impact on performance than which specific manager you select to run that asset type's fund. Therefore, seeking advice at this stage and spending time deliberating over this decision tends to be time well spent.

What are my options for generating an income?

Again, the best response to this question depends on what you are generating an income for: fixed, variable, necessary, or optional expenses all have potentially different investment requirements. This answer influences how much risk you may need to take to achieve a target level of returns from your portfolio (often referred to as your "appetite for risk"). You also need to consider your ability to cope with falls in the portfolio's capital value, a concept that is often described as your "capacity for loss".

Risk appetite

How willing and able are you to reduce the amount of income you draw from your fund? If a certain amount of income is required to meet basic living costs, the amount of risk you may be willing to take on the returns from your portfolio is likely to be quite different to that of an investor who is willing to withdraw nothing from their investments in years with poor returns.

> What other capital do you have and are you willing and able to draw on it? This affects your ability to recover from an investment shock.

This ability to adjust to different circumstances is a psychological capacity as well as a financial one.

Income vs accumulation funds

Collective funds often offer income-distributing units as well as an accumulation class (where the manager reinvests dividends and bond interest automatically). In terms of underlying holdings, there is little difference between the two types. Both funds usually hold the same underlying investments and charge the same fees.

However, for mental accounting purposes, receiving the income into your cash holdings clearly indicates how much you can drawdown without affecting your capital invested. It also saves on disinvestment costs. Disinvestment costs relate to the spread between the unit price quoted to calculate the value of your holdings and the 'bid' price at which those same units are sold.

On the other hand, if you are not going to use this cash and would like to reinvest it, you are likely to pay an investment cost. This is the spread between the unit price at which units can be purchased versus their price quoted to calculate the value of your holdings. In an accumulation fund, there is no explicit charge to reinvest.

Sequencing risk

As with your attitude to risk and capacity for loss, "sequencing risk" is another critical issue to be aware of. This relates to the timing of investment returns; in particular, the risk of an investment portfolio returning less than is withdrawn early on in the retirement journey. This reduces the portfolio's capital value and leaves less invested for the future. Therefore, assets have to work harder to recover their value. Taking income from shrinking investments early on can cause heavy damage to the portfolio, which would have been more manageable if poor returns had happened later on.

> To minimise the damage of a downturn early on in your drawdown plan, there are a few solutions.

Investors can deplete their cash reserves before disinvesting invested assets at their lower value. Depending on circumstances, an investor might drawdown a fixed percentage rather than a fixed sum. In addition, an investor could rely on dividends for income rather than capital growth. However, the common theme of investment options and drawdown plans differing depending on your requirements continues.

Should I take financial advice?

As the problem of how to invest a drawdown fund is complex, personal and fundamental to the outcome produced, we strongly suggest you seek financial advice, which will look at your financial position holistically. You may also wish to employ the experience and resources a discretionary fund manager offers to tailor and monitor your investment portfolio. Your circumstances – and therefore the requirements of your portfolio – are likely to change over time and so it is important to undertake regular reviews of your investment strategy.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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