David Miller - Head of Alternative Investments
Cheviot Asset Management Limited
Tel: +44(0)20 7438 5686 Email: david.miller@cheviot.co.uk
www.cheviot.co.uk
Cheviot Asset Management, 90 Long Acre, London, WC2E 9RA

Is Retirement a 20th Century Concept?

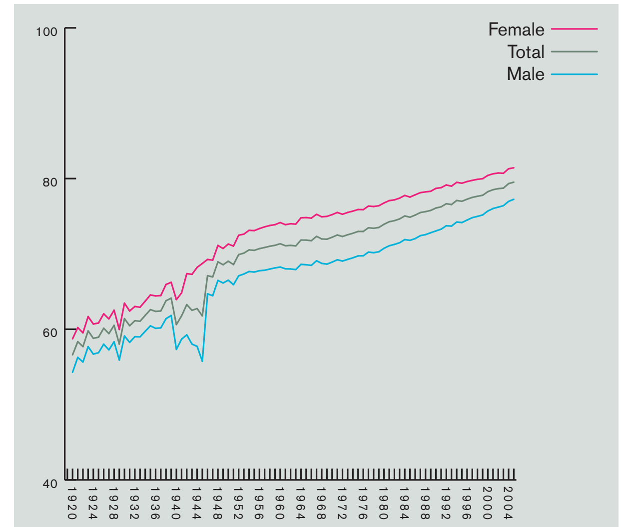
In the last ten years, the way in which we invest for our retirement should have undergone a significant change, but attitudes remain heavily influenced by the past.

In the UK, retirement at 65 was defined by The Contributory Pensions Act (1925) when life expectancy at birth was 59 years. The first country to adopt an old-age social insurance programme was Germany when in 1889 it set the retirement age at 70. At that time life expectancy was 45 years. Although innovative and enlightened at the time, neither looks particularly generous with the benefit of hindsight. Relatively few people lived long enough to draw a pension.

Life expectancy in the UK exceeded 65 for the first time in 1946 and has been improving fairly steadily ever since. By 2005 average life expectancy was approaching 80 and those aged 65 in that year could expect to live a further 18.7 years. Women continue to live longer than men although it is interesting to note that since 1980 men have been catching up. Until recently, retirement at 65, or earlier if you were lucky, was firmly embedded in our attitudes to work and financial planning. It was assumed that expenditure in retirement would be lower because dependents will be long gone and leisure activities, like coach trips to Clacton, were relatively cheap.

Neither is proving to be the case. Between 1971 and 2000, the average age of first births for married couples increased from 24 to nearly 30. The increased availability of higher education has also had an effect and so it is safe to assume that parents will still be receiving calls/texts from their children for a ‘spare £100 for a windsurfing course’ well into their sixties. Let alone their own plans to travel the world and take up new and expensive hobbies.

Life Expectancy at Birth England & Wales 1920-2003



Source: Redington Partners

In pension terms the ‘golden generation’ who were born between 1925 and 1945 are in a strong position. Some were even given generous early retirement packages as major companies restructured in the 1980s and 1990s. For the next generation, however, the financial arithmetic of retirement has undergone a huge change in only a few years. The investment implications are only now starting to sink in.

The government and private sector companies are the biggest providers of pensions. Both are stepping away from providing a safety net for pensioners because it is just too expensive. According to the Office for National Statistics there has been a sustained reduction in the percentage of active employees that are members of Defined Benefit (final salary) pension schemes from 34% in 1997 to 19% by 2005. Since 2003 the rate of decline has accelerated.

The private sector takes on four main risks when providing a final salary pension, which are, in order of importance, interest rates, inflation, equity returns and life expectancy. Investment management techniques can be used to reduce the first three, but at the expense of increasing longevity risk. It has been estimated that a one year increase in life expectancy causes a schemes liabilities to increase between 3% and 4%. Hence the rush to the exit. Increasingly, our standard of living in retirement will be our own responsibility. Defined Contribution schemes are taking over. The Pension Regular estimates that total assets are now £160bn in these schemes. By way of comparison Defined Benefit schemes are worth over £750bn.

Defined Contribution schemes offer a wide range of investment options and advice on how to structure an appropriate portfolio. The investment risk is firmly with a contributor. Lifestyle Funds are particularly popular for those who do not take independent financial advice. The aim of these, in general, is to produce a fund that is 100% invested in bonds and cash at the specified retirement date. This is usually justified on the grounds that the fund will be used to purchase an annuity. Switching to bonds and out of equities normally starts about 5-10 years before retirement. This appears far too early bearing in mind increasing life expectancy and the corrosive effects of inflation.

The conventional solution is to buy an annuity, but if we try to quantify the capital required within a tax free portfolio to allow an individual to retire at 65 with the equivalent to an index linked pension of £100,000 per annum, we get a large number. Assuming average male life expectancy and current market estimates for inflation and interest rates you would need approximately £2 million. I am grateful to Redington Partners for this analysis.

The problem for individuals, as opposed to a company scheme, is that these assumptions may be wrong and there is no one else to underwrite the risk. In particular it would be rather brave to plan an investment policy that results in you spending your last £1 on the day you die. As a result the amount of capital required to produce this illustrative return would need to be significantly higher in order to build in a margin of safety.

For good historic reasons, retirement at 65 is firmly embedded in our attitudes to work and investment. However, it is becoming increasingly clear that these attitudes need to change. It is quite likely that many of us will work for longer than we currently expect and that serial careers will become increasingly common. The implications for investment policy are clear;

- Long term planning and a concerted effort to save will be required to create a reserve capable of generating sufficient revenue to maintain living standards.
- Investment in pension funds remains attractive because of the tax benefits.
- The investment policy adopted needs to take account of an investors total portfolio and not just the pension fund in isolation.
- Continued investment is needed for growth of capital and income for many years past retirement. With the increase in longevity this means that risk should be reduced over a 20-30 year period and not just at 65.

With hindsight we may look back on the latter part of the twentieth century as an aberration so far as retirement and pensions are concerned. A clear investment plan is essential.

David Miller - June 2008

Cheviot Asset Management Limited is authorised and regulated by the Financial Services Authority. The views expressed in this report accurately reflect the personal views of David Miller, Cheviot’s Head of Alternative Investments. This report is for general information purposes only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. It is not a personal recommendation and it should not be regarded as a solicitation or an offer to buy or sell any securities or instruments mentioned in it. This report is based upon public information that Cheviot considers reliable but Cheviot does not represent that the information contained herein is accurate or complete. The price and value of investments mentioned in this report and income arising from them may fluctuate. Past performance is not a guide to future performance and future returns are not guaranteed. This report is not for distribution outside the European Economic Area.