We need to talk about pensions

Tips for engaging with our financial futures

M&G Multi Asset team

We all know pensions are important. When we retire, we will need money to live on, certainly to cover our basic needs and hopefully for a bit more than that. In fact, making financial provision for the future is more than important, it is essential. So why do so many of us bury our heads in the sand when it comes to making decisions about pensions and other means of generating income for retirement? And how can we start engaging with this vital topic?

Your future self

When M&G carried out a survey in conjunction with YouGov on the topic of retirement income recently, almost a third of all respondents said they had not made a financial plan for retirement.

One of the main reasons given was not having enough time or knowledge to do so. However, the largest proportion of people we surveyed also said that generating an income for living expenses in retirement was their main financial priority. We know how important this is, we have all read the warnings in the press about poverty in old-age.

So why do so many of us fail to treat the issue with the urgency it demands? What stops us engaging fully with the challenges and opportunities before it is too late? The answer might be quite surprising. It is not that we do not understand – in theory – the importance of saving and investing for the future. Instead, the problem is that most of us suffer from certain behavioural 'blocks' that prevent us taking action in practice.

It is easy to get distracted by the language used to talk about this topic. Words like 'pension' are difficult to connect with emotionally. Many people think pensions are complicated, boring, and most importantly, too far off in the future to be prioritised over the things we need to deal with right now, today.

Consultant Mercer recently undertook a study in conjunction with the Stanford Center on Longevity* to examine why people in the US – just like us in the UK – fail to make proper provision for retirement.

They found that a key cause was the trouble we have connecting with our 'future selves'. In fact, when they asked people to think about themselves several years into the future, the patterns activated in the brain were the same as when they thought about a stranger. They then discovered that people who were shown age-enhanced images of themselves wanted to contribute significantly more to their pensions than those who were not shown such images.

Therefore, perhaps a good starting point is to try and put ourselves in the shoes of who we will be when we get older. Remember that this person is not a stranger. The things we want to enjoy now, such as holidays, cars, hobbies and freedom from debt and financial worry, are likely to be the same in retirement.

Can you have too much choice?

Logic suggests that having options provides people with a better chance of selecting what is best for them. So we tend to think choice is a good thing, but it can present challenges. It is easy to understand how too much choice can be overwhelming. And when we remember how behavioural impulses can affect our decision-making, we can see how feeling overwhelmed might cause us to put off important decisions altogether, especially if we cannot see immediate evidence of the result.

On the one hand, the introduction of auto-enrolment in 2012 recognised that many people, left to their own devices, may not make prudent decisions about retirement provision. This law requires all employers to automatically enroll employees who meet certain criteria into a type of workplace pension scheme called a Defined Contribution ('DC') scheme.

This is a good starting point, but it does not fully address the problem. It is all too easy to join a pension scheme and then forget about it until it comes to retirement. Many people never make decisions about their pensions while they are active members, such as contribution rates or investment strategy, which could make a difference to their final pot size. It also does not guarantee that when members reach retirement, they will make rational decisions about what to do with their pension savings to make proper provision for themselves throughout their later life.

It is at that stage, on the other hand, that recent pension reform has removed the idea that people need to be 'defaulted' into doing the right thing, and can be expected to make the right decisions for themselves. This has introduced more choice than ever before, which presents both greater opportunity, and greater risk. It is vital we do not allow ourselves to become overwhelmed. People who are uncertain about all their options could benefit from talking to a financial adviser or visiting www.pensionwise.gov.uk. As a starting point, we have provided some tips on things to think about.

Top tips for getting started

- Remember, it is never too early or too late to start saving and investing for retirement.
- Calculate how long you have to go to retirement and how long you can realistically expect to spend in retirement.
- If you have been auto-enrolled, stay enrolled. Remember that pensions are one of the most tax-efficient ways of saving.
- Check what pensions you have and how much is in each. Your pension scheme will provide you with an annual benefit statement to make it easy to keep track.
- If you have more than one pension, consider whether they could be easier to manage if you brought them together in one place.
- Can you afford to contribute more to your pension savings or other investments now, with the aim of achieving more growth for the longer term?
- Don't forget your state pension. Check your National Insurance contributions to see how much you qualify for.
- Think about what other assets you have that could provide an income in retirement, such as savings (including other tax-efficient vehicles like ISAs), investments and property.
- Think about the likely essential liabilities you will have in retirement such as regular household bills, food, fuel, and any outstanding debt you may have, including mortgages.
- Also consider what other expenses you may have such as things that will enhance your lifestyle, make retirement more enjoyable, start a new business venture or help loved ones.
- Think about what provision you have made for passing on your pension savings after your death.
- Consider how you could use your tax-free lump sum cash allowance to the best advantage.
- Remember to consider the impact of inflation on your savings over time. Think about whether you may want to invest some cash for growth. But remember that all investments involve risk.
- Make sure you understand all your options regarding when and how you can start drawing an income from your pension, being particularly mindful of tax issues. If you are uncertain, speak to a financial adviser.

A building-block approach

When it comes to using your pension savings to generate a retirement income, you will need to build a personalised plan, based on your personal circumstances. There are many options available and no 'one size fits all solution'. It is most likely that you will need to mix and match a number of options that offer different benefits for your different needs.

There will be basic, essential living costs that you must cover. For this, you probably require a product paying a guaranteed income. It is also important to keep enough cash to cover short-term needs and emergencies.

However, if you wish to maintain or enhance your current lifestyle, you will have to consider how inflation can erode the value of your savings over time. Therefore, you may decide to try to grow some of your capital to keep pace with inflation by investing in assets, including investment funds. Because investing involves taking risk, which means you could lose some or all of the money you invest, you must ensure you only use the amount of capital you are able to take this risk with. In other words, only use money that would be left over after essential needs are covered. A financial adviser can help you to calculate your so-called 'capacity for loss'.

The following table illustrates some examples of what could be classed as essential needs for which you will want to secure a guaranteed income. It also lists other things you may want to try to achieve by investing for growth.

Essential needs and additional aspirations

	Income requirement	Examples	Enter your calculations here
Essential	Outstanding debts	Mortgages, loans, credit cards	
	Regular necessities	Household bills, food, fuel, clothing	
	Rainy day provision	Cash to cover emergencies or unexpected short-term costs	
Aspirations	Income for enjoyment	Short holidays, eating out, hobbies	
	Helping loved ones	University fees, a first car, a first house, weddings	
	Life-long dreams	Once in a lifetime travel, a one off purchase such as dream car	

Source: M&G, June 2015

Any decisions regarding investments or pension savings are important and you should be aware of all your options. We are unable to give financial advice. If you are unsure about the suitability of your investment, you should speak to your financial adviser who will be able to provide regulated advice. Alternatively, you should consult Pension Wise (www.pensionwise.gov.uk) which is a free and impartial service designed to help you understand your retirement options.

* The Mercer and Stanford Center on Longevity Article Series 2014, http://www.mercer.com/insights/point/2014/mercer-stanford-center-on-longevity-main.html