Rethinking retirement income

September 2020

WILL MY MEMBERS HAVE CONFIDENCE IN RETIREMENT?

with an account-based pension (ABP) only[1]

56% **chance** can afford ASFA modest to age 90

Guaranteed income for life on top of the Age Pension

$0 p.a.

with an ABP+ integrated annuitisation[2]

100% **chance** can afford ASFA modest to age 90

Guaranteed income for life on top of the Age Pension

$3,719 p.a.

1 Assuming a single female homeowner aged 66 with $350,000 in an account-based pension (ABP), invested 70% growth, 30% defensive, and has CPI adjusted spending of $40,000 pa.

2 26.8% invested in a CPI indexed lifetime annuity with immediate payments, and remainder in an ABP. Total assets, overall asset mix, and spending are the same as in 1. Calculations current as of 12 November 2020.

NOTE: 'ASFA modest' refers to the ASFA estimate that singles will need an income of $27,902 p.a. The calculations provided include all income sources including the Age Pension and have been sourced from the Challenger Retirement Illustrator.

challenger

Executive Summary

In less than two years, superannuation funds will be required to provide a strategy to retirees for income in retirement. The traditional approach to retirement of account-based pensions (ABP) is inadequate, leaving members exposed to too many risks.

In retirement, super fund members start drawing on their savings to fund consumption, a fundamentally different proposition to accumulation. How long will a retiree live and how much can they afford to spend each month? Can a retiree do anything to recoup poor investment returns and how should inflation be considered?

Already superannuation is moving from supplementing the age pension, to substituting it. After more than 30 years of compulsory superannuation in Australia, 58 per cent of retirees have sufficient means to reduce, or eliminate, their entitlement to government support. While this is good news, not enough consideration has been given to income strategies for the retirement phase of life.

ABPs aren't designed to produce a particular level of income, or last for life. They expose members to risks that they are not well placed to manage. This has been exacerbated by retirees living longer. As a result, many retires underspend and don't enjoy the standard of living they deserve.

While the goal in the accumulation stage of a retirement plan is to build up the largest pool of assets possible, there's no clear measure of success in the drawdown phase. While meeting living and emergency costs for the rest of their lives is the broad goal, it remains difficult to quantify, and members' needs change over time.

The three stages in the lifecycle of a member should be considered discretely.

1. Early stage accumulation – key success factors include high investment returns and low costs.
2. Late stage accumulation – the transition from accumulation to decumulation needs to be managed, including strategies to address sequencing and timing of retirement risks.
3. Decumulation – different risks arise when members shift to converting capital into income.

A key objective is to ensure that a superannuation fund's retirement product delivers both income for life and the upside from potential growth. To secure the income for the retired member's needs, a capital guaranteed allocation can be used to fund the income liability through the members entire retirement. The growth allocation can remain invested to provide the member with longer term upside potential and allow flexibility for discretionary spending.

The success of superannuation means many people are retiring at a time when the number of financial advisers is in decline. This provides scope for scaled advice to assist retirees, but better product design can be a more effective solution. The ideal retirement product is one that is integrated into the member's super lifecycle.

A retirement income solution that integrates an annuities stream within an ABP can manage key risks in retirement and be more likely to meet members' needs. It overcomes many of the risks for retirees associated with the traditional approach to retirement of ABPs. Superannuation trustees have a rare opportunity to lead by example and redefine the retirement experience for members.

Introduction

There is a growing awareness from super funds that the account-based pension (ABP) alone will fall short of achieving a suitable retirement outcome for many members. Funds are now rethinking their retirement offering, not least because the retirement income covenant is due to start on 1 July 2022. Quite apart from government policy, there is a need for funds to differentiate and innovate. There is already around $400 billion in the retirement phase in large APRA funds; another reason for them to be focusing on their retirement proposition. But there are other issues to consider: member retention, member segmentation, and the role of advice. There is an opportunity for trustees to deliver a seamless and financially stress-free retirement experience for members. Trustees can take the complexity away from members and, instead, deliver simplicity and certainty.

Funds are now rethinking their retirement offering, and there is a need for them to differentiate and innovate.

This paper provides funds with some ideas for their retirement income proposition.

The challenge – retirement is different from accumulation

What is it about retirement that makes a fund, relying solely on asset allocation, struggle to provide an adequate solution for retirees? In retirement:

- The 'financial dynamics' of accumulation are reversed. A retiree starts drawing on their savings to fund consumption. This makes it a fundamentally different proposition from accumulating savings and introduces new risks. For example, dollar cost averaging works in reverse, against the retiree's interests.
- Retirees are exposed to the problem of financing longevity. There is the risk that they outlive their savings.
- They don't know how long they will actually live so they can't determine the appropriate amount to spend.
- The sustainability of retirement savings becomes a new and important concept. What most retirees lack is an understanding of the probability of success of their retirement plan (expressed as a percentage of the likelihood of reaching a particular age and still being able to access sufficient income).
- Retirees' aversion to loss is greatly increased. In a large 2007 US study, just under half the retirees surveyed said they would be unwilling to risk even $10 in a bet that offered a 50% chance of winning $100.[1]
- In the five or so years each side of retirement, more of a retiree's money is exposed to potential losses and so negative market movements around that time have the most adverse impact on the long term sustainability of cash flows.
- A retiree's ability to recover from poor investment returns (or take advantage of lower market prices) is generally limited.
- Inflation takes on a new dimension because the retiree is disconnected from wage rises and can generally only maintain purchasing power via the Age Pension or explicitly inflation-linked investments. Contrary to a widely-held view, equities do not provide an adequate hedge against inflation.
- The financial needs of retirees differ. The spending profile for someone with a $500,000 super balance won't be the same as someone who has only $150,000. A different rate of outflow from the investment portfolio might require a completely different investment mix to get a suitable outcome.

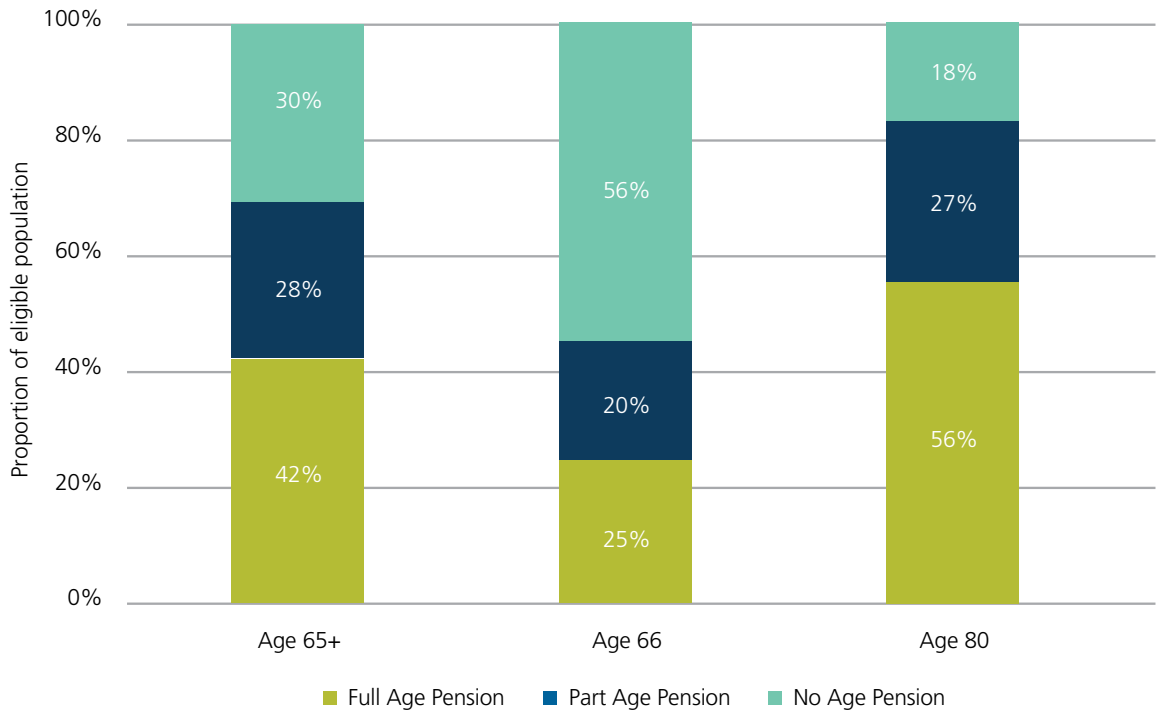
1 What Now? How Retirees Manage Money to Make it Last Through Retirement Report of Findings AARP and American Council of Life Insurers (ACLI) December 2007.
Available at https://assets.aarp.org/rgcenter/econ/guaranteed_income.pdf

Super is now providing a launchpad for retirement

Super is moving from merely **supplementing** the Age Pension to **substituting** it for an increasing proportion of retirees. The evidence is already in. At December 2018, only 25% of 66-year-olds were getting a full Age Pension, with a further 20% on a part pension.[2]

Put another way, more than half of today's retirees of all ages (58%) have sufficient means to reduce, or eliminate, their entitlement to government income support. The trend towards the need for private provision of stable, longevity-hedged retirement income is clear, as Figure 1 shows. Apart from anything else, the eligibility age goes up from the current 66 to 66.5 in 2021 and then to 67 in 2023. ASFA projections suggest that by 2025, around 20% of people aged 67 will still be working, with a further 40% or so ineligible for the Age Pension.[3]

Figure 1: Age Pension access at selected ages at December 2018



Source: Calculations based on ABS and supplied DSS data.

The problem: defined contribution super is not fit for purpose in retirement

An ABP alone falls short of a quality retirement solution. First, they aren't designed to produce a particular level of income, nor to last for life. Second, they expose members to risks they are not well placed to bear. Lastly, the individualised, exclusively account-based, design can lead to a range of inefficiencies. There are winners and losers.

2 Includes age-based veterans' pensions. Age of eligibility for the Age Pension increased to 66 from 1 July 2019.

3 ASFA Pre-Budget Submission for the 2018-19 Budget, February 2018.

The result is that members often underspend and don't enjoy the standard of living they deserve. Why? Because they find it hard to estimate how much they can spend each year to fund a retirement of an indeterminate length. They 'self-insure', buffering this risk by holding onto their capital. To date, it has been common to make sense of this difficulty by using averages: average length of retirement, average investment returns, and average rate of consumption. This doesn't help members, almost none of whom will have an 'average' retirement.

Central to status quo is the belief that asset allocation in individual retiree accounts, with no longevity pooling or institutional capital buffering, can solve for all risks. The flexibility of the ABP is prioritised at the expense of risk management, income certainty and sustainability.

Former Prime Minister Paul Keating conceded some years ago that the super system was not designed for people who were going to live over the age of 80. The system he conceived was for 55-75-year-olds.[4]

Today's retirees are typically living into their late 80s, more than nine years longer than they did in the 1990s. 66-year-old women today can expect to live to 89 on average, with one-in-five expected to live to 96.[5] In some fund cohorts, particularly white-collar workers with higher average educational qualifications and/or higher than average incomes, life expectancies are likely to be materially higher. These longer lives come at a cost. Interestingly, the super system pools and insures the financial risk of a shorter-than-expected life, but leaves the risk of a longer life with the member alone.

Success or failure of a retirement plan

One of the biggest challenges in providing appropriate retirement income solutions is the lack of a clear success measure. In accumulating assets, there is only one goal, accumulate as many assets as possible, with minimal outgoings and an optimal level of volatility to create the largest possible pool of savings. This provides a clear success measure and well-known steps to improve the ultimate outcome, including: asset allocation; saving more; reducing costs; minimising taxes; contributing (working) for longer; right down to the typical competition to get better investment returns. Funds are well accustomed to working in this paradigm.[6]

In retirement, a typical member has four forms of expenditure to plan for:

- everyday living costs which requires predictable and regular cash flows. These can be further divided between needs (essential expenditure) and wants (discretionary expenditure);
- emergency or lumpy items (financial assistance for an adult child or renovating a bathroom);
- expenditure beyond life expectancy (which is itself only an expectation based on averages); and
- bequests for the estate.

Success will often involve meeting all these objectives; making success much more difficult to measure in retirement. Successful retirement solutions also call for a focus on the lengthy time horizons involved. Retirees who start spending in year one of retirement need to know how that is going to affect the availability of income in year 20 and beyond. They also want to be able to meet health and aged care costs later in life.

4 Opening address at the 50th Anniversary ASFA Conference in Sydney on 28 November 2012.

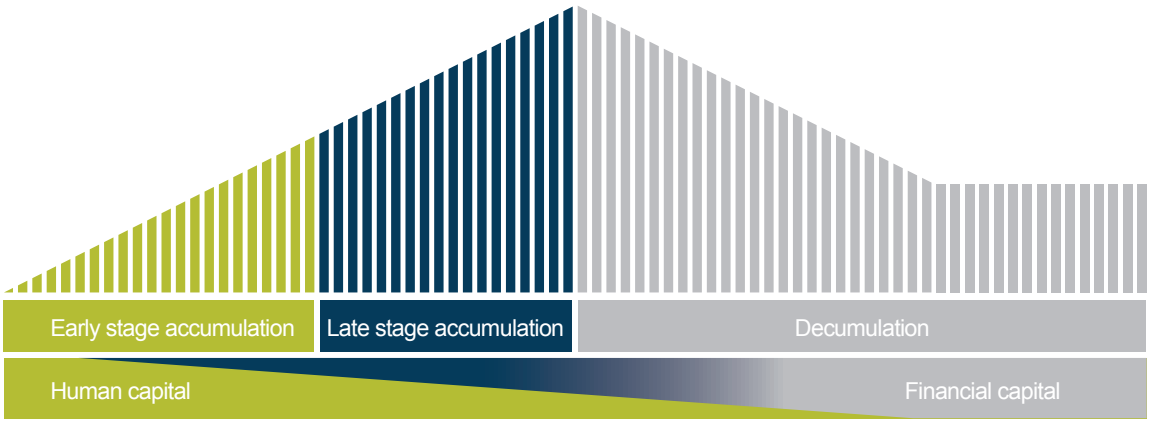
5 Based on ALT2015-17 with 25-year mortality improvements from the Australian Government Actuary.

6 J. Stock, W. Sharpe and J. Watson, 2009 'The 4% Rule— At What Price?' Journal of Investment Management Q3 2009 provides a discussion on the different costs associated with failure and the surplus with success for a retiree following a simple plan.

The complete super lifecycle for members

Member needs change over time, with the imperative switching from growth at younger ages to secure income through retirement. Lifecycle funds have been developed to manage this, but the results have not been consistent and depend on the design of the glidepath, among other things. In addition, the individualisation required to track member needs precisely is currently too complex for many funds to implement. An alternative would be to consider the three key stages of the lifecycle and aim to meet member needs in each of those stages.

Figure 2: Three stages in the lifecycle of a member



The three stages are represented in Figure 2. The initial stage is the accumulation of assets from a low base as workers defer wages for later consumption in retirement. As balances grow, the concerns of members change and, in the late stages of accumulation, they are (or should be) more focused on achieving a particular level of retirement income.

Early Stage Accumulation

The key success factors to the early stage accumulation are high investment returns and low costs. Clearly, a higher rate of saving (contributions) will increase the level of accumulated wealth, but higher investment returns will grow more wealth from any level of contributions. With ongoing contributions over a working career, an appropriate choice is a 'growth' portfolio with 70% or more of the allocation to growth assets aimed to deliver the highest possible investment returns over the long term. There is little need for sequencing risk management in the wealth creation phase as dollar cost averaging provides a benefit to a saver.

Late-stage accumulation: the transition to retirement

Wealth creation is a long-term endeavour. In a member's super lifecycle, there will come a point where the cash flows switch from contributions (positive) to spending (negative). To prevent a potential dislocation, there is a need for a transition between these two states.

One common approach is to apply an investment glide path to reduce the investment risk leading into retirement. Studies have shown that the lifecycle investment strategy is not always optimal.[7] A key part of the transition is not just removing capital volatility, but also the need to prepare for a retirement phase with negative cash flows.

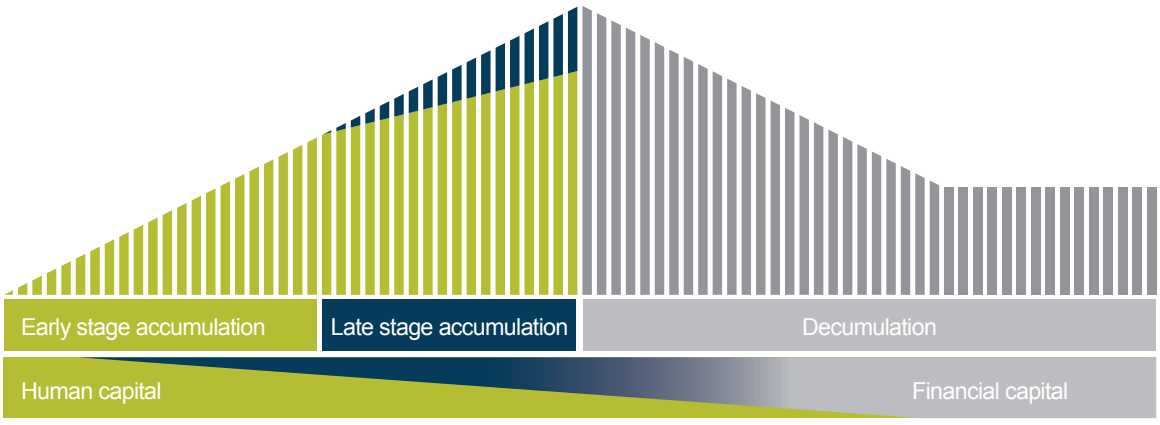
There are several approaches available to manage the transition from accumulation to decumulation more effectively than a traditional lifecycle glide path. The preferred method of de-risking in the late-stage accumulation phase is highlighted in Figure 3. This next generation of sequencing risk management aims to match assets to the 'liabilities' represented by future spending. Capital guaranteed investments can be used to secure the desired future income. The last of the contributions, which will be spent in the near term, are not invested in any growth assets in order to avoid investment horizon and risk mismatch.

The next generation de-risking glidepath can be seen in the blue section in Figure 3. The peak of this accumulation mountain is now flatter because the final contributions are directed away from growth assets. By spreading the peak where the growth portfolio switches from accumulation to decumulation, both sequencing risk and the timing of retirement risk are reduced. This can make the transition to retirement smoother for the member, and avoids mission impairment should there be a negative market event.

There are several approaches available to manage the transition from accumulation to decumulation more effectively than a traditional lifecycle glide path.

The next generation of sequencing risk management aims to match assets to the 'liabilities' represented by future spending.

Figure 3: The transition in late-stage accumulation



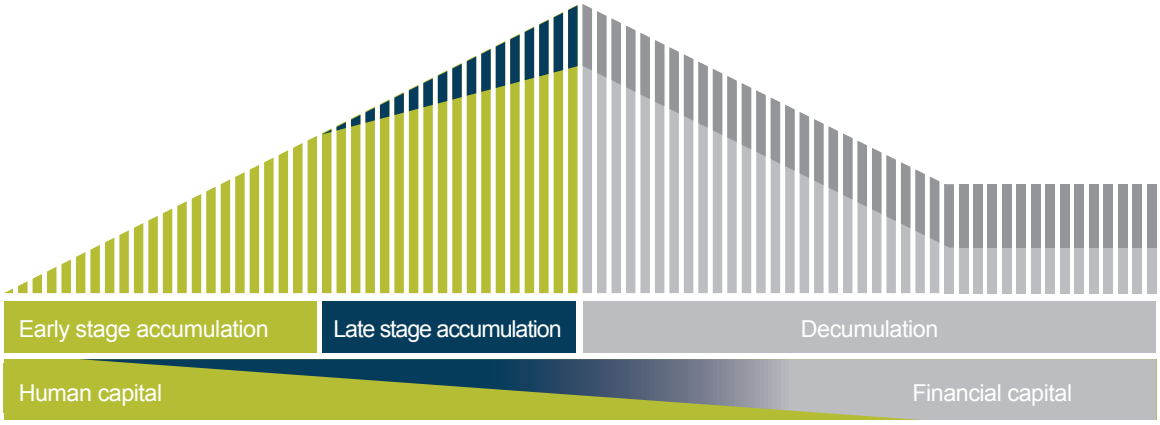
7 For example see Arnott, R., K. Sherrerd, and L. Wu (2013) "The Glidepath Illusion…and Potential Solutions" The Journal of Retirement Fall 2013, 1(2) pp13-28.

In Figure 3, half of the member's contributions (after tax) for the last 15 years in late-stage accumulation are invested in a capital guaranteed investment strategy designed to mature at (the expected) retirement. This results in an allocation over time of around 15%-20% of the total portfolio that is capital guaranteed, allowing the remainder of the portfolio to be maintained in high growth assets. Growth exposure can be maintained without cause for concern to the member. Additionally, this next generation of glide path control means that sequencing risk is reduced while maintaining exposure to growth assets. This is an example of a 'safety-first' approach. It locks in only what is required while enabling the portfolio to benefit from a long-term accumulation approach.

Decumulation: Converting capital into income

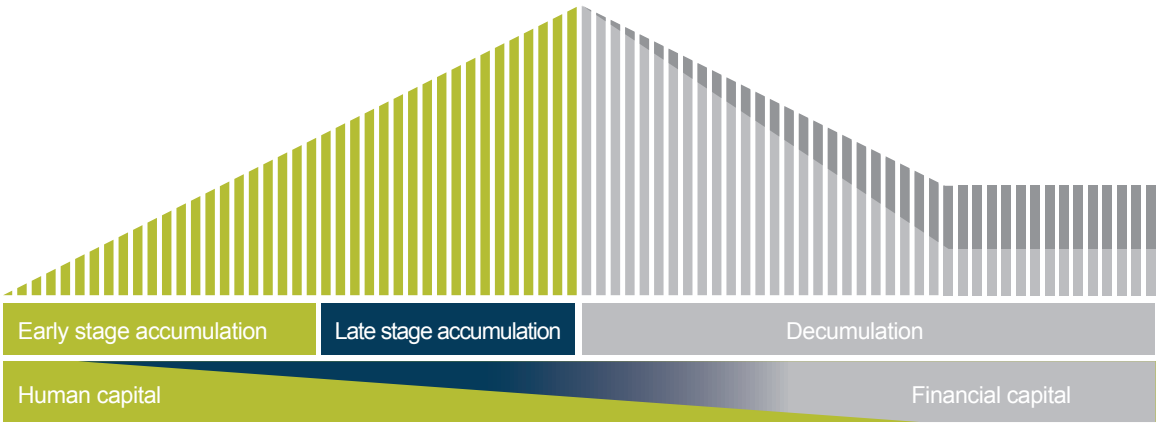
The last stage for a super fund member is to convert capital into income for consumption. As discussed, there are new risks to be managed for members in retirement. Using the modified three-stage approach will provide a base for secure income through retirement, without disrupting the wealth creation portfolio. In Figure 4, this secure income is seen in the darker section of the grey bars and can be set to be paid for life.

Figure 4: Generating lifetime income from the transitional contributions



An alternative is shown in Figure 5. In this case, the retirement product enables the transition after the point of retirement. Instead of building a base for the whole of retirement, the aim is to secure the income for the later stages of retirement. This is when a retiree might have spent down all their capital and be solely reliant on the Age Pension. In other words, this approach is an effective method of building up longevity insurance as the probability of requiring protection increases.

Figure 5: Transitioning after the point of retirement



A key objective is to ensure that the superannuation fund's retirement product delivers both income for life and the upside from potential growth. Studies have shown that spending needs tend to fall through retirement.[8] A retiree only needs to secure income for their essentials (needs). Other spending will be desirable while the retired member is relatively young and active but spending such as on travel declines at older ages. To secure the income for the retired member's needs, the capital guaranteed allocation accumulated during late-stage accumulation can be used to fund the income liability through the member's entire retirement. The growth allocation can remain invested to provide the member with longer term upside potential and allow for flexibility for discretionary spending.

The following example illustrates how the three stages can be managed within the one framework. The range of outcomes in late-stage accumulation are shown in Figure 6. Market returns create the largest potential variation in outcomes for members as their balances grow. Transition to retirement is set up from contributions after age 52.

Implementation considerations

Historically, many retirees would find a suitable retirement income strategy by paying a financial adviser. For some, retirement might be the only time in their life that they use a financial adviser. However, the success of super means
a larger number of people are retiring with significant savings at the same time as the number of advisers is in decline.
This will leave scope for scaled advice to assist retirees, but better product design can be a more effective solution. That way, members wouldn't need a lot of additional advice to find the right retirement income option. Trustees could see that members were guided to the outcome that was in their best interests, without needing extensive advice resources.

The ideal retirement product is one that is integrated into the member's super lifecycle. The member experience should smoothly transition between accumulating assets and getting an income in retirement. Key components of success here involve:

- appropriate design and sign-posted communication;
- reduced retirement complexity for members; and
- a retirement product that seamlessly evolves with the member through the three phases.

It will also be necessary for the design of the recommended pathway for retirement to include clear exit paths for those members whose likely best outcome is a different strategy. This design could include in-built longevity insurance for the member, with the ability to opt-out if preferred.

Late-stage accumulation implementation

Transition towards retirement typically begins in the late-stage accumulation phase. The adjustments enable a pivot from wealth creation to the provision of income and greater stability of capital.

a **Lifecycle glidepath** – A traditional approach to the transition is the glidepath where exposure to growth assets is reduced in order to provide a portfolio in retirement with a lower exposure to growth assets. The glidepath gradually reduces the exposure as the member ages.

b. **Overlay strategies** – Another approach is the adoption of overlay strategies, either through an overall portfolio hedging approach or through option-based strategies on individual asset classes or investments. In effect, a premium is paid to maintain underlying exposure to growth assets, but with protection from a market fall.

8 For example, see Daley J. and B. Coates. Money in retirement: More than enough. Technical report, Grattan Institute, No. 2018-17, June 2019. https://grattan.edu.au/report/money-in-retirement

c. **Next generation glidepath** – The evolutionary glidepath described above focusses on generating the income in retirement through the implementation of income hedging. Contributions in the late-stage accumulation can be directed to investments that will pay the income that is required for retirement, including guaranteed income for life options.

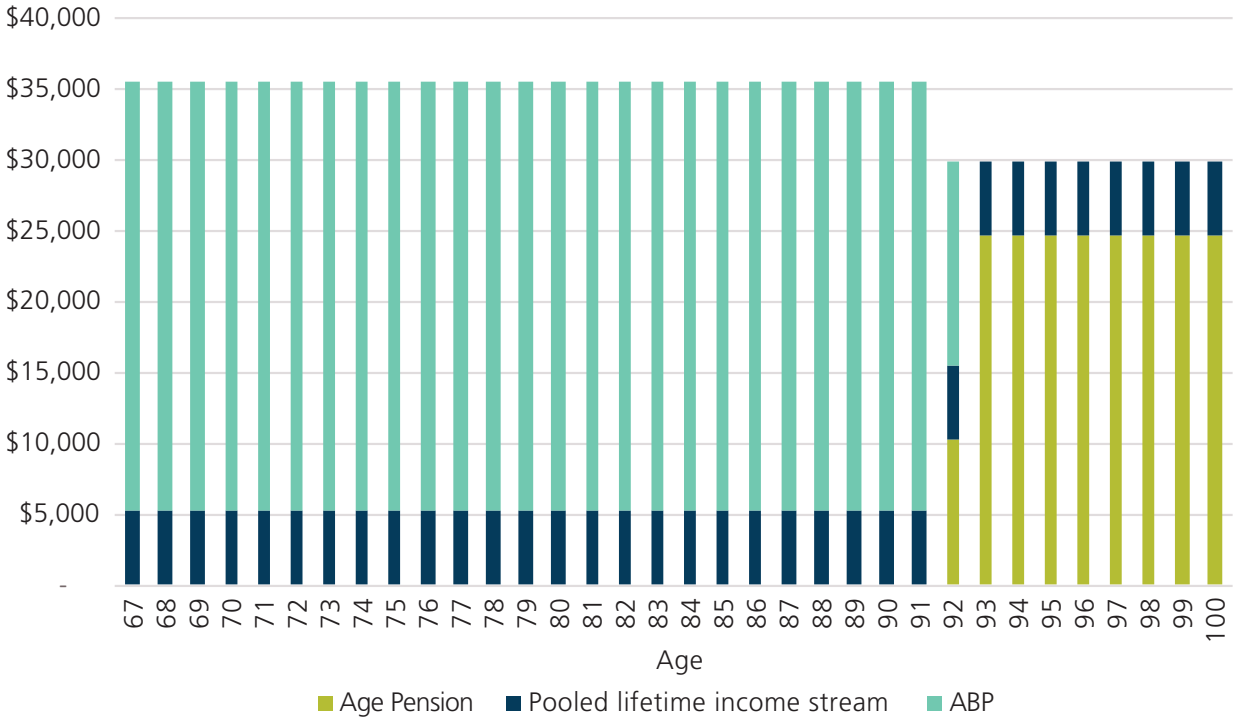
Case study on a smooth transition to retirement: Sam

Member	Sam started work as a 25-year-old earning $40,000 a year and is now 52. Wage growth of 3.2% p.a. is expected in the future. Sam expects to retire at 67.
Contributions	Only the compulsory SG, currently 9.5% increasing to 12% by 2025.
Investment	A growth portfolio expected to return 3% above inflation before fees and taxes.
Initial accumulation	By age 52, Sam has $250,000 in super.
Transition	Half of the SG contributions are directed to a capital-protected target date allocation, which can transition into a longevity allocation at retirement.
Retirement	A retirement fund, that consists of a seamlessly packaged ABP and longevity protection resulting in retirement income that never runs out.

The accumulation of Sam's assets from age 45 is shown in Figure 6. The income that will be available for spending is shown in Figure 7. Sam will be able meet all his essential spending for life with the combination of his pre-purchased longevity-hedged income and the Age Pension. Sam will also have enough money in super to spend a little more in the earlier, active, stages of retirement.

Figure 6: The last stage of accumulation

Figure 7: Sam's income through retirement



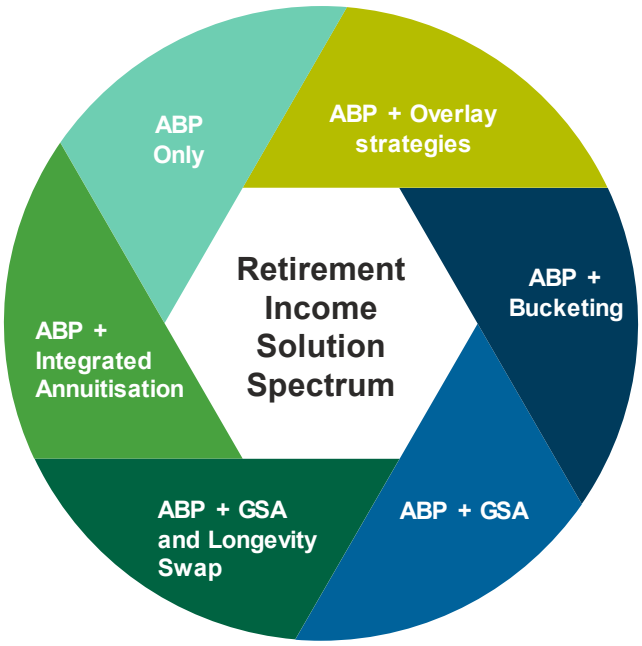
Retirement income implementation

There are a range of options in implementing a retirement income solution. Figure 8 presents some of these options. The standard approach, which utilises only an ABP, does not meet all the requirements of a retirement income solution for members. Combining the ABP with another option can help a fund deliver a retirement product that can meet members' needs for:

- flexibility;
- exposure to growth assets;
- low costs;
- simplicity;
- sequencing risk management; and
- longevity risk management.

A successful combination will help members achieve their retirement goals and assist funds in retaining members.

Figure 8: Retirement income solution spectrum



The components of potential solutions meet retiree needs in different ways.

ABP

The typical retirement offer flows through from the investment portfolio used in the wealth creation phase and offers flexibility and exposure to growth in a familiar portfolio for members.

Flexibility, including growth exposure	✔
Low cost & simplicity	✔
Sequencing risk management	✘
Longevity risk management	✘

Overlay strategies

Overlay strategies are implemented to reduce the risk in the portfolio that arises from high exposure to growth assets. These reduce sequencing risk by protecting the overall portfolio from the market swings at a time when the savings pool is at a peak. While some overlays are simple, many are complex structures that increase costs.

Flexibility, including growth exposure	✔
Low cost & simplicity	✘
Sequencing risk management	✔
Longevity risk management	✘

Bucketing

As a retirement solution, bucketing is effectively an advice process that is applied to the ABP. Management of cash will reduce sequencing risk, but a bucket approach does not manage the long-term risks.

Flexibility, including growth exposure	✔
Low cost & simplicity	✔
Sequencing risk management	✔
Longevity risk management	✘

Group self-annuitisation (GSA)

The GSA product is pooled product that does not have a guarantee. By pooling the longevity risk across members in the GSA, some longevity risk is managed. The GSA will maintain the flexibility of the ABP, but needing to explain that members are exposed if everyone lives longer (systematic longevity risk). complicates this solution.

Flexibility, including growth exposure	✔
Low cost & simplicity	✘
Sequencing risk management	✘
Longevity risk management	✔

Longevity swaps

A longevity swap can solve the gap for the GSA in managing systematic longevity risk. The counterparty to the swap takes this risk on for the fund, for a cost, so members are not exposed to longevity risk if used in conjunction with a GSA.

Flexibility, including growth exposure	✔
Low cost & simplicity	✘
Sequencing risk management	✘
Longevity risk management	✔

Lifetime annuity

A lifetime annuity is a simple way for a super fund to provide guaranteed income for life that is protected from longevity and sequencing risk. The gap is the lack of exposure to growth assets which is why they have typically been used in combination with growth-oriented investments.

Flexibility, including growth exposure	✘
Low cost & simplicity	✔
Sequencing risk management	✔
Longevity risk management	✔

Integrated annuitisation and ABP

Funds are now able to integrate annuitisation alongside an ABP into a holistic retirement offer that provides all the benefits that members are seeking in retirement.

Flexibility, including growth exposure	✔
Low cost & simplicity	✔
Sequencing risk management	✔
Longevity risk management	✔
Member retention	✔

Summary

The traditional approach to retirement of the ABP leaves members exposed to too many risks and funds are exploring ways to implement a better retirement income offer for their members. While the ABP is the incumbent product and provides flexibility and liquidity, it doesn't manage retirement risks appropriately.

A better approach to retirement recognises the need to transition from saving to spending in order to smoothly transition into retirement. Beginning the transition in late-stage accumulation enables funds to deliver an option for members that maximises wealth creation, while setting them up for secure income through retirement.

The purpose of super is to provide income for retired members so they can continue to enjoy the lifestyle they had while working. Funds that deliver an integrated approach, managing the key risks in retirement, as well as the challenges of accumulation, will be more likely to meet members' goals. Superannuation trustees have a rare opportunity to lead by example and redefine the retirement experience for members.

For more information or a discussion on how Challenger can work with you on your decumulation strategy please contact Simon Brinsmead, Head of Institutional Partnerships, on **02 9994 7507** or email **sbrinsmead@challenger.com.au**

46341 VA011/0721