



White paper **Smiles, handshakes & farewells...then what?**

The changing dynamics of wealth, risk and needs in retirement



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White Paper

Introduction

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Most life-changing events involve an ongoing process of emotional adjustment. Retirement is no exception. The emotional and psychological impact of retirement has been largely unexplored until recently. More than 75 million baby boomers commencing retirement in the US alone and over 5.5 million in Australia has forced a shift in focus by those whose livelihood depends on servicing this market.

The onset of this demographic tidal wave is being felt throughout the financial services community, from the way financial advice is delivered through to the investment approaches and products used by retirees.

Some of the most pronounced effects are occurring within the financial advice industry, which, for many years, has focused on wealth accumulation strategies. It's no coincidence that these strategies have served the industry well as they effectively followed the needs of the baby boomers. However, with the transition of the baby boomers into the retirement phase, there is a natural shift from wealth generation (saving) to decumulation (spending). As this trend has gathered pace, we've observed an evolution of the advice provided to retirees in terms of portfolio construction, and the products used to support its implementation. This has been further supported through the innovation of various product providers that have focused their efforts on this increasingly important part of the market.

As discussed in our initial white paper "Boomers, Herding, Denial and Zeitgeist", the added complexity of the issues faced by clients close to and in retirement,

combined with the increasing range of possible solutions, adds to the challenges faced by advisers and their clients. It is critically important that the construction of portfolios for retirement be based on an understanding of the various objectives and needs of a retiree.

For the most part, current advice practices contain, at best, an imperfect link between a client's objectives and the asset allocation used to (hopefully) achieve them.

Derived from a risk profile questionnaire, the resulting asset allocation will generally attempt to reflect the client's attitude towards risk, with labels such as conservative, balanced or growth. While risk profiling can be useful in determining a client's propensity to take risk, or attitude to risk, it provides no feedback on whether the client actually needs to take risk given the objectives they have set – i.e. their capacity for risk.

This is akin to the risk taker that often speeds when driving in their car (risk propensity), who, faced with the prospect of a speed camera instantly becomes a more conservative driver and slows down. Simply put, when the impact of the risky behavior, in this case a speeding fine is clearly illustrated, the risk profile of the driver changes dramatically (risk capacity).

In this paper we explore how behavioral factors impact client needs in retirement, as well as the dynamics between the changing composition of wealth throughout our lives and how behavioral factors drive investment decisions once we reach retirement.

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Wealth over time

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As retirement approaches, the composition of an individual's wealth materially changes, which has a direct impact on investment decisions and attitudes to risk.

If we consider the net worth of an individual, it can be classified into four key components:

- The value of future earnings (human capital)
- Accumulated past savings and investments (financial capital). For most people this will be their superannuation lump sum or home
- The value of future investment earnings on both human capital and financial capital.
- The value of means-tested state benefits such as the Age Pension.

As the transition from accumulation to retirement takes place, it is possible to categorise a client's wealth into three life stages, namely early career, late career/early retirement and mid/late retirement. Each of these stages is distinct in terms of its wealth composition (i.e. human capital and financial capital) and as a result, is sensitive to different risks.

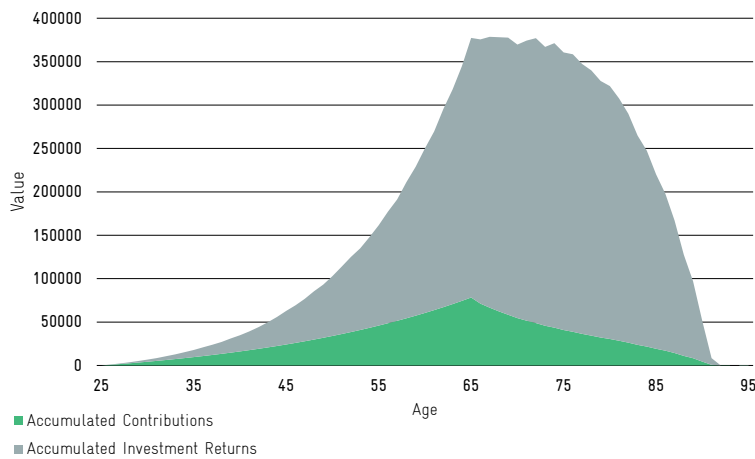
- Early career: human capital is typically the single largest asset an investor has. Where human capital (future earnings) outweighs financial capital

substantially, investors have the maximum ability to accept risk. In fact, they are more likely to benefit from a major market catastrophe given that their future contributions would be able to purchase assets at a discount relative to historical prices.

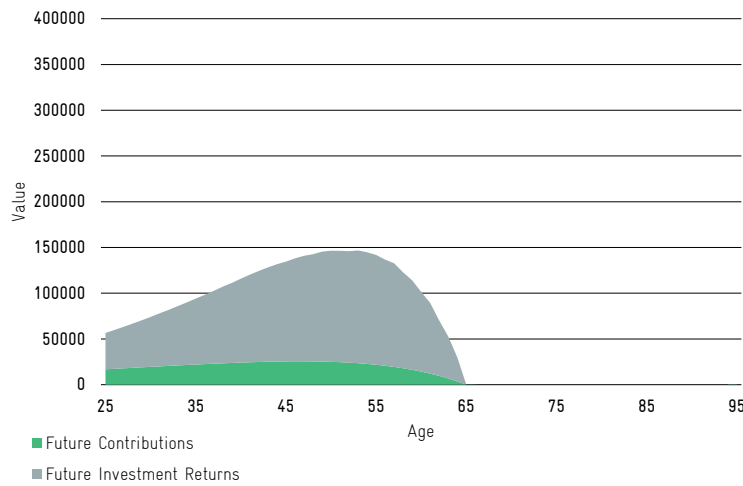
- Late career / early retirement: as human capital is transferred into financial capital, an investor's risk profile becomes increasingly asymmetric i.e. the client has a greater sensitivity to capital loss as they approach or enter retirement. This is due to the impact poor market performance can have on their retirement savings, combined with a decreased ability to supplement losses through future contributions. At the same time there is a clear trade-off between 'de-risking' a portfolio to more defensive assets and maintaining exposure to growth assets in order to potentially extend the life, or longevity of a portfolio throughout retirement. At this life stage, sequencing risk — or the impact market corrections can have on the longevity of a portfolio in retirement — magnifies significantly.
- Mid / late retirement: as sources of capital begin to be depleted, inflation and longevity risk become increasingly significant financial risks to be addressed. While certain expenses may cease or reduce, other expenses such as healthcare and aged care costs become important considerations.

In figure 1, using our proprietary analytical tools, we have illustrated the projected relative median dollar value¹ of the various components of wealth at each year from age 25 to 95 for a specific client example. The median dollar value factors in the future value of each of the components in today's terms.

Financial capital



Human capital



Value of Future Age Pension

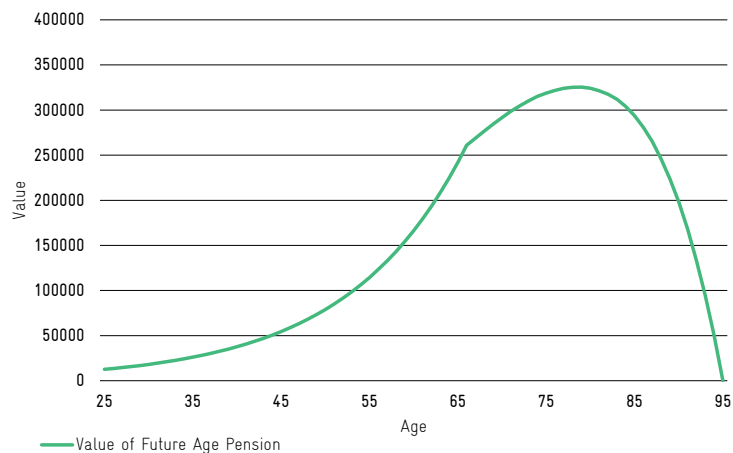
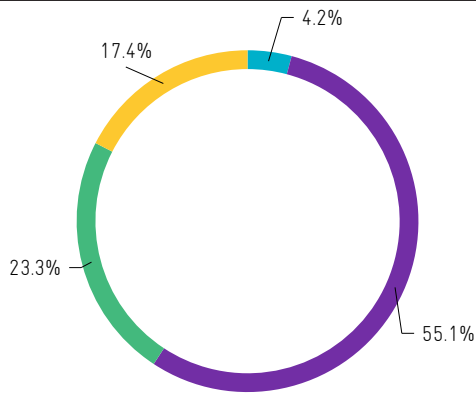


Figure 1: Projection of relative retirement wealth components over time

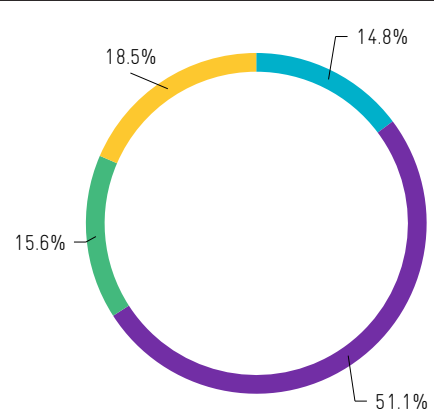
¹Based on a simulation of the aggregate financial position of that investor over 1000 stochastic scenarios. The sample individual was assumed to be, on average, consistent with the individual modelled in our previous paper "Boomers, Herding, Denial & Zeitgeist". This sample is based upon an average portfolio of \$400,000 at age 65, with a comfortable level of retirement income based on the current Associate of Superannuation Funds of Australia (ASFA) guidelines.

Human capital vs. financial capital and investment returns at 25



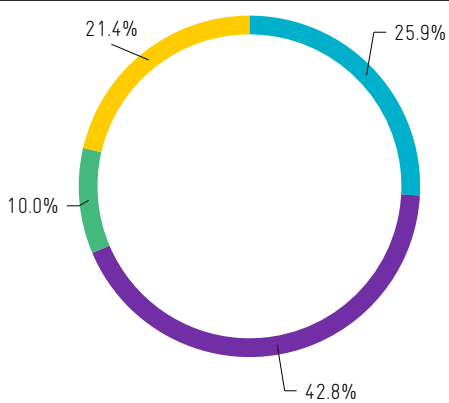
FINANCIAL CAPITAL FUTURE INVESTMENT RETURNS
HUMAN CAPITAL AGE PENSION

Human capital vs. financial capital and investment returns at 35



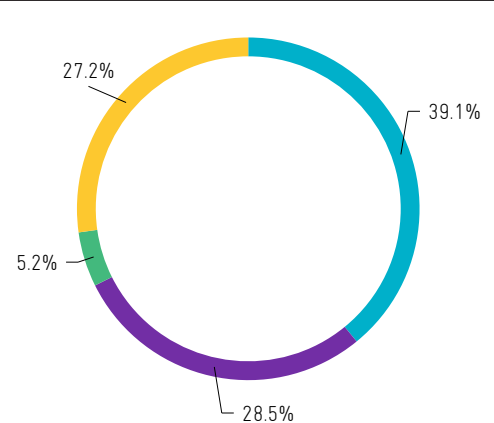
FINANCIAL CAPITAL FUTURE INVESTMENT RETURNS
HUMAN CAPITAL AGE PENSION

Human capital vs. financial capital and investment returns at 45



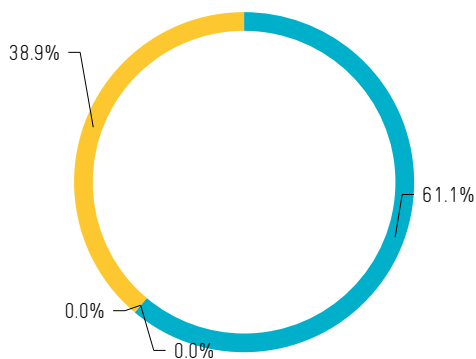
FINANCIAL CAPITAL FUTURE INVESTMENT RETURNS
HUMAN CAPITAL AGE PENSION

Human capital vs. financial capital and investment returns at 55



FINANCIAL CAPITAL FUTURE INVESTMENT RETURNS
HUMAN CAPITAL AGE PENSION

Human capital vs. financial capital and investment returns at 65



FINANCIAL CAPITAL FUTURE INVESTMENT RETURNS
HUMAN CAPITAL AGE PENSION

Figure 2: Human capital vs. financial capital.

Several key points can be drawn from the charts depicted in figure 2:

- For younger investors, the vast majority of their value is represented by future contributions and the amount of investment return earned on them. These future contributions are naturally salary-linked, and so provide a meaningful inflation-protection benefit. The value of accumulated savings and the age pension will be largely irrelevant to an investor's overall retirement net worth at this stage of life.
- As an investor ages, the relative value of financial capital increases. Managing investment risk and earning sufficient returns on this capital to protect against the risk of inflation to ensure the desired level of income in retirement becomes increasingly important.
- As an investor approaches retirement, investment risk on their accumulated financial capital dominates. This also coincides with a typical investor's increasing risk aversion. Importantly, an investors' accumulated retirement wealth is likely to be largest at this point, immediately prior to drawing any retirement income.
- Through retirement, as withdrawals deplete the accumulated retirement savings of investors, the value of the (means-tested) age pension can grow – particularly as the pool of assets gets smaller and clients become eligible for age pension payments.

The relative importance of these elements varies over time and when combined with an individuals' behavioural biases, leads to varying levels of risk capacity when entering retirement.

Replacement Ratio

The replacement ratio is a person's gross income after retirement, divided by their gross pre-retirement income. For example if a person's pre-retirement income was \$60,000 p.a. and post-retirement income (inclusive of the Age Pension) was \$40,000 p.a, the replacement ratio would be 67% (\$40,000/\$60,000). The ratio is commonly used as a guide to how much income a person will need to generate to maintain their pre-retirement lifestyle in retirement. Various studies suggest that a replacement ratio of 70% to 75% is required for a person to maintain their pre-retirement lifestyle in retirement.

Table 1 illustrates the relative proportion of financial capital to total retirement assets (i.e. financial capital + the value of the Age Pension) for the same sample investor, given different income objectives – illustrated via income replacement ratios (i.e. the ratio of post-retirement income to the individual's salary immediately prior to retirement).²

AGE	100	90	80	ASFA COMFORTABLE	70	60	50
65	57%	58%	60%	61%	63%	65%	69%
70	47%	50%	55%	56%	59%	64%	71%
75	31%	41%	50%	53%	59%	66%	74%
80	0%	24%	45%	50%	58%	70%	79%
85	0%	0%	31%	43%	59%	75%	85%
90	0%	0%	0%	21%	63%	83%	91%

Table 1: Proportion of financial assets to total retirement "assets", by replacement ratio

The red segments indicate areas where the investor is unlikely to be able to meet their income objective, and as a result, the Age Pension completely dominates their source of income. For the subject of this case study, electing to receive 100% of their pre-retirement income throughout retirement, their financial capital runs out by age 80, resulting in complete dependence on the Age Pension. This picture is reversed as income levels are reduced – the Age Pension continues to provide the bulk of the modest income requirements, and financial capital can even grow in retirement, if the income taken from it is sufficiently small.

Therefore, by including various sensitivities of the investor's goals against changing circumstances, it is

possible to gain a sense of their capacity for risk. This approach also helps to identify the relevance of particular risks at different stages of life. For example in the late career/early retirement phase of life, market returns will have a significant impact on the size of an investor's lump sum as well as the longevity of an investor's portfolio/s. Therefore, investors are faced with several key decisions such as:

- Do I de-risk my portfolio to preserve capital?
- Will this be appropriate to meet my retirement goals?
- If I take on more risk to grow my asset base am I comfortable with the additional volatility?
- Can I reduce risk via the utilisation of certain investment strategies?

² For our sample investor, the 'ASFA Comfortable' income standard represents a replacement ratio of around 75% of pre-retirement income. The table show ratios in the same median dollar scenario as used in producing Figure 1.

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The human condition

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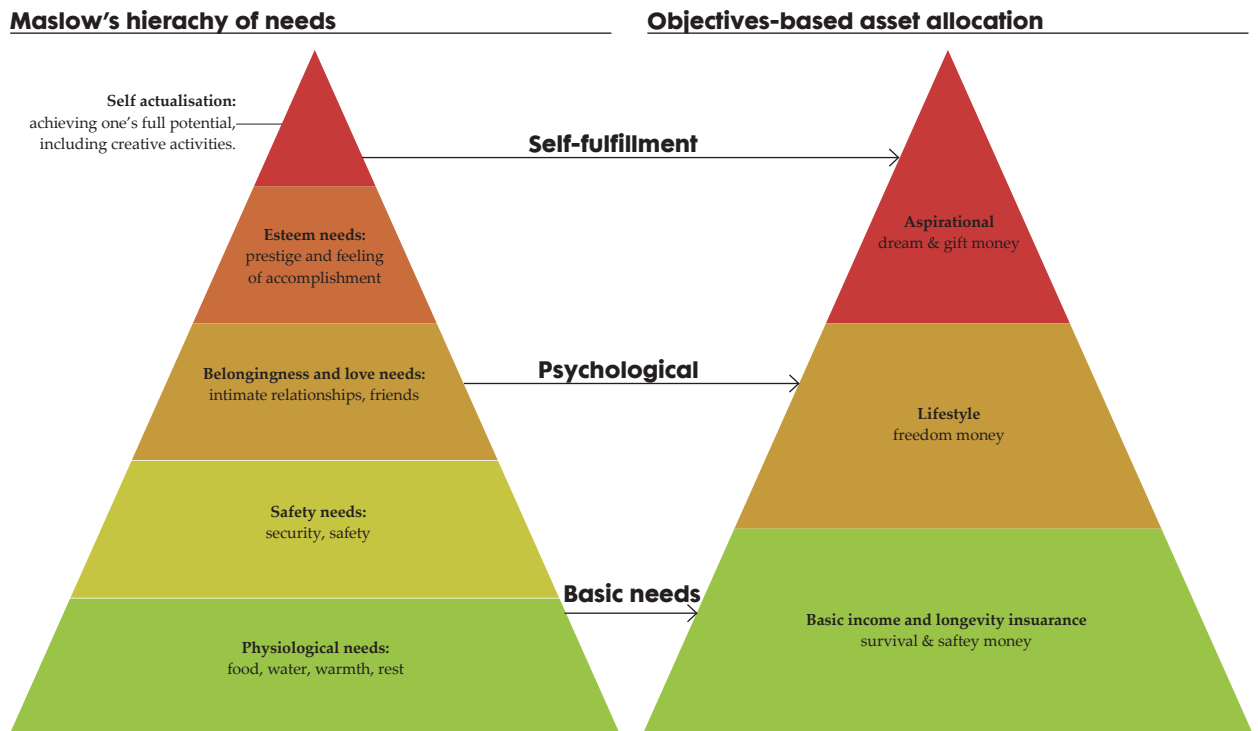


Figure 3: Maslow's hierarchy of needs vs. objectives-based asset allocation.

If we consider the hierarchy of needs as developed by Abraham Maslow³ in 1943, it's possible to view the retirement advice through the fundamental hierarchy of needs inherent in the human condition.

The Maslow pyramid puts in perspective how important it is to understand and take into account both the physiological and psychological needs of the client when constructing a retirement portfolio. Not surprisingly, Maslow's pyramid closely resembles the pyramid used to describe the objectives-based asset allocation detailed in Lonsec's and Milliman's initial paper⁴. The objectives for building a retirement portfolio are consistent with a basic analysis of the hierarchy of needs as set out by Maslow.

The initial need is to ensure the availability of income cover the physiological and safety needs. That is, how much money does a retiree require to meet their basic needs? Following on from this is to grow the retiree's portfolio further to allow them to take part in things that will bring joy and fulfillment, such as travel and entertainment. The final component is aspirational money, which includes bequests.

Breaking income needs down to such levels makes it possible to track the success of a retirement plan; it also enables retirees to mentally organise their spending.

³Maslow, A.H. (1943) A Theory of Human Motivation; Psychological Review, 50(4), 370-96

⁴Boomers Herding Denial and Zeitgeist - Lonsec, Milliman – November 2012

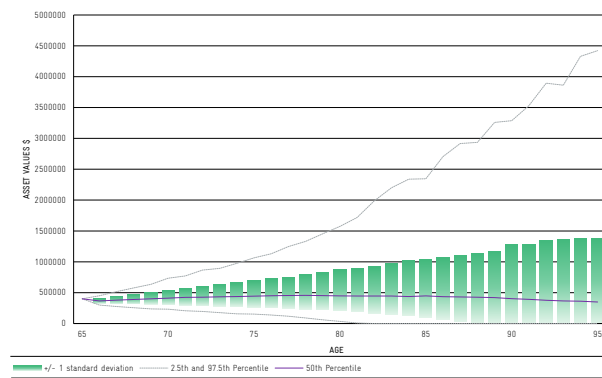
The foundation of the traditional financial planning model is in direct conflict with both Maslow’s theory and the needs of retirees, as it does not reflect that every individual’s ideal retirement is different, as is **every individual’s financial situation and income needs**.

Take the very simple fear of losing money as an example. The fear of losing money is very tightly connected to the fear of poverty, meeting a basic physiological need. The intensity of this fear can prevent retirees from thinking along rational lines with respect to their investment decisions. However, the juxtaposition is that the immediacy of the solution – i.e. don’t invest in anything risky – potentially increases the likelihood that they will realize their long-term fear of running out of money – as illustrated in figure 4.

Therefore, it is important that part of the planning process involves the ability to illustrate the potential risks (or trade-offs) involved in choosing to emphasise one objective over another (“don’t risk my money” over “don’t let my money run out before I die”).

While all concerns are logical and obvious, each individual retiree regards each risk differently. It is therefore the role of the financial adviser to manage this issue and ensure that the client understands how the recommended investment portfolio is based around their priorities.

Asset values in nominal terms — 70/30



Asset values in nominal terms — 100% cash

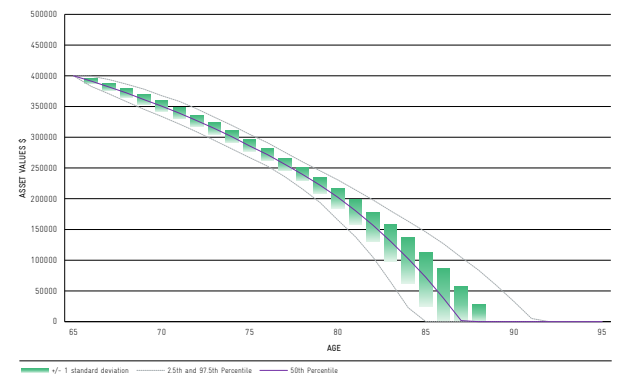


Figure 4: Asset values in nominal terms.

White Paper Key Takeouts

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- A retirement period of 25 years is feasible and highly probable for today's generation of baby boomers. Indeed, at least one member of a couple aged 65 will likely reach age 90.
- Financial advisers have the opportunity to position their business around the offering of strategic advice to retirees based on understanding the trade-offs and opportunities available when constructing a retirement portfolio. This can be done without 'reinventing the wheel', albeit the challenge is understanding how to bring all the pieces of the puzzle together.
- A traditional asset allocation approach involves establishing return requirements, a risk tolerance and an investment time frame. Understanding both the physiological and psychological thought processes of retirees is crucial to help determine objectives and their order of importance. Ensuring that retirees understand that there is a trade-off between every decision they make and every objective they prioritise is critical.
- Traditional approaches try to produce a quantitative output based on highly qualitative data.
- Risk capacity assessment is a key to successful retirement. This is the most important component of portfolio risk and one that should be fully explored and understood during the financial planning process.
- Transitioning to retirement is a change and with change people experience different emotions, such as fear and excitement. Without meeting the basic needs of Maslow's hierarchy, panic and desperation may set in and can lead to unsound financial decisions. Investors who fail to have an adequate income stream are likely to participate in bigger risks to "catch up" their retirement goals, exposing themselves to more volatility.
- The market environment in which one retires can significantly impair the retiree's view of how their portfolio should be invested. Ignoring these biases can lead to poor and potentially irreversible decisions being made.

White paper Conclusion

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As individuals retire, the decision making process relating to investments becomes significantly more complex as the composition of an individual's wealth and the exposure to certain risks evolves. In addition to these factors the transition to retirement brings with it emotional considerations, such as the fear of running out of money, or the possibility of having to adjust lifestyle expectations. These emotional reactions have an impact on investment decision making. We believe that recognizing these changes is important when discussing retirement investment strategies with clients. For most individuals there will be a need to prioritise objectives and potentially adjust expectations in retirement. The market and regulatory environment has materially changed compared to 10 years ago, with generally lower return expectations for most asset classes and increased regulation in the advice world. These changes have accentuated the need to improve the alignment of investor objectives with their portfolio strategy. We believe that the days of simply relying on a risk profile questionnaire to drive investment strategy are limited and that although this approach will not necessarily be superseded, it can be enhanced to produce better outcomes for clients.

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