THE Frontier Line

Thought leadership and insights from Frontier Advisors

Issue 133 September 2017

Providing Retirement Income:

Analysis of Current Approaches

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 $265B 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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Prior to Frontier David spent nineteen years at Mercer in roles that included global product management in the areas of Investment Data and Analytics and Wealth Management and in the design and implementation of Mercer's GIMD database. He also worked with Mercer in London as the Head of Investment Information Services for Europe and was a member of the Executive Group responsible for the operation of the UK practice. Prior to joining Mercer, David was at Towers Perrin for around six years, working with a number of clients in an investment advisory and research capacity. David holds a Bachelor of Economics from Macquarie University and is a Fellow of the Institute of Actuaries (in both the UK and Australia).

Providing retirement income - analysis of current approaches.

The government is legislating the objective of superannuation as to provide "…income in retirement".

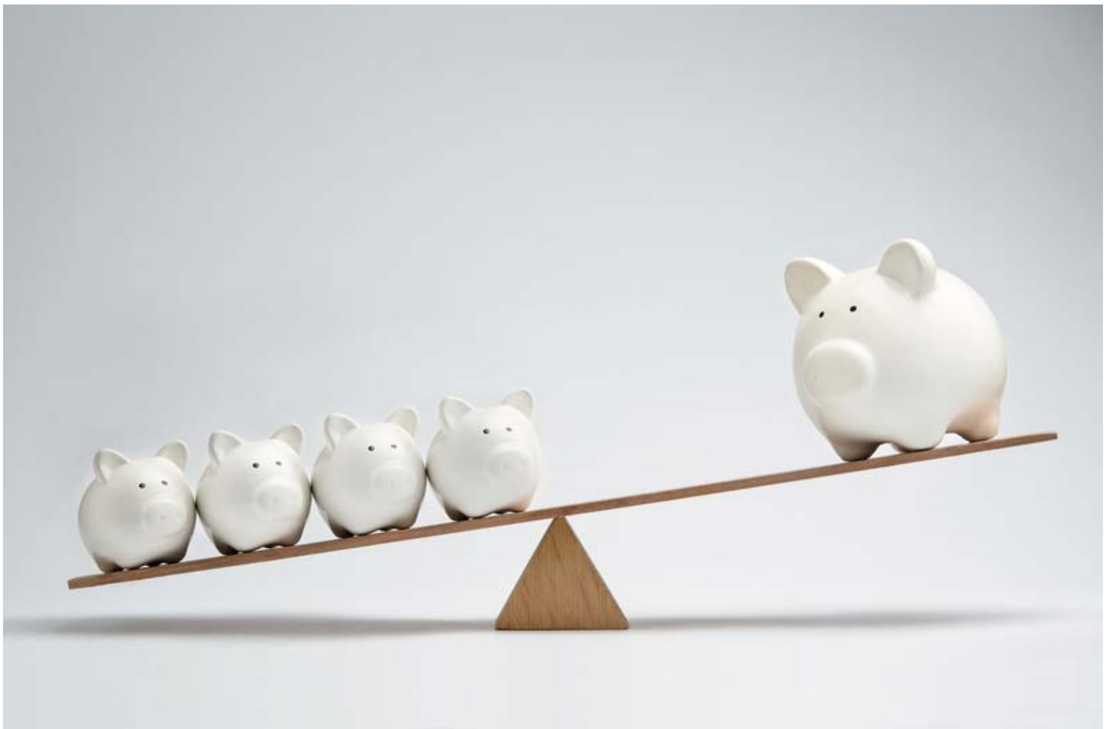
While most members are still in the accumulation phase, pensioners account for a disproportionate share of a typical funds' assets, currently almost 25% in aggregate. Additionally, members in the retirement phase are increasing rapidly, with the number of retirees more than doubling over the last ten years. Furthermore, because members' balances increase with age, over half of the investment returns that a member earns over their lifetime are earnt in the retirement phase.

To date, meeting members' needs in retirement has received much less attention than their needs in accumulation. This reflects both the higher number of members in accumulation, but also the greater difficulty of meeting the needs of retirees.

For most accumulation members, the most appropriate objective entails focussing on accumulating the largest lump sum at retirement, without taking undue risk. In retirement, the needs of individual members are more diverse, and there is less likely to be a "typical member".

Despite this, most superannuation funds offer their retirees the same products they offer to their accumulation members. Few funds offer products which are designed specifically with the needs of retirees in mind.

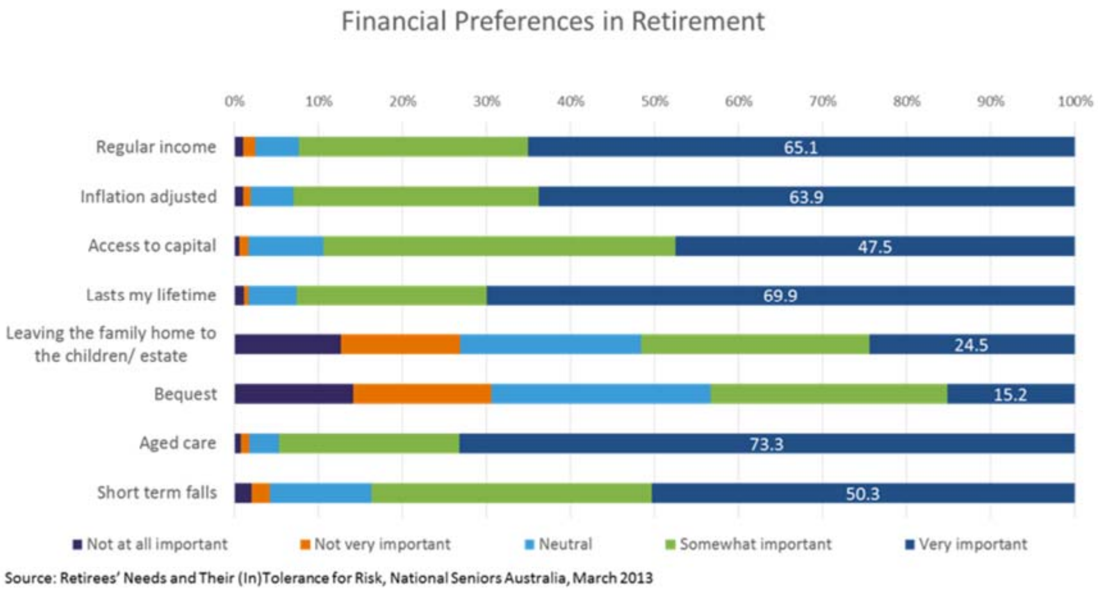
In this Frontier Line, we investigate further the needs of retirees, and then assess how the current products offered by superannuation funds meet these needs.



Members' needs in retirement

Individuals' financial needs in retirement are diverse and heterogeneous. The needs of a retiree who is receiving the age pension will be different from a retiree who is self-funded. Retirees who own their own home will have different income needs to a renter. Understanding retirees' needs is difficult, but crucial.

Figure 1: Survey of retirees' financial needs



National Seniors Australia (NSA) conducted a survey in 2002 of 2,000 Australians aged over 50, asking what was important to them[1].

The foremost concerns that seniors in, or approaching, retirement have about their finances were:

- Being able to afford aged care and medical expenses (73.3% very important);
- Money that lasts a lifetime (69.9% very important);
- Regular income to cover the essentials (65.1% very important); and
- Income that adjusts for inflation (63.9% very important).

There were two other objectives outside the top four that were still important:

- Savings not adversely affected by market falls (50.3% very important); and
- Savings can be withdrawn instantly when needed (47.5% very important).

The other financial objective surveyed was the "bequest motive", or the preference to leave an inheritance. Interestingly, less than half those surveyed attached any importance to bequeathing anything beyond the family home, and over a quarter of respondents thought that bequeathing the family home was either not very important, or not at all important.

[1] National Seniors Australia, *Retirees' Needs and Their (In)Tolerance for Risk*, March 2013

CIPR/MyRetirement

The Murray Inquiry recognised that Australia has an under-developed retirement income stream market, with at least 94% of pension assets in account based pensions. The Murray Inquiry recommended that superannuation trustees pre-select a comprehensive income product for retirement (CIPR/MyRetirement) for members to receive their benefits in retirement. The features of such a MyRetirement product would ideally include a regular and stable income stream, longevity risk management and flexibility.

Consistent with the Murray Inquiry's recommendation, Treasury has proposed there be a limited number of principles based requirements for a MyRetirement product:[2]

1. Deliver a ***minimum level of income*** that would generally exceed an equivalent amount invested fully in an account based pension that is drawn down at minimum rates;
2. Provide a ***stream of broadly constant real income for life*** (to manage risks such as longevity); and
3. Include a component to ***provide flexibility*** to access a lump sum and/or leave a bequest.

Most of the industry discussion has centred on the trade-off between flexibility and risk management. Little attention has been given to the need for a regular and stable income, despite this being identified as very important to most retirees in the NSA survey.

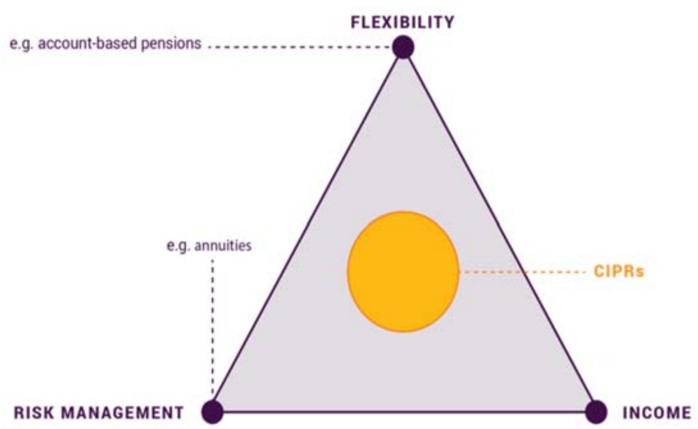
Under consuming

The NSA survey and the MyRetirement framework highlight that retirees value a regular income that lasts a lifetime more highly than leaving money to the next generation. However, various surveys of retirees' actual spending habits have shown a somewhat different story.

Research by the Centre of Excellence in Population Ageing Research[3] that analysed the spending habits of 10,000 pensioners revealed that pensioners spend conservatively, preserving their wealth and ultimately passing on substantial bequests. According to their analysis, age pensioners in Australia tend to "under consume", holding on to assets, and even building a buffer, well into their later years.

One explanation put forth is that pensioners may be self-insuring for investment and expenditure shocks, but the outcome of low spending profiles is that a large proportion of pensioner households leave significant assets as bequests.

Figure 2: Desired features of retirement income products



2. Treasury Discussion Paper, Development of the Framework for Comprehensive Income Products for Retirement, 2016
3. Centre of Excellence in Population Ageing Research, *Age Pensioner Profiles: A Longitudinal Study of Income, Assets and Decumulation*, 2015

Analysis of current approach

Current approach to setting income drawdown

Almost all pension assets are in account based pensions, which provide the member flexibility to drawdown any amount, subject to prescribed minimums. However, most superannuation funds provide little help in determining the level of income to take, except through the use of a retirement calculator or via full personal financial advice.

The minimum drawdown rates are highlighted in Table 1.

Table 1: Minimum drawdown rates

Age	Minimum Drawdown Rate
55 – 64	4%
65 – 74	5%
75 – 79	6%
80 – 84	7%
85 – 89	9%
90 – 94	11%
95 +	14%

A study by the Institute of Actuaries of Australia[4] found that close to 50% of superannuation retirees seem very cautious and withdraw the regulated minimum from their accounts. This outcome applied equally to members of retail superannuation funds (where members are more likely to be receiving financial advice) and industry funds.

A Frontier analysis of the 40 largest superannuation funds shows that all but two of the funds "encourages" the selection of the minimum drawdown rate, either by explicitly selecting it for the member if they make no choice, or by listing it first on their application form. All the funds except one allow the retiree to select a fixed dollar amount instead of the minimum drawdown rate. However, only 13 of those funds will automatically (if the member chooses) increase this amount each year in line with inflation, with seven of these funds also allowing the amount to increase at a different rate chosen by the retiree. Finally, only six funds allow the member to choose a drawdown rate other than the minimum rate.

With superannuation funds seemingly actively encouraging retirees to draw down at the minimum rate, it is unsurprising that a significant proportion of retirees simply choose this option.

4. Institute of Actuaries of Australia, *Retirement Income Market Report – Media Release*, 28 July 2016

Analysis

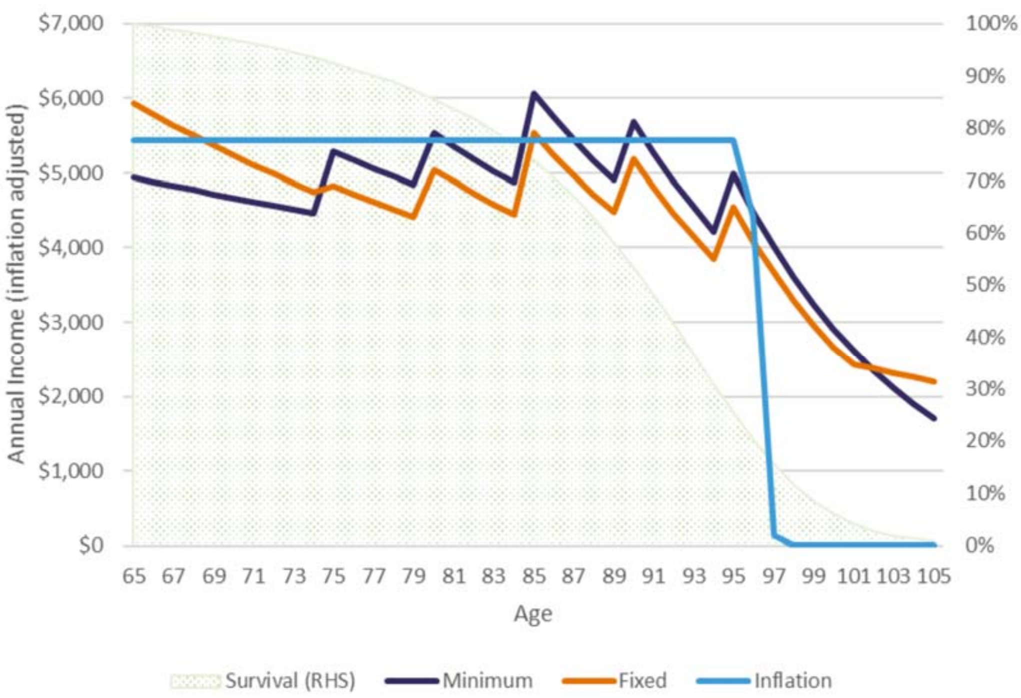
We have projected the expected income of various account based pension (ABP) approaches. The calculations have been based on a female retiring at age 65 with a balance of $100,000. Any income from the Age Pension has been ignored. The draw down approaches analysed are:

- **Minimum**: An ABP drawn down at minimum rates – initially $5,000 p.a., increasing in line with the investment returns and the increase in the age based minimums;
- **Fixed**: An ABP drawn down at a set dollar amount (subject to minimum rates) – $6,000 p.a. remaining constant until it falls below the minimum rates; and
- **Inflation**: An ABP drawn down at a set dollar amount, increased each year in line with inflation (subject to minimum rates) – $5,500 p.a. increasing annually in line with inflation.

Under each approach, the assets are invested in the same way (a real return of 4% p.a. has been assumed) and the retiree draws down approximately $180,000 in real terms over their projected lifetime.

The real (i.e. adjusted for inflation) income each year is highlighted in the chart below. The probability of survival for each age has been superimposed on the chart, highlighting that the retiree has a 50% probability of living to the age of 90 and a 25% probability of living to age 95.

Figure 3: Real income



In the case of an ABP draw down at minimum rates, the chart highlights the following.

- That income decreases in real value in the first ten years. During this period, 5% of the assets are drawn down each year. As the assets are declining in real value over this period, the income also decreases.
- From age 75, the minimum draw down rate increases every five years. This results in an increase in the income payments each five years, after which it then declines again in real terms until the rate increases again.
- As the income draw down is based on a percentage of the assets, the assets will never be completely used up. At age 90 (the retiree's expected age of death), they will be receiving a similar income in real terms to the initial income payments. If the retiree survived until age 93, they will be receiving 10% less than their starting income in real terms.

In the case of a fixed dollar approach, the chart highlights the following.

- That income decreases in real value in the first twenty years, at which point the fixed amount is less than the minimum draw down. By this point, the fixed amount has lost 26% of its real value. It then follows a trajectory similar to the minimum rates.
- At age 90 (the retiree's expected age of death), they will be receiving 25% less in real terms than the initial income payments, and 9% less than if they had drawn down at the minimum rates. If the retiree survived until age 95, they will be receiving less two-thirds of their starting income in real terms.
- The retiree is expected to run out of money at age 109.

In the case of the inflation adjusted dollar approach, the chart highlights the following.

- That income remains stable in real terms for the first 30 years. This is by design.
- Because the retiree is drawing down at a higher rate than the minimum, the assets could be used up. Under the expected scenario, the assets would be completely used up if the retiree survived until age 97.

Analysis against retirees' needs

In terms of meeting a retiree's needs, all current account based pension approaches:

- Rate highly in terms of flexibility, allowing retirees to withdraw any amount when needed. According to the NSA survey, this was very important to half of retirees, but only the sixth most important characteristic;
- Generally lack longevity risk management features. While drawing down at the minimum rates will never fully use up assets, there is no explicit protection. Drawing down at a higher rate risks the retiree being left with no funds, if the retiree survives longer than average. This was the second most important characteristic in the NSA survey; and
- Provide little protection against short term market falls, a characteristic important to over 50% of NSA survey respondents.

In terms of providing money that lasts a lifetime and regular income (the two most important NSA survey identified characteristics after aged care and medical expenses):

- The approach encouraged by most superannuation funds, drawing down at the minimum rates, often results in the lowest level of income being drawn down. It is poor in terms of providing regular, stable income and doesn't provide a natural inflation protection;
- Almost all superannuation funds provide the alternative of drawing down a fixed dollar amount. This approach is slightly better as it provides a regular stable income, at least in the early years. However, the real value decreases over time and, once the fixed dollar value drops below the minimum rates, this approach provides a similar outcome to the minimum rates approach; and
- Of the approaches considered, the inflation adjusted dollar amount performs the best in terms of providing a stable, real income. It provides a stable, real income and income will typically be higher than the minimum rates approach. However, it introduces a higher likelihood that the pension will not last a lifetime.

The final word…

With most of their members still in the accumulation phase, superannuation funds have concentrated on providing for the needs of their members in this phase. However, pension assets now account for around 25% of total superannuation system assets, and are growing quickly.

To date, most superannuation funds have merely provided the same products in retirement as they offer in the accumulation phase. This is despite the fact that the needs of retirees are very different from the accumulation phase, and also very diverse amongst retirees. Whilst retirees' needs are not homogeneous, a regular, inflation adjusted income that lasts a lifetime, together with some flexibility to withdraw savings, is highly valued.

Retirees can use personal financial advice (at a cost) or retirement calculators to help determine the level of income appropriate for them. For those retirees who don't (and for many funds this is the majority of members), they are left to their own devices to determine the level of income to draw down.

Superannuation funds passively encourage members to draw down income at the minimum rates that the Government has set. This produces poor outcomes. Drawing down at a set amount, increased by inflation, produces much better outcomes. However, less than a 20% of superannuation funds provide this option to retirees.

In a forthcoming Frontier Line, we will investigate other ways in which funds can better meet the income needs of their members, without trading off flexibility.

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