An adviser's guide to supporting client income objectives

Contents

Learning objectives

This guide will help you understand the concept of ‘income at risk’ so you can;

- Learn why it’s important to consider different risks when drawing an income for your client
- Differentiate between your clients’ growth and income objectives
- See how ‘income at risk’ can fit within your existing advice process
- Easily explain risk to your clients in a way that is easy to understand

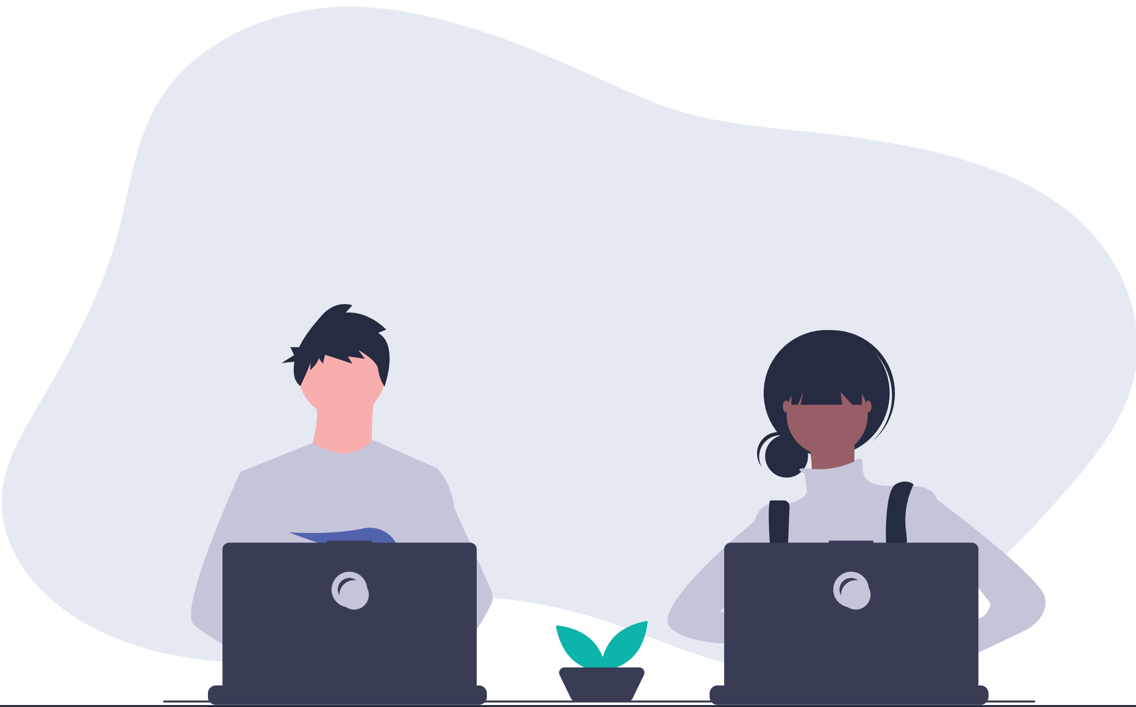
Background

At EV, we have been producing adviser tools for modelling drawdown since 2002. Our asset model forecasts the two components of total return i.e. capital appreciation and investment income separately. This enables the different risk and reward characteristics of of income and growth to be identified.

In 2017, we launched a risk questionnaire to facilitate income-focused risk discussions for clients in drawdown. This highlighted the difference between clients’ attitude to investment and income risk. With income risk, it is clear that there is a heightened awareness of risk when it comes to loss of income compared to capital.

We have further extended this suitability with our “income at risk” methodology and cash flow planning, which together allow you to map funds to clients’ income risk and show the impact on their goals.

Incorporating this complementary definition of risk into the advice process offers opportunities to advisers to demonstrate further added value to clients and to offer improved outcomes.



Risks to client outcomes: Growth vs Income

Consumers' attitude to risk changes not only as they progress towards retirement but also, fundamentally, when their objective changes from saving for retirement to drawing an income.

Grow assets for the future	Take an income from existing assets
Growth	**Income**

These separate risk definitions are necessary as they accommodate how sequencing and volatility affect each objective differently. For example, when drawdown is based on a traditional growth model, retirees are at risk of drawing income at unsustainable levels.

Accumulation (Growth)	Decumulation (Income)
Sequencing risk is a run of poor returns in the final years when the accumulated capital is large and outcomes are seriously impacted	Sequencing risk is a run of poor returns in the early years, which result in income withdrawals seriously eroding the initial capital to support the income
High volatility is beneficial when making regular savings – the effect is known as "pound cost averaging."	High volatility is detrimental when making regular withdrawals – the effect known as "pound cost ravaging."

The efficient frontier represents a set of optimal portfolios that offer the highest expected return for a defined level of risk.

With accumulation funds, we're used to the idea that proximity to the efficient frontier shows how good a fund or portfolio maximises the return for a given level of capital risk.

The same analysis, however, can be done for funds delivering an income. A different efficient frontier represents a set of optimal portfolios maximising the income for a given level of income risk.

Proximity to the decumulation frontier can then be expressed as an efficiency percentage adding context alongside the risk rating.

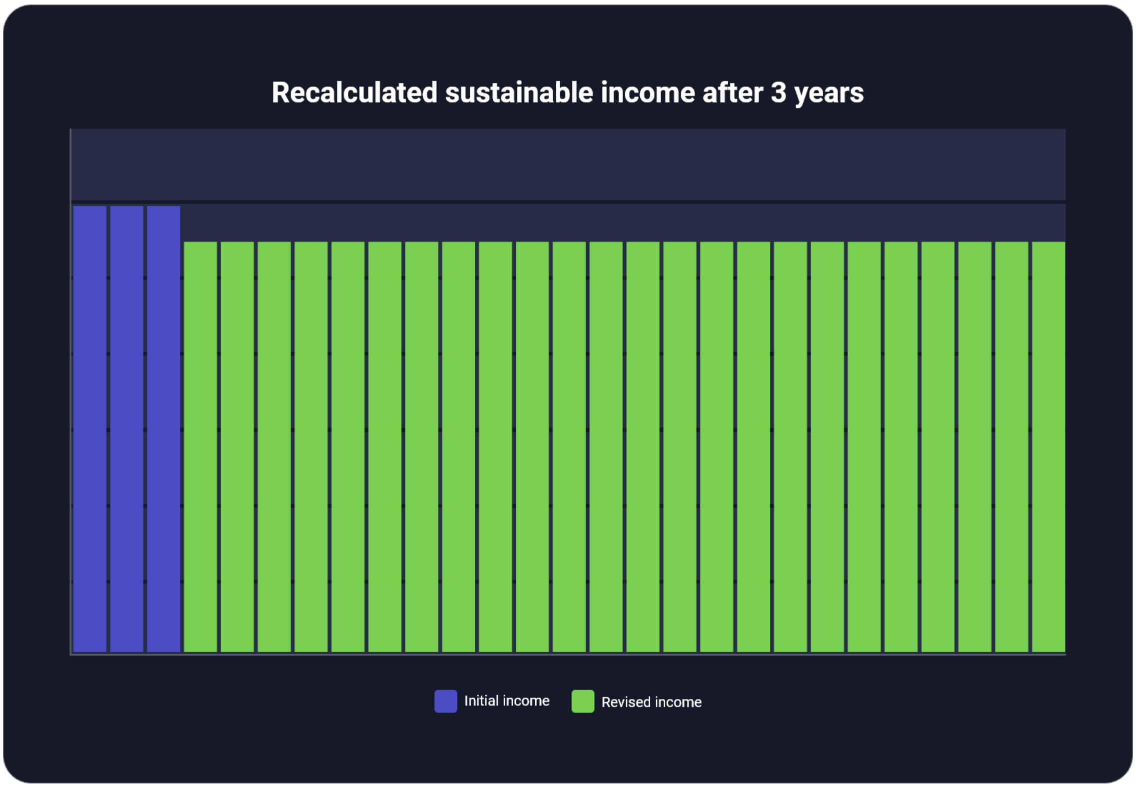
How does this work?

Income at Risk (IaR) is a measure of risk to income equivalent to volatility which is the measure of risk typically used for growth (or accumulation) objectives. This section explains the underlying income risk methodology in three simple steps, giving you a digestible way of explaining the income at risk to your clients. It is simply a measure of risk to be used to ensure suitability when selecting funds or building portfolios to deliver clients' income withdrawal plans.

Step 1 – identify the sustainable income that can be supported by an investment solution

First, we calculate the median (best estimate) sustainable income for life so the fund would be fully used by the end of the period. For the purposes of assessing income risk, we assume a level income and ignore charges. Charges do not have any impact on income risk, however, if annual increases in line with inflation are planned rather than fixed increases, this could affect the assessed income risk. Sustainable income will depend on the age of a retiree as capital is drawn down over the future life expectancy.

We measure the sensitivity of a fund or portfolio to income risk over a three year period and the percentage downside in income we call Income at Risk (IaR) and this has the very useful feature of being largely independent of the age of the retiree.

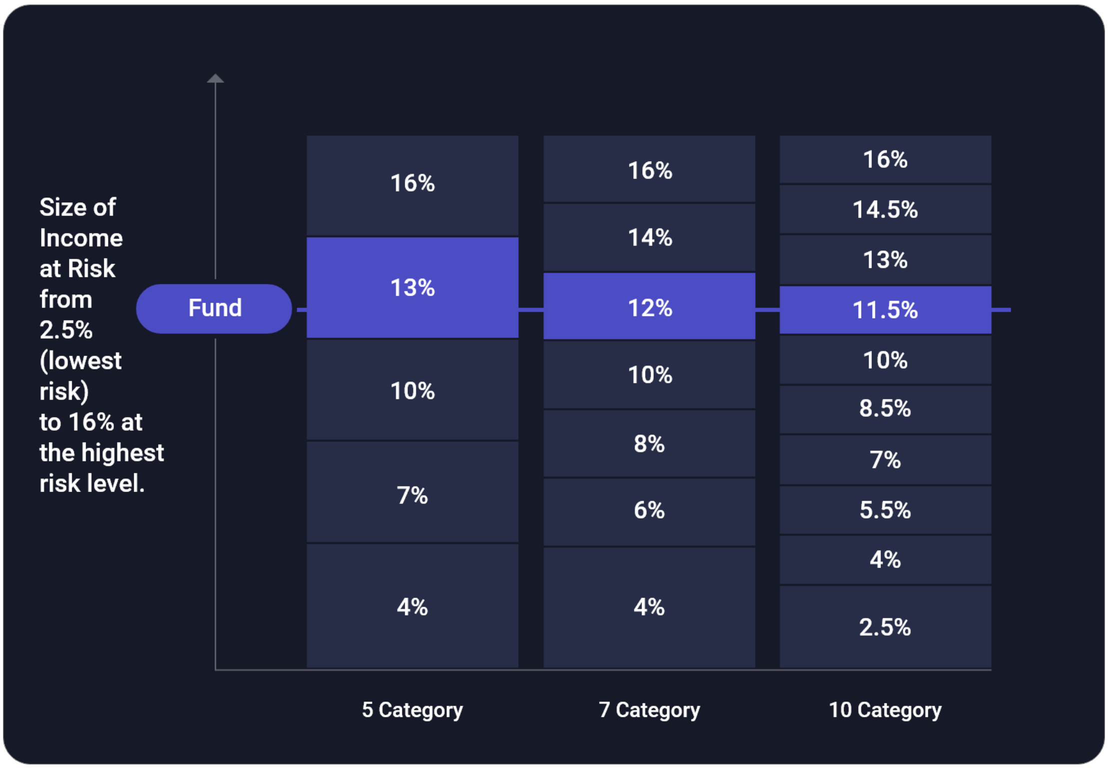


Step 2 – reassess the sustainable income after three years

Next we forecast the impact of drawing the sustainable income from the fund or portfolio for 3 years and then reassess the sustainable income. There is a range of possible outcomes depending on the investment performance while the income is being drawn and we look at the percentage fall in the income that could arise with a 1 in 4 chance. This allows for sequencing risk and provides a measure of the susceptibility of the fund or portfolio to income risk which we call the Income at Risk. IaR is largely independent of the retiree's age and life expectancy.

Step 3a – compare to benchmark IaR percentages.

The income risk profile is then calculated as the one that matches the appropriate benchmark. Thus, in the example above, if the IaR is 11.3%, the fund or portfolio would be risk level risk profile 4 out of 5 categories, 5 out of 7, and 7 out of 10.



Step 3b – compare to benchmark for risk profiles.

Importance of regular client reviews

Income at Risk measures the potential fall in sustainable income in the next three years. It emphasises the importance of regular client reviews. Working with your clients to manage their income withdrawal plans annually and understanding income risk should enable clients to feel more comfortable about the risk they are running and avoid the undue caution that can occur when risks are unclear.

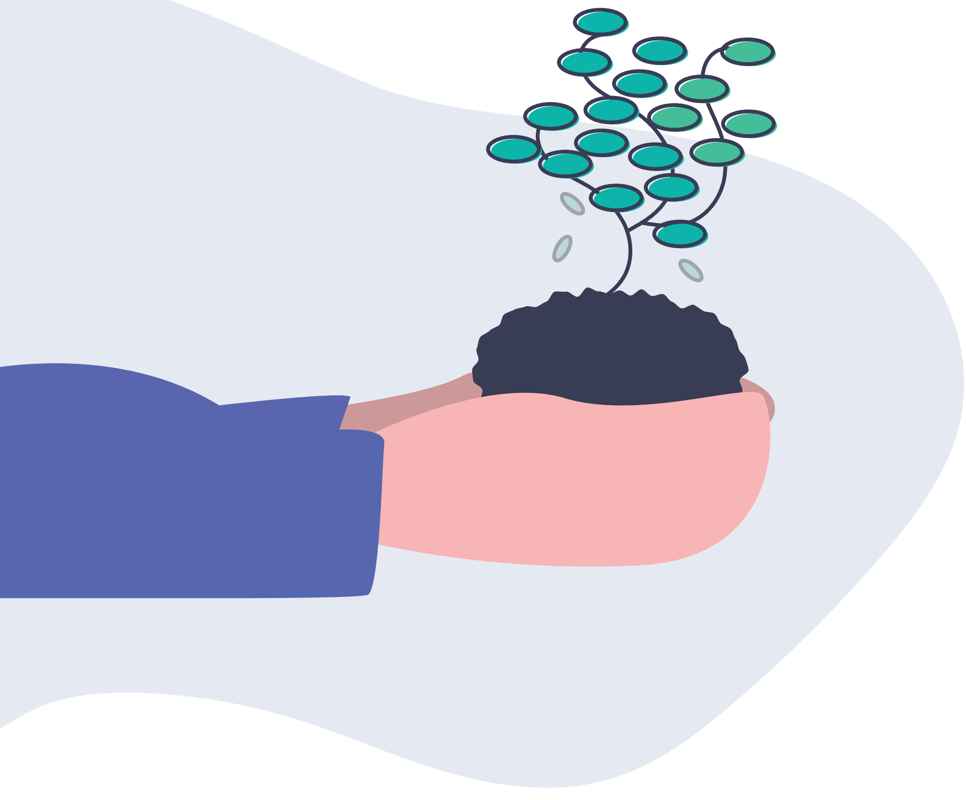
Add value through more informed discussions with clients about the acceptable level of risk they can take without fear of running out and reducing sleepless nights. You can show and improve the income efficiency of their funds and portfolios so that they can benefit from a higher income at no extra risk. In addition, be confident that you are providing advice and recommendations that are suitable to your client's risk tolerance.

What could my future advice process look like?

Our income risk questionnaire and fund risk ratings are designed to create a workflow that mirrors the existing process for establishing a client's attitude to risk during the accumulation phase.

You can risk profile your client, evaluate their existing portfolio's risk and efficiency and demonstrate the impact of your recommendations on their income withdrawal plan. Your recommendations and the improvement in efficiency of your proposed investment solution can show up clearly in the likelihood of success of your clients' income withdrawal plans.

The below four-step process remains the same regardless of whether the clients' objective is for growth or income. It allows you to outline the advice given and demonstrate how the recommendation is suitable for your client.



Evaluate

Complete a risk questionnaire
to understand the client risk profile.

STEP
01

STEP
02

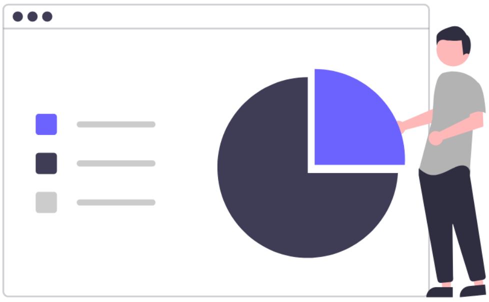
Recommend

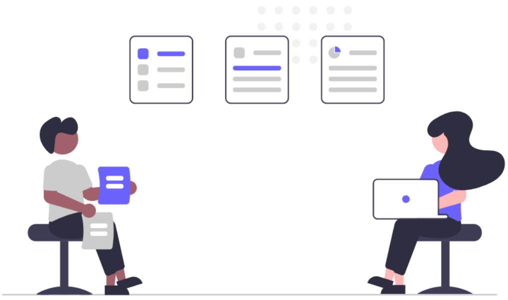
Select a suitable investment product that matches the clients' risk profile and term.

Explain

Demonstrate suitability with risk rating and visual forecasts, charts and graphs.

STEP
03





STEP
04

Review

Set up regular client reviews to ensure the recommendations remain suitable for client objectives. Take action if off track.

Conclusion

Our consistent approach to advising on growth and income ensures that your advice is robust and at the same time allows you to mirror your existing advice process whilst explicitly focusing on the income objectives of your clients.

Currently, there is no comparable transparent methodology to measure income risk, similar to the way funds and portfolios are risk-rated for accumulation.

The clear danger is your clients running out of money, so make sure you understand the risks and incorporate the proper workflows into your advice process.