



# The retirement bucket list

Why effective solutions demand a rethink

**Creating investment solutions for clients nearing or in retirement is exercising the best and brightest minds in the business as new ways are sought to manage risks and reliably meet appropriate return targets. Simon Hoyle reports.**

In some quarters, nothing short of a top-to-bottom rethink of the financial planning process is considered necessary as increasing numbers of clients retire and find the traditional approach to financial planning and portfolio construction to be wanting.

That the traditional approach doesn't work isn't the fault of anyone in particular, "because the way things are done at the moment, we [all] treat people in accumulation phase the same as in drawdown phase - it just doesn't make sense", says Dan Miles, managing director and co-chief investment officer of Innova.

Every client is different, Miles says, and has a different starting point, a different path to the goals they want to achieve, and different goals. Effective planning and investment solutions need to take all of this into account.

"What stage they are in life and how much money they've got saved can make a huge difference to how their portfolio should be constructed," Miles says.

“If you follow the typical process and the way things are done at the moment, somebody may come out [of a risk profiling tool] as a three out of five, have a 20-year investment time horizon and be in a balanced or a growth-style of portfolio; but that person could be 40 or be 65. The 40-year-old might have a 20-year time horizon, and the 65-year-old might have a 20-year time horizon. They might have the same ‘risk tolerance’, but there’s no possible way their portfolios should look the same – that’s ridiculous.”

The factors that financial planners need to consider for their clients should encompass “the risks that they’ll be exposed to in their life between now and [when they reach] the goals they want to achieve throughout their life”, Miles says.

These are goals such as what school they want to send their kids to, and what age they want to work to because they want to, not because they have to. And the risks include factors that would affect their future earning capacity.

“You should always be focused on risk, but risk changes throughout a client’s life,” Miles says.

“Or maybe the risks don’t necessarily change, but your capacity to deal with them, your tolerance to them and your need to take them will change.”

In the emerging retirement planning paradigm there are at least three dimensions to risk.

One is risk tolerance: the psychological ability to deal with loss. Does the idea of losing 10, 15 or 20 per cent of capital cause stress?

Second is risk capacity: the financial ability to withstand risk. Does losing 20 per cent of capital affect a 25-year-old as much as it affects a 65-year-old who is on the cusp of retirement?

And third, there’s “risk requirement”: the investment risk required to generate a desired level of return.

“Let’s say you’ve got two clients,” Miles says.

“They’re both 65; they’re both in retirement; they both have no intention of working. They both want to live off about \$1000 a week to survive. One of them has got \$5 million and the other one has \$500,000. They may have the exact same goals, the exact same health. They may have the same everything – the only thing I’m changing is the amount of money they’ve got, not their actual goals and outputs.

“If you can understand the risks they’re exposed to, the amount of money they have got gives them either a lot more freedom, or there could be a lot more constraints in terms of how you go about building their portfolio.

“Because no matter what happens with a client – whether they take your advice or not – there need to be trade-offs. There’s always going to be consequences to the actions they take; it’s the adviser’s job to communicate that to them. So the person with \$5 million who only wants to live off \$1000 a week might be able to take out an index-linked annuity stream type of thing...with a relatively secure capital base. The person with \$500,000 is going to need to draw down, or take on some sort of capital risk. But how much capital risk can they tolerate, and how much capacity do they have?”

An unavoidable consequence of this approach is that potentially every client requires a different portfolio – in terms of risk and asset allocation – from every other client.

“You need to have a software package that can handle individual clients’ rules, preferences and constraints,” Miles says.

“If you do not have something that allows that at a portfolio modelling level, forget about it, because otherwise you have to do it manually. And if you have to do it manually there’s no scalability and it can’t be done.

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“But it’s 2014, it’s not 1980 – we’ve got pretty fast computers these days.”

Wade Matterson, principal, senior consultant and the leader of the Australian Financial Risk Management practice for Milliman, says the thinking on how to plan and construct portfolios for retirement is evolving rapidly.

“The traditional approach is driven by the advisory process – so, how does the advice process work?” he says. “People have

that conversation around what are your goals and objectives and dreams and everything else, and then the adviser proceeds through this checklist to create a risk profile.”

The problem that often emerges, Matterson says, is “that [a] high-growth risk profile may bear no resemblance to the risk they actually need to achieve their goals and objectives”.

“But from a compliance perspective, you can’t break that,” he says.

“This is where it gets really interesting, about how you implement it. My thesis now, having worked through a variety of products and worked through the advisory process numerous times, is that you’re not going to break that, you’re not going to break that whole risk-profiling mechanism.

“The question is: how do you get that world to blend more into this objectives-focused world, and get these

two things to come together, so you can have a process that meets your compliance hurdles, but moves people down the right path and their long-term goals and aspirations?”

Matterson says that along with risk profiling, another favoured technique is cash-flow “bucketing”, which involves creating buckets – really, discrete portfolios – to fund different cash-flow requirements, typically categorised into short-term, medium-term and long-term.

“The whole inertia thing means people are not going to move massively to another step. You can’t walk in and say everything you’re doing is wrong, you’ve got to overhaul the whole thing. You’ve got to start working with the existing processes and say, how do I nudge you along? Acknowledge that there is this inertia and then nudge people to make better decisions.

“One way we’ve started thinking about it is to use the bucket analogy and say the bucket analogy is a really good one.

“It’s good to have your cash-flow buckets, but where are my buckets lacking? There’s three obvious areas: the ability to manage...sequencing risk; the ability to manage longevity risk; and over time, the ability to manage things like long-term care.

“You can then start to enhance the bucket structure they’re already inherently familiar with.

“And then take risk profiling. In our opinion the risk profile is disconnected from the goals and objectives, so how do you bridge that gap again? I think rather than saying throw it out, you maintain the risk profiling approach, but then you introduce the concept of stress testing.

“You’re saying, I’ve risk profiled you; it says you’re a balanced investor. If I put you into a balanced investment, what does that mean in terms of your ability to meet your income needs or your lump sum needs, or your liquidity needs over time? You also need to say what stresses can occur within that risk profile that means you won’t meet your objectives.”

Even as the advice process evolves, there continues to be product innovation taking place as fund managers and institutions also grapple with issues presented by the move to objectives-

based solutions.

Joe Fernandes, executive director and global head of Colonial First State Global Asset Management’s (CFSGAM’s) Investment Solutions Group, says developing a solution starts with assessing likely liabilities in retirement.

“Each of us has a liability profile, a future liability profile, which is our spending requirements in retirement,” Fernandes says.

“We can define what that looks like; that’s really the start of the process. Once we agree there’s a future liability profile that we invest towards, that leads to a discussion about what is the combination of exposures that are going to achieve that objective.



“A primary risk is the risk of a shortfall relative to your objectives.”

CFSGAM’s solution is the Multi Asset Real Return Fund, “a fund [that] is managed for the maximum likelihood of achievement of that objective”.

“A traditional balanced fund will invest in a number of underlying sectors; those sectors are generally managed to a mainstream benchmark. So, for example, Australian shares are managed to exceed the S&P/ASX 200 Index,” he says.

“When you’re building an objectives-oriented portfolio, you have to ask yourself whether that mainstream exposure to Australian equities is [the] best exposure that aligns to achieving that investment objective.”

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Fernandes says the “building blocks” of the multi-asset portfolio are selected for their alignment with the fund’s top-level return objective “and what contribution they will make to the top-level objective”.

“So this product invests broadly across a range of asset classes, including commodities, and including a range of protection and enhancement strategies,” Fernandes says.

He says that the fund’s “underlying neutral asset allocation changes over time” as the risk and return characteristics of the asset classes change over time.

“And then on top of that the team employs a dynamic asset allocation process,” he says.

“In an objective-oriented world, it’s the path of investment returns that’s important. It’s not set-and-forget strategic asset allocation; and it’s not strategic asset allocation with dynamic tilts on top.

“Everything has to be operated in an integrated fashion, and happen and be monitored on a real-time basis.”

As at June 30, 2014, the fund’s greatest exposure was to Australian bonds (35 per cent), followed by global equities (20 per cent), Australian equities (15 per cent), cash (10 per cent), global bonds (7 per cent), precious metals (5 per cent), industrial metals, energy and agriculture (2 per cent each), and volatility strategies (2 per cent).

Fernandes says the fund’s return objective is Consumer Price Index (CPI) plus 4.5 percentage points. The fund was seeded with CFSGAM’s own money about 18 months ago; it is now open to the investing public.

“When we designed the product, we took advice from a number of different channels,” he says.

“There’s a demand aspect for CPI+4.5, as well as our conviction to be able to deliver that. It’s also a target which we feel is relevant for a number of different investors, both pre- and post-retirement.” **P**

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