WHITE PAPER

AUG 2019

SOLVING FOR THE RETIREE PROBLEM WITH INNOVATION

Reece Birtles
Chief Investment Officer, Martin Currie Australia

Will Baylis
Portfolio Manager, Martin Currie Australia

Australia has a serious problem. Many retirees do not have enough income to fund a comfortable retirement because of an over-reliance by the industry on recommending low yield / low growth or so-called "low risk" asset allocations. In particular, term deposit rates are close to negative in real rates of return following successive rate cuts.

In May 2014, Martin Currie launched a multi-asset allocation solution that looked at the problem very differently to these traditional retirement options.

On its five-year anniversary, we take the opportunity to examine traditional retirement strategies and the issues surrounding them. In addition, we reflect on the Martin Currie approach and it's focus on providing **'a sufficient income for life'**.

CONTENTS

"We believe that a retirement income strategy and asset mix should be very different to a typical balanced fund strategy for people in the accumulation phase of their investments."

WE THINK ABOUT THE PROBLEM DIFFERENTLY

Most existing multi-asset retirement products assume that when retirees get to 65, they automatically become more risk adverse and should move away from growth-style assets (i.e. equities, or growth-tilted balanced funds) and more towards defensive assets (i.e. term deposits, fixed income or more defensive balanced funds).

Back in 2010, the high nominal income yields generated by low risk fixed income and term deposit strategies meant that a defensive asset allocation for retirees was relatively easy. But we knew that this was not going to be sustainable as yields began to fall. This has proved to be true, with the cash rate steadily falling since then, and the RBA now lowering the cash rate to its lowest level ever seen in July 2019.

Based on feedback from investors, institutional clients, financial advisers, and even our own retirement-age parents, we have found that the solution to Australia's retirement problem requires a focus on providing for a **'sufficient income for life'**.

The key characteristics of a strategy that can provide a 'sufficient income for life' are:

- A high and stable franked dollar income stream to support annual expenses
- Income growth for inflation protection
- Capital growth with lower to moderate capital volatility to manage longevity risk
- Diversified growth exposures to reduce sequencing risk

WHAT OUR RESEARCH FOUND

Our hypothesis was that, going forward, retirement solutions would need to move away from the traditional industry solution of so-called "low risk" defensive assets which are in fact low yielding, low growth and have high income volatility, and into higher growth-style allocations.

Our research showed us that the characteristics of a **'sufficient income for life'** can be achieved by combining more of the right type of growth-style assets with the right type of defensive assets, and focusing on income volatility as a better risk proxy, rather than solely on capital or total volatility as a measure of risk.

Summary of our findings

To meet the above characteristics at a total portfolio level, retirees need more growth-style assets, in the order of ~70%, growing at least 2-3% per year to offset inflation. This is almost a complete reversal of the traditional approach for retirement of a 30% growth / 70% defensive strategy.

We do not agree that all growth assets are high risk and that all defensive assets are low risk, because this concept of risk is focused solely on capital volatility. Income volatility, a proxy for the risk of impaired living standards is a bigger problem than capital volatility.

But not all growth equities are appropriate, and the sustainability of income and future income growth must be considered. Our research shows that with the right growth allocation, a retirement portfolio can not only exhibit lower income risk, better protection against inflation, but also offer higher dollar income and provide valuable franking credits to maximise after-tax income for 0% tax payers as well as long-term capital and income growth.

We have found that even today, eight years later, the industry is still not focused on what retirees really need.

In this section we show the conclusions of our analysis of various retirement products such as **term deposits** & fixed annuities, traditional 'low risk' **30/70 balanced funds**, and rules-based **high yield index approach**.

Do Australians need global assets in retirement? Challenging the traditional asset mix

Another interesting outcome of our analysis is that global equities might not be appropriate for all retirees, even though they have been traditionally included in conservative balanced funds.

However, for retirees, the cost of living is largely domestically driven, i.e. inflation is mostly Australian, therefore the risk to the investor Australian in nature.

For example, a fall in consumer prices in, say, New York or London will not boost your spending power as a retiree in Melbourne or Sydney.

Additionally, yields on global equities and bonds are at all-time lows and franking credits are not available. Foreign-exchange risk, rather than adding diversification, has introduced an additional unintended risk in volatility of the income stream.

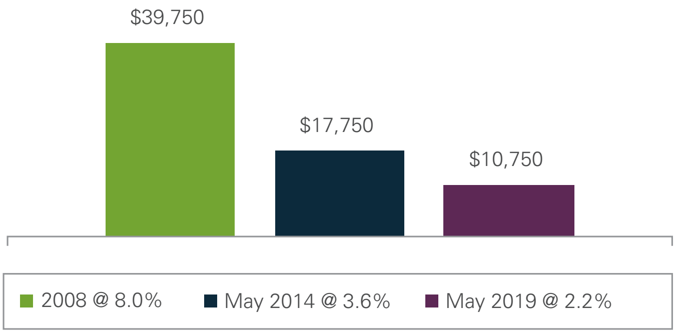
As such, we discuss only strategies that invest in Australian assets/AUD in this paper.

A HIGH AND STABLE FRANKED DOLLAR INCOME STREAM TO SUPPORT LIVING STANDARD

For retirees who require a reliable income stream to replace the wages that they received when working, it is important to focus on a stable dollar income generated over time, rather than targeting a stable headline yield.

Why is this important? Think back prior to the global financial crisis (GFC), when **term deposit** rates of almost 8% were readily available, it would have been possible to annuitize a retirement balance of say $500,000 and live comfortably off that.

Falling term deposit income



However, since the GFC, there has been a general fall in official interest rates, both here and overseas, with the current yield on best-rate term deposits falling to just 2.2%[5]. This dollar income is not stable.

Fixed annuities face the same falling dollar income problem as term deposits, albeit delayed as their characteristics are similar to a 3-5 year duration term deposit, as does the **30/70 balanced fund** due to the larger weighting towards fixed income.

The lower dollar income available today from term deposits requires an investment of more than three times as much as the peak in 2008 to generate the same dollar of income. Consequently, retirees have had to either take a massive hit to their standard of living, or significantly draw down their capital assets to meet their cost of living.

Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate.

Source: Martin Currie, FactSet, Morningstar Direct; as of 31 May 2019. Data calculated as per assumptions below in A$ gross of management fees unless otherwise noted. Inception date for performance: 31 May 2014.

Please refer to disclaimer on page 4.

[5] Source: Martin Currie, FactSet, RBA; as of 31 May 2019.

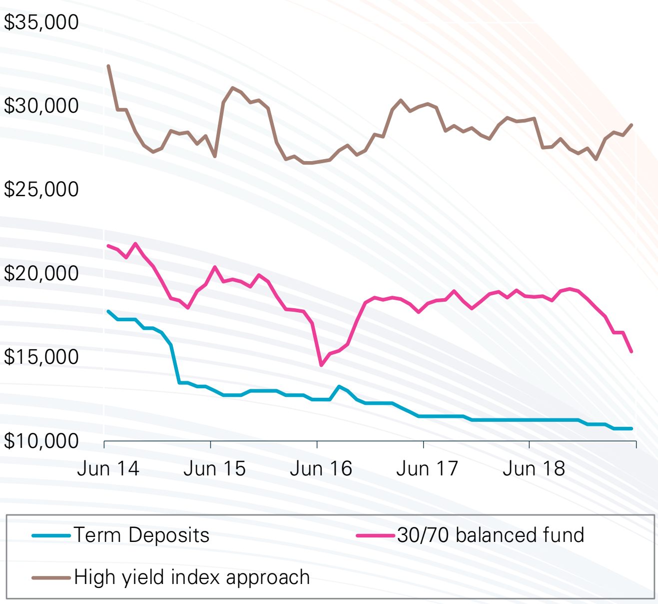
Drawing down on capital creates a downward spiral: the risk of running out of capital, the inability to fund a 30+ year retirement, and the impairment of the future dollar income generation of assets.

As a consequence, investors have turned to rules-based tilts towards high yielding stocks - for example, a high yield ETF index. Such strategies generally do not consider the sustainability of such high dividends.

When a company is forced to cut an unsustainable dividend, it can create an income and capital shock. Moreover, if sold automatically after the cut, this can result in an impaired capital value, as well.

A focus on franking can help retirees get more of their return from the dividend income stream and rely less on the capital growth component. Income from franked equities can be significant. We have found over time that the additional tax refund is over 2% p.a., and the current expected franking boost for the S&P/ASX 200 is 1.5%[6]. Significant weighting to fixed income or term deposits in retirement forfeits this retirement 'free lunch'.

NTM expected income from $500k investment on 31 May 2014 (after paying distributions)



INCOME GROWTH FOR INFLATION PROTECTION

ASFA's current standard for a comfortable retirement for a couple assumes an income of over $60k a year[6]. But income growth is required every year to offset inflation and longevity risk.

Income needs over potential 30 year retirement

While lower than long term assumptions, actual consumer price index (CPI) inflation has still averaged 1.6% p.a. over the last five years[7].

After taking inflation, and also the falling dollar income mentioned earlier into consideration, **term deposits** and fixed annuities now provide only half the expected next 12-month income today versus what was expected five years earlier. Their income has been shrinking, not growing.

The chart on the previous page highlights that **30/70 balanced funds** are suffering the same fate. Poor yields, and negative income growth rates, mean that income paid may not keep up with inflation.

Equity based income strategies such as those based on a **high yield index**, should fare better with inflation protection because of the ability to invest in companies that can grow their dividends along with or ahead of inflation.

However, the impaired capital issue described earlier also stifles the ability to grow income. Furthermore, the dividends of many high yield equities are correlated to the economic cycle and can be volatile.

"Retirees need to have reliable income growth, so they can have certainty in their ongoing inflation protection."

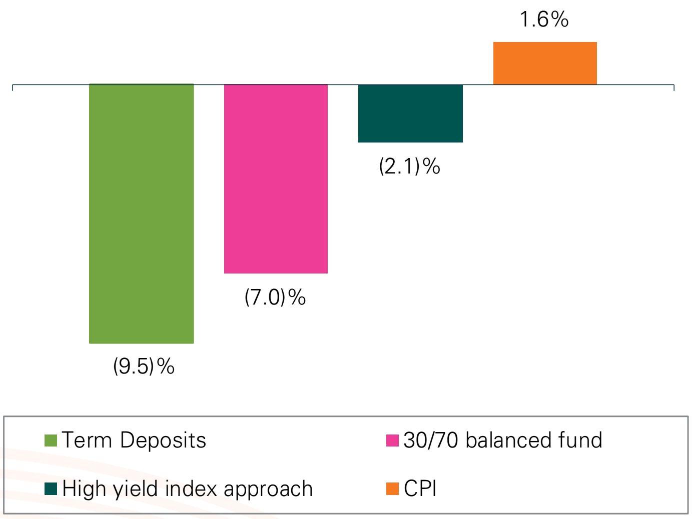
Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate. Please refer to disclaimers on page 4.

[6] Source: Martin Currie, ASFA; as at March quarter 2019; 2.5% p.a. long term inflation assumption.

[7] Source: Martin Currie, FactSet: as at 31 May 2019.

CAPITAL GROWTH TO MANAGE LONGEVITY RISK

Expected NTM income stream growth (%p.a.)



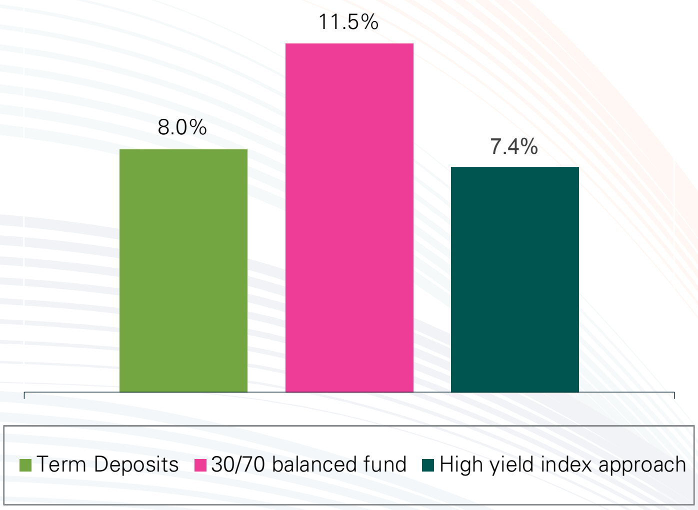
We are all aware that equities can be a volatile place to invest. However, younger retirees who have a long life-expectancy and 30+ year time horizon can tolerate capital volatility for a long period. They cannot, however, be short of regular income, or drawdown that capital too soon.

Capital growth is required to grow the asset base to ensure the future dollar income generating ability of their assets, and this requires investment growth assets.

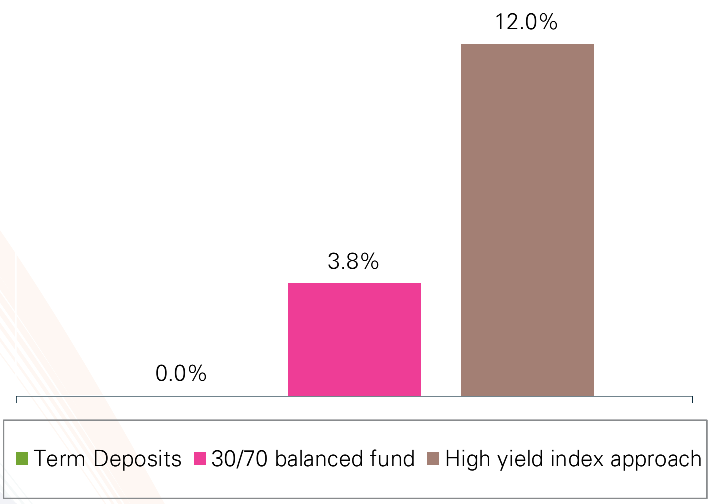
Term deposits and fixed annuities have no capital growth, and the **30/70 balance fund's** tilt to fixed income creates lower capital volatility, but very low growth. The **high yield index**, as discussed earlier, has impaired its capital base.

Remember, however, that not all equities are created equal. When combined with a disciplined investment process, high-quality companies may be able to provide both capital growth and income with less volatility than the broader equity universe.

Volatility in expected NTM income stream growth (%p.a.)



Capital volatility (%p.a.)



A side note, strategies using derivatives to provide income enhancements or capital protection may be potentially detrimental to long-run income growth as the cost is borne from impaired capital.

Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate.
Please refer to disclaimers on page 4.

DIVERSIFIED GROWTH EXPOSURES TO REDUCE SEQUENCING RISK

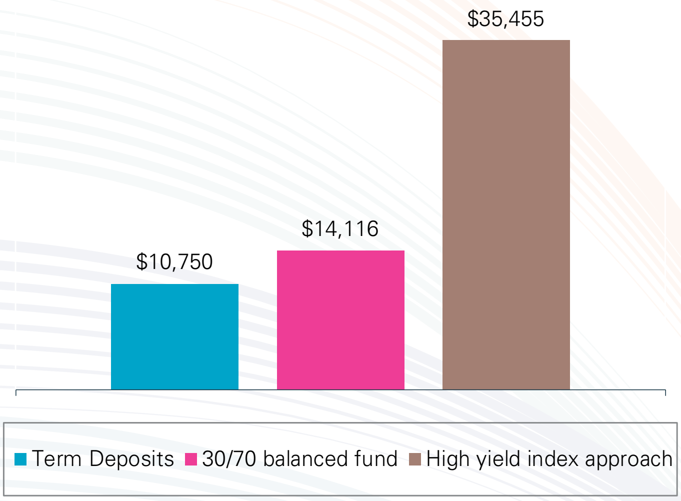
Sequencing risk is often discussed in terms of the order that capital returns occur and their impact on future portfolio values; E.g. shifting to an investment allocation at an arbitrary date (i.e. your date of retirement), when the equity market has fallen and locking in an impaired capital value.

While we recognize that the issue of impaired capital is a problem for future income growth, an equally important and often neglected risk is that of locking in impaired yields.

If you look at the expected next 12-month income available across the various options we have mentioned above, you will see that for a retirement balance of $500,000, **term deposits** or a **30/70 fund** will fall significantly short. Compare this with those who happened to retire in 2008 and could get that 8% term deposit.

Poor income early in retirement can be a significant income sequencing risk and have a long-lasting impact on the income available in future years.

Expected NTM income for $500k in assets invested today



A 30-year time horizon in retirement can allow for capital returns to improve, but only if the capital and income growth ability hasn't been permanently impaired as maybe the case with the **high yield index.**

By maintaining diversified exposures, we believe you can avoid locking in a very low yield or crystallising capital losses, and defer the growth / defensive asset allocation question until a time when longevity is less of a risk.

"We see the risk to income from moving into defensive assets at low yields, such as they are today, as a more significant concern than capital returns near the point of retirement."

SUMMARY

The last five years reinforce why retirement products need to be built to specifically provide retirees with the characteristics of a **'sufficient income for life'**. As our research demonstrates, the current environment requires us to look beyond traditional industry solutions.

At Martin Currie, we are continually developing and refining offerings to address the retirement needs of Australians. Now, more than ever, retirement solutions require a thoughtful and disciplined approach.

Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate. Please refer to disclaimers on page 4.

1800 679 541
www.leggmason.com.au

LEGG MASON
GLOBAL ASSET MANAGEMENT

Brandywine GLOBAL | CLARION PARTNERS | ClearBridge Investments | EnTrust Global | MARTIN CURRIE | QS Investors | RARE | Royce&Associates | Western Asset