

MyConsultant

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Danielle Bose

Consultant

Danielle is a consultant and a member of the Global Equities and Portfolio Construction research teams.

Prior to joining JANA in 2008, Danielle was a Strategy Analyst at MLC for two years. Danielle also completed the two-year MLC Graduate Program with rotations in Finance and ThreeSixty Research. As part of her tertiary 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.



The post retirement conundrum

How to invest a well earned 'nest egg' after retirement is a question that challenges retirees and Trustees alike.

We are at a Post Retirement "Tipping Point"

The issue of Post Retirement has come to the forefront for Trustees and investors. Due to the ageing of the Australian population, there is a wave of Baby Boomers reaching retirement age. Chart 1 outlines the expected growth in Post Retirement assets over the next 20 years, as estimated by Deloitte in their publication: Deloitte: Dynamics of the Australian Superannuation System The next 20 years: 2013 – 2033.

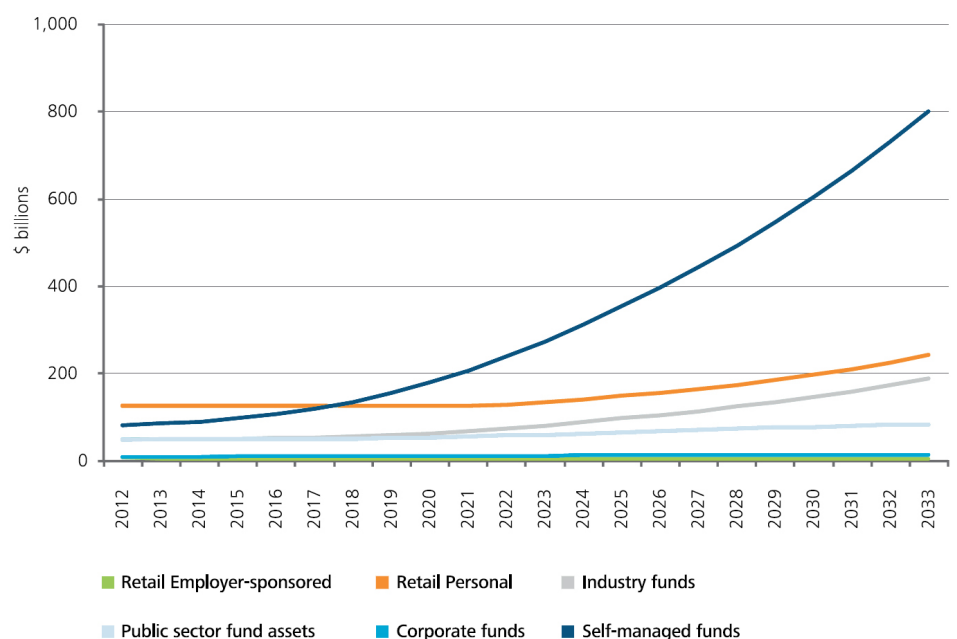
Startlingly, the projections below indicate that Industry Super Funds and Corporate Funds are

expected to lose considerable post retirement asset flows to self managed super funds (SMSFs), based on previous trends.

This highlights two issues for Trustees of Industry Super Funds and Corporate Funds today:

- Pension assets can be expected to increase as a percentage of assets under management. Therefore, the need for a Fund to review its Post Retirement product offering is vital.
- Industry funds and corporate funds have not captured a large portion of the post-retirement market and this provides a potential opportunity going forward. For a Fund with Pension products, this requires

Chart 1



Source: Deloitte: Dynamics of the Australian Superannuation System The next 20 years: 2013 – 2033

taking a closer look at what has and hasn't worked. For Funds that don't yet have a Pension product, this involves designing a Post Retirement offering as Post Retirement assets grow.

Post Retirement Product Design

The starting point for a Fund is to evaluate their pre-retirement member engagement, and what their members want.

What do retirees want?

The key question that we start with when designing any retirement solution is to think about the end customer, the retiree.

Various studies have been undertaken to identify the needs and wants of retirees. In summary, the key areas of focus for a retiree are:

- Will my product pay me a regular income stream?
- Can I leave the product or change my investment when my circumstances change?
- Will my product give me downside protection?
- Will my money keep pace with increases in the cost of living?

In summary, a retiree wants the best of all worlds – an income stream, flexibility, and adequate upside with limited or no downside. It has been well established that retirees are generally more risk averse in Post Retirement than in Pre Retirement.

There is no silver bullet when it comes to Post Retirement, and as a result, there are trade-

offs to be considered. For example, there is a trade-off between the security of a low-risk investment and making sure a retirement savings balance can, at a minimum, keep pace with inflation and rising living costs. There is also a trade-off between locking up capital for future growth, versus the flexibility of being able to spend the money today. Most importantly, a retiree faces the risk that they will outlive their retirement savings.

It is also important to note that a member's super account is just one asset available in retirement. In addition there may be:

- a home (a large proportion of Australians own a home at retirement, and research indicates that most retain this or a home of similar proportion throughout retirement);
- other non-superannuation financial assets; and
- the prospect of receiving the old age pension (the higher the age of a retiree the more likely it is that they are in receipt of a full or partial pension).

No two members are the same, and no two Funds are the same, and as a result, different Funds are likely to offer different solutions for their members. Rather than attempting to design the holy grail of post retirement products, it is likely that Funds will offer a suite of products that meet the different needs of their retirees.

...but does a retiree want a return or an income stream?

In the investment world, it is common for us to

focus on maximising returns as an investment objective. However, for a retiree, in many cases it is more important to maximise the life of an income stream, or seek a "life of income" objective. It is a common practice for retirees to opt for an income based solution, such as an allocated pension, which will pay a regular income stream to meet known expenses.

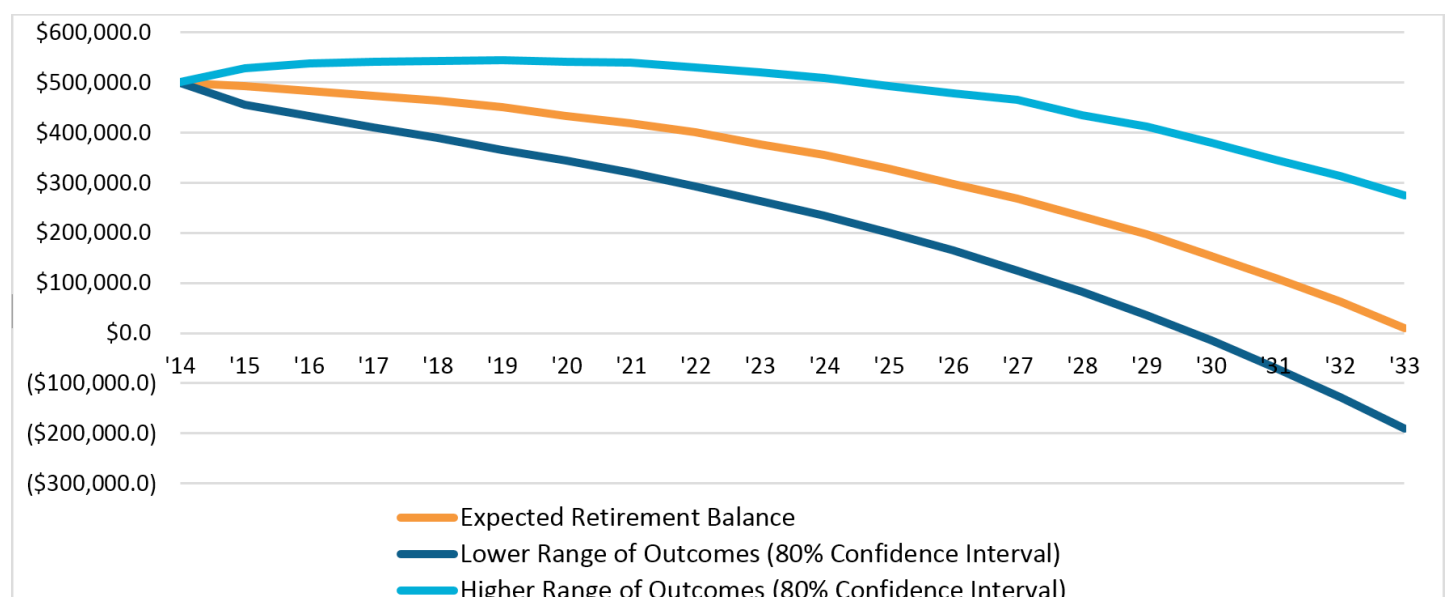
In Chart 2 we have converted the 'maximising returns' objective to an income stream. For example, an objective of outperforming CPI + 3% with a 7% drawdown rate, on a \$500,000 balance, equates to an annual income of approximately \$33,700, lasting for approximately 19 years. This objective also has a range of maturity outcomes depending on market conditions.

Managing to a "Life of Income" Objective

Changing our investment objective to a "Life of Income" objective has an important bearing on Post Retirement product design. We believe that the following areas should be considered when designing a Post Retirement product:

- De-risking – ways to reduce the risk of a market collapse at retirement, or approaching retirement
- Ways to increase returns – through active management and dynamic asset allocation
- Tax sensitive investing
- The timely use of selective tail risk insurance strategies, to protect on the downside
- Education programmes that encourage dynamic drawdowns and contributions

Chart 2



Source: JANA, 2014

- Financial planning services to support informed decision making

How are retirees managing their 'nest egg' today?

Retirees have historically used various approaches to manage their well earned 'nest egg' through retirement:

- Some retirees have opted for an income based solution, such as an allocated pension, which will pay a regular income stream, to meet known expenses. Life time annuities also offer certainty of income flow, but at a cost.
- Some retirees have opted to take their super balance as a lump sum (to pay off outstanding debts or to go on a long awaited holiday, such as living the Australian dream of buying a caravan and travelling to Uluru). They may have also taken their entire balance to transfer to their own Self Managed Super Fund structure.
- Other retirees have opted for a combination of part lump sum withdrawal, and part income stream.

Whilst a large number of members are disengaged during the Super accumulation phase, it is common for members to seek some

form of advice as they near retirement.

One common Financial Planner approach is to divide a retiree's financial assets across three categories:

1. A short term category: This would be an amount invested in cash, to fund spending needs for the next say 3 years;
2. A medium term category: This would include the bulk of the member's assets, invested to provide a moderate level of growth; and
3. A longer term category: This would be a smaller amount invested to provide a higher level of growth for future spending needs.

With this in mind, an appealing post retirement product offering would enable the same approach to be implemented at the Fund level or by the member themselves.

Another Consideration: The Age Pension

The Centrelink Age Pension forms a significant component of many members' overall post retirement benefits and for many today, the age pension will be a meaningful component of their retirement income. Therefore, super supplements the age pension for many Australian retirees.

There is the need for different solutions for members with different superannuation balances, and different circumstances. Some retirees will not have benefited from compulsory superannuation contributions for their whole working lives, and as a result, these members may have lower superannuation balances at retirement. When setting an appropriate drawdown rate for an income stream, the difference between the total target income and the Centrelink Age Pension can help guide the determination of what the drawdown rate should be.

The present value of an Age Pension (i.e. if purchased as an annuity) is worth approximately \$500,000 - \$600,000.

For members with a modest account balance (say, less than \$350,000), the reality is that the bulk of their retirement income will be attributable to the Age Pension. Table 1 demonstrates that even for retirees with quite high superannuation balances, the income contribution from the Age Pension can be significant.

Five Key Questions for Trustees

Every Fund is different, and each Fund has a unique membership profile. However, JANA

Table 1

Account Balance (combined spouses)	ASFA Retirement Income Index ¹	Estimated Age Pension (couple) ²	Super drawdown	Total	How long with the Superannuation last?
\$100,000	\$33,358	\$32,417	\$6,500	\$38,917	Super will last approximately 20 years. Total income under this scenario exceeds the ASFA Retirement Standard for a 'modest' standard of living.
\$350,000	\$33,358	\$25,747	\$19,000	\$44,747	Super will last approximately 25 years. Total income under this scenario easily exceeds the ASFA Retirement Standard for a 'modest' standard of living.
\$500,000	\$33,358	\$19,898	\$28,000	\$47,898	Super will last approximately 25 years. Total income under this scenario easily exceeds the ASFA Retirement Standard for a 'modest' standard of living.
\$750,000	\$57,665	\$10,147	\$47,000	\$57,147	Super will last approximately 20 years. Total income under this scenario meets the ASFA Retirement Standard for a 'comfortable' standard of living.

1 Based on the ASFA Retirement Standard for couples for 'modest' retirement (\$33,358 per annum) and 'comfortable' retirement (\$57,665 per annum).

2 Assumptions: a home owning couple (both aged 67) with superannuation as their only financial assets, personal Centrelink assessable assets of \$100,000, a 6% earnings rate (net of fees and tax) on the superannuation account balance with superannuation drawdowns indexed by CPI per annum.

believes that there are five key questions that a Trustee needs to focus on:

1. What elements of the membership should be targeted?

This part of the process involves considering the demographic profile of members, and how many characteristics should be used to segment members. Part of this step involves making sure the current default option is appropriate. If not, why not?

2. What should the Post Retirement product suite mix be?

This step involves making sure the post retirement member investment choice mix is appropriate. If not, why not?

This includes giving consideration to the risk and return objectives of the members, giving consideration to their account balances. This includes thinking about how a post retirement product can help members reach a targeted retirement balance or income stream.

3. How complex should the product solution be?

This includes considerations around cost constraints, complexity, business risk, and any other administrative issues.

4. How will you de-risk your Post Retirement product?

Post retirement should be a natural transition from the pre-retirement accumulation phase. A key consideration is the timing and magnitude of de-risking of your Post Retirement product. It is important to factor in a members account balances, age pension and income target when de-risking. De-risking should be performed with caution as naive or simplistic approaches have the potential to impair outcomes. Active management is just as important, if not more important in Post Retirement.

5. How will you communicate with members? Will you offer a Financial Planning capability?

Communication with members is vital. As members approach retirement, they are likely to seek financial advice with regards to their retirement savings. As a result, it is also important for a Fund to identify how and when it will communicate to members, and if a Fund will utilise a financial planning capability to assist in engaging members.

JANA's Three 'Bucket' Approach

JANA believes that it is important for a Fund to offer a simple and flexible approach for retirees. Our analysis concludes that a "one size fits all" solution, whether it is an aged based or target date fund or one of the many available annuity products, is unlikely to actually "fit all" all that well. A Fund's post-retirement product range needs to cater for the wide range of member profiles and the important fact that members' own requirements will change through retirement.

A Post Retirement solution that could be used by many Funds in Post Retirement is a three 'bucket' approach.

This approach includes:

1. A short term "bucket": This would be an amount invested in cash, to fund spending needs for the next say 3 years;
2. A medium term "bucket": This would include the bulk of the member's assets, invested to provide a moderate level of growth, with active management and a greater focus on downside protection; and
3. For investors with larger account balances, a longer term "bucket" with a portion of savings invested into growth assets, to protect against longevity risk (i.e. the risk that a member will outlive their savings).

The three bucket approach utilises different investment managers and mandates compared to pre-retirement which would include a specific focus on tax aware strategies and downside risk protection for retirees. Tail risk protection strategies can be used to further protect on the downside. The critical part of all our analysis is that a member's final Life of Income is fundamentally determined not just by the structure of the investment product, but how effectively it is managed. For example, an extra 1% pa in returns would extend the Life of Income for some members by over a decade. The consequential impact on well being and security throughout retirement is enormous.

This approach is aligned with a Fund having a financial planning capability, to ensure regular review, education and engagement with the member.

Conclusion

The success of a Post Retirement solution starts with knowing your members. "One size does not fit all" when it comes to Post Retirement, so it is likely that a Fund will need to offer different solutions for different members. Active management is still important, if not more important at Post Retirement, and there is the need to be thoughtful about de-risking. It is also important to ensure that there is a smooth transition for a member from the Pre Retirement (Super) to Post Retirement phase. The key focus is to engage with members early on in their journey, and to give them confidence that their hard earned "nest egg" is in safe hands.

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