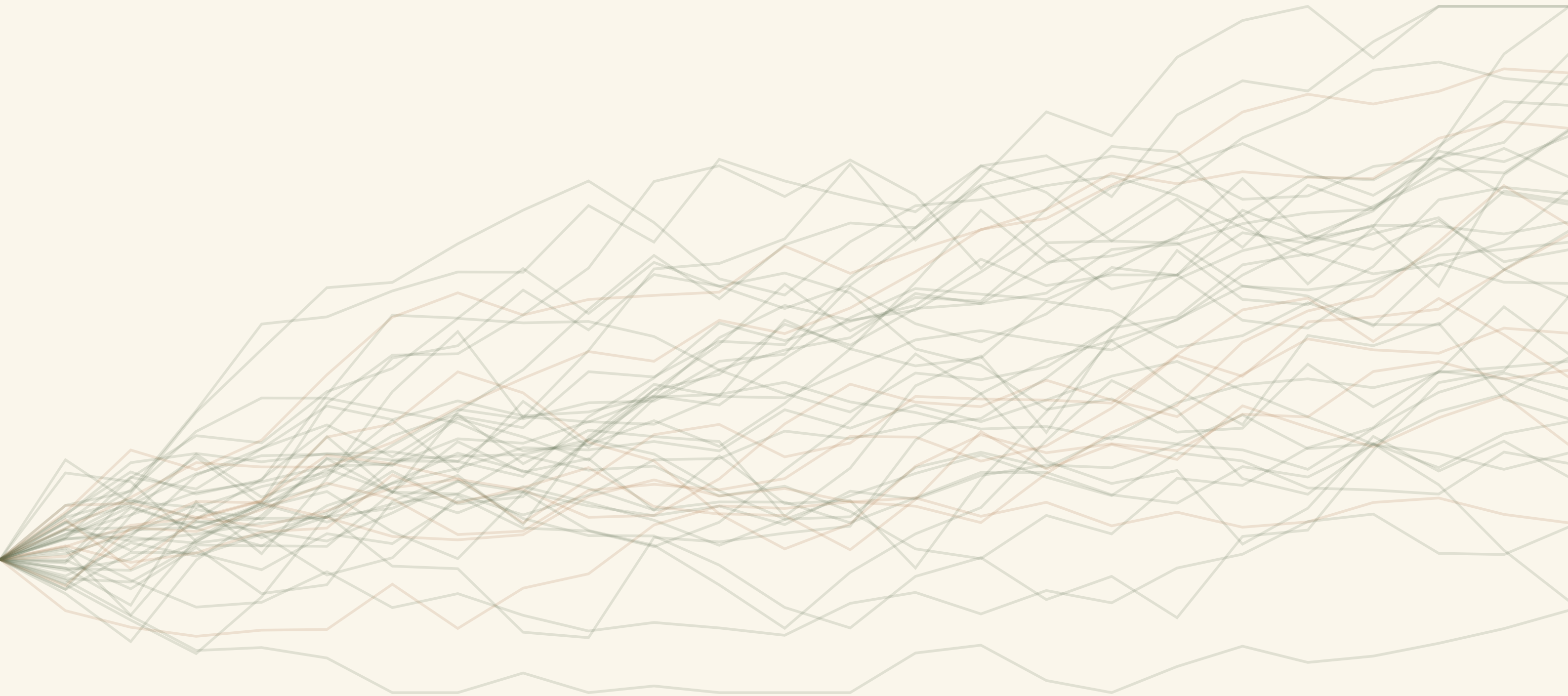
Your Future Compass

RETIREMENT GUIDE

Pension drawdown explained: how to actually run it

Drawdown keeps your pot invested and flexible, but running it is where the decisions are. Here are the moving parts: how much to take (and the 4% 'rule'), sequence risk, which pots in which order, crystallisation methods, the MPAA trap, and keeping it sustainable for a 30-year-plus retirement.



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Pension drawdown explained: how to actually run it

> **Guidance and illustrations only, not regulated financial advice.** This guide explains how income drawdown works in general terms. It isn't a recommendation about how *you* should run yours. The right approach depends on your circumstances, so consider speaking to a qualified, regulated financial adviser.

If you've decided on **drawdown** rather than an annuity (buying a guaranteed income for life with your pot; that choice is covered in annuity vs drawdown), the real work starts. Drawdown isn't a product you set and forget; it's something you *run*, year after year. This guide walks through the moving parts in plain English, so you know what actually matters.

A quick recap of what drawdown is

With drawdown you keep your pension pot **invested** and take income (and lump sums) from it as you choose. You normally get up to **25% tax-free**, and the rest is taxed as income when drawn. The appeal is flexibility and growth potential; the catch is that **the risks are yours to manage**, which is exactly what the rest of this guide is about.

1. How much to take: the withdrawal rate

The single biggest lever is **how much you withdraw each year**. Take too much and you risk running dry; take too little and you under-live a retirement you saved hard for. A few common approaches:

- **The "4% rule".** You may have heard it: take 4% of your pot in year one, then rise with inflation. It's a **US rule of thumb from the 1990s** based on US market history, useful as a mental anchor, but UK costs, returns, taxes and longer lives mean many people here treat it cautiously, or start lower. It's a starting point for thinking, not a law.
- **Fixed real income**: a set amount that rises with inflation. Predictable, but doesn't flex if markets fall.
- **Flexible / "guardrails"**: take more in good years, trim in bad ones. Harder on the lifestyle but far kinder to the pot's survival.
- **Natural yield**: spend only the income (dividends/interest) the pot produces, leaving the capital. Very sustainable, but the income can be lumpy and may be less than you need.

There's no universally right number. It depends on your other income, how long the money must last, and how much variability you can live with.

2. Sequence-of-returns risk (the one that catches people out)

This is the most important risk in drawdown and the least understood. A poor run of returns **just after you start drawing income** does far more damage than the same fall later, because you're selling investments while they're down, locking in the losses. The same average return, a very different outcome.

You can't control markets, and nobody can forecast them. These are the approaches that tend to come up. None of them is a recommendation, none removes the risk, and each has a cost worth understanding:

- **A cash buffer**, often one to two years of spending, means income can come from cash rather than from selling investments while prices are down. The cost is that cash tends to lose value to inflation over long periods.
- **Flexible withdrawals**, trimmed in poor early years, tend to cope better than a fixed amount drawn regardless. The cost is that your income is no longer predictable.
- **Testing the early years** specifically, rather than an average, shows how exposed a plan is before it's relied on.

If one idea from this guide is worth an extra ten minutes, it's this one: why the order of returns matters shows the same average return producing very different outcomes purely from the order it arrives in.

3. Which pots, and in what order

Most people retire with more than one pot: **pensions, ISAs, and taxable cash/savings** (ISAs being Individual Savings Accounts, with tax-free withdrawals), and they're taxed differently, so the **order and mix** you draw them in changes both your tax bill and what your family inherits:

- **Pension-heavy drawing** → more taxable income now, but a smaller pension pot (which counts towards **inheritance tax from April 2027**, as explained in what happens to my pension when I die).
- **ISA-heavy drawing** → lower tax now (ISA withdrawals are tax-free), but the pension is left untouched and more exposed to IHT later.

There's a genuine tax-versus-inheritance trade-off here, and it's personal. (In the app, the "how you draw" view lets you move the pension-vs-ISA mix and see the lifetime tax and IHT side by side.)

4. Crystallisation: how you take the tax-free cash

"Crystallising" just means moving pension money from the untouched pot into drawdown. How you do it changes the tax timing:

- **PCLS**: take your 25% **tax-free lump sum up front**, then draw taxable income from the rest.
- **UFPLS**: leave it uncrystallised and take chunks as you go; **25% of each withdrawal is tax-free**, 75% taxable.
- **Staged / phased**: crystallise only what you need each year, often keeping taxable income within the basic-rate band so it never tips into higher-rate tax (topping up from ISAs if needed).

The tax-free entitlement is the same overall; what differs is the **timing** and how much control you have over your tax band each year. The cap and the case for taking it in stages are covered in the 25% tax-free lump sum explained, and the deduction on the very first payment has its own arithmetic: emergency tax on your first pension withdrawal.

5. The contribution trap most people miss (the MPAA)

If you're **still working and paying in**, beware: once you take **taxable income flexibly** from a defined contribution pension (DC, a pot of money you've built up, rather than a guaranteed income), you can trigger the **Money Purchase Annual Allowance**, which cuts how much you can still contribute to pensions to just **£10,000 a year** (from the usual £60,000), with no carry-forward. Taking *only* your tax-free cash generally doesn't trigger it. More in when can I access my pension.

6. Keeping it invested and making it last

Your pot is still invested all the way through drawdown, so the basics from investing basics still apply: your **asset mix**, your **fees** (they compound for decades), and how much risk suits a pot you're drawing from. And remember **longevity**: many people will draw for **30 years or more**, so plan to a realistic older age, not an average one.

Common mistakes people make

- **Drawing a fixed big number regardless of markets**: the fast track to sequence-risk damage.
- **No cash buffer**, so a crash forces selling at the worst time.
- **Ignoring the tax band**: large one-off withdrawals can tip income into higher-rate tax.
- **Forgetting the MPAA** while still contributing.

- **Setting and forgetting**: drawdown needs a yearly review, because life and markets move.

A quick checklist

1. **Pick a withdrawal approach** (fixed, flexible/guardrails, or natural yield) and a sustainable rate.
2. **Decide how much cash to hold** for the early years, weighing sequence risk against inflation.
3. **Decide which pots to draw, in what order**, weighing tax now vs IHT later.
4. **Choose how you crystallise** (PCLS / UFPLS / staged) and mind your tax band.
5. **Watch the MPAA** if you're still paying in.
6. **Review every year** and pressure-test against bad markets and a long life.

Drawdown gives you freedom, but freedom comes with decisions. The goal isn't to predict the future. It's to run a plan that can cope with a range of futures. You can model all of the above (withdrawal rate, the pot mix, and how your plan might cope with crashes) with our free planning tool, and a regulated adviser can help with the personal calls.

This guide is general information, not regulated financial or tax advice. Investments can fall as well as rise, rules and allowances change, and the right approach depends on your circumstances. For free, impartial guidance, Pension Wise offers a free appointment if you are 50 or over, and MoneyHelper has more on your retirement options. Consider regulated advice before acting.

See it for your own numbers.

Build a free plan at **yourfuturecompass.co.uk/app**