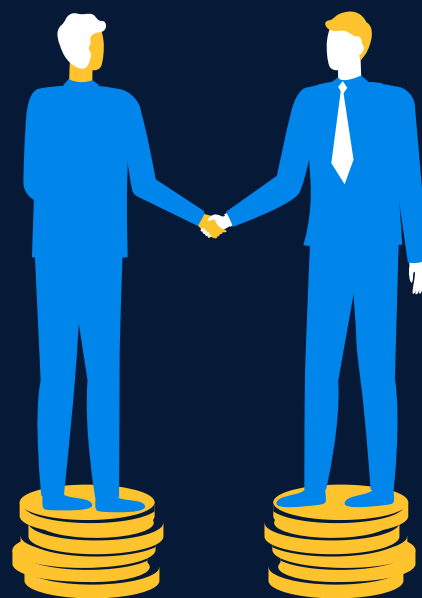


Building an innovative, collaborative solution for UK retirement

In the Spotlight
January 2025



Key Insights

- The 2015 *pension freedom reforms* transformed the UK retirement landscape, empowering individuals to tailor retirement income strategies to personal needs.
- However, the reforms also introduced complexities and risk, heightening the potential for a rapid depletion of funds if not managed wisely.
- Our innovative UK retirement solution is designed to address the unique challenges and complexities of retirement planning during the decumulation phase.



Yoram Lustig
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This paper outlines our innovative retirement solution for the UK. It combines a multi-asset portfolio designed to offer income, growth, and flexibility alongside the option of an annuity (or annuities) to deliver secured lifetime income. Our approach aims to address the complexities of retirement planning during the decumulation phase. We believe some changes introduced in the latest Budget will make our flexible and innovative framework more relevant and timelier.

From accumulation to decumulation

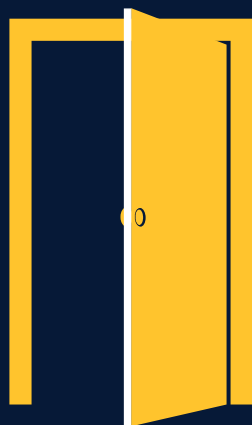
The accumulation and decumulation phases in retirement signify two distinct stages in an individual's financial life cycle. During *accumulation*, individuals work, earn income, and invest to enhance their retirement savings, typically spanning several decades. The primary focus is on maximising contributions to savings and investment vehicles, such as employer-sponsored pension schemes, while benefiting from the time value of money and compound interest.

In contrast, *decumulation* begins when individuals retire and withdraw from their accumulated savings to cover living expenses. This phase presents unique challenges, including the *sequence of returns risk*, which involves financial vulnerability due to the order and timing of returns during the withdrawal period. Negative market returns early in retirement can compel retirees to sell assets at a loss to meet their expenditure needs, potentially leading to a more rapid depletion of funds than anticipated. Additionally, the uncertain time horizon during the decumulation phase introduces *longevity risk*—the possibility of outliving one's savings.

Key differences between these phases lie in their objectives and financial flexibility. In accumulation, individuals can control contributions and capitalise on market growth. In decumulation, they must manage withdrawals strategically while mitigating risks associated with market volatility and longevity. Effective retirement planning should be a lifelong endeavor, allowing individuals to enjoy a secure financial future without outliving their savings.

(Fig. 1) Transformation of the UK retirement savings landscape

2015 PENSION FREEDOM REFORMS:



1 Cash Lump Sum



2 Flexi-access Drawdown



3 Annuity



Are pensions freer post-pension freedom reforms?

The 2015 pension freedom reforms fundamentally transformed the retirement savings landscape in the UK, enabling individuals over 55 to access their *defined contribution* (DC) pension pots with unprecedented flexibility. Before these reforms, over 90% of retirees opted for an annuity, which provided a guaranteed income for life but was often viewed as rigid, opaque, and expensive. Post-reforms, retirees have three primary options for accessing their savings: (1) *cash lump sum*, (2) *flexi-access drawdown*, and (3) *annuity*.

Pension freedom reforms aimed to empower individuals to tailor their retirement income strategies to personal needs and market conditions. But they also introduced complexities and risks, such as rapid depletion of funds if not managed wisely, financial anxiety, and poor decision-making due to inadequate support and guidance.¹

Drawdown has become the most popular pension product post-pension freedom reforms,² allowing individuals from age 55³ to withdraw funds from their pension savings flexibly. This enables individuals to take as much, or as little, income as needed while keeping the remaining funds invested for potential growth. Up to 25% of the pension pot can be accessed tax-free, with withdrawals outside of that subject to income tax. This arrangement contrasts with annuities, offering retirees greater control over their income and investment strategies. However, drawdown carries risks such as early depletion due to market downturns and/or imprudent withdrawals. Increased control and flexibility mean individuals bear more responsibility for making

complex financial decisions. Tailored post-retirement advice can mitigate these risks and ensure long-term economic stability.

Since introducing pension freedom reforms, individuals have changed how they manage and withdraw retirement savings. However, whilst most retirement solutions remained suitable for accumulation, they often overlooked the distinct challenges of decumulation. This emphasis on accumulation over decumulation has resulted in many retirement products inadequately supporting individuals in navigating post-retirement complexities. At the same time, many retirees lack sufficient guidance to manage their withdrawals and investments during this phase effectively. Consequently, while pension freedom reforms have empowered individuals to access their savings, a need remains for suitable, personalised decumulation solutions, balancing financial security and income sources throughout retirement.

The Financial Conduct Authority (FCA) thematic review

The FCA's thematic review on retirement income advice, published in March 2024,⁴ underscores the benefits of blending income drawdown with annuities as a key retirement strategy. This hybrid approach allows retirees to benefit from the flexibility and potential growth of income drawdown while securing a guaranteed income through annuities. Such combinations can effectively mitigate longevity risk, offering a stable income stream throughout retirement while retaining access to capital for unforeseen expenses.

¹ Hyman Robertson (March 2024), 'Reflections on the 10th anniversary of pension freedoms announcement.'

² Financial Conduct Authority (FCA), 'Retirement income market data 2023/24.'

³ This is set to change to 57 on 6 April 2028.

⁴ FCA (March 2024), 'Thematic Review TR24/1: Retirement income advice thematic review.'

(Fig. 2) 5D framework: Decumulation is five-dimensional



For illustrative purposes only.
Source: T. Rowe Price.

The review highlights the need for financial advisers to tailor solutions to individual client circumstances, considering their risk profiles and income needs. By integrating income drawdown and annuities, retirees can create a more resilient financial plan addressing immediate cash flow requirements and long-term sustainability. The FCA encourages a holistic view in advising clients on retirement income options, distinguishing between accumulation and decumulation phases, and ensuring recommendations align with clients' broader financial goals, as outlined in the FCA's *Retirement Income Advice Assessment Tool* (RIAAT) and accompanying guidelines.^{5,6} The FCA has indicated this will be a focus area for further work.

The 5D framework: Balancing trade-offs in decumulation

T. Rowe Price has developed a *five-dimensional (5D) framework* to assess retirement income solutions, addressing the unique challenges of decumulation. While investing in accumulation is two-dimensional—return and risk—we believe that in decumulation it is five-dimensional.

During decumulation, retirees must balance five essential attributes: *longevity risk hedge, unexpected balance depletion, level of*

payments, liquidity of balance, and volatility of payments. Our market research revealed that savers typically prioritise longevity risk hedge and unexpected balance depletion as their primary concerns.

Longevity risk hedge minimises the possibility of outliving the individual's savings. *Unexpected balance depletion* involves the probability of depleting funds faster than anticipated. Following these, retirees consider the level of payments they can comfortably receive, as well as the liquidity of their balance for emergencies and extraordinary outlays, such as holidays or home renovations. Lastly, *the volatility of payments* is deemed the least critical dimension for retirees. This aligns with studies showing that consumers adapt spending habits to match financial pressures, such as cost of living and inflation in recent years.⁷ Overall, retirees still prefer stable, salary-like income over fluctuating amounts.

The five dimensions of decumulation are inherently interrelated trade-offs that retirees must balance. For instance, opting for higher payments may require higher portfolio risk, leading to increased risk of unexpected balance depletion. Conversely, prioritising liquidity can limit the amount available for withdrawals, potentially compromising the level of payments received to meet living expenses. These trade-offs require careful planning, modeling, and balancing to develop a decumulation strategy aligned with individual goals while addressing risks.

Unlike traditional methods primarily focusing on accumulation, our 5D framework quantifies trade-offs among the five attributes in decumulation. This allows investors to consider preferences systematically by providing a common language and standardised metrics for assessing various solutions.⁸ This holistic approach could also empower financial advisers to identify suitable post-retirement solutions for their clients. We welcome the opportunity to partner with investment professionals for constructive discussions, offering guidance and analysis in applying our process.

The fall and rise of annuities

An *annuity* is a form of insurance policy that retirees can buy with their pension pot to provide a guaranteed income for life or a fixed number of years. Following pension freedom reforms, demand for annuities in the UK declined as retirees opted for drawdown products, seeking to maintain control over their investments and potentially grow assets. This shift was primarily because annuities offered limited value due to low long-term interest rates and legislation enabling the passing of pension assets to dependents tax-free. The latter meant that pension assets became an inheritance tax (IHT) haven for many savers.

⁵ FCA (March 2024), 'Dear CEO letter: Thematic review of retirement income advice.'

⁶ Pensions and Lifetime Savings Association (PLSA) (October 2020), 'DC decumulation: Evolving the pension freedoms – final recommendations.'

⁷ IPSOS (January 2022), 'How inflation is changing consumer behaviour.'

⁸ Cui, Berg and Jessica Sclafani (June 2024), 'A five-dimensional framework for retirement income needs and solutions,' T. Rowe Price.

However, recent trends indicate a resurgence in annuity demand due to more competitive annuity rates, which have increased considerably, making them a viable option for guaranteed income. The recent Budget exacerbated the revival in annuity demand, firmly bringing pension savings back into the estate for IHT purposes from 2027 and, in many cases, subjecting them to double taxation if the deceased is 75 or above.

Annuities offer advantages—they provide a steady, reliable income stream that can last a lifetime, alleviating longevity risk. This predictability allows retirees to budget effectively. However, they have drawbacks, such as limited liquidity; cash lump sums are handed over to the insurance company once purchased, making them typically inaccessible. Broader market conditions also influence annuity rates, thus timing the purchase could be essential yet difficult. Annuities are usually not investment-linked and may not benefit from potential market growth, leading to lower income rates than other options. They are complex financial products with intricate terms and conditions; understanding options and riders can be challenging, with added costs for customised features like inflation protection or death benefits.

A hybrid retirement solution

Blending a drawdown strategy with an annuity can effectively mitigate these shortcomings. A multi-asset portfolio for drawdown allows for diversification, growth potential, and flexibility, while allocating a portion of savings to an annuity provides guaranteed income. This hybrid approach addresses the desire for predictable, stable income and the need for investment growth and flexibility, enhancing financial security and providing a buffer against inflation and unexpected expenses.

Blending should follow a structural approach, coupled with a good understanding of client needs, requirements, and risk attitudes. Extensive modeling and simulations allow for optimal blend, risk mitigation, and enhanced retirement outcomes. Our approach provides financial advisors with the necessary information to communicate with clients and evaluate various scenarios across the five dimensions of decumulation. We can generate potential future market conditions by employing Monte Carlo simulations to assess how different asset allocations and blends with an annuity respond to different scenarios. This data-driven analysis helps identify the optimal combination, balancing the need for stable income against market fluctuations and longevity risk, ultimately enhancing the likelihood of achieving sustainable income. The analysis can also be combined with personalisation, whereby the investment design and corresponding trade-offs are visually presented to investors using our 5D framework before deciding on suitable, tailored solutions.

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Head of Multi-Asset Solutions, EMEA**

Traditional scenario analysis and stress testing can help design the drawdown portfolio by evaluating how it might perform under extreme market conditions or unexpected economic shifts. These methodologies provide additional insights into the portfolio's sensitivity to various factors, enabling us to design components that advisers can blend effectively to personalise for individual circumstances. By integrating these advanced modelling techniques, advisors and clients can make informed decisions, aiming to address immediate income needs, mitigate risks and deliver a robust decumulation solution.

Personalisation through partnership with financial advisors

Our solution emphasises collaboration with financial advisors who can tailor strategies to meet individual savers' needs. Each retiree can select a personalised combination of a multi-asset portfolio and annuities by utilising expert guidance and advice. This partnership ensures that retirees are well informed and equipped to make financial decisions that best suit their circumstances. Personalisation is essential during decumulation. In accumulation, the investment objectives are more uniform across individuals: maximising contributions, investing in line with risk tolerance and aiming to benefit from time and compounding. In contrast, decumulation strategies considerably vary across retirees, each with specific circumstances and income needs.

We offer three distinct versions of our retirement solution:

1. **Immediate annuity with multi-asset portfolio.** For savers seeking guaranteed income from day one if annuity prices are favourable today.

Blending an immediate annuity with a flexi-access income portfolio can offer retirees a balanced approach to managing their retirement income, especially when annuity prices are favourable. This strategy allows individuals to secure a guaranteed income stream from the immediate annuity, providing financial stability and peace of mind while maintaining flexibility through the flexi-access portfolio. The drawdown portfolio enables retirees to withdraw funds as needed, allowing for adjustments based on changing financial circumstances or unexpected expenses while also providing the potential for investment growth. This combination helps optimise tax efficiency by allowing for strategic withdrawals and ensures that retirees can adapt their income strategy over time.

2. **Incremental addition to annuity.** This involves a multi-asset portfolio with the option to incrementally add to an annuity each year, depending on prevailing annuity rates. The saver averages the price of the annuity over time instead of accepting less favourable prices through one-time purchases.

Blending a flexi-access income portfolio with incremental contributions to an annuity can provide a strategic approach to retirement income, especially when annuity prices are currently unfavourable. It can also accommodate savers who are hesitant to purchase an annuity in a single lump sum. This method allows retirees to take advantage of the flexibility offered by a multi-asset portfolio, enabling them to withdraw funds as needed while keeping their funds invested. By adding to an annuity periodically, retirees can pound-cost average the price of the annuity, mitigating the impact of market fluctuations and potentially securing a more favourable rate over time. This strategy helps manage immediate cash flow needs and positions retirees to benefit from improved annuity pricing in the future.

3. **Deferred annuity purchase.** This combines a multi-asset portfolio for income and an annuity price hedging portfolio primarily invested in long-term gilts and UK corporate bonds. This method allows savers to defer the annuity purchase by approximately 15 years (or earlier or later, based on their needs) while maintaining complete flexibility over their investments.

Blending a multi-asset income portfolio with the deferral of annuity purchases through an annuity-price hedging portfolio can provide substantial benefits, mainly when current annuity prices are favourable. This strategy allows retirees to maintain liquidity and flexibility in their income withdrawals while strategically postponing purchasing their annuity. By investing

“Multi-asset diversification becomes paramount as individuals transition from accumulating wealth to drawing down their retirement savings.”

– Eva Wu
Multi-Asset Solutions Strategist

in a hedging portfolio, retirees can protect themselves against future market volatility while securing today's favourable annuity rates when converting their investments into an annuity. This approach offers complete access to their funds. It allows the flexibility to adjust their plans by purchasing the annuity earlier or later, potentially benefiting from more attractive annuity prices as they age.

Diversification in decumulation

Multi-asset diversification becomes paramount as individuals transition from accumulating wealth to drawing down their retirement savings. Multi-asset portfolios can provide a smoother return profile. This is vital during retirement when market downturns can impact the sustainability of withdrawals. By diversifying across assets with different characteristics and roles, retirees can reduce the likelihood of severe capital erosion during periods of market volatility.

The importance of managing sequencing risk cannot be overstated. Our approach is to construct portfolios across assets with three distinct roles:

- (i) **Growth-oriented assets**, such as equities, provide growth, dividend income and flexibility.
- (ii) **Mid-risk assets**, such as high yield bonds, mainly provide income.
- (iii) **Defensive assets**, such as high-quality government bonds and safe-haven currencies, provide diversification and cushion during market drawdowns, thereby preserving capital for future withdrawals.

Dynamic asset allocation and active strategies within a multi-asset framework allow for adjustments, aiming to achieve desired income levels while adapting to market conditions.



Expertise as a global asset manager

As a global asset manager with over 20 years of experience modelling and managing retirement solutions, we utilise our expertise to navigate the complexities of retirement planning. We are the largest active asset manager in retirement globally, with a track record of proven performance. Our strong local market presence and partnerships with financial advisors in the UK uniquely position us to offer comprehensive solutions tailored to diverse client needs. We recognise that effective retirement planning necessitates innovative products and strategic partnerships that empower advisors to assist savers in making informed choices about their financial futures. By focusing on

collaboration and customised strategies, we ensure that clients are well equipped to achieve their retirement goals and secure their economic well-being.

The innovative retirement solution outlined blends stability and growth potential through a thoughtful combination of multi-asset portfolios and annuities. It effectively addresses retirees' primary concerns, such as income security and investment risk, while ensuring personalised support from experienced financial advisors. Integrating these elements enhances financial resilience and empowers retirees to make informed decisions tailored to their unique circumstances, ultimately fostering a more secure and fulfilling retirement experience.

RETIRE WITH CONFIDENCE®

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

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