

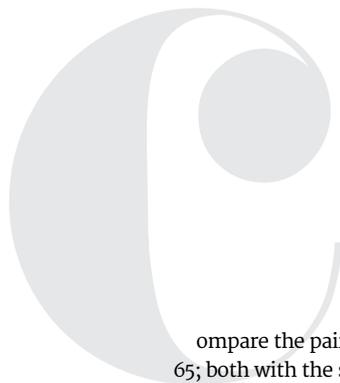


RETIREMENT PLANNING *KICKS THE BUCKET*

How new thinking is
reshaping strategies and
portfolio construction



New and emerging ways of assessing risk are leading to a range of fresh approaches to planning retirement strategies – and some of the old thinking is being thrown out the window.



Compare the pair. Two people, both aged 65; both with the same life expectancy; both with the aim of earning income of \$58,000 a year in retirement. Both are assessed, using a standard risk-profiling tool, as having a “moderate” risk tolerance, and their asset allocation is set accordingly. So far, they sound much the same.

But if one has a superannuation balance of \$500,000 and the other has a balance of \$5 million, then right away it is obvious that the strategies for generating the desired income for each client can be as different as night and day. Irrespective of their assessed tolerance for risk, one strategy can be relatively low-risk, while the other will need to be significantly higher-risk. Or in other words, one person is exposed to more risk than they necessarily need to take; the other may not be exposed to enough.

But too often, how well someone lives in retirement comes down to plain luck – the simple matter of the date on which they retire. Retire after a period when markets have been kind, and you’re set. Retire on the cusp of, say, the global financial crisis (GFC) and it can be a completely different story.

Simon Hoyle reports.

Reducing, if not eliminating, this “luck of the draw” aspect of retirement is a growing preoccupation for financial planners, consultants and product manufacturers alike.

Many of the traditional tools used by financial planners to set retirement income strategies just aren’t up to the job any more. And as strategies evolve, they demand new, innovative and flexible product solutions.

Technology continues to evolve to allow far more complex strategies to be developed and implemented. The optimal path from employment to retirement is different for everyone; financial planners need to be able to cater to that range of scenarios – shoehorning clients in to a limited range of strategies or portfolios just doesn’t cut it any more, if it ever did.

And it means that now, more than ever, planning for retirement can’t start at five minutes to midnight; and it has to be an ongoing process throughout an individual’s retirement.

“But this is something that until people get quite close to retirement, they never actually sit down and do; and in fact for many couples it’s a very challenging discussion with a financial planner about what do you want the next 20 or 30 years of your life to look like and what are your goals?” says consultant Paul Maddock, who has previously worked with MLC, BT and SFG.

And that's the job of the planner, to go through that whole exercise of getting the aspirations on the table; what's needed for that; can you afford it; and then okay, let's look at probabilities

Kicking the bucket

When risk is defined and measured in new ways, some of the traditional approaches – even some of the newer ones – can be called into question. One such strategy is the so-called “bucket strategy”, which involves an individual setting up a series of “buckets” – really, individual portfolios – with a specific objective for each: for example, one to meet day-to-day cash-flow needs; one to create a lump sum to pass on to the grandchildren; and so on.

Milliman has analysed this strategy and its objectives for generating returns and managing risks.

“And the outcome of that is if you assume that there is a lot of long-term mean-reversion in equity markets, then yes, it's a naturally very good strategy,” says Milliman senior consultant Craig McCulloch.

The problem is that even looking back over 100 years of data, the evidence for mean reversion is sketchy.

“Which doesn't mean [buckets] are a bad thing; they can have very good impacts when it comes to doing things like managing behaviour and making sure that people focus on their cash bucket for income, that kind of thing,” McCulloch says.

“But...the question I have for those kinds of strategies is, are they actually a tool for doing what they're intended to do or are they a nice cookie-cutter [solution]?”

“The issue there is how many independent long-term periods do you have within that 100 years of data?”

“How many independent 25-year return periods do you actually have in that 100 years? So is there actually any statistical validity in extrapolating what's happened for 100 years over ultra-long periods of time going forward?”

Financial planner John Cameron, principal of Black Swan Event Financial Planning, says he'd argue that “over the long term it probably will work, but over short and medium terms maybe not”, but McCulloch adds that “the ‘probably will’ is based on four observations”: four consecutive, independent 25-year periods that make up the 100 years.

“So that's why it's always a little bit dangerous just to focus too heavily on what seems like a long history,” he says.

“As a behavioural strategy, I have no problem with that. As a risk management strategy, I think there are much better ways that we can actually look at managing risk – genuinely managing risk for individuals.”

“That's what it gets down to, and being very clear about what the spend, not the income...is going to be needed to actually do that.

“And the next step is an expectation-management exercise, because it's a question of well, all right, do you want to spend, let's say...the ASFA [Association of Superannuation Funds of Australia] ‘comfortable’ [retirement]-index quoted amount, which is around \$58,000. If you want that, what sort of capital sum do you need to support it?”

“Then it's a real question of stochastic modelling, in terms of what level of confidence you can have for that spend of \$58,000 – what sort of capital sum you're going to need, assuming an average asset allocation.

“That gets down to your risk profile. ‘I want an absolute 100 per cent guarantee’ – well okay, but that's going to cost a lot more than an 80 per cent statistically probable expectation.

“And that's the job of the planner, to go through that whole exercise of getting the aspirations on the table; what's needed for that; can you afford it; and then okay, let's look at probabilities.”

How those probabilities play out ultimately is determined to a large extent by how risk is defined and measured. Craig McCulloch, a senior consultant with Milliman, says irrespective of the age of the client, they have “a whole host of risks that are barriers to them achieving what they want to achieve”.

“Ideally we'd be measuring each of those risks at any particular point in time and the conversation with any particular client would be around, well, how could you perceive your situation relevant to these risks?” McCulloch says.

“Are these risks actually important to you right now to achieving your objectives, to achieving what you actually want to do? And do you want to do something about those risks at any particular point in time?”

“The point about the whole of this technical analysis is that it's really just drawn out the point that there are risks there, and ultimately you don't really know what's going to happen. You just know that you're going to be exposed to risks if you take one path before another.





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Rethinking profiling

Lukasz de Pourbaix, general manager of investment consulting for Lonsec, says there's a very clear shift in how financial planners approach retirement strategies, and they're moving away from traditional risk profiling.

"A lot of clients that we're working with are thinking about what types of strategies do I have in my portfolio that can manage those risks that are relevant to all clients, but certainly to retirees, such as market risk, inflation risk et cetera," he says.

"And in most cases they still have a risk profiler, but the risk profiler is not a straight line to the asset allocation outcome. It's part of the process...and I think that's a real trend."

Craig McCulloch, a senior consultant with Milliman, says financial planners should consider "getting rid of or at least vastly reducing the importance of risk profiling [because] it is very important for accumulators but perhaps should be second grade to objectives-based [planning] for retirees".

Dan Miles, a director and co-chief investment officer of Innova Asset Management, says that's because the terminology or the process of risk profiling doesn't necessarily mesh with how clients actually think.

"Can you handle a negative return once every 10 years of up to 30 per cent?" Miles says.

"No one knows what that means until it all happens. So, can we actually show them [a different way] so that they can use emotive responses to understand what the consequences of their actions are?"

"And if they get their head around that, then maybe we're halfway to understanding what the actual goal is. Because irrespective of where they should get advice from, they've invested money, they're going to be exposed to risks and liabilities."

De Pourbaix says a shortcoming of poor risk profiling is that if used lazily – or as a compliance tool more than as a tool for setting strategy – it can produce one-size-fits-all portfolio responses.

"Let's say hypothetically you did a risk profile and you came out as 'high growth', but then you say, 'my objective is', let's say, 'x amount of income'," he says. "The reality is that maybe you don't need to take the high-growth amount of risk to achieve that outcome. So you can still have a risk profile, that's fine; but it shouldn't be the primary driver of [strategy]."

And in most cases they still have a risk profiler, but the risk profiler is not a straight line to the asset allocation outcome. It's part of the process...and I think that's a real trend

"And you come up with some kind of asset allocation that is structured to the objective you are trying to achieve. Now, there's different takes on it, you can be dynamic, whatever approach you take. But then the risk profile is there as a [check] to say, 'Well okay, here's your objectives, here's a strategy that will seek to achieve those objectives, now here's your risk tolerance."

"There may be a mismatch between the two. The world isn't perfect, so there has to be a trade-off. Either you say, 'Okay, I'll take on more risk', or whatever it is to achieve that objective, or I re-prioritise; and I don't think it's more complicated than that."

However, de Pourbaix says that "at the end of the day, irrespective of what approach or whatever you call it, call it objectives-based, fundamentally at the end of it you are still coming up with some kind of asset allocation".

"Risk profiling is here to stay. We can all say it's flawed et cetera, but as a mass industry at the moment, where we are today, it is still there.

"Where we are seeing evolution is whereby the risk profile is there but the investment structure and the strategy and the policy is structured to an objective first and foremost.

"And some of [those risks] are capital market risks; some of them are draw-down risks; some of them are inflation risks – you know, are you fortunate enough to be retiring in an era where inflation is low and you don't necessarily have to worry about it? Well, you don't actually know. So how do you manage each of those different risks? And I think that's the conversation that needs to be had much, much more."

Ian Knox, managing director of Paragem, says an objectives-based approach to retirement planning is becoming more feasible as the nature of advice changes.

"I really do believe that we're going through an era where advice is finally being defined the right way," Knox says.

"If you look at the last 25 years to where we are today, certainly 15 to 20 years ago, a lot of it was putting investments into managed funds.

"We understand that. The truth of the matter is, you weren't financially rewarded putting people into cash. You were rewarded for putting people into growth assets, and that is a fact.

"And if you roll the clock forward to today and say 'One of the things I'm going to do is manage the security of your outcome for retirement', it could be that you're saying to the person, 'I want you to put 70 per cent into cash', and you charge a professional fee for that. That's a very big difference to some years ago, where you wouldn't have sought to charge a fee for giving that type of advice.

"And I think that's beginning to come through. People will be more comfortable, increasingly, with putting the value of advice to the fee versus the fee connected to the asset allocation and the reward that goes with that."

Knox says "more and more advisers are accepting that their remuneration is connected with the strategy and the management of that strategy on an ongoing basis, and less [connected with] the expectation of managing money through picking and selling fund managers".

General manager of investment consulting for Lonsec, Lukasz de Pourbaix, says there is also a growing realisation that because of the sheer range of risks retirees face, fund managers in isolation are not necessarily ideally placed to define and create effective retirement income solutions.

"What we've certainly observed, from

a research perspective, is that you get the product provider who says, 'OK, this is great – we're going to try to manage all these risks all under the one roof and here's the solution'," he says.

"It's just another one-stop shop that is not related to an individual's objectives. Those products in our observation have actually tended to not gain a lot of traction because they're trying to do too much, and they're inflexible and so forth.

"Whereas what we're finding is that advisers that are doing more of an objectives-based approach, they will use a range of different strategies that have a very specific role within the portfolio, whether it's income or whether it's risk management, whatever it may be.

"We think advice...is in a prime position to take advantage of this, because unlike a product provider, unlike, say, the industry fund, they do have that client relationship and there is real opportunity."

But the tools that financial planners are developing to meet clients' requirements need to be relevant to, and understood by, those very clients, says Dan Miles, a director and co-chief investment officer of Innova Asset Management.

"What is risk to a client?" he says.

"We talk about volatility; we talk about maximising Sharpe ratios and tracking error. Clients don't give a rat's arse. CPI-plus – do they really care? Make sure you don't lose my dough. Make sure I've got money at the end of it."

Todd Kennedy, a senior portfolio manager with Plato Investment Management, says an adviser's kit has to contain the right tools. For example, a tool based on an arithmetic mean of volatility or returns may not produce the expected result.

"Do these tools incorporate sequencing risk?" he says.

"My assumption would be [they use] static numbers for a return expectation and volatility. The real world isn't static. We experience geometric returns – and everything I've seen is arithmetic. So there is a fundamental mismatch between inputs and experience."

Financial planners are the link between new, emerging smart tools and the end client, says McCulloch.

"The advice is just absolutely crucial in all of this," he says. "The adviser is the bridge between kind of complex technical

analysis, and the end client."

Maddock says the key to good advice lies in "explaining risk to clients in a way that they can understand [while] not compromising on the information".

"For example, in this stochastic modelling of outcomes, the thousand scenarios that underpin that are a lot for a client to understand, and the challenge for the adviser is to say, 'I've done this work and this gives me this level of confidence your portfolio will do that'," he says.

"But it's hard to explain that or what's behind that without compromising the detail."

Miles suggests that advisers start to explain things differently, "like, instead of how much can you lose, are you happy with the fact that you might run out of money when you're 77?".

"Or this is the range of [possible ages]," he says.

"You could be worth this much or this much – I don't know, but somewhere in between. Not happy with that level? Okay, cool. So what do we do to narrow that range?"



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Financial planner John Cameron, principal of Black Swan Event Financial Planning, says too much modelling of retirement income is “done with a long-term asset accumulator in mind, not with a retiree who’s drawing down”.

“Stuff changes every six months and I think a lot of those asset weightings...for the different risk profiles, are really done on the basis of wanting an asset accumulated,” he says.

“And they should be pretty much irrelevant to somebody who’s drawing down. The maths becomes completely different when you start drawing down, not putting in.

“The other thing too, I think, in the industry there is a language we use, when we use the language of ‘long-term average returns’ and so on. That’s not what [clients] see; and I think the other thing that leads into [this] is the need for ongoing advice in retirement. You know, it’s just as important as the initial advice.”

A black swan event?

A paper published recently by Cameron, called *Funding retirement income*, based on financial modelling undertaken by Michael Furey’s Delta Research & Advisory, illustrates starkly the challenges facing financial planners and their clients.

It shows how the value of a portfolio after 25 years of accumulation varies, understandably, according to the asset allocation, but also that the relative portfolio value is massively dependent on the particular 25-year period in question.

It’s a stark reminder of the risks an individual must negotiate along the way to retirement.

“What most people are talking about is accumulation, when they’re talking longer run; and then the assumption is that equities is a growth asset class and you get the average experience,” says Todd Kennedy, a senior portfolio manager with Plato Investment Management.

“You’ve showed effectively...that sequencing risk increases as time goes on, as you get closer to retirement. If the account balance is low, draw-downs don’t matter a lot, but once your account balance is high and you approach retirement, it becomes critical.

“What that tells me is equities is a high growth asset class [with] high volatility: sequencing risk [is] very high. So if you want the growth and you want the equities, the volatility is so high that if you’re lucky, and you’ve retired around this period – 2002 to 2003, or 2007 to 2008, where you’ve experienced fantastic equity runs – you’ve done really well. But if you’re unlucky, you’ve destroyed your capital very quickly.

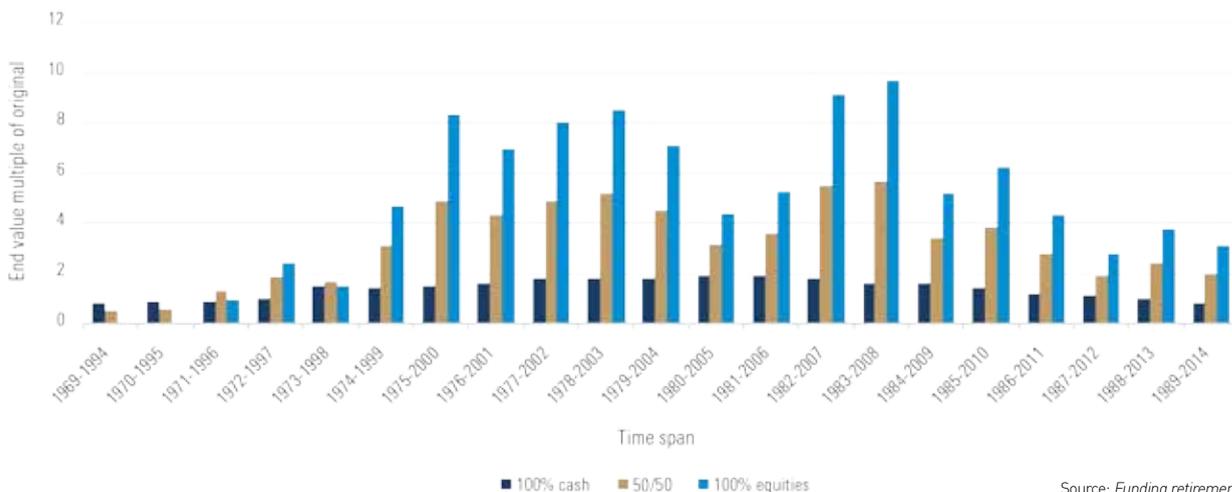
“One of the solutions to this conundrum is you need to pay more attention to sequencing risk, and to volatility of returns, as opposed to just assuming you’re going to get the average experience – because as life expectancy increases, the sequencing risk becomes more and more important.”

Dan Miles, a director and co-chief investment officer of Innova Asset Management, says it’s not the financial planner’s job to pick the likely returns, or the likely sequence of returns. Rather, it is to “educate the client as to what could go right and what could go wrong”.

“And I think it goes back to the crux of the problem, which is the advice process,” Miles says.

“We as dealers have not done a great job arming ourselves with ways to educate clients about what can go wrong. Whether you invested in 1969 versus 1980, the problem is you don’t know what the variability could be. I have no idea what the market is going to be. Does anyone know?”

End values – after 25 years



Source: *Funding retirement income*, Black Swan Event Financial Planning