



PIONEERING PROTECTION PRODUCTS

Australia has tended to lag behind other countries in the development of retirement and longevity products. But with volatile markets, and more people than ever on the cusp of retirement, fund managers are starting to become more innovative, as Ben Power reports.

In recent years, the first of Australia’s baby boomers have hit retirement age. They have done so amid a surge in market volatility. That combination has triggered a renewed focus on the provision of innovative retirement and longevity products that give retirees a stable income, but also address a range of complex risks.

“We’re seeing product innovation in this space and demand is emerging,” says MLC retirement solutions general manager, Andrew Barnett.

But Barnett says that despite innovations and his optimism for growing demand, the retirement product space is still “embryonic” in Australia.

The conventional view is that when it comes to retirement or longevity products, Australia has lagged behind other countries, such as the UK, Europe and United States.

“Culturally Australia doesn’t have an income-oriented society,” Barnett says. “In the US, one third of Fortune 500 companies have an open defined benefits schemes. Here, obviously, we have an accumulation mindset with the super guarantee.”

But Barnett says we have witnessed product innovation in both lifetime and variable annuity products. “Australia now has a complete set of variable annuity products,” he says.

MLC itself offers the Investment Protection products through its MasterKey platform. The products have more than 1300 clients with \$470 million under management.

Capital or income can be protected for terms of 10 years, 20 years or for life. Investment Protection offers two types of guarantee: “Protected Income” provides a minimum guaranteed withdrawal value through a specified

term; and “Protected Capital” provides a minimum guaranteed capital value at the end of a specified term. The minimum value in both cases may rise with positive market performance.

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INNOVATION

Senior investment analyst at Zenith Investment Partners, Dugald Higgins, agrees that institutions and fund managers are showing innovation (within the limits imposed by regulation).

“Principally, this has been around flexibility in products,” he says. “Over time, product development has addressed the issues of longevity

protection, downside protection and accessibility to these products – people want flexibility.”

Design of longevity products is challenging because of the raft of risks they need to address. The risks most focused on include: sequencing risk, which is the risk of low or negative returns early in the drawdown phase; longevity risk, which is the risk of outliving retirement funds; and investment risk from specific products.

But Higgins says the retirement products may also need to address market risk (the risk of a market downturn); inflation risk, which not all products deal with; credit risk; and benefit risk, which is the risk that benefits won't be accessible unless a protection event is triggered.

Higgins says he doesn't believe a single product can easily address all issues and risks. “While product development is seeking to address multiple issues, it is unlikely in our view that a single product can address all risks adequately for all people,” he says.

Higgins says choosing retirement products typically involves a trade-off between income generation, product flexibility and risk management.

“Given the wide range of individual preferences from users, a single product is unlikely to be suitable for all people,” he says. “Also, longer life expectancies mean it is becoming harder to guarantee an income for the whole of a person's retirement. Therefore, a greater choice of retirement income products are required.”

INSURANCE COSTS

Another issue has been the inherent cost of the insurance component of some retirement products. Higgins says several retirement products are comprised of a market-linked investment with an insurance component. That insurance component significantly increases the cost of offering the product. “Cost tends to be a big inhibitor to take-up,” Higgins says.

Mercer's newly developed LifetimePlus product removes the high implicit cost of insurance. Instead, its underlying investment strategy is a fixed-income portfolio, which is combined with “longevity pooling”. Higgins says the pooling, or “Living Bonus”, is created by levying members who commute their investment either voluntarily or by death. The bonus payments are distributed on a six-monthly basis as income to the remaining members.

But Higgins says that while there has been innovation, the pace of innovation has still been hurt by the regulatory environment.

“Product design has been a case of innovation being stifled by regulation,” he says. “Innovation has been occurring over the past five to six years, but is cramped by regulatory barriers where eligible income stream products have to comply with the standards in the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations).”

Higgins says it can be argued that government regulation in the past two decades has had a stronger influence on product development than the product developers themselves.

“Obviously, a product that cannot qualify for a tax exemption (account-based pensions, or ABP, et cetera), is going to have little chance to gain traction,” he says.

REGULATION IMPEDIMENT

But Barnett says that from MLC's perspective, regulation is really only an impediment for one particular product type: deferred lifetime annuities, which delay payouts. He says requirements that annuities pay out a minimum of the account balance every year means they can't build a product in that space.

However, Barnett notes that deferred lifetime annuities “globally don't account for large volumes”. Instead, he says that if anything, what has cramped growth of retirement products is demand.

He says that in 1992, when compulsory superannuation was introduced, risks were effectively transferred from institutions to individuals. But “the risks [that were] shifted to individuals were hidden; they didn't recognise the risks, so they didn't think they needed insurance against those risks”, he says.

Barnett says Australia “hasn't had bulging demographics coming through until very recently” to create demand; but now that super accounts are maturing, investors are beginning to become fully aware of risks.

Barnett says that when super accounts top \$100,000, people become aware of the income they can generate and the risk that they're bearing. “It creates a couple of conditions for people to be aware of risk,” he says.

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RISK-AWARE

Higgins agrees that Australians are becoming more aware of risks surrounding retirement.

“The risks faced in accumulation as opposed to retirement are very, very different,” he says. “We haven't had large numbers of people facing those risks up until now.”

Higgins says that not only are more people on the cusp of retirement, but markets have been volatile in the past six to seven years. “It's been a double wake-up call,” he says. “All of a sudden they have had to try and grapple with a whole new set of issues they have got to understand.”

Consumer ignorance is a big impediment to the uptake of retirement products. “If they don't understand products, they're not going to go out on a limb and take that up,” he says.

That puts the onus on product manufacturers to educate both consumers and advisers.

“The requirement for the product isn't going away any time soon,” Higgins says.

“Over the next two to three years we will continue to see more products and more innovation happening. How quickly that happens is going to be up to a) regulation, and b) how quickly the education side of things will work to make sure people understand there are other options out there.” ■

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