THE Frontier Line

Thought leadership and insights from Frontier Advisors

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One Size Fits All

Designing a Retirement Default

FRONTIER ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $260B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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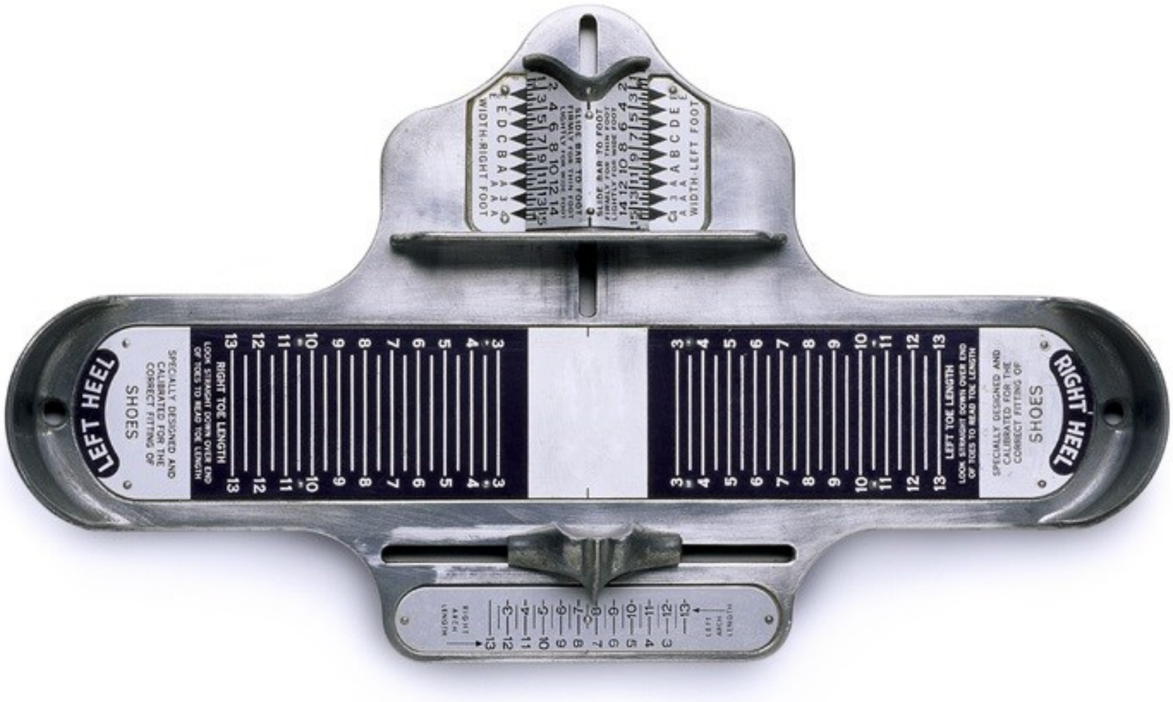
One size fits all

I have a confession – I have a big head. For people who have known me for a while, this may not come as a surprise. This doesn't normally present me with too many issues, except when it comes to buying a hat or cap. A store which only sells one-size-fits-all hats will never get my business.

When it comes to superannuation, funds have been operating in a "choice" environment for many years now. Funds have long since recognised that a "one size fits all approach" is not viable. All funds offer a range of different investment options for their members, with many also offering the ability to invest directly in individual shares. If anything, members are offered too much choice, rather than too little.

Despite this, the latest APRA figures show that, for the average industry fund, around two-thirds of assets are invested in the default/MySuper option. For many funds, less than 20% of members are taking advantage of the range of choice available.



Retirees are different

However, when it comes to providing choices for retired members, too many funds are offering the same options as for their accumulation members.

To extend the retailing analogy, too many funds are operating like Zara or H&M (catering for the young demographic) and not enough like Myer and DJs, let alone like Millers (aimed at the "ageless customer").

Frontier's analysis of MySuper funds shows that:

- 57% of funds have the same (or similar) option for their default retirement fund as their default accumulation fund;
- only 24% of funds offer a default retirement option which is lower risk than the default in accumulation; and
- a small number of (mainly retail) funds provide a lifecycle approach, where the risk decreases as the member approaches retirement, or a bucketing approach where part of the assets are held in cash.

Such a situation would have merit if the needs of retirees were the same as those in the accumulation phase. However, it's universally recognised that they aren't. Generally, retirees are more risk averse, have a greater need for income and have a shorter time horizon, together with a different tax position.

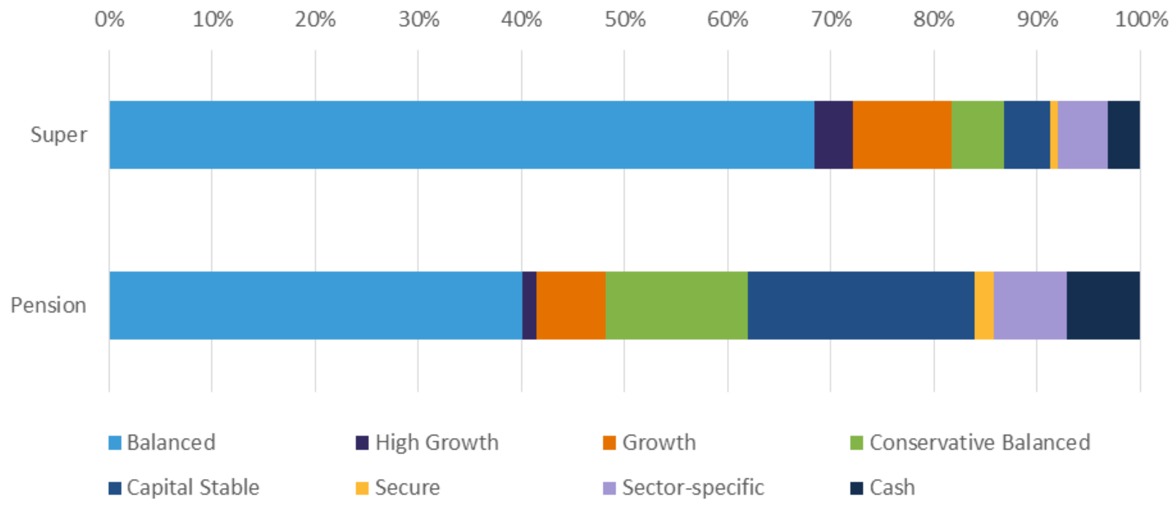
Despite most funds offering identical default accumulation and retirement funds, members are making different investment decisions once they reach retirement. Chart 1 highlights that, whilst the two-thirds of members are invested in balanced funds in accumulation, this drops to less than 40% for retirees. Members in the pension phase choose to be invested across a wider range of fund options, and typically invested more conservatively.

"Decisions about retirement are more complex than most decisions made in the accumulation phase"

Financial Systems Inquiry, Final Report December 2014

Additionally, the needs of retirees are much more diverse than accumulation members. The quantum of their retirement savings, access to the Age Pension and expectations for retirement all differ and will impact on the appropriate retirement product for them. The FSI Final Report noted that "… despite the heterogeneous nature of retirees, at least 94 per cent of pension assets are in account-based pensions, which provide flexibility but lack risk management features and may not deliver high levels of income".

Chart 1: Split of assets between fund options



Source: Frontier Advisors, SuperRatings, December 2015

Retirement default

With this background, the FSI recommended (and the government has accepted) that trustees "… pre-select a comprehensive income product for members' retirement (CIPR). The product would commence on the member's instruction, or the member may choose to take their benefits in another way".

The FSI recognised managing multiple financial objectives and risks in retirement is complex. Furthermore, they suggested many retirees find it challenging to navigate the transition to retirement. Their rationale for recommending trustees pre-select a default, despite this complexity, was:

- retirees are generally not confident enough to make these decisions for themselves, and face behavioural biases;
- many don't seek professional advice and, for those that do, research has shown the quality of this advice can vary significantly;
- pre-selecting options can have a significant impact on decision making, both for the disengaged and less financially sophisticated as well as guiding the more engaged members;
- the current range of products available is limited and, in particular, generally does not address longevity risk; and
- well designed, pre-selected defaults could result in a more efficient retirement incomes system through its use of longevity pooling.

In effect, it appears the FSI is implying that (1) members are unable to make these important decisions, (2) financial advisers can't be trusted, and (3) mandating a specific product is too difficult. Therefore, superannuation trustees are best placed to guide members.

Designing a default

As a result, superannuation trustees will soon be faced with the onerous task of designing an appropriate default retirement product for their fund. The FSI recommended these default products have required features (including flexibility, high income and risk management) which will be specified in regulation.

As no product currently has all these features, the default product is likely to be a combination of products, such as:

- a liquid, relatively short term focussed product to meet the incomes needs of the retiree;
- a more growth oriented product to meet the longer terms needs of the retiree; and
- a longevity risk protection product for those retirees who expect to live longer than average.

However, a single default for all members is unlikely to be a suitable solution. For example, a member who will receive the Age Pension will have a reduced need for a longevity solution. A member with large assets outside of super may wish to use those assets first, and therefore has little immediate need for an income focussed product.

Whilst it may be a while before any regulations are released, it seems logical that the default retirement product will be a combination of the above products, the weight of which will depend on each member's circumstances.

Indeed, recognising that no one size fits all, the FSI further recommend that the default product could vary with the "… known characteristics of the member, including the size of their superannuation benefits".

Furthermore, the Productivity Commission noted:

"… often, in formulating superannuation policy, too much focus is placed on the 'average' retiree. Designing appropriate 'defaults' necessitates a thorough understanding of people's superannuation balances, other assets, debts, as well as their personal needs in retirement, which may be affected by their health, marital status and expected lifespan. Absent careful design, such prescriptive approaches, even in the form of relatively flexible soft defaults, might be ineffective or make some retirees worse off."

Superannuation Policy for Post-Retirement, July 2015

Knowing your members

It seems clear a default MyPension style option will need to be much more member focussed than the comparable MySuper option. However, the key issue is whether funds know more than the basic details about their membership.

The table below highlights the details a typical superannuation fund will know about their members, together with further details funds should know in order to provide their retirees with an appropriate default.

The additional member details are the type of information generally collected as part of a financial planning fact find. Indeed, a number of funds are realising the importance of providing full service financial advice to their members as they approach retirement. The complexity, particularly of Age Pension entitlements, is such that good quality unbiased personal financial advice would be highly valuable for all members approaching retirement.

Table1: Member details

Known member details	**Additional member details**
Age	Marital status
Superannuation balance	Home ownership and mortgage
Gender	Other superannuation balances
Salary (estimate)	Assets outside super
	Age Pension eligibility
	Income requirements
	Dependents
	Goals, attitude to risk
	Health

More than just creating product

Creating a pension default product is a necessary step in meeting the needs of retirees.

However, funds also need to ensure that their members understand how the products meet their individual needs. As some funds have learnt the hard way, creating industry leading products only leads to a successful outcome if member take-up is good.

Funds need to use the details they know about members to engage with them. In particular, funds should be segregating their membership and directing different messages based on each member's likely retirement adequacy. The more personalised this messaging is, the higher engagement funds are likely to see.

The final word

With a Federal election looming, it's unlikely any legislative changes (either detailing the new default requirements or removing legislation which currently restricts certain products being developed) will be seen for some time.

However, this doesn't mean superannuation funds should be doing nothing. Funds should be looking to increase their engagement programs, particularly those directed at members approaching retirement.

At the same time, funds should be re-looking at their financial planning strategy and thinking about how they can collect and utilise more data on their members. Those funds providing comprehensive financial advice, rather than a one-size-fits-all approach, are likely to have a better retention rate of members with large balances.

