

RETHINKING RETIREE INVESTMENT RISKS



▲ Kim Bowater, Frontier Advisors

Some of the leading thinkers in superannuation investing met up with two representatives of Wellington Management to discuss how good the industry actually is at investing for retirement. DAVID ROWLEY reports.

What does your retirement offering look like and how much do you expect to evolve?

It is rare to find a superannuation fund that has a fulsome answer to this question. Some cite a lack of members in retirement, the popularity of lump sums or members with small balances at retirement as a reason for their lack of a developed pension offering.

Others say that they are working towards a solution. There is a growing acknowledgement that a one-size fits all offering is unlikely to be what the future looks like.

David Schneider, head of research at UniSuper, predicted funds creating options for members that will allow members to transition over time into different risk categories. UniSuper is also not far off launching its long anticipated collective defined contribution plan, which on paper would appear to offer members higher balances than ordinary defined contribution and with the ability to smooth outcomes at retirement.

Many pension offerings are the funds' conservative growth option rebadged, but one fund that has stepped away from this pattern is LUCRF with its targeted return option, which while not a specific retirement product is partially aimed at retirees. The option has the least traditional asset allocation of all the fund's products, combining nine different strategies, many with an absolute return focus.

Daniel Grioli, portfolio manager at LUCRF, says: "It is designed to give a similar long-

term CPI plus outcome as our balanced fund, but without the left and right tails of our distribution, so you won't get the bigger highs or the bigger lows. You will get more consistency."

At Vision Super targeted return strategies and low volatility strategies are being explored, but a common thread from the other funds in the room was that they would innovate once they had a larger mass of members in retirement.

At Kinetic Super, there is no pension product at all, the default carrying into retirement. Paul Kessell, chief investment officer at Kinetic explained that with very low balances and only 0.1 per cent of members in retirement it was not a priority.

At Cbus, the retirees are put into the funds' Conservative Growth option. The fund explored a lifecycle option with greater derisking, but the analysis was that members with very low balances needed growth for longer.

Tim Riley, investment strategist at the fund, foresees innovation in retirement as including a different structure of equity manager styles, particularly in the use of low volatility options.

By contrast, the AustralianSuper default starts derisking before retirement. Alistair Barker predicts more innovation as members in retirement grow, but currently the age pension is the major backstop for members.

"The bulk of our membership is low to middle income earners and their major retirement income is the government age pension, which is index linked and quite secure," he said.



There is a growing acknowledgement that a one-size fits all offering is unlikely to be what the future looks like



▲ Sunil Kapadia, Wellington Management makes a point

SPEAKERS:

Alistair Barker

co-head of macro and portfolio construction, AustralianSuper

Kim Bowater

senior consultant, Frontier Advisors

Aisling Freiheit

investment director, Wellington Management

Daniel Grioli

portfolio manager, LUCRF

Zoran Josic

head of fixed income, Telstra Super

Sunil Kapadia

asset allocation strategist, Wellington Management

Paul Kessell

chief investment officer, Kinetic Super

Tim Ridley

investment strategy manager, Cbus

David Schneider

head of research, UniSuper

Jeremy Willmott

senior consultant, JANA

Michael Wyrch

chief investment officer, Vision Super

The investment consultants emphasised communication.

Kim Bowater, senior consultant at Frontier Advisors, said a better understanding of fund membership would be the key to better more targeted products and the ways these communicated. Jeremy Willmott of JANA, saw this communication as often being around members' understanding of their own longevity.

The experience of Wellington Management in this space was helping clients on portfolio construction and helping define the range of outcomes, whether this be for a CPI or a cash target. Sunil Kapadia, asset allocation strategist at Wellington Management, said the process was difficult as members were not a homogenous group and that longevity and sequential risk was also a factor in building better solutions.

Lastly, all funds were asked about their progress towards segregating their pension assets for tax efficiency reasons. The answer was no from all funds, largely as the cost of doing this has not been justified by the returns it would bring.

How bad are current markets in limiting the ability of funds to achieve their targets for retirees?

The discussion on optimal retirement strategies returned again and again to the difficulty in current markets of achieving retirement outcomes based on traditional approaches.

Kapadia pointed out that today's investment environment was very different to the last 30 years, where it was fairly simple to get CPI plus 3-5 per cent with even a low risk Australian cash and bonds approach.

"So now you either have to be comfortable taking more risk to achieve that return or you need to think more creatively about how to put different assets together or use portfolio construction techniques to narrow the distribution of returns around your underlying targets."

He added that non-traditional defensive assets such as real estate, infrastructure and utilities had an inherent duration risk which added to the difficulty factor for investors.

"With both styles you may be taking on unrewarded risks and then trying to balance



▲ Paul Kessell, Kinetic Super

that versus the changing nature of risk for an individual over time and how to address that,” said Kapadia. “It is going to remain a structural issue that we are all going to have grapple with.”

Research carried out by Grioli pointed out the real return to US treasuries from 1981 to 2012 was 7.8 per cent a year, a return which outperformed equities, which had a real return of 6.8 per cent over that period. This return on bonds is three times the average returns for the 75 years prior to this.

Grioli estimated that for such a return to be achieved over the next 30 years, then the world would need the incredible situation of deflation at 6 per cent a year for the next 30 years.

Resetting targets

Here the conversation turned to the number of funds that were forced to reset the return assumptions for low risk options.

Josic said: “Our fixed income product used to be CPI plus 2 when real rates globally are around zero, that’s just unrealistic; the risk return profile for what we have promised our members is a little bit ridiculous.”

Wyrsh pointed out that such objectives were in danger of forcing funds to take more risk when it was least going to pay off.

Grioli talked up the virtues of holding cash in this environment.

“The one asset that no one seems to talk about is cash and if anything the drag to having cash is lower than it has ever been, so if I had a choice between a low return with a fairly high probability versus a low return with no risk. I know which one I would choose.”



▲ Aisling Freiheit, Wellington Management

Kapadia questioned the wisdom of this approach if high inflation returns.

While Josic raised the spectre of deflation: “Central banks have been penalising savers globally for years and years, something has to give,” he said. “You can go down to minus 2 and 3 per cent. We are in a very, very risky environment.”

He added that a bond sell off could be caused by something as simple as a misinterpretation of a sentence uttered by central bankers.

One unique approach to asset allocation for retirement portfolios was outlined by Schneider, which proposed the purchase of ‘moderate risk’ assets, nominally individual specific stocks offering risk free plus 2.5 per cent.

“They often have a very high dividend yield, quite a few are Australian based and come with a very attractive franking credit. We are also looking around internationally for moderate risk assets, companies that have been paying dividends since the 1950s and never stopped.”

What are the possible options to help with a mismatch of retirement objectives and the assets held to achieve that?

On the general agreement that traditional asset allocations are unlikely to give members the returns they and the industry have come to expect over the next few years, the question was raised by Aisling Freiheit of Wellington Management as to whether protection strategies, such as tail risk hedging, inflation hedging, volatility management, would be palatable to funds.

“There are other things you can do to make your portfolio more defensive rather than looking for more defensive asset classes, but they will come with issues about complexity, they will come with these issues of leverage, they will come with all these issues that seem to be a hurdle,” she asked. “How easy are they to explain to both investment committees and to members?”

The question produced a mixed response from investors in the room.

Paul Kessell of Kinetic Super said such strategies would be unlikely to be accepted at a board meeting, not least because of the risk



▲ Michael Wyrsh, VisionSuper

◀ David Schneider, UniSuper



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it posed for trustees.

He added that boards would rather accept period of underperformance, as long as this was balanced by high performance.

He explained: "Boards accept that there are periods where objectives won't be met and they are prepared to say to the investment team 'we are comfortable that you achieve a return that is below in the short term, because we understand there are risks involved of actually going up the risk curve, because we know that over the longer term you will achieve the objective, but there will be periods where that is not the case.'"

There are other barriers for funds. David Schnieder, head of research at UniSuper, said that governance was not an issue for his fund, which has already given consideration to such strategies on its investment committee, but that rather size was the impediment, as it was too hard to put an option overlay on a \$30 billion equity portfolio.

Daniel Grioli of LUCRF saw explaining the use of such strategies to members as another hurdle to be overcome.

"For so long in the accumulation phase

it has been easy to talk about growth and defensive, where defensive gives you income and growth gives you capital gain," he said. "Then you start talking about protection strategies and tail risk hedging, fat tails and objective base portfolios and members do not understand. That's part of the reluctance that trustees might have, as they think 'why should we build a product our members do not understand'."

Zoran Josic of Telstra Super was not convinced by this argument.

"Members do not need to know every single detail, it's like going to a surgeon and asking for a heart by-pass. We do not need to know every single procedure of it," he said.

Kim Bowater of Frontier Advisors saw the interest in such solutions only taking place at funds that had well developed internal investment teams and that fully understood how they worked.

"Even if it is something funds choose not to do right now, it's worth a good look. It is a really tool kit for people to have," she said. "Strategies and assets that do not have this fundamental value issue, where everything will reprice together are worth a look." She added that standalone funds where volatility or tail risk strategies were being used should be expected to do well in a market crash.

How do you define investment risk in retirement?

The discussion raised some interesting insights into what actually constitutes a risky asset for retirees.

Kapadia observed the high risk ratio of lifecycle funds listed in the APRA database, where on average late accumulation and



People actually withdrew less as a general rule after the crisis

retirement funds had a 75 per cent exposure to growth asset risk.

Barker questioned the use of the word risk here, and its emphasis that risk comes from the volatility of assets.

“Ultimately, the focus is on whether you deliver to the end objective. The biggest risk to that is probably more around bond yields than inflation, as much as equities,” he said.

Barker added that whether an asset was ‘defensive’ was conditional on the type of event an investor was worried about.

“The notion of growth and defensive is a bit irrelevant unless you can say what you are trying to protect against. That involves then having a conversation with a board or investment committee about some form of scenario based approach, a far more complicated more rich style of analysis to come to terms with how protected your portfolio might be.”

Schneider picked up on these points.

“Whilst equity markets are volatile and clearly no one wants to see a fall in their value, retirees are not selling down all of their assets every day, they are only selling down a small proportion of the assets,” he said. “Equity market risk is very important, but longevity risk is even more important for those members who do not have access to a defined benefit product.”

He added another critique of how APRA figures might be misinterpreted.

“APRA has that reporting standard where you have to specify the number of years out of 20 where you have a negative return, which is cute, because it seems like a number that can resonate with individuals. The problem is it tells you nothing about the severity of that negative return.”

Others at the discussion were also warm



▲ Alistair Barker, AustralianSuper

to the idea of educating members to the worth of equities in helping with longevity. The fallibility of this approach was highlighted by Kim Bowater.

“What we want to avoid is an unengaged member who goes into the default with a 75 per cent growth portfolio and then if they cannot hack that, it is a worse outcome if they then go to cash after a loss.” She suggested protection strategies were one approach to avoiding this problem.

Alistair Barker raised an interesting issue on members’ behaviour. He called for greater product innovation around the way members were likely to cut their consumption following a market crisis.

“People actually withdrew less as a general rule after the crisis, when the government changed the minimum you could withdraw from an allocated pension, there were many people that went to the minimum and they went to the revised new minimum,” he said. “That kind of behaviour is something you could build into a product in the future.”

Jeremy Willmot raised an interesting proposal around the three bucket approach favoured by financial advisers. Under his proposal the first bucket for retirees would be made up of cash to pay for three years’ worth of drawdowns. A second bucket would

look like a conservative growth option and would have five to six years’ worth of drawdowns. The third bucket would cover longevity risk and would “shoot for the stars” with 80-90 per cent in growth assets.

“You can achieve a lot from structuring it that way rather than individual strategies,” he said.

The last word went to Barker, for whom the “end game” was to marry up the investment strategy with how funds distribute and explain the options and products to members.

“That is actually where the funds are probably the most deficient,” he said, explaining that funds were very good at coming up with investment strategies to member problems, but less successful at engaging members with these solutions

“The problem is the take up has been problem. It is about how the funds deal with the challenge of distribution, whether that’s advice, whether that is embedded in products whether that is online, whatever it is, I don’t think the funds have moved to the end game on distribution and until that happens, the investment solution will be dancing around the edges.” ■