

# Living off capital: understanding drawdown

Like all self-employed people, barristers cannot duck choices about how they finance their spending when they stop earning. There is no shortage of technical explanations about how pensions work. They are tedious but rules-based so barristers should have little trouble mastering that aspect of the brief quickly. This is not enough.

By Stuart Fowler, institutional investment manager, founder, No Monkey Business Ltd.

Retirement spending usually involves more sources of capital than just pensions and financial goals cover more than retirement spending. Now the choices look like part of a broad approach to good financial management, involving more complex dependencies and requiring better advice. This aspect of the brief is harder to master. Mistakes can be costly, with time to regret them but not enough time to correct them.

They are avoided by advisers and their clients applying a few powerful generic insights which are based on essential principles. This is what we seek to provide in this article.

## Bath time

The process is divided into two sequential phases: accumulation and drawdown. Viewed as a bath, accumulation is about filling it and drawdown is about emptying it. As long as there is some water in the bath, its volume is subject to a capital-market process of expansion and contraction, as a function of any trend rate of return (expansion) and volatility (expanding faster or even contracting). The return and risk characteristics of a portfolio (describing a particular stock of water) depend on the sort of assets it holds and how they are put together.

Whilst the bath is filling up, the effect of volatility will be cushioned by these new inputs. Whilst drawing down, the speed with which the capital stock is exhausted depends on the rate of draw and the particular path taken by the portfolio value.

The returns we are interested in are called 'total return' and include both change in capital value and any dividend or interest. Cumulative returns are calculated assuming this income is reinvested as received. Markets trade off yields and growth potential on a presumption of a common required rate of return. It follows that consuming income is in any circumstances (including distributions from trusts) a form of drawdown from capital.

Plan outcomes can be defined in terms of the rate of drawdown in real pounds, or directly in terms of the after-tax spending it supports.

## Constraints

How the entire process is planned and managed depends on the constraints imposed on the process. If these are not specified correctly, the plan will not be managed efficiently.

The first key constraint is that the target outcomes need to be expressed in real terms, whatever the actual rate and profile of inflation over the life of the plan. Unless outcomes have comparable purchasing power, they are as meaningless as if expressed in Turkish lire. Even the illustrative growth rates for pension products prescribed by the FSA fall into this trap.

The second is that the bath must not run out before it has achieved its minimum objectives. This constraint needs to bite hardest if all spending depends on the plan assets alone.

From their mastery of the rules governing personal pensions, barristers will see that, to the extent the plan assets include pension accounts, these now constrain the level of inputs, the stock (in the form of a 'lifetime allowance'), the rate of draw and the benefit of generation-skipping bequests.

A further set of constraints that particularise these general principles covers unique personal welfare preferences. These include

- stability of the rate of draw (adjusted for inflation), as in being able to sustain spending through a series of bad years for portfolio values (think of Japan, for instance)
- control, as in a preference for drawing down rather than buying an annuity to provide the income stream
- time preferences, such as valuing high payoffs from investment bets less the later they emerge.

## Balance

For a plan to have technical integrity, its defined parameters must be quantified and the values must be internally consistent. The parameters are: the resources applied, the target outcomes, the time horizons (if drawing down, these are a sequence of dates not a single date) and the amount of risk accepted or sought. This inconvenient truth flows from the same theoretical source as the tenet 'there is no such thing as a free lunch'. For instance, taking more risk increases the uncertainty of outcome so achieving a given minimum acceptable outcome at the same level of confidence must call for additional resources.

## Risk management

The entire process is subject to several sources of uncertainty that need to be allowed for when planning but also call to be managed somehow. The management techniques can be one of three: avoiding a risk, insuring (or hedging it) and embracing it but also trying to control it.

As financial management tasks go, living off capital subject to constraints is one of the toughest and is mostly performed with hopelessly inadequate technical resources. Mistakes made in less complex situations, such as Equitable Life and endowment mortgages, have been the source of widespread regret and recrimination. In this case there is even less scope for recompense.

The three risk sources are inflation, longevity and investment.

## Inflation risk

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hitman", said Ronald Reagan in 1978. Inflation risk is also very well disguised and difficult to model. No Monkey Business avoids this problem by estimating the return and risk of asset classes in real terms, based on all available histories of real total return for equity markets around the world.

This approach has a striking impact on fixed income investing. It precludes it. This is because it is inflation's most frequent and most damaged victim. This can be observed from histories of real total return for bonds over long holding periods. It happens because inflation is so well disguised that the markets' implicit estimates of future inflation, which make up most of the

nominal yield of a bond, have historically shown very large cumulative errors.

## Longevity risk

Longevity defines how long the plan needs to last. Uncertainty about longevity for a single life is very high so self-funding of the risk means you have to plan on a long life and draw less. This risk can be eliminated by an annuity, whose payout reflects the mean mortality of all insured lives of the same age.

You have a choice about the form of annuity you buy, affecting the level of income. Options include: a pension for the surviving spouse; maximising starting nominal yield (leaving inflation risk uncovered); maximising inflation protection; covering mortality risk while still enjoying payoffs from equity bets. Once drawdown starts, the option of leaving the casino by covering some or all of the longevity risk needs to be constantly assessed as part of the management of the plan. The impact on the welfare value assigned to a bequest has to be part of this assessment.

## Investment risk

Investment risk is, as we have seen, best described as the uncertainty or possible error associated with assumptions about the portfolio's real total return. Since we are interested mainly in risk as the uncertainty of real outcomes, we need this to be specific to the time horizon. For foreign markets, the risk also needs to take into account currency volatility.

A market is a potential building block of the portfolio and exposure to different markets should be diversified. But this principle mainly applies to equity markets since the diversification benefits of conventional bonds are very weak relative to their high outcome risk and low real returns. The risk within each market should be minimised by diversification, which can be achieved very cheaply using index tracking funds or exchange traded funds.

Outcome risk is best managed by diluting equity risk using a risk free asset. We divide the plan into time slices (each funding say three years of draw) and manage the asset allocation for each time-slice portfolio dynamically as market conditions and horizons change. Broadly speaking, early years are matched by cash, middle years by a combination of equities and index linked (the only risk free asset in real terms) and later years by equities. Clients see the aggregate portfolio allocations.

## Knowing the odds

In a mathematical, modeled approach like ours, planning outcomes can be quantified and expressed as probabilities, like quoting odds. Odds can be used to differentiate between different ways of balancing risk and resources, obviating the need for silly questions about risk tolerance which mean nothing or anything. They can also be used to make choices along the way, based on the progress of the plan. They are part of how an unbiased adviser will demonstrate the impact on possible outcomes of paying low or high industry charges. Above all, odds can be used to ensure any claims made about a safely-sustainable real rate of draw can be backed up.

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