While many Australians understand the need to save for retirement, few comprehend the imperative to preserve and grow their capital once they are no longer part of the workforce and as they transition towards retirement. Making sure retirement funds last a lifetime is far from simple – but a growing number of funds are focused on delivering solutions to help meet these client needs.
When it comes to retirement, Australians have their sights set on a lifestyle outcome. However, the challenge for the advice industry is building retirees’ knowledge of the wealth they need to achieve it.

With such a strong focus on the accumulation phase traditionally – and less focus on the transition from earning income to having to regenerate capital – many investors are unsure how to prepare for that stage of their life. The basic questions of how much income is required, what products will generate the required cash flow and how to mitigate the associated risks, remain inadequately addressed. With so many potential retirement solutions in the market, it’s not surprising that investors are often unsure of the most suitable option, and how to structure portfolios appropriately. But with the biggest generation in Australia’s history marching inexorably towards the end of their working lives, solving the income equation is now an urgent priority.

THE RETIREMENT CHALLENGE

Certainly there are a number of challenges involved in adequately funding retirement. Despite the focus on saving, the fact is many Australians simply won’t have enough money set aside by the time they stop work. Sobering data indicates that 50 percent of Australians will outlive their super by 13 years. This poses a huge problem for retirees individually and for the Australian government, placing enormous pressure on the social security system. Ultimately it means many retirees will have to moderate their lifestyle accordingly. This is unavoidable if savings are inadequate. For all retirees, though, getting the best out of their retirement savings requires a better understanding of what income streams are, how to generate them and how to protect them. Pauline Vamos, Chief Executive Officer of the Association of Superannuation Funds of Australia (ASFA), says, “The most difficult challenge is arranging a framework of income streams that suit a wide range of individuals. Post-retirement is not ‘one size fits all’.” (For more insight on ASFA’s views on structuring retirement income streams, see Pauline’s interview with Benchmark on p8).

Capital preservation is also key. That means retirees cannot afford to spend their money too early or quickly once they do retire – and they need to understand that they cannot top up their super with additional cash once they are no longer working. MLC Australian Equities Portfolio Manager Peter Sumner says, “If their capital base is eroded early on in the piece, the ability to generate capital growth and income becomes trickier still.”

The real pain of sequencing risk

Compare the impact of the year you retire on a $500,000 investment:

If you had retired in 1994, you would have $713 capital value in August 2014.

If you had retired in 1995, you would have $250,000 capital value in August 2014.

Hyman adds that if retirees focused on steady, dependable income and liquidity within the defensive assets held, they would have been able to meet their consumption needs through the GFC without having to sell equities at very depressed prices. “Unfortunately some of the so-called defensive, liquid assets were in frozen funds,” says Hyman.

“Inflation is another risk that is often forgotten, the result of it being something of a non-issue these past 30 years,” says Hyman. Yet for those who stopped working in the 1970s, when inflation often sat in the double digits, it was very significant. “It wiped out the real value of a lot of their retirement savings,” he notes.

Of course, if you are investing over a long time horizon and can avoid eating into your capital, the issue is not so critical. History has shown eventually losses should be recouped. For retirees, the need is to avoid those significant negatives to protect lifestyle outcomes.

However, there is also danger for retirees in adopting too low a risk stance with the result that the return is inadequate to support the desired lifestyle. This presents a conundrum: how to generate an adequate return and avoid the significant drawdowns.

In addition to these investment related risks, many retirees fail to fully take into account just how long they might live. “The average 50-year-old is likely to underestimate their mortality by seven years,” says Darren Thompson, Chief Investment Officer at MLC. “That is to buy it when it goes down. As a broker, you get closer to retirement.”

Looking back, it is clear that there are both lucky and unlucky points in time to retire, says Gosling. The 2008 global financial crisis (GFC) is an example of a significant negative event. Equities were down 30 to 40 percent, and diversified funds delivered significant negative returns. For those retirees that needed to draw on their money, it hit hard. “The GFC was the worst time to liquidate your assets to pay bills,” says Antares’ Hyman. “Sequencing really bites then.” Of course, for others entering the market for the first time, it was a great time to buy.

LESIONS LEARNT

The GFC was a wake-up call for many investors. For those retirees who got burnt, it became clear that there was no such thing as easy money. “They learnt that it needs to be about the sustainability of retirement income rather than just printing a big number, and that means avoiding the big negatives,” says MLC’s Sumner.

MANAGING THE RIGHT RISKS

Fund managers are offering investment solutions designed to manage the risks that matter most to retirees, including capital preservation, sequencing risk, liquidity and inflation. This has led to the rise in popularity of real return funds which focus on generating attractive returns while seeking to avoid the significant negatives. There are also single asset class funds which focus more on capital preservation, income generation and liquidity rather than just out-performing the market.

While these funds all focus on managing certain risks in different ways, Rhett Kessler, Senior Fund Manager at Pengana Australian Equities Fund, notes that some funds are often focused on managing the risk of underperformance.

“The risks that matter to retirees are not necessarily the same as for the rest of the industry,” explains Kessler. The definition of risk for much of the industry comes down to tracking errors – that is, how you performed compared to the market. “But for retirees, the underlying risk is investment risk. That is a question of: have you preserved their capital and have you made them money?”

Kessler points to BHP Billiton, which makes up about 10 percent of the S&P/ASX 200 index. The compulsion, he says, is to buy it when it goes down. As a broker, you advise him, if he doesn’t buy it and the stock goes up he will underperform the market. If it goes down further, well, everyone in is a similar position. “That is business risk to a fund manager, not investment risk.”
A focus on generating reliable real returns began to make much more sense. Pengana’s Kessler says, “What retirees learnt is that beating the market isn’t enough. For example, if the market is down 25 percent, you can argue you did well because your assets are down just 20 percent. But that’s relative returns. It doesn’t help retirees at the end of the day.”

Yet Antares’ Hyman is not convinced the lessons have been learnt by everyone. He notes that some in the industry have short memories. “Already certain aggressive income funds that had dubious records through the GFC, sometimes suspending redemptions, are getting good returns at present and are receiving strong support.”

Part of the problem is the continuing low interest rates, according to Antares Equities Portfolio Manager Glenn Hart. “Unfortunately the artificially low interest rates that the governments of the world are orchestrating are pushing people into areas they wouldn’t naturally go.”

**INVESTMENT STRATEGIES FOR RETIREES**

While risk control is dominating much of the thinking post-GFC, risk and return are interwined. It does not work in terms of lifestyle outcomes if controlling risk means inadequate returns. You may sleep better at night with your money in the bank earning 2.5 percent but you are quickly going to run down your assets. That is a risk in itself – particularly when interest rates are so low.

But Antares’ Hart does not believe any one portfolio design can provide the required solution, which is a sufficient income stream for retirees. “Some people believe the design of investment products can make a difference to retirement lifestyles. You can only get what assets give you and the fact is, in the current environment, the underlying assets aren’t generating high enough returns to support people’s standard of living.”

According to Redpoint Investment Management (Redpoint) Executive Director Eric Smith, costs to achieve investment outcomes should be front of mind for retirees. Smith notes, “In some cases, if you compare products with quite different approaches their outcomes can be more the same than different.” He points to two investment portfolios – one a more traditional diversified portfolio, the other a more complex fund. “Both experienced drawdowns of more than 30 percent during the GFC, both recovered and have generated similar long-term returns. So for all their design differences, they are not so dramatically different.” With similar investment outcomes, costs matter, he adds.

However, MLC’s Gosling argues that design is pivotal. She says, “There is no one strategy that is a panacea. The key is having the right strategy at the right time. The main thing is investing in a strategy where the manager has the flexibility to significantly change the asset allocation as conditions change. This means not being constrained by having to beat a benchmark, but instead focusing on preserving and growing capital.”

She notes that perhaps the biggest challenge we face is that risk is counter-intuitive – risk is highest when complacency is greatest. That makes it difficult to keep investors in products which correctly maintain control of risk – a difficulty lies in getting that message through. “There will be times when investment managers need to move away from risky assets while returns remain strong. We must set investors’ expectations accurately so that they stay invested during these times,” she comments.

**FOCUSING ON RETIREMENT**

There are other areas where there is room for improvement. For example, there’s clearly too much focus on the accumulation phase, at the expense of those years when a retiree needs to preserve and grow their capital. For now, Australians are limited to the annuity market and account-based pensions once they retire. The lack of robust retirement products in Australia has long been an issue for ASFA – regulatory and tax hurdles make product development an ongoing challenge (see p8 for more detail).

Antares’ Hyman points out there is confusion between investment income and retirement income that is unhelpful. He says, “In the retirement phase there is no tax which should make the investor indifferent between investment income and capital gains. What matters is the total return and the risk taken to achieve it.”

We also need to be particularly mindful of how shifting demographics will impact the retirement equation. According to the Federal Government’s ‘Intergenerational Report®’, over the next 40 years the proportion of the population over 65 years will almost double to around 25%. While existing retirement solutions have performed well for the accumulation phase, there will be much more demand for multiple options for retirees moving forward. MLC’s Gosling and Sumner believe investors can do a lot better, and a new generation of more flexible and objective-based (or real return) solutions are being developed which aim to achieve much more reliable lifestyle outcomes in retirement. “The focus has to be on preserving real spending power over the long term, to mitigate the risks that retirees actually outlive savings,” says Sumner.

In the meantime the Financial Services Inquiry is on the right track, looking into a Comprehensive Income Product for Retirement (CIPR) which super fund trustees would select for their members prior to retirement. Notes Sumner, “It makes sense that the CIPR might require a combination of underlyings products to successfully meet the needs of retirees.” Ultimately a new generation of retirees requires a new generation of solutions designed to manage their changing needs in a shifting world. Knowledge, professional advice, advocacy and a commitment to innovative product design are the keys to a better future and improved retirement outcomes.

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