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Prior to joining JANA in 2008, Danielle was a Strategy Analyst at MLC for two years, which involved delivering structured communication, including reports, presentations and business cases to the Head of Strategy and CEO. Danielle also completed the two-year MLC Graduate Program with rotations in Accounting, Finance and ThreeSixty Investment Research. As part of her tertiary Bachelor of Accounting Scholarship Co-operative Program, Danielle undertook internships with MLC and Ernst & Young.

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APPROACHING THE RETIREMENT PUZZLE

In previous editions of the JANA MyConsultant publication, we shared our thinking on retiree preferences for retirement product design. We also provided a framework for Trustees to use when tackling the retirement conundrum and shared our key principles when investing for retirement.

In this article, we provide an overview of the roadblocks that superannuation funds have faced, and also outline a number of approaches that superannuation funds are exploring to tackle the retirement puzzle.

Summary

The dust is beginning to settle in terms of the regulatory framework that will apply to the offering of pension products for members in retirement. The Government's publication of the key Comprehensive Income Products for Retirement (CIPR) design features now means that funds should be getting close to the decision-making stage as to how they will provide retirement products for their members.

However, it is not clear yet whether the CIPR structure will be attractive for all funds, and each Trustee will need to review the criteria against its own members' needs.

Some funds have already embarked on a range of different approaches to retirement product design, and these approaches listed in this article prove the maxim that there is no single right way to proceed from here.

However, JANA does believe that there is a proper and systematic approach for working through all the issues. It starts at understanding your membership base in detail, and then working through a series of questions relating to complexity and objectives.

Investment design is a fundamental part of product design, but only one part. Communications, administration, member education and financial planning are fully integrated pieces of the retirement jigsaw.

A brief recap

One of the key issues currently facing superannuation Trustees is how to manage members' investments in retirement in a practical and efficient manner while meeting retirees' expectations. The overarching findings from our retirement research shows:

- There is no single absolute solution for all superannuation funds, or for all members;
- In designing a retirement solution (or solutions), Trustees should work systematically through a structured process starting with identifying what are the needs of their members;
- The key elements for a successful retirement investment approach include simplicity, low cost, ease of understanding and flexibility; and
- Any solution should be integrated into an advice capability – online and/or face-to-face.



The regulatory backdrop: What has changed?

In recent times, there have been important reviews undertaken by the Commonwealth Department of Treasury which impact funds offering retirement products. A brief summary is contained below.

The Treasury's Retirement Income Streams Review

The first important review to note is the Government's Retirement Income Streams Review. On 21 July 2014, the Government released a consultation discussion paper titled '*Review of retirement income stream regulation*'. On 3 May 2016, the Government released the final report of the review.

The review examined the existing minimum drawdown requirements for account-based pensions, and concluded that the current annual requirements are appropriate and consistent with the objective of providing income in retirement. The review recommended that the Australian Government Actuary should be asked to undertake a review of the annual minimum drawdown rates every five years to ensure that they remain appropriate (based on any increases in life expectancy). The only other reason for considering a change in drawdown rate related to significant economic shocks and would be based on further advice from the Actuary.

The review also concluded that the existing regulatory framework for retirement income stream products is a barrier to the development of other annuity-style products that could help to manage longevity risk (i.e. the risk of outliving your savings). The review recommended that:

- An additional set of rules for income streams should be developed which would allow lifetime products to qualify for the

earnings tax exemption, provided they meet a declining capital access schedule.

- The alternative product rules should be designed to accommodate purchase via multiple premiums but additions to existing income stream products should continue to be prohibited.
- Self-Managed Superannuation Funds (SMSFs) and small Australian Prudential Regulation Authority (APRA) regulated funds should not be eligible to offer products in the new category.
- A coordinated process should be implemented to streamline administrative dealings with multiple government agencies.¹

Treasury's Framework for Comprehensive Income Products for Retirement (CIPR)

Following the Financial System Inquiry, the Government agreed to support the development of more efficient retirement income products and to facilitate Trustees offering these products to members. In December 2016, the Government released a discussion paper for public consultation titled '*Development of the framework for Comprehensive Income Products for Retirement*'.

A CIPR is expected to be a mass customised, composite retirement income product that a Trustee could offer to members.

CIPRs are required to meet three minimum criteria:

1. Deliver a minimum level of income (at least the amount invested in an account-based pension drawn down at minimum rates);
2. Deliver a stream of broadly constant real income for life (to manage longevity risk); and

3. Include a component to provide flexibility to access a lump sum and/or provide a bequest.

Treasury has proposed that a CIPR is required to be in the best interests of the majority of members. If a Trustee designs a product that meets the proposed minimum product requirements, is in the best interests of the majority of their members and offers the product in line with the offering requirements, then Treasury proposes that the Trustee will receive a 'safe harbour'. The safe harbour would protect the Trustee from a claim on the basis that the CIPR was not in the best interest of an individual member.²

Implementation of CIPRs is not expected before mid-2018.

The Government proposes to label these products as 'MyRetirement' products. The MyRetirement framework is intended to increase individuals' standard of living in retirement, increase the range of retirement income products available, and empower Trustees to provide members with an easier transition into retirement.³

New tax arrangements for deferred lifetime annuities and group 'self-annuitisation' products

The Treasury has proposed changes to the tax treatment of a range of innovative income stream products including deferred lifetime annuities and group self-annuitised products. The proposed changes extend the tax exemption on earnings in the retirement phase to these products. The purpose of this change is to enhance the product choice and flexibility for Australian retirees looking to better manage the risk of outliving their retirement savings. These changes are expected to come into place from 1 July 2017.⁴

What does this mean for superannuation funds?

For Trustees of superannuation funds, the above changes mean that:

1. Funds will need to consider if they will offer a CIPR within their pension product offering and how best to structure the solution; and
2. Funds will need to consider the impact that any changes to tax arrangements will have on any existing or future investment within their pension offering.

It is too early to determine categorically whether a CIPR is the right solution or not for any particular fund, at least until the final specifications are published. The key questions for funds will be:

- Is the cost of income certainty likely to diminish long term financial outcomes prohibitively?
- Will members be likely to take up the CIPR given the possible loss of control and flexibility?

- At what age profile is a CIPR likely to be attractive?
- Which segment of the fund's members should the CIPR be targeting?

Therefore, the need for a fund to review its retirement product offering is vital.

¹ Based on the Australian Government the Treasury data; '*Retirement Income Streams Review*' (May 2016)

² Based on the Australian Government the Treasury data; '*Development of the framework for Comprehensive Income Products for Retirement, Discussion Paper*' (15 December 2016)

³ Based on the Australian Government the Treasury data

⁴ Based on the Australian Government the Treasury data; '*Budget 2016 Superannuation Reform: Enhancing choice in retirement income products, Superannuation Fact Sheet 10*' (9 November 2016)

Challenges and roadblocks: Issues that funds face when tackling the retirement puzzle

Six issues that Trustees face when tackling the retirement puzzle

1. Understanding the changing rules
2. Knowing members' requirements
3. Engagement, education and advice
4. Managing members' transition to pension options
5. Administration of pensions
6. Scale and impact on costs

The following section summarises the key challenges and roadblocks that we believe Trustees have faced when tackling the retirement puzzle.

Understanding the changing rules (e.g. CIPR, tax treatment of deferred lifetime annuities)

Broadly speaking, superannuation funds have been hesitant to commit to a retirement solution until the change in regulations have been finalised. Given there is now much more certainty surrounding timing and outcomes, we believe that we are at a stage where decisions need to be made.

Knowing members' requirements

Reviewing the investment component of a retirement strategy is only one of the pieces of the retirement puzzle. Knowing your members is the starting point. For Trustees starting out on the retirement strategy journey, the framework that we outlined in our [February 2014 MyConsultant article](#) provides a useful starting point for analysing your membership base. A summary of the key considerations from that article are outlined below:

1. What elements of the membership should be targeted?
2. What should the retirement product suite mix be?
3. How complex should the product solution be?
4. How will you de-risk your retirement products?
5. How will you communicate with members? Will you offer a financial planning capability?

Engagement, education and advice

One of the biggest factors in the success of a retirement offering is the strength of a fund's communication and education of the product strategy to members. Whilst a lot of funds have a financial planning

capability, we believe that successful funds will complement this capability with online functionality which captures the growing part of the self-directed market. In conjunction with a financial planner offering, an online presence encourages regular review, education and engagement with a broader range of members.

Managing members' transition to pension options

Funds have also faced the challenge of how to transition members smoothly across from the accumulation (super phase) options and into the pension options. Part of the retirement challenge has been to navigate the 'pre-retirement' years that are at risk of a capital drawdown if there is unexpected market volatility. Defensive assets, or a downside protection strategy, will have a more significant part to play for members approaching retirement. However, active management remains vital, and it is important to be thoughtful about de-risking to ensure that portfolios are not de-risked too early.

Administration of pensions

As the design of pension options have become more tailored (above and beyond the accumulation options), funds have faced a challenge of what can be administered by their outsourced administration provider. Funds have also faced the prospect of large increases in their administration costs for restructuring pension options with relatively low levels of funds under management. Engagement with your fund's administrator for any change to a retirement strategy early on in the process is critical.

Scale and impact on costs

A key reason some funds have deferred making any changes to their pension offerings has been the small size of the assets within their pension options. In our view, a fund can begin to make changes at any size, in a phased fashion as scale grows. Reasonable steps include:

1. Ensuring that the pension options are operating in a different tax structure to the accumulation options;
2. Establishing standalone pension option asset allocations, to ensure that the investment objectives and strategic asset allocation of the pension options are tailored to retirees' needs;
3. Reviewing the downside protection characteristics of the pension options; and
4. As scale grows, employing different active managers in the pension options that have a specific focus on retirement.

Different approaches that funds are exploring to tackle the retirement puzzle

The following section outlines a number of approaches that superannuation funds are taking with regards to their retirement offerings.

Mirroring accumulation and pension options

Today, the most common approach across superannuation funds is to mirror the same investment structure for both accumulation and pension options. That is, the same asset allocation and manager selection is used for both options. The key difference has been the tax structure that applies to the accumulation (taxed) and pension (non-taxed) options with the different structures being provided by the fund's custodian. This approach provides members with a simple transition to retirement with minimal transaction costs. However, it doesn't address the issues of sequencing risk, that is, the risk of a retiree experiencing a significant negative market movement in the lead up to or during their retirement or the changes in risk profiles as members move to the pension stage.

Mirroring accumulation and pension options... and beyond

A more advanced approach that funds have undertaken has been to have the pension options mirror accumulation options but with tailored asset allocation. In addition, other funds have also tailored the managers (with different mandates) and building blocks within their pension options. This approach is more advanced as it introduces the underlying building blocks that enable the fund to tailor the investments to the needs of retirees.

Bucketing approaches

We introduced you to our preferred 'Three Pillar' approach for retirement at the JANA 2013 Conference. This is a 'bucketing' approach which is a simple and effective solution for pension members which mirrors the approach to portfolio rebalancing and cashflow management widely applied by financial planners. Bucketing approaches can vary based on the number of 'buckets' that are included in the strategy but typically include two or three 'buckets.' The JANA Retirement Pillars include:

- A short term 'pillar' ('Cash pillar'): This is invested in cash to fund spending needs for the near term, usually the next two to three years;
- A medium term 'pillar' (or 'Stable growth pillar'): This includes the bulk of retirees' assets which will be invested to provide a moderate level of growth, utilising active management and focusing on downside protection; and

- For investors with larger account balances, a longer term 'pillar' (or 'Longevity pillar'): This includes a significant allocation to growth assets to help protect against longevity risk (the risk that members outlive their savings). To help mitigate longevity risk, we believe in investing for the long term.

Bucketing approaches can be easily tailored by individual members for their specific needs and circumstances. Educating members on how to determine their appropriate income drawdown rate will also help to manage longevity risk for members.

A key component of a successful bucketing approach is the algorithm used for rebalancing the members' funds across the various 'buckets' in different investment market environments. The rebalancing between the three pillars is designed to avoid, where possible, selling assets at depressed market valuations (at times when assets might be most attractively positioned for growth). This helps to manage the sequencing risk of returns for retirees.

Bucketing approaches also allow members to access their capital when required.

Annuities and capital protected products

There are various ways to protect against longevity risk, including investments in products such as annuities and capital protected products. In our view, these products may be suitable at a member by member level, but depends upon the member's specific situation and risk tolerances. The level of yield versus cost is an important consideration, as there is a cost associated with receiving a guaranteed income stream. There are also risks to manage including regulatory and tax barriers, counterparty risk and reduced flexibility. The proposed tax exemptions for these products will make investing in these products more attractive. Other considerations include whether or not the retiree receives any residual capital back (e.g. to bequeath).

We believe that the market for these products will expand as funds develop CIPR solutions. In recent times, there has been a trend towards offerings that combine a 'guaranteed income component,' which

is provided via an annuity, with a more traditional allocated pension product.

High income products

Some funds are offering pension options that are designed to deliver high income and include allocations to high dividend paying companies. These funds have a focus on franking credits, higher yielding interest rate investments and, in some cases, property and infrastructure investments. These pension options do have particular appeal to some retirees, although the balance between growth and income will not be suitable for all retirees.

Mortality pooling approaches

In recent times, we have seen some funds invest into pooled products that operate similar to an account-based pension, by providing an income stream which is not guaranteed. The additional feature is that income within these products is expected to increase over time for surviving members (based on the pooled mortality assumptions of the members in the product). Members may also be able to access a large component of their capital up to a set age.

Managed volatility strategies

Some funds have adopted managed volatility strategies which use derivative overlays or hedging techniques to remove specific risks within the portfolios. These strategies have been implemented to reduce the downside risk in the portfolio (as a market shock can be catastrophic for retirees, and can be particularly disturbing for older members).

Real return (CPI+) strategies

In recent years we have seen the uptake of real return strategies (or 'CPI plus' funds) which have been offered by investment managers. These products are diversified and employ different techniques to generate returns and more importantly, manage downside risk. Many of these products are tailored for the retirement phase either as individual 'building blocks' within a retirement strategy or as standalone products that may be combined with an annuity type product to deliver an income stream.

Conclusion

There are various approaches that funds are already exploring and implementing when considering a retirement solution.

There is no single 'right' solution for all funds, or for all members. The starting point is knowing your member and working systematically through a structured process to choose an appropriate solution (or solutions) to meet the majority of your members' needs. Member engagement is critical and investments are just one piece of the retirement puzzle. It is important to establish a strategy with regards to member communications, education and financial advice. Engagement with your administrator for any change to a retirement strategy is also critical.

We believe that the changes to the regulatory environment are providing funds with the opportunity to revisit their retirement offering, especially in light of the proposed CIPR framework. Funds will need to consider if they will offer a CIPR within their pension offering and how best to structure the solution. JANA is heavily engaged in this space and we look forward to sharing more of our retirement research with you at our Annual Conference in September.

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