

MyConsultant

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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 the 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.

Danielle holds a Bachelor of Accounting (majoring in Finance and Accounting) from the University of Technology, Sydney. Danielle is also a member of the Institute of Chartered Accountants in Australia, and is a passionate member of Women in super.

The Retirement Opportunity

This is a follow up article to our February 2014 edition of JANA MyConsultant, where 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. In this article, we share our key considerations when investing for retirement.

A brief recap

JANA believes a key issue currently facing superannuation Trustees is how to manage members' investments in retirement in a practical and efficient manner to provide suitable member outcomes. We are not unique in this belief; however, we have committed considerable time and resources researching this important topic over the past couple of years.

The over-arching findings from our Retirement research are as follows:

- There is no single 'one-size-fits-all' solution for all superannuation funds, or for all members;
- Trustees should work systematically through a structured process so that they can choose an appropriate solution (or solutions) to meet the majority of their members' needs;
- The key elements for a successful in-retirement investment approach include simplicity, low cost, ease of understanding and flexibility; and
- Any solution should be integrated into an advice capability – on-line and/or face-to-face.

We introduced you to our preferred '**Three Pillars**' approach for Retirement (previously known as 'Three Buckets') at the 2013 JANA Annual Conference. This approach is a simple and effective solution for pension members which mirrors the approach to portfolio rebalancing and cashflow management widely applied by financial planners. Furthermore, the '**Three Pillars**' approach can be easily tailored by individual members for their specific needs and circumstances.

JANA's Retirement Pillars include:

- A short term 'pillar' ('Cash pillar'): This is invested in cash to fund planned 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' superannuation balances which will be invested to seek 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 and aims to help protect against longevity risk (the risk that members outlive their savings).

A key feature of **JANA Retirement Pillars** is a JANA-developed rebalancing algorithm which is applied, at a member-level basis, in a disciplined manner to transfer funds between the investment pillars.

Critical to the success of any retirement solution, including the **JANA Retirement Pillars**, will be an integrated member engagement plan, which will need to encompass:

- The fund's engagement with their administrator
- on-line advice tool for members;
- financial advice capability; and
- member communications and education.

We have progressed our research in respect to each of these considerations, and we will provide you with an update at our JANA Annual Conference in September. In this article, we include some of the key insights from our retirement research program.

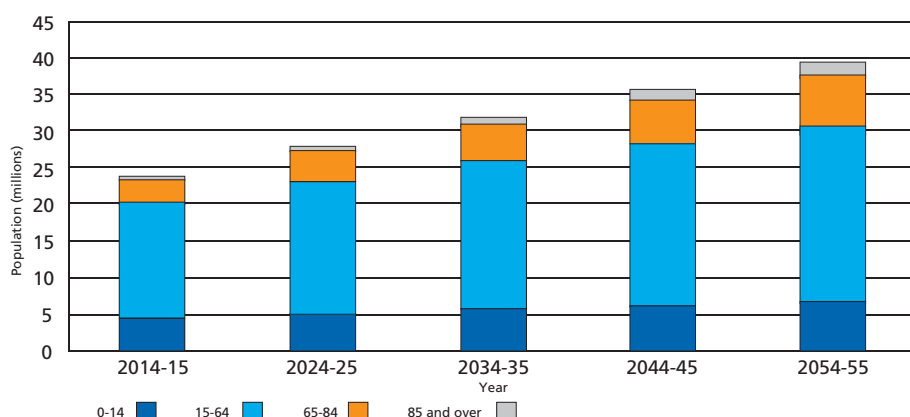
The demographic backdrop: why we need to focus on Retirement solutions now

The findings of the Australian Government's *2015 Intergenerational Report* highlight that the issue of retirement funding continues to grow in importance. A few key statistics include:

- The number of Australians aged 65 and over is projected to more than double by 2054–55, with 1 in 1,000 people projected to be aged over 100. In 1975, this was 1 in 10,000.
- Australians will live longer and continue to have one of the longest life expectancies in the world. In 2054–55, life expectancy at birth is projected to be 95.1 years for men and 96.6 years for women, compared with 91.5 and 93.6 years today.
- The number of people aged 15 to 64 for every person aged 65 and over has fallen from 7.3 people in 1975 to an estimated 4.5 people today. By 2054–55, this is projected to nearly halve again to 2.7 people.

The projected growth in the 65-84 and 85 and over age groups can be seen in Chart 1 above.

Chart 1: Demographic projections for Australia - an aging population



Source: Treasury projections from the Australian Government's 2015 Intergenerational Report

For Superannuation Trustees, this highlights that:

1. Pension assets will increase as a percentage of assets under management;
2. Member retention from the accumulation phase to the pension phase is critical; and
3. Therefore, the need for a fund to review its in-retirement product offering is vital.

In the section that follows, we include a summary of our thinking on the key considerations when investing for retirement.

Retirement considerations: investing in retirement is different to the accumulation phase

There are limitations in mirroring accumulation (super) into pension options

Today, a common approach across super 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 accumulation and pension options. The key difference has been the tax structure that applies to the accumulation (taxed) and pension (non-taxed) Options, which is primarily implemented by a fund's custodian.

The issue has primarily been one of scale, and as a result, most funds have not differentiated between the needs of members in the accumulation phase from those in the retirement phase. However, with the number of Australians over age 65 only expected to increase, there is a pressing need for a differentiated solution between these two groups to be considered.

The two key questions often asked by Trustees are:

1. What should we focus on when tailoring our pension options?
2. When is my fund at sufficient scale to implement different accumulation (super) and pension options?

Tax management is key in retirement, and is wider reaching than we think

Members in the accumulation (super) phase pay up to 15% tax on income (investment earnings) earned in Australia within their superannuation investment strategy. In addition, realised capital gains held for longer than 12 months within a superannuation fund are taxed at 10%.¹

In contrast, a qualifying account based pensioner does not pay any tax on investment earnings or realised capital gains earned in Australia. A person aged 60 or over is not taxed on annual pension payments, and they can elect how much income they receive from their pension product each year, subject to minimum limits.²

1. Source: ASIC's *Moneysmart*, 2015

2. Source: ASIC's *Moneysmart*, 2015

There are implications of the difference in tax structure for assets in the Australian equities asset class. In particular, a qualifying account based pensioner receives the full benefits of franking credits earned from Australian listed equity allocations. This is also true for individuals in the accumulation phase; however, franking credits have a cash consequence for account based pensioners (because given the zero tax rate, franking credits are received as a cash refund rather than via a lower tax rate).

Within the Australian market, these tax benefits are not just limited to franking credits. Higher turnover managers can also be more beneficial in a pension tax structure, given there is no capital gains tax on realised gains. Off-market buybacks are typically more beneficial for pension investors. Buy-write strategies can also provide a lower volatility return profile with additional untaxed income and franking. Therefore, for a fund, it may make sense to establish a different Australian equities configuration for the fund's pension Options.

The tax benefits don't just end at Australian equities. For example, within the fixed interest asset class, investments in bonds also benefit from a zero tax pension structure. High turnover strategies, such as some hedge funds, can also benefit significantly from a zero tax environment.

Active management of assets is even more important in retirement

Based on the 2014/15 life expectancy forecasts in the Treasury's 2015 Intergenerational Report, Australian males aged 65 can expect to live (on average) another 26.5 years and females aged 65 can expect to live (on average) a further 28.6 years. This highlights the following key risks when managing retirement assets:

1. There is the danger that a high security, low risk investment will 'run out' during a retiree's lifetime, especially given today's low interest rate environment;
2. There is the need to make sure a retirement savings balance can, at a minimum, keep pace with inflation and rising living costs;
3. There is a trade-off between locking up capital for future growth, versus the flexibility of being able to withdraw funds as retirees' needs change unexpectedly; and
4. Behaviourally, the greatest risk for retirees is 'following the herd', that is, selling low and buying high.

As a result, we believe that active management in retirement is even more important than in the accumulation phase, as retirees face unique risks, have a shorter investment time frame, and will be drawing down assets during the investment period. Active management of asset allocation in pension Options is vital to balance these competing risks, to provide liquidity to fund income requirements, and to provide a smoother investment journey for members along the way. It is also important to ensure that there is a smooth transition for a member from the pre-retirement (super) to the in-retirement phase. Employing different active managers in the pension options that have a specific focus on retirement is also vital.

The management of downside risk is vital in retirement...

As the time horizon for a retiree is less than for a member in the accumulation phase, market volatility can have a greater impact on retiree outcomes. Retirees have less time to recover from any catastrophic losses, and there is the added complication that they will also be drawing down on assets to fund their income requirements. Therefore, defensive assets, or a downside protection strategy, will have a more significant part to play for a retiree compared to members in the accumulation phase. However, simply being 'low risk' does not solve the problem given that such a strategy actually increases the problem of longevity risk, that is, the risk of running out of money. The essence is to ensure that portfolios are not de-risked too early. In addition to the design of the 'Three Pillars' portfolio allocation, JANA's approach has been to craft new style mandates with underlying investment managers that are specifically focused on downside protection, while seeking to capture all or more of the available upside potential. This has resulted in JANA negotiating a range of new mandates in equity markets and alternatives, specifically designed for members 'in-retirement' which are available for our client funds' portfolios.

...and longevity protection should form a part of any retirement solution

You are already well aware that one of the biggest risks for a retiree is outliving their retirement savings.

There are various ways to protect against longevity risk, including investments in products such as annuities and capital protected strategies. In our view, these products may be suitable at a member

by member level; however it requires an understanding of each member's specific situation and risk tolerances. The level of yield versus cost is an important consideration. There are also risks to manage including regulatory and tax barriers, counterparty risk and reduced flexibility. Other considerations include whether or not the retiree receives any residual capital back (to bequeath).

To help mitigate longevity risk, we believe that **one of the most effective means is to invest for the long term**. Educating members on how to determine their appropriate income draw-down rate will also help to manage longevity risk for members. To illustrate, our analysis has found that an extra 1% pa in returns from active management would extend the 'life of income' for some members by over a decade.

The scale fallacy in retirement

A key question from Trustees is **"how big does my fund need to be to be able to implement these changes for my pension Options?"**

In our view, a fund can begin to make the above 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 stand-alone pension option asset allocations, to ensure that the strategic asset allocation of the pension options is tailored to retirees;
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.

Therefore, the key take-away is that all funds can take action to enhance their retirement offerings, today.

Non-investment retirement considerations

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 journey, the framework that we outlined in our February 2014 MyConsultant article (available on the JANA website) will provide a useful starting point for analysing your membership base.

Member engagement is key....

The success of any retirement strategy lies in knowing your members, and educating and engaging members throughout their journey with the fund. A key role of member engagement is to make members confident in the fund and in their retirement outcomes. A key objective should be to encourage members, early on in their journey, to save more for their retirement, and to give them confidence that their hard earned 'nest egg' is in safe hands.

...and members are becoming more self-directed

In recent years, a growing trend that we have seen is that members have become more self-directed. The rise of Self Managed Superannuation Funds and technological advancements has meant that many funds have developed their on-line presence with members. This has extended into the retirement space. Whilst many funds have a financial planning and advisory capability, we expect that this will be complemented with on-line education and functionality to capture the growing part of the self-directed market. In conjunction with a financial planner offering, an on-line presence would encourage regular review, education and engagement with a broader range of members.

Conclusion

The management of retirement assets continues to grow in importance in the Australian market. We believe that tax management, active management, a focus on downside risk protection, and an element of longevity risk protection are all sensible components to include in a retirement strategy for members. Whilst there is a long held belief that scale is required to implement a tailored strategy, we believe that it is better to start with achievable enhancements to a retirement offering that can be phased in over time as assets grow. We also believe that member engagement is the key, and that it is important for funds to start to think about member communications, education, and advice. Engagement with your fund's administrator for any change to a retirement strategy is also critical.

We look forward to sharing more of our retirement research, including an update of our **JANA Retirement Pillars** approach, with you at our Annual Conference in September 2015.

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