

Guaranteed Products in Australia: A market ready for launch or dead on arrival?

Introduction

As of December 2014, the value of assets in Australia's superannuation system totalled \$1.87 trillion¹. With a population of just over 23 million, this incredible feat – a virtue of introducing compulsory superannuation in 1992, is the envy of many, resulting in accolades and compliments on the advanced state of Australia's retirement savings industry.

However, the Global Financial Crisis ("GFC") served to remind us that the global shift towards defined contribution systems has resulted in lumbering members with market, inflation and longevity risk.

A side effect of Australia's long-term love affair with superannuation (combined with a 20 year bull market prior to the GFC) has resulted in a system dominated by account based products with limited tools for members to manage these risks, exposing them to random events which have the potential to disrupt even the best laid retirement plans.

Further, as with much of the western world, Australia is afflicted with the challenges of an aging population (the productivity commission estimates that the proportion of the population over 75 will rise from 6.4% to 14.4% from 2012 to 2060²).

Consequently, over recent years there has been an increasing focus on the needs of Australians approaching and entering retirement. With the Cooper review and Financial Services Inquiry both committing substantial resources to the needs of superannuation members in retirement, these challenges are increasingly being viewed as a vital element of public policy that will need to be dealt with in order to ensure the long-term sustainability of the system.

From a commercial perspective, these factors have created what many might view as a perfect storm for the development of guaranteed products designed to provide members with confidence when it comes to their expectations regarding preservation of capital or income. However, despite a limited number of products emerging over the last decade, they have yet to go beyond niche market status.

The remainder of this article will explore this phenomenon and whether this is simply a matter of poor timing or representative of something more systemic.

Experience to Date

There have been numerous attempts to develop products to provide superannuants with the ability to guarantee capital or income, with mixed success. Variable annuities, lifetime & deferred annuities, capital protected and structured products have all been developed with the same goal in mind – to provide certainty in a system that has, since its inception, offered no promises regarding retirement outcomes.

¹ Source: ASFA <http://www.superannuation.asn.au/resources/superannuation-statistics/>

² Source: <http://www.pc.gov.au/research/completed/ageing-australia#key-points>

As this table, which summarises some of the recent guaranteed solutions in Australia demonstrates, these products have been developed and offered by large, reputable organisations with a history of making and meeting long-term promises.

Organisation	Product	Active?
AMP	North	Yes
BT Financial Group	Wrap Capital Protection	Yes
Challenger	Liquid Lifetime	Yes
MetLife	RetireSafe	No
MLC	Investment Protection	Yes
OnePath	Money 4 Life	No

However, despite this, many of these products have so far failed to make substantial inroads against the traditional account based (and riskier) alternatives. This begs the question, "What is missing when it comes to the market for guaranteed products?"

Lessons

Sceptics and those invested in maintaining the status quo can often be heard rejoicing when new innovations experience a false start, however, to paraphrase one of my sporting idols (see below) – it is these past failures that ultimately give birth to success.

I've missed more than 9000 shots in my career. I've lost almost 300 games. 26 times, I've been trusted to take the game winning shot and missed. I've failed over and over and over again in my life. And that is why I succeed.

Michael Jordan

My own experience in Australia and abroad in the search, development and success or failure of solutions to these fundamental retirement issues has led me to characterise the following key principles;

- ▲ Psychology matters
- ▲ Advice trumps product
- ▲ Keep it simple
- ▲ Get help

Psychology Matters

As technicians and experts in the field of superannuation, it is possible to ignore the basic psychology that influences and drives member and advisor behaviour. Loss aversion, short-termism, inertia and other behavioural biases all serve as major factors when investors make their, often irrational, decisions. In fact, entire texts have been devoted to the topic³ and are worth reading for those interested.

³ See Ricciardi et al Investor Behaviour: The Psychology of Financial Planning and Investing <http://au.wiley.com/WileyCDA/WileyTitle/productCd-1118492986.html>

For example, hyperbolic discounting, which represents the limited value that people place on outcomes that occur many years into the future can largely explain global industry experience when it comes to the sale of lifetime and deferred annuities.

Recognising these issues when designing and communicating guaranteed products – as well as developing strategies to manage or avoid them - will have a significant impact on the potential success or otherwise of a product.

Advice Trumps Product

Historically, the success of a product could simply be determined by the level of commission it paid to the adviser responsible for the sale. Over time, as regulators in various markets have focussed on shifting the advice industry to fee for service models, this simple tactic has lost its effectiveness.

Rather, successful organisations have begun their product development activities by focusing on the underlying advice process and then developing an understanding of how to design and position their solution to leverage the inherent inertia present within financial advice models.

For example, the risk profiling process adopted by the majority of advisors (and often required for compliance purposes) ensures that clients are allocated into conservative, balanced, growth buckets. The majority are then provided with an asset allocation or model portfolio that is aligned to this risk profile. This simple activity negates the ability of advisors to ascertain the value of a guarantee, which often sits outside this simple framework.

Recently, the Australian market (along with others) has begun to see a shift towards what has been loosely termed “objectives based advice” which has the potential to incorporate greater sophistication beyond relatively simplistic risk profiling to include elements of stress and scenario testing. This has the potential to open the door to the inclusion of a broader range of risk management and guaranteed solutions.

Keep It Simple

It is worth pointing out that manufacturing guarantees and other risk management solutions is often a complex and multi-faceted task. However, like a duck gliding across the surface of a pond, the furious activity should be hidden from the view of the customer.

Simple messages and communications will often yield benefits when it comes to the sales and marketing effort – often in spite of the what is going on behind the scenes.

Get Help

Finally, given the variety of issues facing the development, management, distribution and ultimate success of these types of solutions it is essential that organisations ensure that they have access or insight from those with significant experience.

In my experience, this has ranged from the use of marketing, branding and behavioural economics experts through to the use of outsourced hedging and risk management providers.

Given the complex web of advice, psychology and operational complexity many of these products attempt to navigate, utilising external expertise can often result in better and more cost effective solutions for clients.

Opportunities for the Future

As highlighted earlier in this piece, the sustainability of a retirement system that exposes participants to a variety of complicated and material risks is questionable. As the Financial Services Inquiry has recently flagged, superannuation funds will be required to develop a comprehensive retirement income strategy. The resultant opportunities for products that manage market, inflation and longevity risks will only grow as more Baby Boomers approach and enter retirement.

Indeed, we've begun to see competition heat up as the market for these solutions has expanded beyond products offering guaranteed outcomes to more flexible and dynamic risk aware solutions (see table 2).

Funds that seek to manage volatility and limit drawdowns, risk management overlays and pooled longevity solutions are amongst the recent swathe of solutions introduced to solve these issues – often utilising the same techniques guarantee providers have successfully used to manage their balance sheet risks.

Organisation	Product	Active?
Asteron	Asteron Longevity Insurance Solution	No
Betashares	Dividend Harvester ETF	Yes
Fortnum Financial Advisers	P2 Protection Solution	Yes
Maritime Super	Managed Volatility Process	Yes
Mercer	LifeTime Plus (Pooled Longevity Solution)	Yes
Plato	Australian Income Fund (Managed Risk)	Yes
Schroders	Real Return Fund	Yes
Standard Life	Global Absolute Return Strategy Fund (GARS)	Yes

By staying clear of providing an absolute guarantee, these products are arguably capable of retaining more flexibility and operating at a lower cost relative to their more capital intensive counterparts.

In fact, in some markets these two approaches have been combined, whereby company balance sheets are wrapped around risk management solutions to offer an incremental approach that is integrated with existing advice processes. This approach has also provided clients and advisers with a broad tool-kit to address emerging retirement risks.

Whilst the early Australian experience with respect to many of these products may have been underwhelming, the future is destined to benefit from this experience and will be the better for it going forwards.

Wade Matterson