
# Funding Retirees' Budgets: Ways of Managing the Investment Risks

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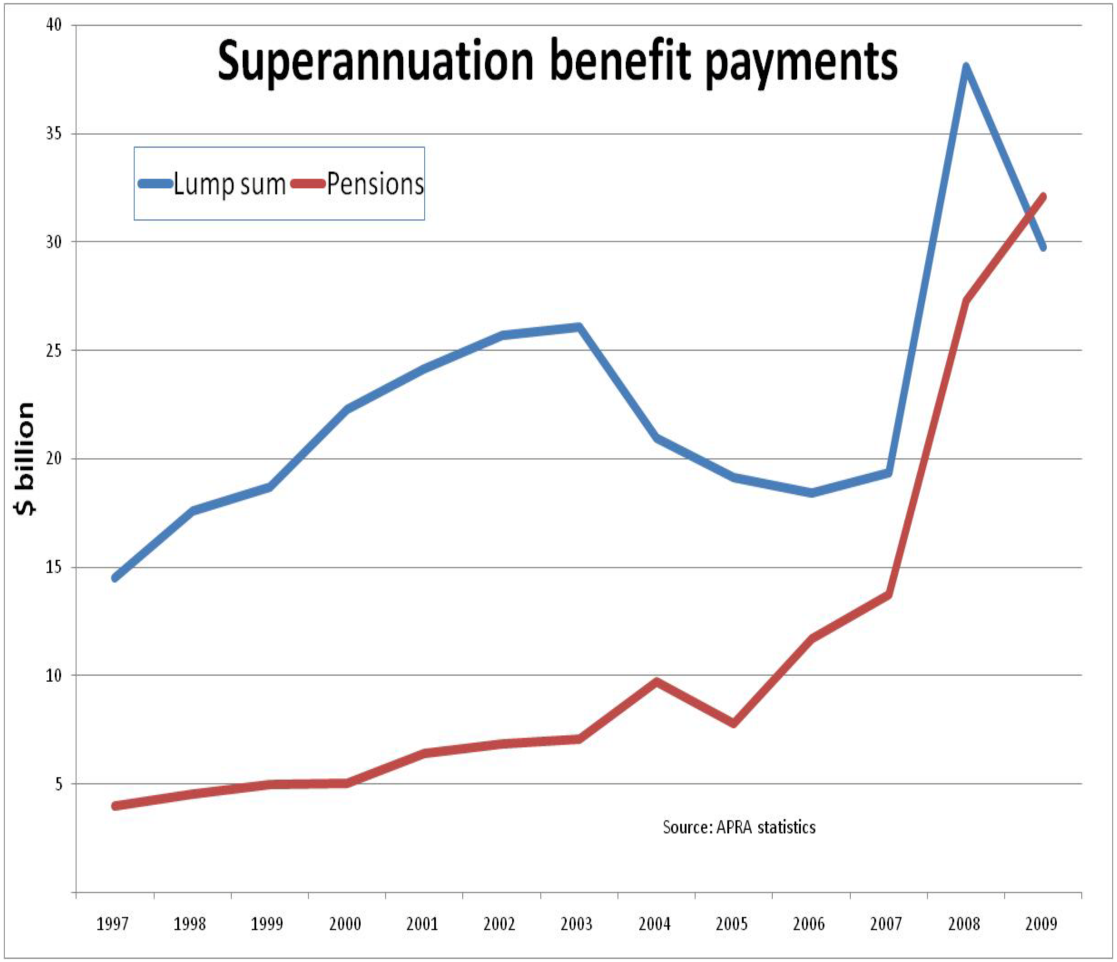
# Agenda

- Introduction
- Discussion
  - Consumption Plans
  - Managing Equity Investment Risk
    - Alternative approach to smoothing
  - Key Takeaways
- Questions

# Australians and pensions

- Australians are increasingly taking pensions (if not lifetime annuities)

- 50% of which are civil service and most of these are DB life pensions



# Framing them as consumption plans

- The ready availability of properly designed lifetime annuities would enable Australians to spend increasingly more money as they age (if they want or need)

- Research shows considerably greater demand for life annuities where they are framed as consumption rather than investment plans

# Constructing Consumption Plans

| Age | Medical classification | Financial implications |
|---|---|---|
| 65 to 74? | Healthy (90% brain intact)<br>Mobile & independent | Can control own finances<br>Need regular income and perhaps other money |
| 75 to 84? | At-risk (50% brain intact)<br>50% Mobile & independent<br>34% brain function at risk if stressed<br>16% have a dementia | Reduced financial ability<br>Need regular income protected against inflation and opportunists<br>Cover for health care |
| 85 to 100+? | Frail (30% brain intact)<br>70% have difficulties with cognition and independent living | Limited ability to control finances<br>Health and long term care |

# Assumptions

- The risks associated with guaranteeing lifetime annuities are too high to be practical
- Present value of pensions almost $1tr
  - Impact of 1% pa change in mortality improvement is of the order of $200m
  - Impact of 20% fall in equity market would be $200m
  - Total ASX profits less than $200m
- Government will continue not to take on risk for higher income earners

=> Creates need for risk-sharing annuities

# Need to capture the risk premium

- Government indexed linked bonds yield 2.7% real currently; 10 year range 2.1-3.8%

- Historical dividend yield currently 3.7% plus franking credits of some 1%; 10 year forward range 3.4 – 5.4% (70% greater return)

- Equity risk premium too large to ignore, and annuity design must try and capture some of it

# Ways to Manage Equity Risk

- Diversified Investments
- Lifestyle Investing
- Guaranteed Minimum Benefits
- Alternative Investment Instruments
- Smoothing Investment Returns

*Approaches to make life annuities attractive to Australian Retirees*

# Diversified Investments

The most common way to implement this strategy is to use a combination of investments in order to give an optimal mix of security, inflation protection and participation in the equity market

# Lifestyle Investing

- The concept refers to the idea that in the years leading up to retirement, consumers switch from equity investments to more stable investments, over a few years, rather than a single date
- The availability of suitable long term inflation protected products is key for this strategy to be successful

# Guaranteed Minimum Benefits

## New guarantee products

- Guaranteed Minimum Income Benefit: provides a guaranteed minimum income benefit upon annuitisation
- Guaranteed Minimum Withdrawal Benefit: provides a regular minimum withdrawal amount, either for a fixed period or for life

***Events in the financial marketplace have lead to questions of viability: large providers are withdrawing from markets***

# Alternative Investment Instruments

There is perhaps greater scope for borrowers other than government to issue annuity investment loans where capital and interest are repaid in an income stream that is linked to inflation – and provides a higher return than government stock

# Smoothing Investment Returns (SIR)

Traditionally, many DC and DB funds operated through declaring smooth discretionary bonuses to distribute investment and other profits

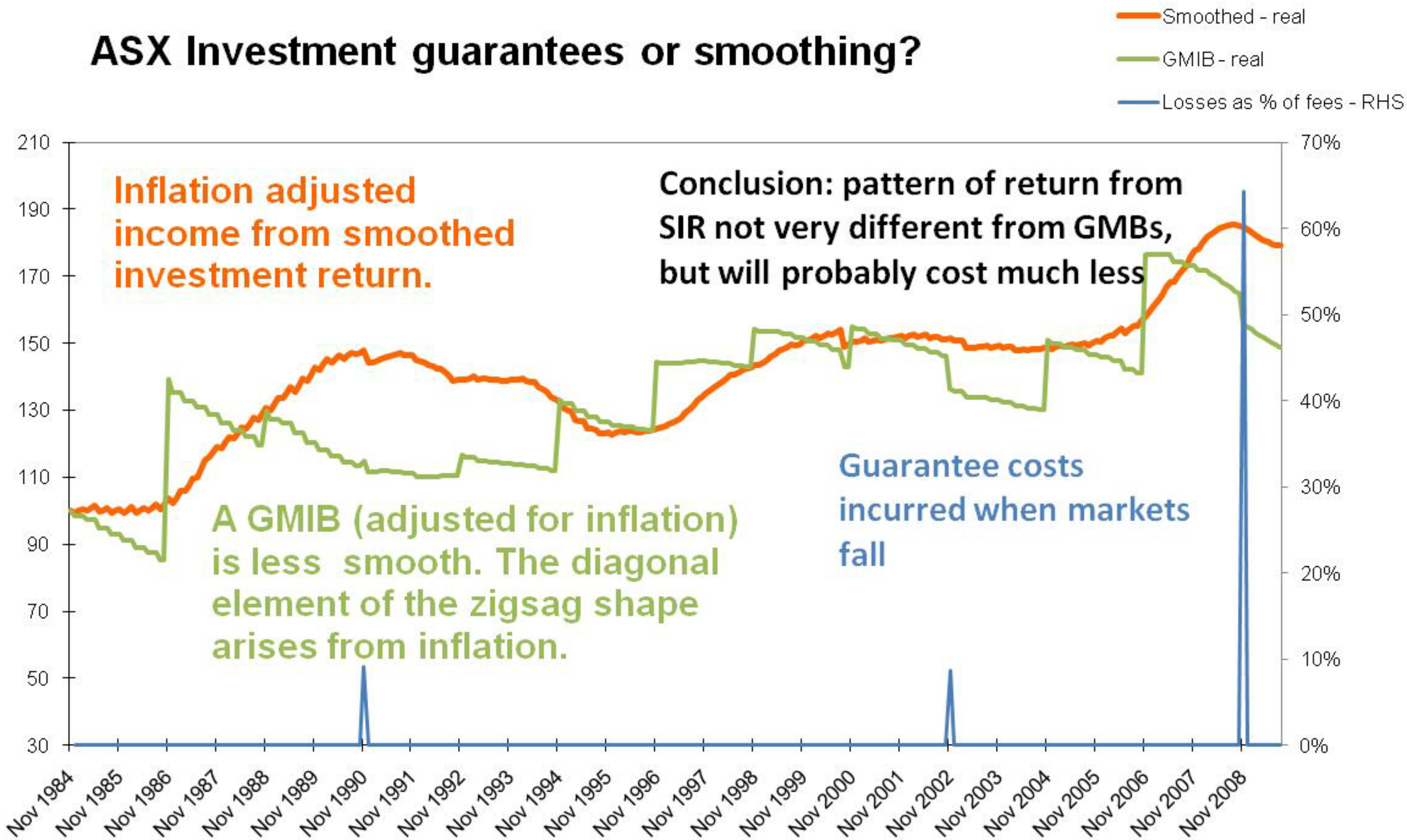
…some weaknesses of this approach:

- Possibility of anti-selection
- When market values are below actuarial values, the fund is exposed to risk that may lead to a drop in benefits for remaining members
- Discretions can be abused

# SIR – An Alternative Approach

- Objective is to capture as much of the equity risk premium as possible
- Systematically in cash over a fixed period
  - Sell risky assets and invest safely as approaching retirement
- Selling down equal numbers of “units” for each of the 60 months before each payment seems to provide acceptable smoothing
- This method captures 70% or more of the equity premium over retirement ages
- Produces a cash flow that is relatively smooth

# ASX Investment guarantees or smoothing?



# Advantages of Proposed Approach

Creates the advantages of smooth with profit

- without discretions
- entirely market consistent
- captures 70% of ERP with less than 20% of the standard deviation
- other possibilities of arrangements with other generations within the fund

# Key Takeaways…

- Life annuities could have an important role in many people's retirement planning
- Annuities need to be framed as consumption plans, rather than investments
- Additional returns that can be obtained from investment in equities are worth the risk…but the risks need to managed more actively – with guarantees and smoothing – before annuities become attractive in the market