Pensions

Pensions: why do those retiring face 'massive' losses despite FTSE highs?

Retired planner was shocked to see that his Aviva pension had dropped 20% in value last year

Deadline extended for NI top-ups that can mean £55,000 extra

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Neil Brown says he was surprised to see the valuation from Aviva, just as he was hoping to pay for a new kitchen. Photograph: Katherine Anne Rose/The Observer

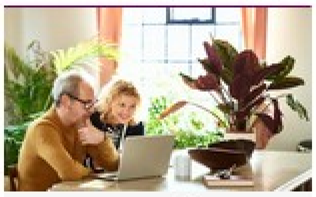
A former government pensions minister is warning of "massive losses" for pensioners retiring this year, with big providers telling older customers their funds have plummeted by 20% or more over the past 12 months.

The losses come despite the UK's FTSE 100 stock market index hitting record highs in recent weeks. What has emerged is that many workers reaching retirement this year were effectively locked into government bonds that fell dramatically in value as the Bank of England raised interest rates and Liz Truss's ill-fated premiership rocked the bond markets.

Neil Brown, 68, who lives near Oban in Scotland, was shocked to see his latest valuation from Aviva, just as he was hoping to take some of the money to pay for a new kitchen.

The newly retired former transport planner recently received his latest Aviva pension fund report, and was alarmed to see that his fund dropped 20% in value in 2022 – which, coming after a fall of 4% in 2021, has left him 24% worse off over the two years.

"A few years ago Aviva noted in their annual statement that as I was then approaching retirement age, my pension was being moved into safer investments (its lifestyle investment programme)," he recalls. He was told this meant "your pension fund is moved from funds with a greater exposure



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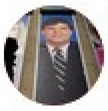
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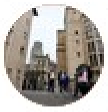
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to the stock market into more cautious investments. This helps reduce your exposure to risk from stock market fluctuations."

Aviva was not alone in doing this. It is estimated that, in terms of the big providers, about £10bn is being funnelled through "lifestyle" funds. These are often labelled "cautious", "low-risk" or "protected". But in the worst cases, these funds lost close to 40% of their value during 2022, much of it during the market convulsions after Truss became prime minister.

Brown assumed his pension pot in its later years would be invested safely, "perhaps largely in simple savings accounts" that would not lose value. Some was - about a quarter of his money - but the rest went into bonds that slumped in value.

> **The problem with bonds is that they fall in value when interest rates rise**

Brown and his wife will now have to rely on the state pension plus a small public sector pension to finance much of his retirement.

How could Aviva - and other providers - have lost so much of older workers' money just as they are about to retire? The answer lies in the "lifestyling" approach by pension providers that gradually switches company pension savers out of shares and into bonds, usually between the ages of 55 and 65.

The problem with bonds is that they fall in value when interest rates rise. Over the last 15 months the Bank of England has raised rates from 0.1% to 4%, which has translated into huge losses in gilts: UK government bonds bought in huge volumes by pension and insurance companies. Typically, funds invested in gilts have dropped by about 22% over the past year but some have fallen by significantly more than that.

"I have been warning about the appropriateness of lifestyling for a long time" says Ros Altmann, who was the UK pensions minister from 2015-16. "The well-meaning approach of trying to lower risk in the run-up to retirement has created massive losses that people may not be able to recover and will be poorer for the rest of their lives as a result."

Many say the bonds used in lifestyling were artificially overvalued by years of ultra-low interest rates and the Bank of England's quantitative easing programme, and were ripe for a major downturn.

Laith Khalaf of the investment firm AJ Bell - who a year ago warned about the risks of pension savers sleepwalking into a disaster - says: "Unfortunately, bonds were inflated into a big bubble by years of low interest rates and QE, which went pop when inflation returned and interest rates climbed."

The sums of money at stake are huge. Brown's savings were in the Aviva Pension Pre-retirement Fixed Interest FP Fund, which dropped by 24.3% in the 12 months to 2 March 2023, data from Trustnet shows, and has £185m under management.

The former pensions minister Ros Altmann says: 'I have been warning about the appropriateness of lifestyling for a long time.' Photograph: Imageplotter News and Sports/Alamy


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The scale of losses at other fund groups is even bigger. Clerical Medical (part of Lloyds Banking Group) has a Retirement Protection Pension, which has managed to lose 38.7% of its money in the past 12 months.

The Scottish Equitable Retirement Pension - with more than £500m under management by Aegon - has lost 29.2% of its money in the past year.

On a brighter note, rates on annuities (an annual regular income for life) that savers can buy with their pension pots have risen strongly over the past year, in line with the rise in interest rates. Many in the pensions industry argue that the gains in annuity income compensate for the loss of capital over the past year.

In a statement, Aviva says: "We have fully investigated Neil Brown's concerns and have found the value of his pension pot has fallen due to unprecedented market volatility over the last two years.

"We believe the lifestyling investment approach on this policy, which was outlined when the policy was taken out, was an appropriate mechanism to reduce risk approaching retirement because it was designed for customers who will look to buy an annuity at retirement. This was the typical approach at the time when Mr Brown took out his policy. The intention was to reduce risk but this cannot be guaranteed, particularly when investment markets are especially volatile."

However, Brown says he did not intend to buy an annuity. He adds: "I was not aware [I was being placed mostly into gilts], and anyway - I suspect like most people - would not have known the implications, given their repeated statements about low-risk investments."

Some critics say that few people reaching retirement now buy an annuity, making lifestyling into gilts unnecessary unless a saver specifically tells their pension provider they intend to buy one.

Altmann says: "In the olden days, when most people had to buy annuities and retired at a pre-set date, perhaps lifestyling made some sense. However, now that working life is more flexible and people no longer buy annuities but more likely go into drawdown, the idea that they should be automatically denied the chance of better long-term investment returns from their mid-50s onwards, in the name of supposed risk reduction, is clearly flawed."

When asked about the performance of its gilts fund, Clerical Medical said it "expects the fund to reduce in value as annuity rates increase, and vice versa ... This means the fund's performance and level of risk should be considered by comparison to annuity rates, rather than other bond funds, which take different approaches."

> Should the Financial Conduct Authority have done more to warn pension savers?

Aegon, which owns Scottish Equitable, says that before the freedoms on pensions took effect in 2015, it was appropriate to move savers' money gradually into gilts. It says that since then it has offered savers a choice of lifestyle funds, some of which may leave them invested in a mix of shares and bonds for longer.

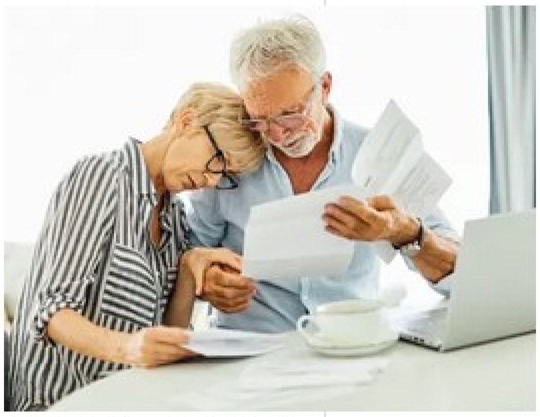
It says: "We regularly write to our customers to remind them which fund they're invested in and tell them that their investments will automatically start to switch into other investments as part of the lifestyle strategy."

Should the Financial Conduct Authority have done more to warn pension savers? Its guidance says that lifestyling remains appropriate but that it should not automatically lead to full disinvestment from growth assets.

What does this mean to me and what can I do?

Am I affected?

It depends on what sort of company pension you have. Mostly this affects older (60-plus) workers at private sector companies who are very close to retirement. If you have a final salary-style scheme, common in the public sector, you are not affected. If you are under 55, it is likely you are in your company's "default" fund, with relatively low exposure to UK government bonds.



Are you fully across the details of your pension scheme? Photograph: Rightdisc/Alamy

I'm 66 and about to retire. What can I do?

If, say, you recently turned 66 and just followed the standard rules for your private sector company pension, there is a risk that you were lifestyled into bonds over the last five to 10 years, and then hit by the big downturn in gilts during 2022. You can request that your pension provider shift you back into a fund that isn't so exposed to bonds but the damage, sadly, is probably already done. If you always intended to buy an annuity, you can comfort yourself that your capital losses will be largely made up by the rise in annuity rates.

I'm in my mid-50s. What can I do?

Log in to your company pension scheme and take a good look at what you have. Normally there will be a note about your NRD - your normal retirement date - or your SRD - your selected retirement date. Let's assume it says 67. Many, though not all, company pension schemes will start gradually lifestyling your investments into bonds within five to 10 years of your retirement date. Some will ask if you are going to take an annuity, in which case you will almost certainly be put into gilts. If you say you are going into drawdown, it is likely that you will remain closer to the standard mix of investments for longer.

Can't I just tell them not to put me in these bonds?

Your company pension scheme will normally allow you to make investment choices. It is likely that you are automatically invested in the default fund, which is usually a mix of UK and international shares, corporate bonds and government bonds. This mix will suit most people. But if you are in your mid- to late 50s, you may want to check if you are being shifted into a fund with higher exposure to bonds and out of shares. You can normally elect to shift back into the standard default fund. You can also make other investment choices. One thing to remember is that government bonds may be a decent investment in the future - in some ways they have simply normalised after the historically low interest rates that followed the financial crash.

It is estimated that, in terms of the big pension providers, about £10bn is being funnelled through lifestyle funds. Photograph: Stocknshares/Getty Images/iStockphoto

So how do I manage my pension pot in retirement?

A big question. Most people with private sector pensions now go into drawdown at retirement, where they draw down a portion of their savings every year, leaving the remaining money invested in a mix of shares and bonds.

Jason Hollands of the advisers Bestinvest says this approach "will lead to more variable outcomes and is riskier than an annuity but with the potential for higher returns and the ability to leave any residual assets left in the pension to your beneficiaries when you die".

At AJ Bell, Khalaf says: "If you have a sizeable final salary scheme, or some Isas, or part-time earnings, you might be willing to take a bit more risk with your pension fund. Within that, I think equity income funds should make up a core part of the solution. The rest can be invested predominantly in bond funds, which after last year's big falls are actually looking much more interesting and providing a reasonable yield again."

Pensioners can also mix and match drawdown and annuities. Use some of your pension pot to get a guaranteed annual income every month until you die - that's what an annuity is - and leave the rest invested in a drawdown fund.

I'm furious at the losses I've sustained. Can I get compensation? How do I complain?

If you have a complaint about how your pension scheme is run, talk to your pension provider first. They have to respond within eight weeks. You can also contact the Pensions Ombudsman if you are concerned about how your pension is run.