



Investing for the Different Phases of Retirement

One of the great legacies of former Labor Treasurer Paul Keating is the mandatory superannuation system introduced in 1985 with a simple employer contribution of 3% of wages. This was reinforced in 1992 with the expanded superannuation guarantee system that increased the 3% to 9% over a decade.

Neither Keating nor his successors showed any foresight in developing the retirement system. Members remain confused about planning for their retirement years. Michael Rice gives his analysis of investing for the phases of retirement.

Matching strategies, products and advice to the specific demands of an ageing population is one of the greatest challenges facing the retirement sector in Australia today.

The reality is that the superannuation sector is currently ill-equipped to serve the needs of a member once they reach the various retirement phases in life.

Rice Warner has encouraged funds to begin looking at better segmentation of their members along with revised investment strategies which utilise separate 'buckets' of funds to meet different financial needs in retirement rather than one generic approach.

We recommend this because every retiree has different needs and these can change during the retirement years. In addition, a single investment strategy cannot deal with all the risks facing retirees – liquidity risks require a short-term horizon whereas inflation and longevity risks require long-term investment solutions.

This is the fundamental challenge for superannuation funds, which generally treat their members as one large, homogenous group. Funds are forced to do this in the absence of sufficient information about members to tailor an investment strategy to their personal circumstances.

Treating everyone the same is fine while accumulating superannuation assets since the common objective is to build the biggest benefit possible subject to taking prudent calculated risks. It also concentrates assets into default funds which provide



scale benefits. However, trustees have little guidance to offer members about how they should be investing before or after retirement.

Most funds also have the same investment strategy for contributing members and retirees – despite the very different underlying attributes of these members.

Some funds have developed life stage products to integrate the accumulation and pension phases. Most of these reduce (but don't eliminate) the so-called sequencing risk of a negative investment return for members just before they retire. But the trade-off is that they also increase inflation risk and longevity risk as they reduce investment returns during the retirement years.

Funds will argue that they set a default template and it is up to members to change their strategies to suit their own requirements. So, what should members do as they approach their retirement date?

Despite the myth about Australians spending their super on lump sums, they actually use their benefits rationally. Most take a small lump sum at retirement and many of these withdrawals are put into bank accounts, so very little is consumed at the time of retirement.

Super funds can do predictive modelling to assess the likely lump sum benefit for members and when they are likely to retire.

Following communication of their strategy, they should then be shifting some funds to cash gradually over the five years before the likely retirement date so the capital for the lump sum is preserved by the time it is needed.

The rest of the benefit should be maintained in growth assets to protect against the dual retirement risks of inflation and longevity.

No funds do this – instead, most assume everyone will take their whole benefit at the point of retirement, so they try and preserve its capital value. Usually, this reduces the ultimate amount of the benefit at retirement – and they compromise on asset allocation so often they don't preserve all capital anyway.

Would it not serve members better for their super fund to understand their specific needs, but also address their changing needs as they hit the different phases in retirement?

THE PHASES OF RETIREMENT

Counter-intuitively, the first phase is actually not retirement but the long period of working. During this time it is important to

accumulate as much as possible without taking excessive risks. This phase starts from the first job through to about five years before retirement.

Phase two is transitional, where members begin planning their retirement, including determining how to manage their finances. During this phase the new retiree would typically anticipate four distinct funding 'buckets':

- a lump sum for immediate expenditure at the time of retirement;
- a liquidity pool for pension payments over the next few years;
- a nest egg for emergencies; and
- a growth pool for later years in retirement.

In practice, they might use two pools, cash and growth, to cater for all of these. A few retirees might also add a lifetime annuity for security.

The next three phases are distinct periods during the actual retirement years. They represent states of health so are correlated to age. We call these the periods of being active, sedentary, and frail.

THE ACTIVE PHASE

Currently, the active years are little different to the years prior to retirement. However, retirees have more leisure time and are more budget-conscious. Expenditure patterns are probably similar to the years approaching retirement, perhaps with a bit of caution towards spending on extravagances.

Ironically, most of the active years of retirement occur before the government's preferred retirement age of 70 (eligibility for the Age Pension will increase to 70 by 2035).

Some retirees have little superannuation, so spend all their benefit during this phase simply because they try and maintain their living standards – as measured by pre-retirement expenditure.

There is a strong argument to substitute part-time work during this phase. This will defer consumption until later in life, so the active years of retirement will be deferred and shortened.

As this is the retirement period with the highest expenditure pattern, any deferral of this period of consumption will help to build an adequate retirement benefit.

THE SEDENTARY PHASE

From about the age of 75 to 80 is when we all begin to slow down, some more significantly than others. Our expenditure falls as lifestyle becomes more sedentary. For



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couples, the shift from active to sedentary could occur at different times.

Retirees should downsize during this time, however many do not. The family home is exempt from the asset test on the Age Pension (so conversion of some value to cash is an economic disincentive). It is also free of capital gains tax so the family benefits from holding onto the home as long as possible.

As mental competency falls, retirees should be removed from making financial decisions.

Lifetime annuities, which provide better value at advanced ages, make sense from the end of the sedentary period.

THE FRAIL PHASE

This phase describes the time from about age 85 when mind and body have significantly declined. Retirees should not be making active investment decisions at this stage of their life.

Very old Australians experience high levels of fraud. Perhaps as many as 20 per cent are ripped off – often by family members!

A lifetime annuity provides some protection against this alarming risk.

IN SUMMARY

Australia's superannuation funds do not currently assist members well with their retirement plans though many are working on a revised approach. The funds' members would be advantaged by investing money in different 'buckets' rather than a single investment strategy.

A default retirement product could be developed, but would need to also use different investment 'buckets'. Funds would also need to segment their members as those with small or high balances would not be suited to the same default approach. **A**

This article is an abridged version of a technical presentation delivered to the Actuaries Institute Financial Services Forum in May 2014. Visit <http://ricewarner.com/newsroom/2014/august/01/financial-services-forum-investing-for-different-phases-of-retirement/> to download the full version of the presentation.