Craving Certainty – The Retirement Mirage

ISSUE DATE 14-08-2015

"How much can I spend?"

This question lies at the heart of so many conversations between a retiree and their adviser. Although not explicitly stated, this simple question ties in to so many other related concerns – Can I spend enough to be comfortable? Will I run out of money? What are my options if my health deteriorates? What about bequests?

All these questions boil down to one thing – a craving for certainty. While this is understandable from the client perspective, the key challenge for the financial advice industry is how much certainty can we provide in answering these questions, and how do we manage client expectations.

This thought piece will look at the factors driving this desire for certainty, and different solutions to the expectations gap between what clients want and what advice can provide.

Summary points

- The desire for certainty is a natural human trait, and the emotional challenges of retirement can exacerbate this need
- Traditional quantitative approaches to portfolio construction cannot be relied on to provide certainty to retirees and ignore certain risks unique to the retirement phase
- There is a growing number of products available to retirees that provide some level of income certainty, but they have unique tradeoffs
- A more strategic approach, which accepts the innate uncertainty of financial markets and instead focuses on individual objectives, can help bridge the expectations gap

The behavioural and emotional challenges of retiring

Certainty biases

Humans are hard wired to prefer certainty over uncertainty, a characteristic that has been studied by psychologists for decades. Through these studies, behavioural finance experts have identified the so-called 'certainty bias', whereby people will prefer a certain outcome to an uncertain one, even if the possible payoff for the uncertain outcome is clearly better. We are also influenced more by smaller changes in probability that provide certainty than larger changes that do not – for example thinking that improving a probability from 99% to 100% is better than going from 50% to 60%.

Related to certainty bias is 'ambiguity aversion', which is the tendency to confuse uncertainty and risk. Much is still unknown about how people assess risk versus uncertainty, but in summary it describes the preference for risk (which can be quantified) over uncertainty (which can't). At an extreme level, it's the belief that if a risk can't be quantified then it doesn't exist.

So we might feel better seeing a number next to 'risk' in our investment reports, but in reality this number has no relation to 'uncertainty', that nebulous concept which may be easy to forget at times, but is never gone for good – otherwise we'd never have heard of the terms 'tech wreck', 'GFC', 'flash crash' or 'Grexit'.

The emotional aspect

Questions about retirement spending are also asked during a time of great emotional turmoil for many retirees. Although retirement sounds great in theory, emerging studies have shown that it can actually be a source of stress in older people, as so many daily routines and social interactions have been taken away. A 2013 report from the Institute of Economic

> **"Questions about retirement spending are asked during a time of great emotional turmoil for many retirees."**

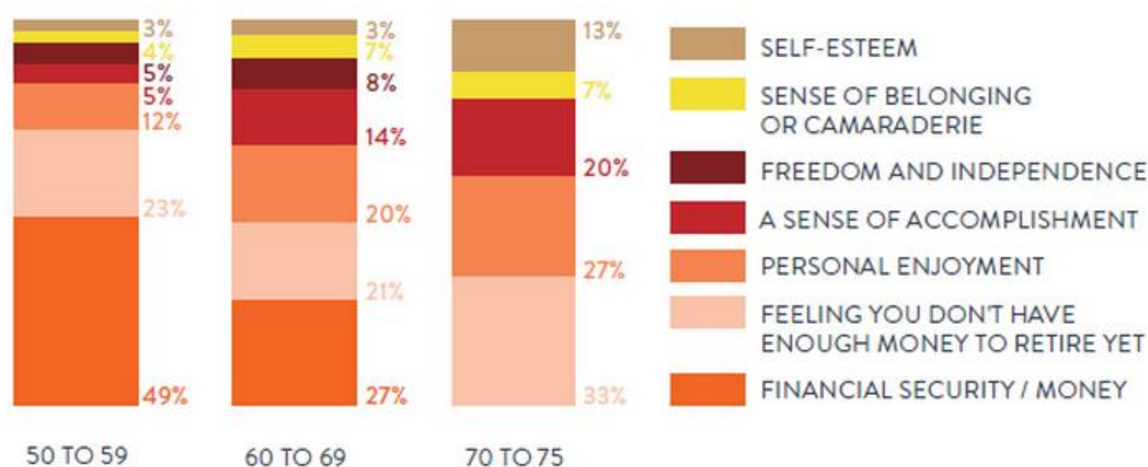
Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

Craving Certainty – The Retirement Mirage

Affairs and the Age Endeavour Fellowship, London, argued that retirement raises the risk of developing clinical depression by around 40%[1].

It is also now widely accepted that positive self esteem is linked to employment. Having a job sends the subconscious message that you are contributing to society and that your efforts are valued, even apart from the social aspect. According to a recent Gallup survey in the US, those not in the workforce are twice as likely to be depressed compared to those who are employed[2].

In Australia, the recently released 2015 Older Workers Report, co-authored by the Financial Services Council and the Commonwealth Bank, said that 52% of respondents aged 60 to 69 and 67% of respondents aged 70 to 75 continued to work for non-monetary reasons such as freedom and independence, self esteem or a sense of accomplishment[3].



Source: FSC – CBA Older Workers Report 2015

These mental health factors come in to play for retirees at a time when they may be re-evaluating their lifestyle and relationships, as they realise they may be spending 20 to 30 years in retirement due to lengthening life expectancies, and want to live these years happy and fulfilled. Divorce is one by-product of this re-evaluation process, and the statistics are quite telling – the divorce rate of seniors in the US has doubled over the past 20 years, and in Australia ABS data shows that the rate of divorce is growing fastest in the 45-64 age bracket.

Quantitative analysis – true rigour or false comfort?

Challenges to traditional portfolio assumptions

Given the myriad emotional changes underway in a recent retiree's life, and our behavioural makeup in general, it's therefore understandable that retirees look for some certainty in their financial affairs – after all, relationships can be unfathomable at the best of times, but money is meant to be relatively straightforward as it's just dollars and cents.

Add to that all the quantitative analysis that has been loaded into client communications in recent years – absolute and relative returns, Sharpe ratios, volatility, expected number of negative years etc, ostensibly to educate and inform clients – and it's not surprising when clients assume that finance is just another scientific field, like engineering or maths, where the universe always follows known rules and future outcomes can be accurately predicted.

There's probably a whole other thought piece that could be written on whether our industry's drive towards the purely quantitative has had a positive or negative effect on our end goal of providing clients with better financial

---

[1] Institute of Economic Affairs, "World Longer, Live Healthier", May 2013, http://www.iea.org.uk/sites/default/files/publications/files/Work%20Longer,%20Live_Healthier.pdf

[2] Gallup, "In US, Employment Most Linked to Being Depression-Free", August 2013, http://www.gallup.com/poll/164090/employment-linked-depression-free.aspx

[3] FSC – CBA Older Workers Report, July 2015, http://www.fsc.org.au/research/olderworkers2015/

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

Craving Certainty – The Retirement Mirage

outcomes, but for now we will keep the focus on retirement – is it then surprising to hear that, when it come to the retirement discussion and the question of income, that clients desire (and expect) a definite answer?

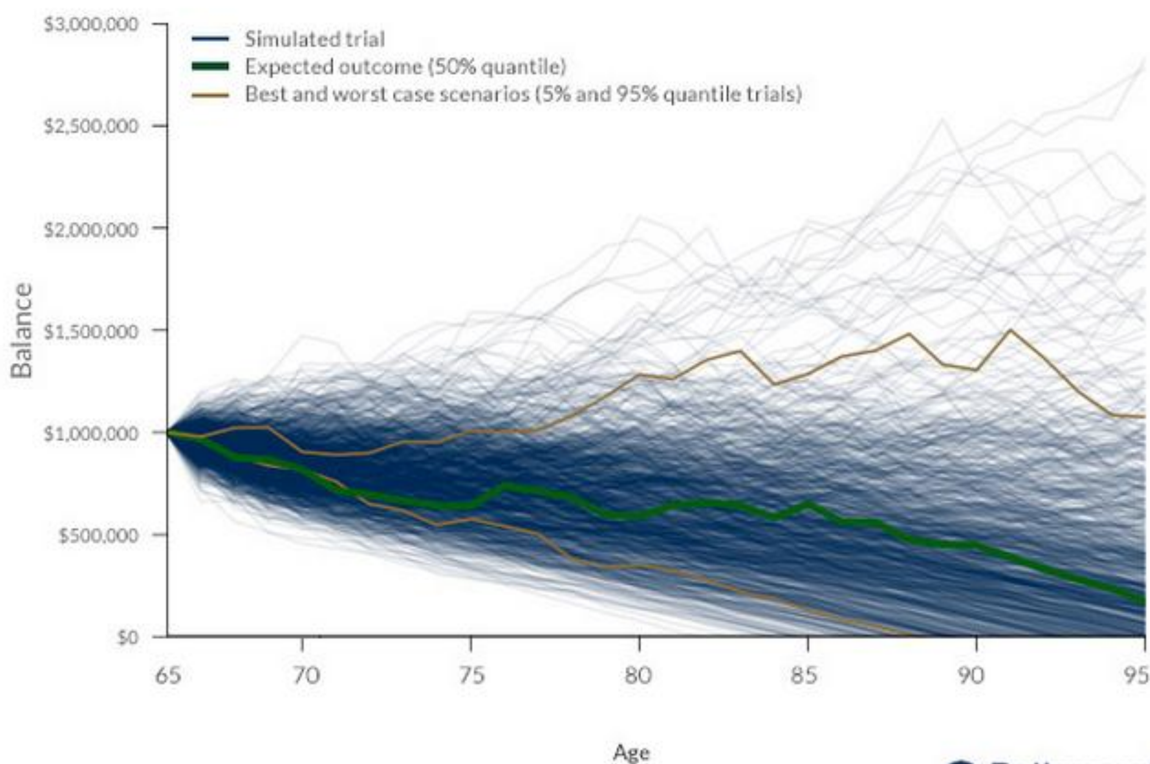
While the answer to this question we would argue is 'no', the fact remains that we cannot expect certainty from financial markets. For a traditional balanced portfolio, our industry can produce the average, median, maximum and minimum expected risk and return outcomes for any range of confidence intervals, expected number of negative years over a 10 year period and annualised probability of a negative return, but no certainty.

"Our industry can produce the average, median, maximum and minimum expected risk and return outcomes for any range of confidence intervals, and expected number of negative years over a 10 year period, but no certainty."

Over the long term, on average, the portfolio will very likely perform as expected, but as we have discussed in other thought pieces (**'Understanding Longevity Risk'** and '**Understanding Sequencing Risk'**), retirees don't always have the luxury of time when actively drawing down on a portfolio. And as for 'average' returns, in reality it's quite rare for an individual to receive the statistical 'average' outcome.

The chart below shows a Monte Carlo simulation of a $1 million retirement account that is invested in a 30/70 portfolio and draws down 4% in income per annum over a 30 year time period. The 'average' path is in green, however as the chart demonstrates, this is merely one possible outcome out of a thousand, and there is a massive dispersion between the very best and very worst outcomes. Statistically these extreme outcome are unlikely, however for an individual starting their 30 year retirement journey they are just as likely as the average outcome.

"Statistically, extreme outcomes are unlikely, however for an individual starting their 30 year retirement journey they are just as likely as the average outcome."



Source: Betterment[4]

[4] Betterment, "Why the 4% Rule Is Broken" April 2014, https://www.betterment.com/resources/retirement/investment-income-retirement/why-the-4-percent-rule-is-broken/

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

Craving Certainty — The Retirement Mirage

To be clear, we're not saying that quantitative analysis has no role to play in the financial advice world, more that it should be considered as a framework to start the discussion with a client, rather than an unambiguous blueprint of what they will experience.

So how to bridge this expectations gap between a retiree wanting certainty from their investments, and financial markets being unable to provide it? We would argue that there are two routes open to an adviser – first, use products that eliminate the uncertainty of financial markets through their design, or accept the uncertainty and choose to participate in markets on your own terms. We'll explore both of these options in more detail below.

Product solutions

Contrary to popular belief, there a number of products available to Australian retail investors that aim to remove some, if not all, uncertainty from their investment returns.

Term deposits & annuities

Term deposits and annuities are probably the most well known products that provide a return that is known at the time of investment. Not only are the return streams on these investments determined at the outset, they're also either government guaranteed (for most term deposits under $250,000, depending on the provider) or backed by life insurance companies and regulated by APRA (in the case of annuities).

Endowment bonds

Less well known are endowment bonds, which essentially are zero coupon bonds which in turn are invested into pools of matching government issued bonds or wholesale bank deposits. Investors don't receive any income over the life of the bond, instead the purchase price is always less than the value received at the maturity date – and both the amount received and the maturity date are set at the time of investment. By investing in a variety of endowment bonds with different issuers and maturity dates, theoretically a retiree can set up an annual income stream that is tailored to their needs.

Our **'Income in retirement – the pros and cons'** retirement perspective contains a more detailed discussed of the advantages and disadvantages of each of these products.

Pooled options

More recently, pooled retirement income products have become available to Australian retail investors. Also known as 'tontines', these products allow investors to pool their money into a single trust structure, and when an investor dies or exits the trust a proportion of their capital is redistributed to the remaining investors. These don't fall in the same basket as the products mentioned above, because the level of income generated by these pooled funds isn't guaranteed and they are a bit more liquid than say term deposits, however they do remove one big uncertainty – the fear of running out of money before you die. In fact, these products are quite unique in that you get rewarded for outliving your fellow investors. But pooled products also come with their own drawbacks – they're not backed by government or regulatory guarantees, and much relies on the pool you invest in – if the other investors are healthier than average for example, the lower the benefit for living longer.

The inevitable tradeoff & the behavioural aspect

For a retiree seeking a guaranteed income stream in their retirement years, all these products sound perfect. Unfortunately, like all things in life, the certainty that these products provide comes at a price. Not necessarily a monetary one, although the fee structures on some of these products can be a little opaque, but more in qualitative costs. The most significant one is opportunity cost – regardless of their dislike of uncertainty, how willing are most retirees to park some, or all, of their retirement savings in a vehicle that may not allow easy access to, or provide a return on, their money for several years?

This goes back to our behavioural biases, 'regret avoidance' in this instance. Humans are inclined to dislike doing things they think they might regret, like locking away their money now when they might need it (or get better returns somewhere else) in future. This natural reaction can be supressed when bigger fears come to the forefront – such as the large losses experienced during the GFC driving many into cash and term deposits - where investors are instead driven by loss aversion and dread risk[5] , but regret avoidance never disappears entirely.

> **"More relevant for a financial adviser, would it be sensible to recommend a guaranteed product if it provides certainty on one hand, but doesn't fit with a retiree's risk profile or their desired investment objectives on the other?"**

[5] Loss aversion' means the fear of a potential loss outweighs the hope for potential gains. 'Dread risk' is when, after one very bad experience, a person becomes overly fearful of more very bad experiences, even if they are statistically rare.

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

Craving Certainty — The Retirement Mirage

Moreover, and more relevant for a financial adviser, would it be sensible to recommend such a product if it provides certainty on one hand, but doesn't fit with a retiree's risk profile or their desired investment objectives on the other, especially in a low interest rate environment?

This discussion has demonstrated the oft-repeated phrase in our industry that 'there's no silver bullet' to solve the tradeoff between certainty of returns and the range of risks investors are exposed to via products. So is there a strategy solution?

A different approach

Different definitions of strategy

When talking about strategy, in this context we mean the philosophy supporting and expectations for a portfolio, rather than an asset allocation or tactical positioning concept. 'Strategy' is something that ideally should be established at the outset of a relationship with a retiree client, and includes discussion of what the adviser can (and can't) do, the unpredictability of financial markets and what are the client's hopes and fears for their financial future.

Aligning portfolios to objectives

One retirement portfolio strategy we have discussed at length on Lonsec Retire is an objectives based approach, where it is the client's goals which drive how their money is allocated, not long term expected risk and return metrics.

Risk profiling is also an important part of this process, especially where a client's risk tolerance is incompatible with their stated goals. However an objectives based approach adds another dimension to the analysis, in that it allows an adviser to consider their client's **need** to take risk to achieve their goals, not just how willing they are to take risk.

"When it comes to managing the craving for certainty, an objectives based approach is about helping retirees accept what can and can't be controlled and focusing effort on the former, namely their personal financial objectives."

When it comes to managing the craving for certainty, this approach is about helping retirees accept what can and can't be controlled and focusing effort on the former, namely their personal financial objectives, and following on from that the asset allocation chosen and the funds/investments used in the portfolio. An objectives based approach means that 'strategy' drives all these decisions regarding the client's investments, and when a decision is made it can be clearly tied back to strategy.

Changing the conversation

When a selecting a managed fund for example, the decision is made with a clear idea of why (as it aligns with the strategy) and what role it is to play in the portfolio.

Future reviews of this fund can therefore be done on the basis of how well it is executing its assigned role, not just being a discussion about performance against the market benchmark and trying to search for tomorrow's outperformer.

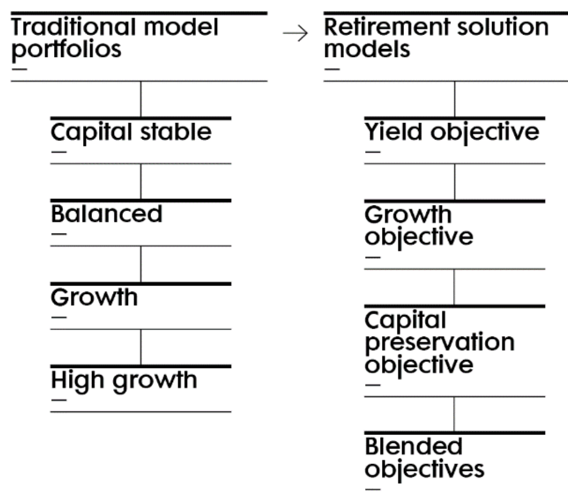
"Fees are a relevant point to discuss, but we would argue it's more about whether the fund's net of fee outcomes are aligned to the client's strategy."

Similarly, fees are a relevant point to discuss, but we would argue it's more about whether the fund's net of fee outcomes are aligned to the client's strategy, not agonising over whether to save a few basis points in fees when no one can guarantee that the net of fee outcome will be better.

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

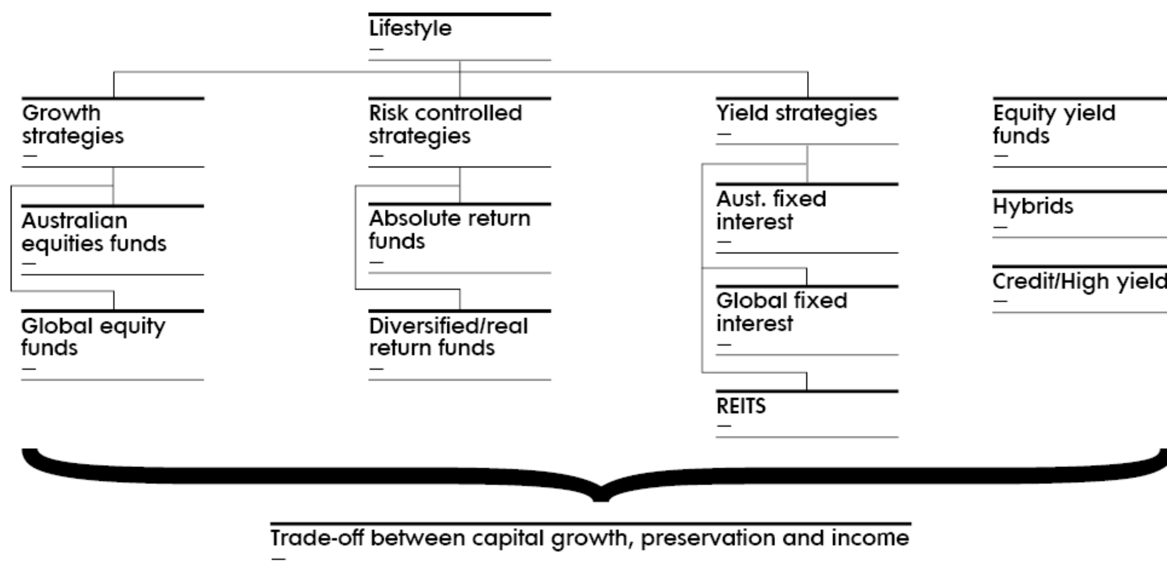
Craving Certainty — The Retirement Mirage

While there are many paths an adviser can take when building an objectives based portfolio, we have advocated in our **Portfolio Construction Guide** for an approach which breaks down a retirement portfolio into yield, growth and capital preservation/risk control objectives:



At the portfolio construction stage, asset classes or investment strategies types can be assigned to one of these three objectives. Depending on the objectives identified, the final portfolio may look quite similar to a traditional diversified portfolio in terms of asset allocation. The key point of difference is the path taken to get there, what criteria determines success or failure of each investment in the portfolio, and how the discussion with the client is framed.

This approach is by no means the only solution to the certainty issue, however it is one we believe resonates with retirees and their needs, and which encourages better quality conversations between a retiree and their adviser.



Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

Craving Certainty — The Retirement Mirage

ISSUE DATE 14-08-2015

Conclusion

In this paper we have aimed to identify the drivers behind retirees' craving for certainty, and how the financial advice industry can help address this issue, either through product or through strategy.

The desire for certainty is deeply ingrained in the human psyche, so the issues raised in this paper will be relevant for many years to come. Whether it be through a greater shift to objectives based portfolio construction, more product solutions or a different approach altogether, how to address uncertainty with retirees will be continue to be a key challenge for the advice industry.

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445 This information must be read in conjunction with the warning, disclaimer, and disclosure at the end of this document.

Craving Certainty — The Retirement Mirage

Analyst disclosure and certification:

Analyst remuneration is not linked to the research or rating outcome. Where financial products are mentioned, the analyst(s) may hold the financial product(s) referred to in this document, but Lonsec considers such holdings not to be sufficiently material to compromise the rating or advice. Analyst(s) holdings may change during the life of this document. The analyst(s) certify that the views expressed in this document accurately reflect their personal, professional opinion about the matters and financial product(s) to which this document refers.

Date prepared

August 2015

Analyst

Eleanor Menniti

LONSEC STRONGLY RECOMMENDS THIS DOCUMENT BE READ IN CONJUNCTION WITH THE RELEVANT PRODUCT DISCLOSURE STATEMENT OR INFORMATION STATEMENT

Important notice: This document is published by Lonsec Research Pty Ltd ABN 11 151 658 561, AFSL No.421445 (Lonsec). Please read the following before making any investment decision about any financial product mentioned in this document.

Disclosure at the date of publication: Lonsec receives a fee from the fund manager or product issuer(s) for researching the financial product(s) set out in this document, using comprehensive and objective criteria. Lonsec may also receive a fee from the fund manager or product issuer(s) for subscribing to research content and other Lonsec services. Lonsec's fee is not linked to the rating(s) outcome.

Lonsec does not hold the product(s) referred to in this document. Lonsec's representatives and/or their associates may hold the product(s) referred to in this document, but details of these holdings are not known to the Analyst(s).

Disclosure of Investment Consulting services: Lonsec receives fees for providing investment consulting advice to clients, which includes model portfolios, approved product lists and other financial advice and may receive fees from this fund manager or product issuer for providing investment consulting services. The investment consulting services are carried out under separate arrangements and processes to the research process adopted for the review of this financial product.

For an explanation of the process by which Lonsec manages conflicts of interest please refer to the Conflicts of Interest Policy which is found at: http://www.lonsec.com.au/aspx/IndexedDocs/general/LonsecResearchConflictsofInterestPolicy.pdf

Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is a "class service" (as defined in the Financial Advisers Act 2008 (NZ)) or limited to "General Advice" (as defined in the Corporations Act 2001(Cth)) and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ('financial circumstances') of any particular person. It is not a "personalised service" (as defined in the Financial Advisers Act 2008 (NZ)) and does not constitute a recommendation to purchase, redeem or sell the relevant financial product(s).

Before making an investment decision based on the rating(s) or advice, the reader must consider whether it is personally appropriate in light of his or her financial circumstances, or should seek independent financial advice on its appropriateness. If our advice relates to the acquisition or possible acquisition of particular financial product(s), the reader should obtain and consider the Investment Statement or Product Disclosure Statement for each financial product before making any decision about whether to acquire a financial product. Lonsec's research process relies upon the participation of the fund manager or product issuer(s). Should the fund manager or product issuer(s) no longer be an active participant in Lonsec's research process, Lonsec reserves the right to withdraw the document at any time and discontinue future coverage of the financial product(s).

Disclaimer: This document is for the exclusive use of the person to whom it is provided by Lonsec and must not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by Lonsec. Financial conclusions, ratings and advice are reasonably held at the time of completion but subject to change without notice. Lonsec assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, Lonsec, its directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.

Copyright © 2015 Lonsec Research Pty Ltd (ABN 11 151 658 561, AFSL No. 421445) (Lonsec). This report is subject to copyright of Lonsec. Except for the temporary copy held in a computer's cache and a single permanent copy for your personal reference or other than as permitted under the Copyright Act 1968 (Cth), no part of this report may, in any form or by any means (electronic, mechanical, micro-copying, photocopying, recording or otherwise), be reproduced, stored or transmitted without the prior written permission of Lonsec.

This report may also contain third party supplied material that is subject to copyright. Any such material is the intellectual property of that third party or its content providers. The same restrictions applying above to Lonsec copyrighted material, applies to such third party content.