THE NEW GAME

As Baby Boomers enjoy retirement or start to head that way, the lucky generation are faced with some tough realities. Historically low cash rates and a stretched market for dividend-earning equities mean they need a new breed of retirement income options. **Elizabeth McArthur** writes.

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The Baby Boomers paid off mortgages when interest rates were sky high, weathered the Global Financial Crisis (GFC) as they were nearing retirement and now, they are retiring when the Reserve Bank of Australia (RBA) cash rate is a once unimaginable 0.10%.

That cash rate means the lowest-risk, most liquid asset is completely unable to keep up with inflation.

Couple this with the uncertainty of the ongoing COVID-19 pandemic, equity markets reaching the highs they did right before the 2008 GFC and an ever-increasing cost of living.

There is also the fact to consider that Australia, like many wealthy nations, has an ageing population and in turn a smaller pool of taxpayers to support them. By 2047, it is estimated 25% of the Australian population will be over the age of 65 - a larger proportion than ever before.

But the Baby Boomers are also the first generation to retire with about 30 solid years of guaranteed superannuation under their belts and there is certainly political will to support positive retirement outcomes in Australia.

With these factors combined, the generation entering retirement now are about to be part of an experiment - they will be the first to really have the chance to benefit from a new wave of retirement income products, and a new political determination to prioritise retirement income.

"A lot of people have this view that the Baby Boomers got off easy, they got free university and so on. But really, like every generation, they had some wins and some losses. From an investment and savings perspective, they've had some real headwinds as well," La Trobe Financial chief investment officer Chris Andrews[01] says.

"It's an incredibly difficult journey they've been on, so these guys who want nothing more than to have a dignified standard of living in their retirement are suddenly faced with such a limited range of opportunities for them to generate yield."

Andrews says retirees now are in such a different landscape to what existed pre-GFC that there really are a complex set of problems for them to navigate. Financial advisers, super funds and product providers will have to meet Baby Boomers with a more innovative approach to retirement.

Recently AustralianSuper teamed up with WorkSafe Victoria and Transitioning Well to produce a study on the ageing workforce in Australia and what it means for retirement incomes.

AustralianSuper's research suggests that Baby Boomers' retirement is going to look very different to that of previous generations. Of those nearing retirement age, it found, 70% plan to continue working in some capacity and 56% are worried they won't have enough savings to retire.

Retirement isn't going to be one big decision, a party and a watch from the boss and many afternoons spent sitting on the front verandah. Baby Boomers are likely to dip in and out of retirement, the research found, taking up jobs when they find something they care about that is in their skillset.

Fidelity head of client solutions and retirement Richard Dinham[02] explains that for the last 40 years interest rates have come down gradually and have only trended in one direction.

"That trend has brought yields down on every asset class you can think of. And thinking about it going forward, yields are likely to stay low," he says.

"Expected returns from growth assets, things like equities and property, are likely to be lower than in the past."

Dinham points out that the recent Retirement Income Review observed that retirees were reluctant to spend and in many circumstances were living more frugally than they had to.

"One thing we have observed is that there was quite an entrenched mindset among retirees of living off income only.... Living off the income and trying to preserve the initial capital," he explains.

Soon-to-be-released research from Fidelity, Dinham says, has confirmed that the most commonplace concerns like affording healthcare and managing longevity risk are very much still front of mind for new retirees.

It's up to financial advisers, super funds, fund managers and product manufacturers to address these issues for the largest - and wealthiest - generation of retirees Australia has seen.

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The numbers

25%

The proportion of Australia's population that will be over 65 by 2047.

The income conundrum

Sarah Forman[03] is group executive, advice at $200 billion industry fund Aware Super. She agrees with Andrews that the past 15 years have seen two of the biggest economic disruptions since the Great Depression.

She points out that those who retired in the last decade were likely to be financially ahead of where they might have expected to be, as markets rebounded rapidly following the GFC and the COVID-19 volatility of 2020. Unfortunately, that is not likely to be the case for those retiring over the next decade.

"The return outlook for all asset classes, however, is looking more challenging now and that means those retiring in the next 10 years may be more reliant on their super contributions, rather than market growth, to achieve their retirement goals," Forman says.

"Far more so than for the previous generation, they'll need a clear and considered plan as they approach and enter retirement to achieve the kind of lifestyle they aspire to."

American Century Investments head of portfolio management, multi-asset strategies Vidya Rajappa[04] observes the same.

"From an investment perspective, the current low interest rate environment combined with the near-term prospect of higher inflation and rates coming out of the pandemic-induced recession presents a significant challenge for retirement investing," she says.

Bennelong head of research and asset consultant relationships Stuart Fechner[05] echoes Rajappa. He points out the key difference for new retirees is that 10 years ago, the RBA target cash rate was 4.75% but today it is 0.10%.

"The level of capital security is effectively the same, but clearly there is a stark and significant difference in the level of return that cash provides today. Who knows what may unfold, but it would be a brave prediction to say that the target cash rate in several years' time will be 4.75%," Fechner says.

In this climate, the expectations of investors and super fund members have not necessarily caught up with reality, Schroders head of fixed income Simon Doyle says.

"Retirees will soon need to adjust to the reality that future returns will be lower than enjoyed

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over the last few years. Investment managers are guiding expectations lower (for example we have adjusted our return objectives earlier this year for our objective based multi-asset funds), but the message hasn't taken hold just yet," he says.

The Schroder Global Investor study showed that Australians still have very unrealistic expectations (8.8%) about the likely income to be generated from their investments and a modest rise in yields will not close this gap materially.

While the Schroders research suggests this cohort of retirees don't have the ideal level of education on what to expect from their portfolios, the Baby Boomer generation is one of the most engaged with their investments and they have the largest nest egg to retire on.

Despite the headwinds, this generation is going to do retirement their way. Agreeing with the AustralianSuper research, Lifespan Financial Planning senior investment specialist - managed accounts Brian Long[06] sees the word 'retirement' becoming almost redundant.

"They wish to remain active in the workforce whether through working part-time, starting their own business, or volunteering and continuing their education (life-long learning). They also have higher expectations for their retirement lifestyle such as travelling extensively and living well," he says of retirees.

But to retire in the fashion they desire, Long says, Baby Boomers are going to need to address the income conundrum. To some extent, the increase in compulsory super can support their level of ambition but to navigate longevity risk - the fact retirement is likely to last decades for many - along with the economic headwinds, Baby Boomers are going to need financial advice.

Centaur Financial Services managing director and senior financial adviser Hugh Robertson[07] uses a total return approach for retirement income, taking advantage of the tax concession in the drawdown phase which takes away the capital gains tax (CGT) constraint.

He also generally sees the benefits of a laddered approach. This is where year one might be in cash, two to three in short duration active fixed income strategies, three to seven in a diversified investments portfolio reflective of a balanced asset allocation, and beyond seven years it might be wise to look to Australian and global equities to generate long term growth and keep the portfolio ahead of inflation.

He's sceptical of some of the longevity products that are increasingly coming onto the market designed to meet the needs of a generation of retirees who are living longer. Instead, Robertson sees the benefit of the tried and tested "balanced" portfolio - even in retirement.

"The 65% into growth assets and 35% in defensive assets that is purpose-built with clear rules about retirement income spending, cash reserves, well diversified, blue-chip companies on the investing side that produce revenue, and a dynamic investment in the fund that can work as a shock absorber for the portfolio," he says.

Crucially, 60% to 70% of a retirement portfolio should be in growth assets because for this generation retirement could easily be 30 years long, Robertson says.

Andrews agrees with Robertson's point on staying ahead of inflation and of the benefits of diversification in retirement. They also agree that unfortunately, the income conundrum this generation of retirees face has led to some unscrupulous actors taking advantage and some retirees being encouraged to take on far more risk than they are really comfortable with.

"There are options that are taking advantage of retirees in this situation. And so, what retirees need to be very careful of is that they measure risk and return. Chasing outsized returns in equities for income strategies or highly leveraged strategies might not be worth it for some. They can offer an attractive headline, but they carry with them risk," Andrews says.

"At the other end, there's a whole group of managers and products offering a fixed income type of return, which in principle is generally considered as more suitable for people looking for reliable income. But of course, those are exposed to the risk of the underlying assets. And in many cases, you've got unsecured exposures. And for investors, it's very difficult for them to properly assess the risk of those strategies."

Robertson adds that he was disappointed to see the way that Mayfair Platinum advertised income products to wholesale investors prior to ASIC acting and Mayfair founder James Mawhinney being banned for 20 years.

If ASIC's allegations about how Mayfair advertised its products prove to be true (the case is currently before the courts) then Mayfair essentially advertised guaranteed income with low to no risk - something Robertson says, just isn't real.

"I am deeply concerned that retirees are taking on too much risk to generate income and not understanding how to build a retirement portfolio," he says.

Long is also concerned that retirees are getting into some high yield credit products that are generally high risk. He agrees with Robertson that having a year or two of cash in one bucket makes sense but beyond that, cash will not keep up with inflation and give them the retirement they want.

"The biggest issues people face with pre- and post-retirement include that they do not know how long they will live, and they cannot relate a capital sum to an income stream in retirement. This leads to a fear of running out of money and a total aversion to loss of savings due to negative market events," he says.

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> **Hugh Robertson**

The Covenant

In direct response to some of these issues, the government has stepped in to place more focus on the decumulation phase through the Retirement Income Covenant.

QMV Legal partner Jonathan Steffanoni[08] explains retirement income has been on the legislative agenda since at least 2014, during the financial systems review, and guidance to the industry on best practice hasn't always been crystal clear.

In 2017, the Federal Budget floated the idea of Comprehensive Income Products in Retirement (CIPRs) and a draft position paper suggested trustees should offer several soft-default retirement income products to members, Steffanoni explains.

"The government had a re-think and what we've seen now is a bit of shift in policy approach. The Retirement Income Covenant is a shift away from a product-focused approach to something that is much more flexible," he says.

"It's likely to result in trustees relying on a combination of tools, financial advice and some product design, that can be arranged to meet the needs of different cohorts of members."

Currently self-managed super fund trustees are not obligated to comply with the covenant, but this could well change.

At Aware Super, Forman says then fund agrees with the objectives of the proposed covenant.

In terms of the legislation as it's drafted, the fund is in the process of reviewing it and expect to make a submission to Treasury later this month.

"While we don't want to pre-empt that submission, we believe super funds still need more policy clarity around their scope to provide advice, guidance, and education to help members achieve the best retirement outcomes," Forman says.

"There isn't a one-size-fits-all approach to retirement, and personalised support plays a critical role in empowering members to achieve the best retirement outcomes."

Andrews agrees that the idea of the covenant, putting emphasis on the decumulation phase, is positive.

"Australia's superannuation system has been an extraordinary boon to the nation, and it's allowed us it's allowed us to build up a nice a retirement savings buffer that is the envy of the world," he says.

"Until recently, it's mostly been in the accumulation phase, you know, we've been building over time. Now we're hitting the point where we're starting to have investors draw down on their retirement savings, and a lot of the work in the super system has been focused naturally

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on the accumulation phase, more work needs to be done on the decumulation phase or the retirement phase. So, this retirement income covenant is inevitable. And it's also useful."

Rajappa at American Century suggests that it's helpful to look to examples overseas, where defined benefit plans have been decreasing and defined contributions becoming more popular.

She points to a recent American Century Investments survey of retirement plan participants, which revealed that alongside longevity and market risks a major concern of retirees is how they will be able to withdraw their savings to provide for income in retirement. Rajappa says the survey clearly found retirees would be interested in holistic financial advice.

"Over the last 10 years many participants were left to navigate decumulation on their own. This meant they needed to understand the risks in retirement such as longevity risk, market risk, inflation risk and interest rate risk," she says.

"They needed to decide how to invest their assets and how to draw income while making their savings last over their lifetime without under-spending or over-spending."

In the US, Rajappa explains, the Setting Every Community Up for Retirement Enhancement (SECURE) Act passed in 2019 raising the age of retirement to 72 and bringing in new retirement income requirements for those who hold US individual retirement accounts (IRAs).

"With improved legislative clarity, such as with the SECURE Act, we have seen more traction in the creation of sophisticated retirement income solutions and as well some early indications of increased adoption of these solutions," Rajappa says.

"Although broader adoption of retirement income strategies remains a risk at least in the near term, we expect this to improve with easier access to retirement income solutions over the next 10 years."

Doyle hopes the Retirement Income Covenant in Australia provides those nearing retirement with more confidence and prompts super funds and product manufacturers to create better solutions.

"But the devil's in the detail and can't completely mitigate the underlying challenge from an investment perspective," he says.

"The accumulation model needs to adapt to better manage the key objectives and risks of retirees. There are two things working against retirees. One is the uncertainty of the investment horizon and the other is the inability to replenish drawdowns through savings.

"Retirement income solutions need to balance out these factors, adopting underlying investment strategies that are more outcome oriented that can provide greater certainty of outcomes particularly with respect to the provision of income to the retiree in the drawdown phase (so sequencing risk needs to be managed), matched with adequate insurance against longevity. The more appropriate the investment engine, the less costly the insurance."

The cutting edge

There seems to be a hive of activity in product development for retirement income, as the financial services sector aims to serve Baby Boomers and meet new legislative requirements.

Long expects to see significant development in the space, which he says is also being driven by the increasing expectations of clients and competition pressure among financial advice groups and super funds.

"The innovation in retirement product design is becoming possible due to the availability of data, technology (such as goals-based advice/portfolio construction and associated tools such as stochastic modelling), and life insurers coming to market with an increasing range of flexible longevity insurance options. Products will become more sophisticated," he says.

"There will initially be products designed around cohorts of clients and ultimately the products will be able to meet the changing needs of individual clients.

"Such flexibility in product design would include the ability for the client to select a bespoke appropriate investment portfolio that is specifically designed for retirement (tax status, liquidity needs, etc.)."

Longevity insurance, through annuities or deferred annuities will be part of the mix but not the full story, he says.

The retirement income covenant specifies that retirees should not have their money locked up in products and should be able to access funds when needed. This is not in line with traditional annuities; however, Challenger Life chief executive Angela Murphy[09] says Challenger's newer annuities do offer this level of flexibility.

"An annuity is there to provide protection against some risks, particularly longevity risk," Murphy says.

"It also provides protection against market risk if you take one of the guaranteed options."

Challenger now offers market-linked annuities, allowing clients to take on a little more risk for more potential return.

"Our liquid lifetime annuity has the option for a withdrawal benefit. Some people have the view that once you put your money into an annuity you can't get it out, that's not necessarily the case," she explains.

Forman agrees with long that product design will become more bespoke going forward.

"In future, retirement income products will be more tailored to meet the individual needs of retirees, focusing on their goals and helping them to feel confident throughout this stage of their life. This means delivering strong returns to maximise their retirement savings, while also helping to mitigate risks of market fluctuations and downturns," she says.

"Given the complexity of Australia's retirement system and the personalised nature of retirement, a key aspect of product innovation will be the need to pair smart, fit-for-purpose retirement products with guidance and help."

Baby Boomers will change what retirement is and everything around that, Fechner agrees.

"Retirees are often lumped together and referred to as a single homogenous group, but this is not the case. There may be segments with similarities, but everyone is different," Fechner says.

In all the talk of new retirement income solutions, he believes it is important to be educated on the fundamentals - especially with cash rates and fixed income returns historically low. And the fundamentals of investing can even be applied on a personal level.

"Return and income is only one side of a retiree's financial profile. Expenses also need to be considered," he adds.

"For example, look at a company which has income/revenue and, on the other side of the ledger, costs/expenses. As we've seen for many companies throughout the challenging COVID-19 environment, when income or revenue is down, to maintain an overall similar 'net' financial position something needs to give on the other side of the ledger – that is, reduce costs/expenses.... That may sound like 'corporate speak' but the fundamentals of it are not too different for personal investors including retirees."

At a time when investment returns are at extremely low levels for some asset classes, Fechner agrees with Robertson that there needs to be a more sophisticated conversation around taking on investment risk.

No matter what solutions the industry brings to the table, retirees are still going have fears around longevity risk, meeting health expenses and being able to support their families.

"January 1 is around the corner, and that will bring with it a lot of little increases in prices. For those of us who are lucky enough to be employed, we can mostly absorb these little increases as they occur. But for retirees it can be the difference between being able to afford a night out to see friends or not. It can be a big difference," Andrews explains.

However, as product development, legislative will, research, and industry support converge, Baby Boomers are poised to have some of the most fortunate retirements in history even in the face of a 0.10% cash rate. FS

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> **Stuart Fechner**

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