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Income generation - but not at the expense of capital loss

In our first paper: "Balancing the Needs, Challenges and Dilemmas of Retirement Investing", we noted that Income generation isn't as easy as it once was. The fact retirees require income needs no explanation.

How should we think about generating income in retirement? In August 1991 the Budget address, by then Treasurer John Kerin, proposed the introduction of compulsory superannuation in 1992. At the time a 90 Day Bank Term Deposit was paying 9.75% p.a.

Bank Term Deposits are one of the reasons Australia is the 'lucky country' as today these are guaranteed[1], or true 'risk free' investments. Unfortunately, while the 'risk free' aspect remains attractive, the investment returns compared to 30 years ago are not.

Income	August 1991	October 2000	October 2010	October 2019
RBA Cash Rate [2]	9.50%	6.25%	4.50%	0.75%
90 Day Term Deposit [3]	9.75%	4.40%	4.20%	1.30%

While cash remains 'risk free' relying on it as your only source of income risks quality of life in retirement.

Therefore, to generate sufficient income to sustain a comfortable retirement, we are forced to accept some level of investment risk. In simple terms, the more risk we accept, the higher income we should expect to generate. While acknowledging this, acceptance of risk increases the probability that the asset base we've spent 40+ years working to build is at some risk of diminishing.

How Much is Enough?

The Australian Financial Security Authority "AFSA" [4] advises that a comfortable retirement for a retiree with the ATO Median superannuation balance [5] eligible for the Government Pension needs to generate 7.6% per annum[6]. Once upon a time, generating this level of income was achievable using "risk free" approaches. This is an exceedingly lofty ambition today with cash rates closer to 1%.

As we've noted investing for the specific needs of retirement is incredibly complex, while much of the commentary proposes solutions that only work for those with adequate assets to be self-sufficient in retirement.

There are various proposals surrounding the use of draw-downs to supplement income generation, such as the concept of a constant draw-down policy in retirement, which we're supportive of. However, we are concerned that their applicability is limited to only those with Asset Bases sufficiently adequate to provide for a self-funded retirement, therefore risking overlooking the issues facing a majority of retirees.

The following commentary attempts to investigate the issues facing those with Asset Bases around the level of the ATO Median 2016-17, where the issue is more stark. For these retirees drawing down their asset base guarantees a retirement well below comfortable[4].

For Retirees with asset bases at or below the level of the ATO Median[5], their Asset Base is sacrosanct.

[1] Up to $250,000. Government guarantee on deposits - *https://www.moneysmart.gov.au/managing-your-money/banking*

[2] Source: RBA – ARBAMPCNCRT - New Cash Rate Target

[3] Source: ABS - FRDIRBTD10K3M - Retail deposit and investment rates; Banks' term deposits ($10000); 3 months

[4] The Association of Superannuation Funds of Australia Limited, Retirement Standard for retirees, March Quarter 2019, Comfortable Lifestyle

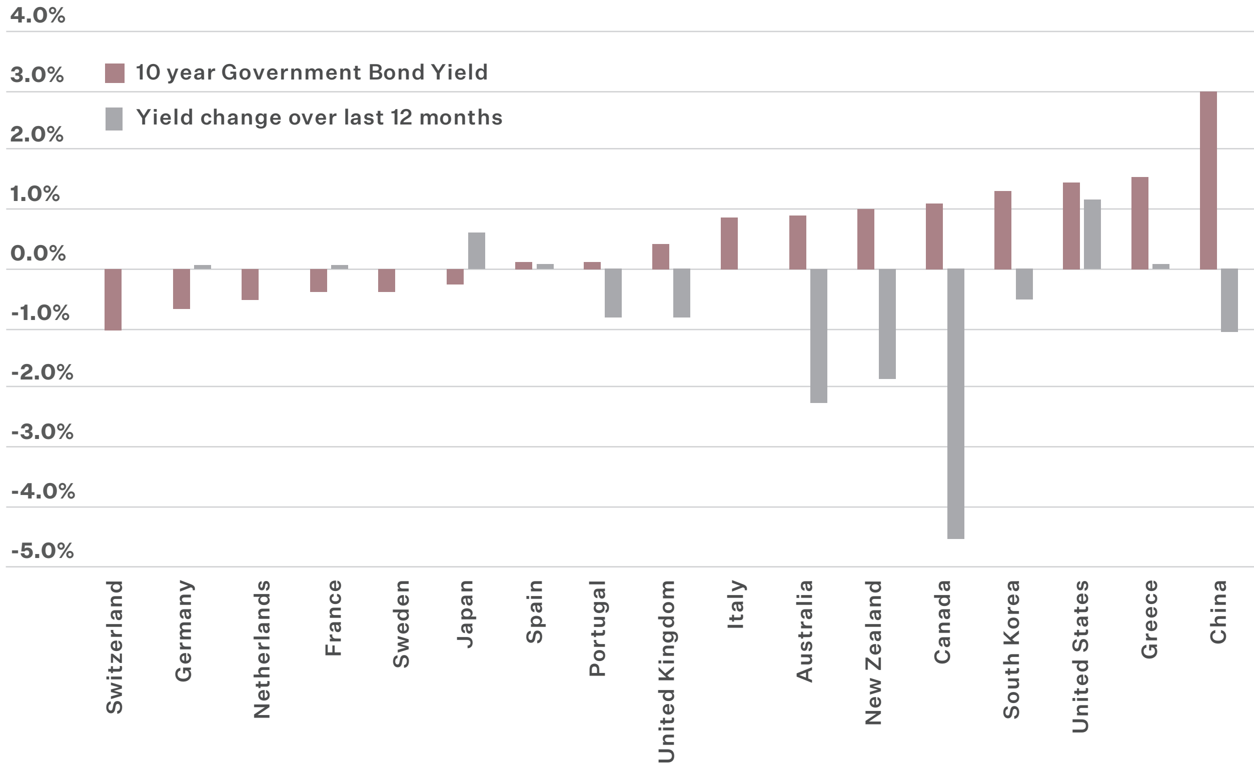
[5] ATO Taxation Statistics 2016–17, Median super account balance, by ages 65 – 69, 2016–17 financial year

[6] Yield required from asset base based on ATO Median 64-69 year old superannuation balance, accounting for pension payment for homeowning couple (Male and Female), using ASFA Comfortable spending requirement

Income generation - where can we find it?

<u>Relying solely on risk-free assets will guarantee a reduced quality of life in retirement!</u>

Declining returns from income generating assets isn't solely an Australian phenomenon. As the chart below shows, government secured investment rates in developed economies have declined globally. In an increasing number of countries, the original definition of 'risk free' no longer applies as negative interest rates guarantee that in 10 years' time (per below chart) investors will receive less money back than originally invested...



Source: Bloomberg, Talaria

- **Traditional approaches are insufficient - to live comfortably we must take some risks**

Risks to generate income

An instinctive reaction to introducing risk is concern about losing some or all of our asset base. While this would be a worse case outcome, it doesn't have to be the case, nor is it the only risk to be aware of.

Below we outline other significant risks worth considering and understanding when constructing income generative solutions for retirees.

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Income generation - risks to generating it

- **Asset Base Risk**
  - Our asset base in retirement is sacrosanct.
  - Our primary concern in retirement is the sustainable generation of enough money to live comfortably.
  - Any reduction in this asset base will negatively impact our future ability to generate income.
    - Some may push back on this notion with claims that the asset base doesn't determine the "%" return that can be derived. However, in decumulation "%" returns mean far less to Retirees than "$".
    - e.g. a 5% income stream from $100,000 ($5,000), is of far greater utility than 8% from $50,000 ($4,000)
  - The table below shows the wide range of annual returns achieved by non-"risk free" sources of income in recent history. They all are subject to variability. This uncertainty is the ultimate dilemma when constructing retirement investment solutions.

Major Asset Class Annual Return Variance Since 2005

Asset Class Annual Returns	Fixed Income [7]	Australian Equities [8]	Global Equities [9]	Equity Insurance[10]
Largest Annual Return	51.86%	44.70%	48.54%	38.88%
Smallest Annual Return	-26.24%	-39.95%	-24.62%	-21.03%

Source: Bloomberg, Talaria

- **Liquidity Risk**
  - Traditional 'Income' investments such as Property and Fixed Income might provide a valuable source of income when constructing retirement investing solutions.
  - However, in the aftermath of an event, be it investment market related (e.g. GFC), corporate event (bankruptcy) or personal event (trauma), the ability to sell assets either in a timely manner or at a reasonable price can be problematic.
  - According to recent data, between July and August 2019 the number of properties that had been on the market for sale for over 180 days increased by nearly 4% to 145,280[7].
    - The chart on the following page shows the days on market of existing stock of residential property for sale nationally:

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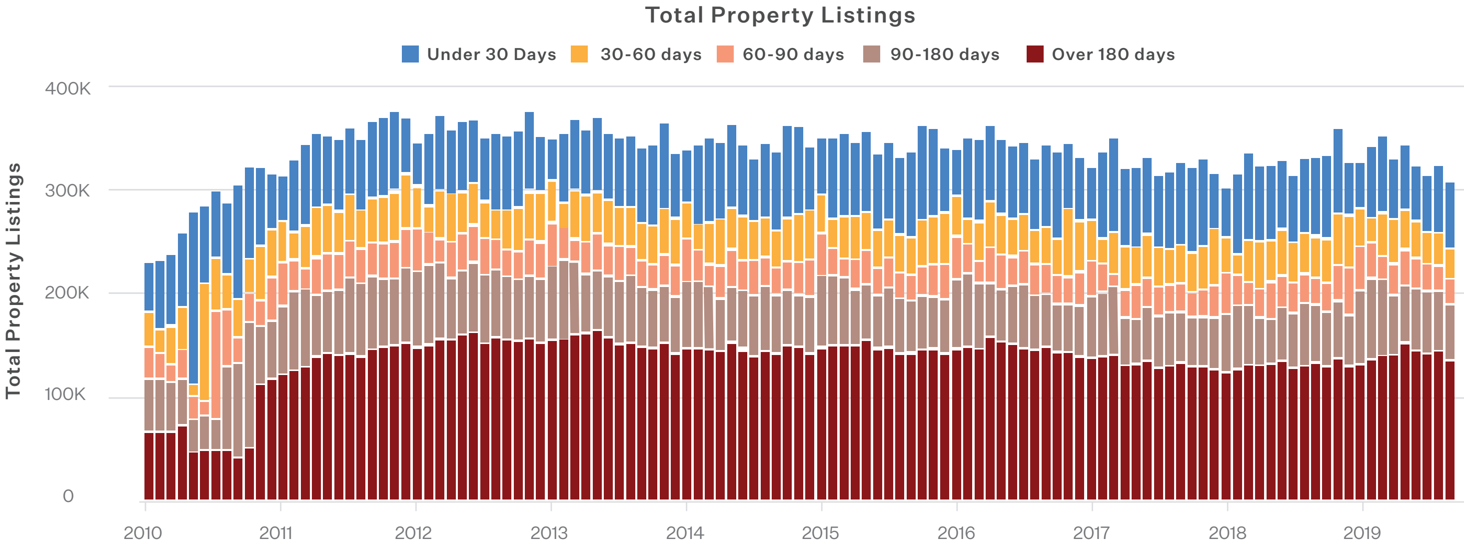
[7] *S&P Global Developed Sovereign Bond Index Total Return Index*

[8] *S&P/ASX 200 Total Return Index*

[9] *Morningstar Developed Markets Index GR (AUD)*

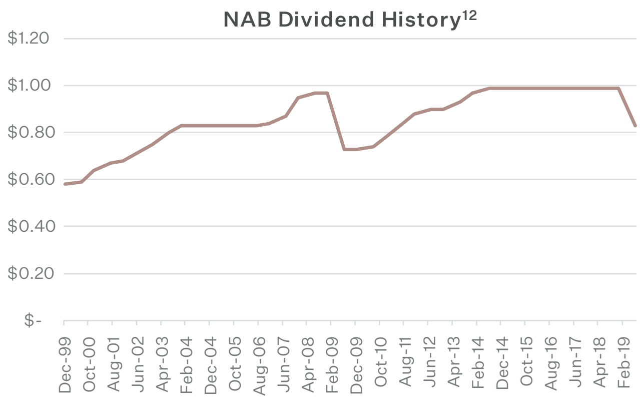
[10] *Talaria Global Equity Strategy (pre-fees Foundation Units) and assumes the reinvestment of distributions.*

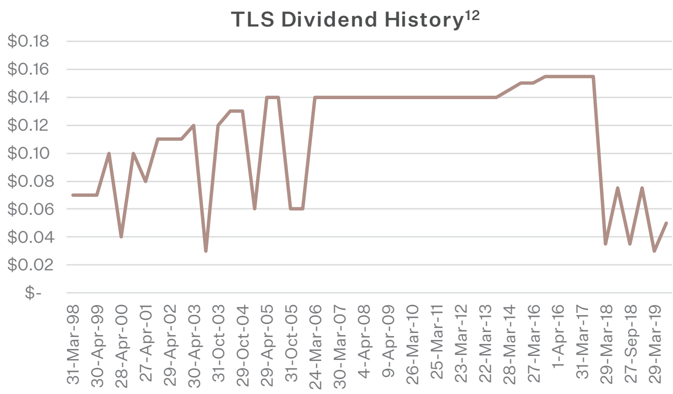


Source: SQM Research[11]

- It's not hard to consider the financial stress imposed upon retirees when it takes over half a year to sell their very valuable asset.
- The common alternative to waiting is to significantly lower the sale price. However, as noted above, anything that has an undue impact on our asset base has a significant impact on our ability to generate our required income to live comfortably into the future.

- **Income consistency**
  - All advisers designing retirement investment solutions recognise this imperative.
  - In recent times we've all been forced to recognise that nothing is guaranteed, or without cost.
  - Telstra's dividend cuts in 2018 & 2019 along with NAB's in 2019, are just 2 of the higher profile events that impacted income streams of many who'd relied on their dividend histories being repeated (forever?)...
    - Telstra's dividend cut in particular served as a stark reminder that dividends aren't guaranteed
    - Unfortunately we hear regular accounts of retirees whose income was over exposed to this event.





[11] SQM Research - *https://sqmresearch.com.au/total-property-listings.php?national=1&t=1*

[12] Dividend History, source: Telstra - *https://www.telstra.com.au/aboutus/investors/shareholder-information/dividends*, National Australia Bank - *https://www.nab.com.au/about-us/shareholder-centre/dividend-information/nab-s-dividend-paymenthistory*

- o Finding income sources that aren't all reliant on the same economic or corporate drivers is critical.
- o Company dividends are influenced by economic and industry conditions and subject to management decisions on how much, if any, of the company profits to make available as dividends. Dividends are not guaranteed.
  On their own, dividend past performance is truly no guide to future performance.

- **Legislation**
- o While most retirees would have appreciated the Federal Election result protecting legislation surrounding Franking Credits, it serves as a welcome reminder that the existing investment landscape can evolve.
- o As retirees have limited scope to add further contributions to their asset base should asset values decline, it's important their investment strategy remains robust via diversification of risks.

Where does all this leave us?

Risk free income isn't enough…placing all our eggs in one basket is too risky… so what are the options?

The purpose of this paper isn't to solve the problem for every instance of an individual retiree's situation. Rather, the table below presents a useful summary of the key investment attributes pertaining to popular sources of income generation. Note how almost none meet ASFA's income guide of 7.6% p.a. for a comfortable retirement for retirees with ATO median superannuation balances.

Source	Liquidity (H/M/L)	12 Month Income*	Relative Income Consistency	Capital at risk
Cash (1 Year TD, Invested August 2019) [13]	H	2.20%	H	L
Australian 10-year Government Bonds [14]	H	0.92%	H	L
German 10-year Govt. Bonds [15]	H	-0.70%	H	L
Corporate Debt (AAA) [16]	M	3.32%	M	M
High Yield Debt [17]	M	5.14%	L	M
Australian Equities [18]	H	4.57%	M	H
Global Equities [19]	H	2.47%	M	H
Residential (Investment) Property [20]	L	3.0%	M	M
ASX Listed Property [21]	H	6.13%	M	H
Equity Insurance [22]	H	8.0%	M	H

** To 31 August 2019*

Solving for one investment need, in this case Income, puts other needs (Growth or Certainty) at significant risk.

By way of example, for the year to August 2019 adding global equity insurance and Australian Listed Property to a 1 Year Term Deposit would have increased the income generated from 2.2% to 5.4%.[23]

[13] Source: ABS - FRDIRBTD10K3M - Retail deposit and investment rates; Banks' term deposits ($10,000); 3 months

[14,15,16,17,18,19,20,21] Source: Bloomberg, Talaria

[16] iShares iBoxx $ Investment Grade Corporate Bond ETF

[17] iBoxx High Yield Corporate Bond ETF

[18] S&P/ASX 200 - 12 month Dividend Yield

[19] FTSE Global All Cap Index - 12 Month Gross Dividend Yield (AUD)

[20] Source: SQM Research, week ending 20 August 2019, Yield = National House SQM Research Weekly Rents Index /National House SQM Research Weekly Asking Price Index

[21] SPDR S&P/ASX 200 LISTED PROP

[22] Talaria Global Equity Fund (Wholesale Units)

[23] 1/3 allocation to each of: 1 Year TD, ASX Listed Property, Equity Insurance – yield only, not total return

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Summary

Industry participants and legislators are pushing the investing for retirement conversation in the right direction. The needs of all retirees, irrespective of asset bases need to be considered. For retirees whose asset bases don't provide for self-sufficient comfortable retirement the impact of poor investment outcomes can be drastic.

With this stark reality, a retiree with a low asset base must treat it as sacrosanct. Unfortunately the investment landscape means they can no longer rely on any single, nor risk-free investments for adequate income generation.

We've shown that traditional bedrocks of income strategies such as Term Deposits, Rental Yields, Dividends are all subject to changes in the level of income they provide over time.

Approaches that utilise different sources of income can reduce retirees' risks, both to their income and asset base through genuine diversification of return sources.

Importantly, while the tenets of the retirement investment approach are unlikely to change, the mix of investment tools utilised today are unlikely to be appropriate for the duration of the retirement journey. Assistance from trusted financial advisors / wealth management professionals is never more important than when seeking to balance the **needs**, **challenges** and **dilemmas** of investing in retirement.

Australians spend 40+ years of our working life building an asset base for retirement, it's sacrosanct!

Make sure your asset base works for you in retirement.

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