SMOOTHING *out the bumps*

EQUITY MARKET INVESTING CAN BE A ROLLERCOASTER RIDE, AND AS CLIENTS APPROACH RETIREMENT, VOLATILITY IS SOMETHING THEY COULD WELL DO WITHOUT. NEW WAYS OF MANAGING RISK ARE BEGINNING TO EMERGE.

WORDS SIMON HOYLE

A rollercoaster is an apt metaphor for the experience investors have as they get close to retirement: strapped into an investment market with no control over its direction, unable to get out.

Some love the thrill of it, but others cannot wait for the ride to be over – and would get out now, if they could. At least a rollercoaster's passengers end up back where they started. Investing in the sharemarket offers no such guarantee.

The investment industry has been working for some time now on how to provide investors nearing retirement, and those in the first few years of retirement, with an investment solution that provides a high enough return to ensure their capital lasts and that they meet their retirement investment objectives, but without the volatility generally associated with high-return investments.

"We still need to have more solutions for financial advisers to help retirees," says Peter Chun, general manager of product and investments for Colonial First State. Chun says advisers need a "toolkit" of solutions that they can use to tailor the best solution for each client.

There's a growing understanding that portfolios need to be made less volatile for retirees, but that doing so by shifting assets into defensive, lower-volatility and lower-growth assets, isn't necessarily an ideal solution.

"Returns are going to be too low – investors still need to take some risk," Chun says. "But retirees have concerns, and advisers have concerns, about retiree risk appetite."

Chun says the task is to give investors confidence to remain invested in the sorts of assets they are going to need to ensure they generate the returns necessary to ensure their capital lasts long enough, and provides a sufficient level of income in retirement.

There have been attempts to do this in the past, but they have not caught on in a big way.

TOO EXPENSIVE, TOO COMPLEX

"Protected products in the past have been too expensive and [too complex] and, more importantly, they do not suit the advice process," Chun says.

"A lot of advice business models have a very open model and it's all around portfolio construction and how do you solve for these kinds of needs?"

A response to these needs is to approach the issue from a risk-management perspective, and with this in mind CFS has introduced a range of risk-managed funds to the Australian market, in conjunction with the South African financial services company Sanlam Group.

The funds feature a risk management overlay, managed by the US-based group Milliman. An overlay approach means the asset allocation of an underlying portfolio can remain focused on growth assets, and investors retain at least a significant portion of the capital gain potential of those assets.

Milliman is known globally for its work with institutional investors, including large insurance companies, to risk-manage very large portfolios.

"Really what this is about is bringing the Milliman capability to retail clients," Chun says.

"The core premise is that it's intended to get you a better risk-adjusted return [and] the path of your returns is smoother."

Chun says CFS chose a partnership with Sanlam to capitalise on the South African firm's experience with this kind of product in the retail market.

"In the retail [market] you can't just have an institutional process and not explain to retail clients how you go about that risk management," Chun says.

He says the risk management approach is mathematically based and "removes

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the emotion" that can blight human investment decisions.

A technical paper published by Sanlam says the Milliman overlays on its funds use futures to hedge against market falls. When the physical market declines, the value of the futures rises, offsetting at least some of the losses, and reducing overall portfolio volatility.

There is a cost associated with managing the futures exposure, and that cost has the effect of reducing the return potential of the underlying portfolio. The benefit is a reduction in volatility. Sanlam stresses that futures are not used to enhance portfolio returns, but are used purely as a risk-management tool.

A principal and senior consultant with Milliman in Australia, Wade Matterson, says "the first premise or the rationale for a fund like this is, if we think about people particularly in and around retirement... the challenge they face is they are retired a long time".

"You have inflation and a whole variety of things, and you face what we call the 'risk tolerance paradox'."

Matterson says the paradox is that retirees often must accept investment risk in order to achieve the longer-term investment returns they need, but they cannot afford to be exposed to the potentially poor shorter-term returns that accompany that risk.

Matterson says a traditional approach to reduce risk is to diversify, which is "useful to a point...but as the financial crisis taught us, it doesn't actually work in a crisis event – in a crisis event you still see substantial losses".

He says an alternative to diversification, seen particularly in lifecycle products, is to de-risk the investor's portfolio by divesting volatile growth assets and investing more heavily in less volatile, but lower returning defensive assets. But Matterson says all this guarantees is that the investor gets a lower return, and possibly a lower return than they need to meet their retirement objectives.

Neither de-risking nor diversification is an ideal solution to the problem, he says.

What is needed is a way of retaining a significant portion of the capital gains generated by growth assets, while reducing the impact of the volatility that accompanies investing in growth assets, and which often spooks retirees into making unwise decisions.

Milliman's approach is to apply an overlay to an existing portfolio – a portfolio that can be set with an adequate exposure to growth assets to meet the retiree's objectives.

"It still gives you access to the good properties of growth [assets], but the focus is to take the sting out of a poor market environment," he says. It also recognises that behavioural finance is real, particularly a characteristic known as "loss aversion", which says that investors feel the "pain" of losses more acutely then the "pleasure" of gains, and will often take counterproductive action, to avoid losses.

REMOVE LOSS AVERSION

If an investment solution can be structured to remove some of the triggers of loss aversion, investors can be "encouraged to make better decisions".

He says it is an approach to risk management that has emerged from the institutional investment world; and through funds such as those offered by Sanlam, via CFS to Australian investors, it's becoming available to retail investors.

Applying institutional thinking and risk-management techniques to the retail space is a critical element in helping people plan for and adjust to retirement as effectively as possible.

Speaking at the PortfolioConstruction Forum Conference in Sydney in August, Dr Joanne Earl, a master of organisational psychology and a senior lecturer and program leader at the University of NSW, stressed the importance of helping people plan for retirement, and the role that financial preparedness plays in helping people make the adjustment to retirement.

"Planning...helps to determine retirement adjustment – that is, how people feel during retirement," Earl said.

Earl said that about 30 per cent of people adjust poorly to retirement, for one reason or another.

"We also know that financial resources are one of the key predictors of retirement adjustment," she said.

"Without proper finances it is difficult to access good health care and social activities that people enjoy.

"We know that a lot of people think that they are going to retire on their super, but in fact they don't. They end up, at some point, going onto a pension. And that's partly because they underestimate how much money they need, and how long they are going to live." ■

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