Building better retirement futures

A report to help financial planners design investment solutions for retirees

Contents

About this report

This report was produced by Fidelity International in conjunction with the Financial Planning Association of Australia (FPA) and CoreData Research.

The research underlying this white paper is drawn from a range of existing sources, including Fidelity's 'Value of Advice' report, Fidelity's Financial Power of Women report, and CoreData's Best Possible Retirement research. Additional insights and analysis were provided by Fidelity.

CoreData also conducted a comprehensive literature review, covering both reports previously published by CoreData and by external parties. The publications covered are recited in the references and literature review.

In November 2020, the Australian Government released the final report of the long-awaited Retirement Income Review (RIR). The review said the Australian retirement system is ‘effective, sound and its costs are broadly sustainable’, but said there are areas where the system can be improved. The system is complex, the review said, and alongside relatively low community financial literacy there is a need to improve understanding of the system.

The review clearly highlighted the need people approaching and entering retirement have for good-quality and accessible financial advice. The focus of the system to date has been on accumulation, with post-retirement issues receiving much less prominence and attention.

It highlights the issue that many retirees are perhaps unnecessarily frugal by not drawing down enough on their savings, and so leave unintentionally large bequests in their estates. Financial advice could give those retirees the confidence to spend more, and enjoy their retirement more, without unduly increasing the risk of running out of capital.

Preparing for a comfortable retirement is often the biggest financial challenge an individual will ever face and financial planners play a crucial role in helping people make the most of what they’ve accumulated during their working life to support their desired lifestyle when they retire.

As Australia’s enviable superannuation system has now been around for almost 30 years, many people are reaching retirement with substantial pots of savings to take them through the next phase of their lives.

We have reached a crucial juncture where the bulk of superannuation assets sit in the hands of fund members aged over 50.

As this shift has happened, there has been growing recognition that more thought needs to be given to strategies and investments specifically designed for post-retirement decumulation – the drawing down of the accumulated savings in the form of income over the lifetime of retired investors.

Australians who have an active relationship with a trusted financial planner generally report having greater peace of mind, more certainty about their financial future and higher financial resilience than individuals who do not have an advice relationship.
The value of advice extends beyond just financial issues, and addresses many aspects of an individual's overall, non-financial wellbeing.

That is because professional, qualified financial planners take the time to understand what's really important to their clients. They develop deep insights into a client's current position, their needs and their goals. And then of course, they help clients achieve those goals by setting the right financial strategies, adjusting as circumstances dictate, and helping them to stay the course.

Financial planners also play an active role in helping to educate clients about financial issues. Clients with an increased level of financial literacy and knowledge are better able to grasp the strategies recommended by their financial planner and are more likely to understand the importance of sticking to a plan, even if things look uncertain in the short term.

In particular, for those entering retirement, and in retirement, advice should be anchored on the achievement of their desired outcomes. Retirement advice should make it clear to the client how the advice will help them achieve their stated goals and objectives, and the implementation of the advice should be easily understood by the client from a day-to-day management perspective.

A retiree's primary goal is certainty of income, and investing in retirement may therefore be quite different from how they invested during their working life.

The Financial Adviser Standards and Ethics Authority (FASEA) Code of Ethics makes it clear that financial planners have an obligation to ensure clients understand the advice they receive and how it will affect them, and that a planner can demonstrate clearly that the advice they have provided puts the client in a better position.

Fidelity's Building Better Retirement Futures report builds on what we know about how great financial advice can materially improve the financial and overall wellbeing of a retiree and adds insights into why a single approach to investing may not meet the needs of all types of clients. It sets out a range of investment strategies, and encourages financial planners to consider whether their current approach is necessarily the best one for all clients.

Dante De Gori
Chief executive
Financial Planning Association of Australia

FPA
FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

Next year will mark 30 years since the introduction of the Superannuation Guarantee in Australia. While they may not have realised it at the time, that budget in 1991 set Australians up to have one of the best retirement systems in the world. The strengths of the Australian retirement system are recognised in the recently released final report of the Retirement Income Review (RIR).

Today, many Australians are reaching retirement with substantial pots of savings to take them through the next phase of their lives. The bulk of superannuation assets are now held by fund members aged over 50. As this shift has happened, and as highlighted by the RIR, there is a growing recognition that more thought needs to be given to strategies for drawing down accumulated savings in the form of income over the lifetime of retired investors.

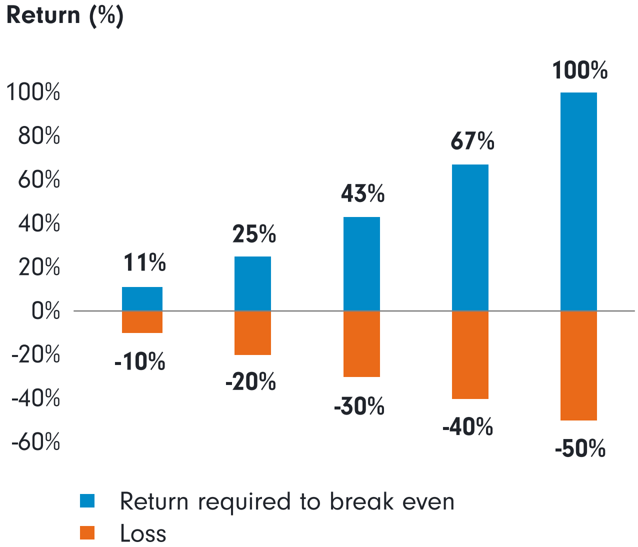
Retirees still need to take appropriate investment risk to address inflation and longevity risks, but there also needs to be a focus on the impact of market volatility on retirement outcomes. While the positive impacts of compounding and dollar-cost averaging are well understood when it comes to saving, many people are not aware that the opposite is true during decumulation. In fact, limiting losses in retirement has a more powerful effect on long-term growth than capturing the full upside of market gains.

There is a simple way to demonstrate this. The chart shows how a 10% investment loss requires an 11% gain to simply return to the original point before the loss occurred. A 20% investment loss requires a 25% gain, and so on, to the point where a 50% loss needs a 100% gain to simply return to the original balance. What worked in accumulation isn't necessarily the right approach for retirement.

Financial planners are at the frontline when it comes to achieving the best outcomes for clients. Asset managers like Fidelity International have a role to play in providing the right building blocks to make that happen.

Compounding is not well understood

What positive returns are required to break even after market losses?



Source: Fidelity International. For illustrative purposes only.

In developing this report, in conjunction with the FPA and CoreData, Fidelity international wanted to provide a helpful reference for financial planners who are working with clients on retirement investment strategies.

The report covers a broad set of considerations that planners should be aware of around the topic of retirement.

It also helps illustrate the motivation and driving forces behind the behaviour of clients as they move through life from saving for retirement into their retirement decumulation phase.

In researching this report, we found that planners are using a variety of different approaches to investment advice for clients in retirement. Each approach has its own strengths and weaknesses which are outlined here.

At Fidelity we are committed to helping the advice community carry out the essential task of providing effective and beneficial advice to clients. We hope that you find this report a helpful source of information and reference on the topic of retirement investing.

Richard Dinham
Head of client solutions and retirement
Fidelity International

The value of a financial planner

Retirement can be a difficult and stressful time, but the guidance and expertise of a professional financial planner can ease the transition.

For many people, superannuation will be the single largest asset they will ever accumulate, not including their family home. Even so, there is understandable fear and trepidation among individuals as they near retirement about how long their savings will last, and whether they will be able to live the lifestyle they desire. Many approach retirement feeling ill-prepared.

Fidelity's 'Value of Advice' report, published earlier this year, revealed that almost two-thirds of people believe they are not particularly prepared for retirement, or not prepared at all. More than half agree or strongly agree that they may need to work past their retirement age, that they're not on track to have enough money for a retirement they can be happy with and that they may not be able to afford to live where they want to when they retire.

By the numbers

Retirement trepidation

As people near retirement:

55.0% agree or strongly agree that they may need to work past their retirement age to fund their retirement.

53.5% don't feel that they're on track to have enough money for a retirement they can be happy with.

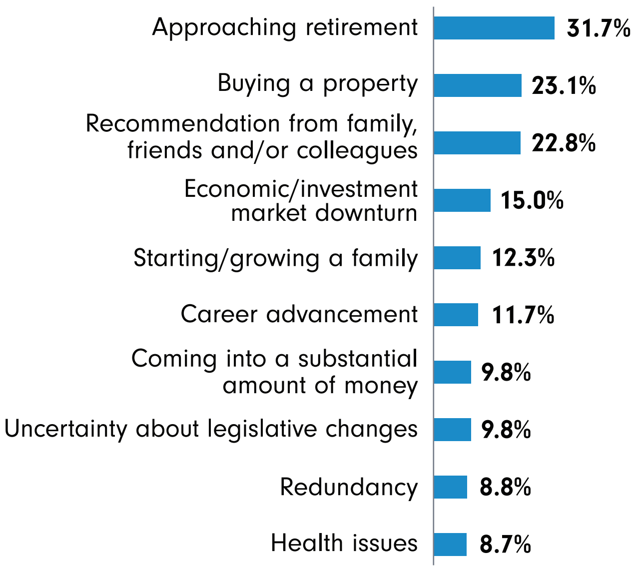
52.6% fear they may not be able to afford to live where they want to when they retire.

Source: Fidelity 'Value of Advice' report

Not surprisingly, approaching retirement is the number one trigger for people to see a financial planner. Almost a third (31.7%) of those who currently receive advice, or who receive it as and when needed, nominated approaching retirement as the reason they sought advice. It is a greater trigger even than buying a property (23.1%), and significantly more likely to make people see a planner than coming into a substantial sum of money (9.8%). Around half of these people (46.7%) seek advice specifically to help them plan a better retirement, as distinct from the more general aims of help with investing (49.7%) and help with managing or growing wealth (43.6%).

It is therefore evident that having the right tools to help clients prepare for retirement, and navigate the shift into this stage of their lives, is key for planners.

Which of the following triggered you to first seek financial advice from a financial planner?



*Top 10 responses; multiple answers allowed.

As a growing number of people reach retirement age feeling poorly prepared for the transition, there is an opportunity for financial planners to really show their value. The *Value of Advice* report shows clearly why the role of the financial planner is absolutely critical. Planners not only help individuals address the technical aspects of retirement (for example, maximising accumulation capacity, or navigating Centrelink issues), but they also help address the intangible aspects of retirement, such as peace of mind and confidence that life in retirement is going to be OK.

We should not underestimate the opportunity for financial planners to improve the lives and wellbeing of Australians as they move from the relative certainty of working life to the perceived uncertainty of retirement. But we should also understand that while retirement for everyone may bear some superficial similarities, the experience is different for each individual.

How we relate to money, our expectations of retirement and how we plan to get there may vary widely from one person to the next – and as we shall see, planners need to meet each client's needs in the way that best suits that client.

At a high level all retirees share some obvious needs and circumstances. Anyone moving into retirement wants to feel confident that they're in control during this period of potentially significant change. They want peace of mind, knowing that they are on track through what may seem to be unpredictable or uncertain circumstances. They do not want to lose their self-identity. They seek purpose and want to feel that they belong to a community and remain connected with society although they do not contribute to the society as active labour.

However, retirees have their own interpretation of these high-level needs based on their personal circumstances. Their personality, level of financial literacy and prior experience affects how they approach their financial affairs and will influence how they feel about moving into retirement.

This means that financial planners have to take into account all these individual circumstances and be aware of a range of investment solutions in order to address their clients' needs.

Considerations will include how financially literate a client is, and how well they will grasp the strategies presented. Some clients need significant hand-holding and want frequent contact, while others are happy for a looser relationship and an annual check-up. Some may thrive on the financial elegance of a solution developed on their behalf, while others may shudder at the first hint of complexity.

Commonly used retirement investing strategies include maintaining the same strategy used by the client to accumulate retirement savings; transitioning to a more conservative investment strategy as retirement nears; income 'bucketing' to varying degrees of sophistication; and income layering.

But it is unlikely that any one of these strategies will serve all clients equally well, and the pros and cons are explored in greater detail elsewhere in this report.

Retirees' fears and expectations

Many people are uncertain about what to expect in retirement, and the issues they may face are not always just financial.

Financial planners whose clients are nearing retirement find themselves dealing not only with the financial aspects of helping them lead a comfortable and dignified life in retirement, but the emotional and psychological impacts of transitioning into retirement as well.

The new-found status of 'retiree' sits well with some clients, but for others it's a different story. And a lot of that depends on how smooth the transition into retirement is, and how a retiree's fears and expectations are managed along the way. Despite the best-laid plans and the most strongly held expectations, around half of Australians do not retire for the reasons they think they will, nor at a time of their choosing. A loss of control over the manner and timing of retirement can set an individual into retirement on the wrong foot from day one.

By the numbers

Unexpected retirement

What was your main reason for retiring?

28.0% health issues

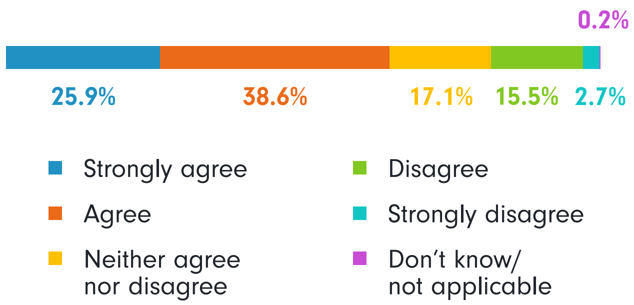
13.8% unemployment

8.4% to take care of a loved one

Source: CoreData Best Possible Retirement.

Retirement may represent the single largest change in an individual's life – and certainly one of the largest financial challenges they'll ever face, and yet CoreData's Best Possible Retirement research shows almost two-thirds (64.5%) of pre-retirees admit to being worried about being able to fund their retirement.

How much do you agree or disagree with the following statement: I worry about being able to fund my retirement



n = 1,491 (pre-retirees)

It is unsurprising that almost every pre-retiree who has no superannuation savings should be worried about funding their retirement, but more than half (56.3%) of those with superannuation balances of $750,000 to $1 million say they worry about funding their retirement. The same worries are present among retirees across superannuation balances and really only recede once an individual has accumulated $1 million or more.

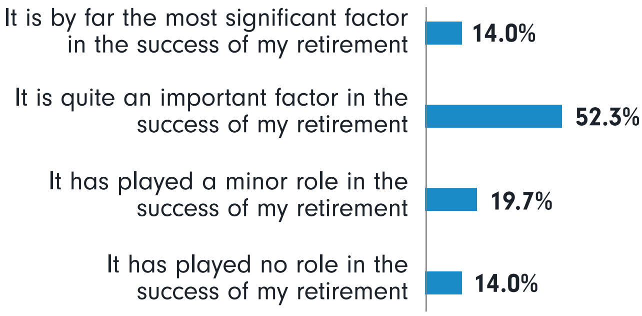
Only a small proportion (13.7%) of pre-retirees are very optimistic about their retirement outcome, believing that they will have adequate financial resources to do everything they want in retirement. However, the most common expectation (43.9%) among pre-retirees is for a reasonable retirement life, while accepting that some of their wants and desires may not be fulfilled. Around four in 10 (42.5%) retirees say that their actual retirement lifestyle is in line with what they anticipated, and three in 10 (30.0%) say their retirement lifestyle is better than they expected.

Adequate saving

A successful retirement involves more than just money. While it may be an enabler for many of the things that make life worth living, there are some things that money can't buy. The factors in a 'successful' retirement include adequate savings, staying healthy (mentally as well as physically), having realistic expectations, and owning a home.

While only 14.0% of retirees think money is by far the most significant factor in the success of their retirement, most (86.0%) acknowledge it is important. In general, a good retirement occurs when a retirement lifestyle matches the retiree's expectation. Not every retiree expects to pursue a luxurious lifestyle, but all of them have common basic needs.

How much of a part would you say money has played in the success of your retirement?



n = 880 (those who answered 'Yes, I am fully retired' or 'Yes, but I am working on a part-time basis' or 'Yes, but I still work from time to time').

A concern for some retirees is running out of savings laterin life. Around one in eight (12.2%) say outliving their savings is their greatest worry, and another 9.9% say they are worried about meeting the cost of high-quality aged care services. The welfare system provides retirees with a basic level of income, but not being able to fund discretionary expenditure can be a source of stress.

While it appears that retirees are adept at adjusting spending behaviour and adapting to reality as they age, they would enjoy better spending flexibility and a stronger sense of control from having greater savings.

Quantifying how much savings is adequate is the nub of retirement planning. Life expectancy and projected expenses are two major factors that determine the level of savings a retiree needs. Other factors – including marital status, health and home ownership – also contribute to how much a retiree needs to save to live their desired lifestyle.

Staying healthy

While some people dream of – and plan for – an early retirement, almost one in three Australians (28.0%) retire unexpectedly early due to ill-health. Almost half (47.2%) of all retirees list their health as their greatest worry in retirement.

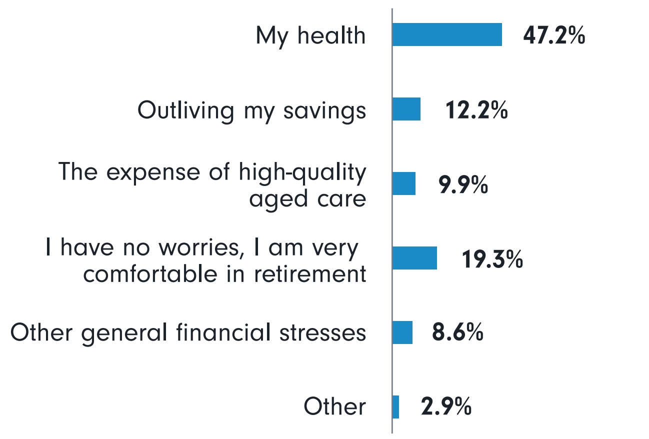
People forced to retire early are often not able to adequately prepare for retirement. Research[1] has shown that those who retire involuntarily due to health issues are likely to have lower incomes to begin with, and lower incomes are correlated with lower superannuation balances.

Also, those who have long-term health problems will likely face additional health expenditure in retirement, especially when pharmaceuticals are involved.

Home ownership

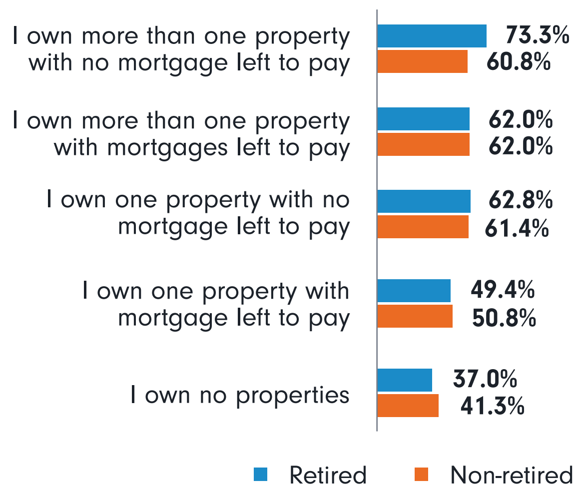
Older Australians greatly value the security of owning their own home. Research[2] shows that older people who know that their long-term accommodation is secure tend to have better physical and mental health. Home ownership status makes a great difference to both retirement preparedness and satisfaction. Owning more than one property with no mortgage left to pay is associated with a high chance of retirement success. Single-property owners also enjoy high level of retirement satisfaction – if they have already paid off their mortgage – albeit to a lesser extent than multi-property owners. Those who do not own any properties score the lowest for retirement satisfaction.

Which of the following would you consider your greatest worry in retirement?



n = 880 (those who answered 'Yes, I am fully retired' or 'Yes, but I am working on a part-time basis' or 'Yes, but I still work from time to time').

What is your current home ownership status?



Average score (0 – 100)

1 Australian Centre for Financial Studies, Involuntary Retirement https://humanrights.gov.au/sites/default/files/Submission%20No%20329%20-%20Annexure%20C.pdf

2 Australian Housing and Urban Research Institute, 'Housing, homelessness and mental health: towards systems change' https://www.ahuri.edu.au/__data/assets/pdf_file/0023/29381/Housing-homelessness-and-mental-health-towards-systems-change.pdf

How retirees' investment needs differ from accumulators

A retired client may view the world very differently from someone still in the workforce, and financial planners must understand how their view of the world may change.

The client sitting across the desk from you today might look and sound today just the same as when they sat in the same place a few months ago, but after an individual retires they can become quite different as a client. And from an investment perspective, perhaps the single largest change a planner may observe is how the client relates to and responds to risk – in its many and varied forms. The investment risks most relevant for a retired client are described below.

Market risk

All investors face market risk, regardless of their retirement status. Market risk is, simply, the risk of losing money when a market they are invested in falls. But retirees' reduced risk capacity makes them more sensitive to a falling market. The market turmoil of the Global Financial Crisis is an extreme example, which resulted in many Australians' retirement plans being disrupted. Those who were approaching retirement or were in the early stages of retirement at that time saw their capital depleted, with consequences for longer-term income generation. Some may never have recouped their capital losses – particularly those who were spooked enough to withdraw from investment markets in favour of holding cash. It may be too early to say whether the COVID-19 crisis will have a similar impact, but it is certainly adding to people's worries.

Sequence of return risk

Sequence of return (or sequencing) risk is a variation of market risk and is the risk that an investor will be forced to draw down on their savings at time when the value of their portfolio has fallen, or is falling.

Longevity risk

Retirees also face risks that are distinctive to them. Put simply, longevity risk is the risk of living too long – in this context, 'too long' means longer than their savingswill produce an adequate level of income.

Longevity risk has become an growing issue for retirees with life expectancy increasing. Individuals are facing the task of generating income over a period of time that is consistently lengthening and representing a growing proportion of the period of time available to them to accumulate savings. This is usually a bigger issue for females than for males, due to females' longer life expectancy.

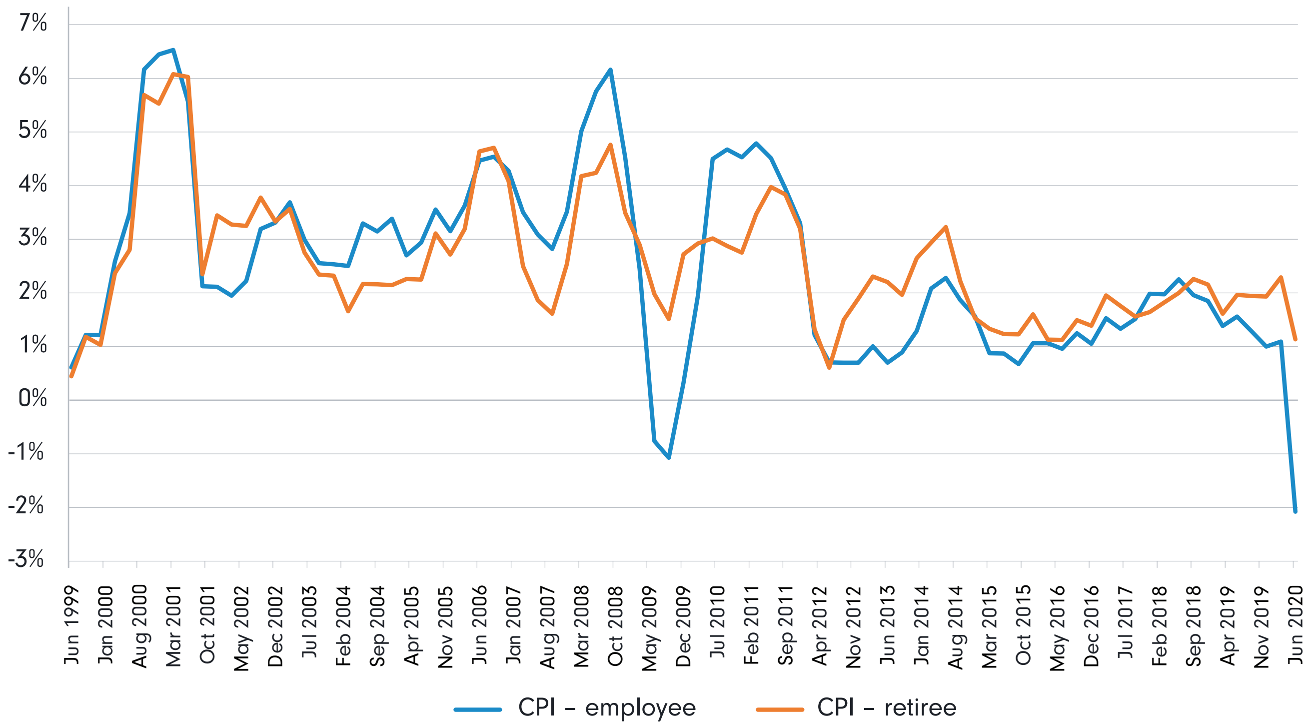
Inflation risk

Inflation describes the tendency for the cost of goods and services to increase over time. As the costs of goods and services increases, the income required to acquire a given basket of those goods also increases. If retirees' income does not increase over time by at least the same rate as the inflation they experience, they will find over time that their income allows them to buy fewer of those goods and services.

The Reserve Bank of Australia aims to achieve a medium-term average inflation rate of 2% to 3% a year. But inflation varies for different types of households, depending on what they spend their money on. For example, self-funded retirees tend to spend more money on luxury items and on recreation and leisure pursuits, and as they get older will spend more on healthcare. Employee households, on the other hand, tend to spend more on things like housing, kids' education, and transport.

Retiree households therefore generally experience different price inflation than employee households, and focusing on the broad CPI figure risks overlooking a retiree's actual experience. The chart below shows how different rates of inflation have been experienced by employees and retirees. Since the goal of retirement planning is to maintain a level of consumption that supports a certain lifestyle, it is important to factor in price inflation that is relevant to retirees' own lifestyles. The ongoing erosion of retirees' spending power as a result of even just modest inflation is a risk that advisers need to help them manage.

12-month rolling CPI



Source: Australian Bureau of Statistics 6467 – Selected living costs indexes, Australia, June 2020.

The retiree's risk requirement, tolerance and capacity

Retirees still need to take some measured investment risk with their superannuation assets otherwise investment outcomes will certainly be less than needed to achieve lifestyle goals. However, attitudes to risk inevitably change when investors move into retirement and their investment time horizon will become shorter. Therefore, risk management becomes an even more critical element of retirees' portfolio management than it is for those saving for retirement.

An effective investment strategy needs to be constructed with close regard to an investor's risk profile. And a risk profile can be assessed from three distinct perspectives:

- Risk tolerance
- Risk capacity
- Risk requirement

Every investor must take some level of investment risk to achieve a targeted investment return – those two things are inextricably linked. Part of a financial planner's job is to take a client from where they are today and get them to where they want to be at some point in the future, defined by their goals, expectations and desires in retirement. It's a relatively straightforward task in principle to work out the rate of investment return needed to achieve those goals and, by extension, the amount of risk they will need to take to achieve those returns – their risk requirement.

However, it's not quite that straightforward in practice. Each individual views risk in a deeply personal way. A client's risk tolerance describes their subjective attitude towards taking risk, this is the component assessed by risk profiling tools that ask questions like 'how would you feel if the value of your portfolio fell by 20% overnight?'. Some clients might fall apart emotionally (and physically); others might shrug their shoulders.

Even if an investor is emotionally or psychologically willing to take risk, they may not be able to afford to. In other words, the investor is constrained by their risk capacity, which is an objective measure of an investor's ability to endure fluctuations in portfolio value without materially affecting their living standards.

It is an important part of the financial planner's role to determine and understand each client's risk requirement to achieve their goals, the client's tolerance for risk, and their capacity to bear investment risk. From time to time, they may need to tackle a client's risk tolerance, perhaps through education about investment issues, to make them more comfortable with taking the level of risk they need to achieve their goals. In some cases a planner may even need to talk a client down from taking more risk than they need to, or they may find themselves counselling clients against taking more risk than they can afford.

One important factor that distinguishes retirees from pre-retirees, or accumulators, is their reduced risk capacity. Accumulators can more comfortably navigate through a market downturn by increasing their savings rate, or possibly even by taking slightly more risk and waiting for the market to turn around or just continuing to invest contributions on a regular basis. This is the power of dollar- cost averaging which works to the benefit of the investor when saving for retirement.

Dollar-cost averaging in decumulation works against the retired investor – drawing an income when markets are depressed leads to a permanent loss of capital. And a retiree's need to take some risk with their retirement savings can mean that excessive risk may be taken by investing in assets that put too great a portion of their capital at risk, which in turn may critically compromise their lifetime income objectives.

As we have seen, a certain level of risk-taking is necessary in every retiree's portfolio. A good retirement investment strategy balances all the three perspectives of an investor's risk profile. It meets the retiree's financial needs and doesn't keep them awake at night worrying about their investments.

Retirement investing strategies

No single investment strategy is likely to suit all clients. Financial planners must be adaptable and flexible in the solutions they offer.

All retirement investment strategies inevitably require financial planners to understand and optimise a set of sometimes complex interactions between an individual's risk profile and financial circumstances, the taxation system, and Centrelink benefits.

For some individuals, the Age Pension will be a very significant component of the income they receive in retirement. It may be less so for those individuals who have accumulated significant superannuation balances. The number of people working part-time is growing, while others experience sporadic working patterns (including individuals who take extended parental leave) and may have periods when they cannot contribute to superannuation.

And for some, superannuation may not be the only source of income that affects pension entitlements or generates income in retirement – assets held outside superannuation may also need to be factored in.

Determining the best strategy, or combination of strategies, is a significant part of the value a planner brings to the table.

In addition to considering the straight financial issues of investing in retirement, planners have legal obligations to clients under the Future of Financial Advice (FoFA) laws – primarily, but not only, the Best Interests Duty and related obligations, as well as a relatively new set of professional obligations under the Financial Adviser Standards and Ethics Authority (FASEA) Code of Ethics.

A planner is obliged to make sure the advice they give leaves a client better off than if the client had not sought the advice, and a planner must be sure that the advice provided is clearly understood and agreed to by the client. Some clients may simply not be able to grasp the concepts and mechanics behind sophisticated retirement investment strategies, and it is not good enough for a planner simply to say 'trust me'.

The spectrum of retirement investment strategies can be thought of as occupying a continuum, from a relatively simple 'business as usual' approach at one end to a significantly more complex 'income layering' approach at the other end. This range of approaches also exhibits varying degrees of personalisation and flexibility, and not all of them address all of the risks individuals face in retirement.

The 'right' approach for any given client will depend on a mix of factors, and the task of the financial planner is to find the best approach to meet the client's needs, goals, financial resources and understanding of advice and other financial issues.

The table summarises the commonly encountered approaches taken by planners when structuring their retirement advice.

Strategy	Primary benefit	Personalisation	Sequence of return risk	Longevity risk	Inflation risk	Market risk	Frequency of review	Complexity
Same as accumulation	Simplicity and consistency	Low	🔴	🔴	🔴	🔴	Low	Simple
Conservative asset allocation	Accounts for retiree's reduced risk tolerance	Low	🟢	🔴	🔴	🟡	Low	
Simple bucketing	Cash bucket provides peace of mind	Medium	🟡	🟡	🟡	🟡	Medium	
Complex bucketing	Extra buffer provides additional layer of security	High	🟢	🟡	🟢	🟢	High	
Income layering	Dynamic allocation and withdraw approach tailored to retiree's needs and wants	High	🟢	🟢	🟢	🟢	High	Complex

*Traffic lights – how well are risks addressed by each advice approach.
Source: Fidelity, CoreData.

Strategy 1: Same as accumulation phase

Retirees could simply choose to do nothing, and extend the same investment strategy from the accumulation phase to the retirement phase.

The goal of investing in the accumulation phase is usually to maximise total return on investment, subject to the investor's risk tolerance. By deploying the same investment strategy in retirement, it assumes that at the point of retirement the goal of investing remains unchanged – the individual remains a long-term investor, and can continue to tolerate market risk. This approach may suit wealthy clients, whose significant asset base can yield sufficient income to fund their desired retirement lifestyle.

The simplicity of such a strategy is advantageous to retirees who focus on the absolute level of real returns over the whole investment horizon.

Investors who have been satisfied with the historical performance of their investment portfolio are likely to maintain their investment strategy. While this strategy seems to require minimal to no adjustment, it still offers a certain level of diversification that reflects an investor's risk appetite.

However, its effectiveness for many is highly debatable and comes at the cost of flexibility. By using a potentially volatile investment portfolio to fund a steady income, it overlooks the sequence of return risk. It also fails to consider retirees' reducing risk capacity as they age.

The strategy focuses on overall lifestyle spending goals but also overlooks the fact that a retiree's spending behaviour is often adjusted according to portfolio performance and time horizon.

A safe withdrawal rate of 4% has been suggested as necessary to satisfy retirees' spending needs, and it is also reflected in the federal government's minimum drawdown rates for superannuation.[3] Clearly, investors with a shorter investment horizon can afford higher withdrawal rates. But cutting withdrawal rates in lean years could significantly reduce the likelihood of retirees outliving their savings. Without a dynamic approach of reviewing performance and withdrawal strategy, maintaining the same strategy used in the accumulation phase could amplify the risk of premature portfolio depletion.

Strategy 2: Transition to a more conservative asset allocation

While risk-averse investors may have already employed a more conservative investment strategy than risk-seeking investors, their risk capacity reduces as they age regardless of their risk tolerance. This justifies moving to a more conservative asset allocation strategy in retirement. The portfolio will generally have a large percentage of the total portfolio allocated to low-risk and low-volatility assets such as conservative equities, fixed-income and money market securities.

Overall, this strategy is easy to understand for investors with a low level of financial literacy. The low volatility of this strategy hedges the sequence of return risk and makes it suitable for retirees who value downside protection more than the upside growth. However, if the downside is overly protected, the relatively constrained upside potential of the strategy may expose the retiree to greater longevity risk and inflation risk.

Strategy 3: Simple bucketing

This approach generally divides the whole investment portfolio into separate components, or 'buckets', with each bucket serving different objectives. A simple bucketing approach has only two buckets: a cash bucket and a diversified investment bucket.

The cash bucket holds adequate cash (and cash equivalents) to cover retirees' immediate financial needs – typically a year or two's worth – while the diversified bucket has substantial allocation to relatively risky assets with the objective of achieving capital growth. As the value of this bucket increases over time with good investment experience, a retiree may transfer (rebalance) assets to the cash bucket, ensuring their immediate cashflow needs continue to be met.

This approach provides a short-term buffer against falls from market shocks and allows the planner to better manage the implications of rebalancing and selling growth assets. It therefore is useful for managing sequencing risk and market risk.

This simple bucketing approach avoids the potentially constrained upside of the conservative asset allocation approach, while also meeting retirees' short-term liquidity needs. It is slightly more complicated than the 'do-nothing' and conservative asset allocation approaches. Another consideration is the so called 'cash drag' of the overall asset allocation. But overall this approach has significant merit in its simplicity, ease of understanding and its effectiveness in dealing with market volatility.

3 ATO, Minimum annual payments for super income streams
https://www.ato.gov.au/rates/key-superannuation-rates-and-thresholds/?page=10

Strategy 4: Complex bucketing

The simple bucketing strategy can be developed into a more sophisticated bucketing strategy tailored to retirees' more detailed spending needs.

The upgraded version of the bucketing strategy also follows the principle of dividing retirees' accumulated savings into discrete pools, each with different objectives.

In addition to a cash bucket (in this case covering two to three years' expected expenses) and a diversified-investment bucket, it also has a capital-certainty bucket to provide an additional layer of income support. This bucket blends in some risky asset classes and covers the few more years' expected expenses (usually three to five years). Specifically, this bucket could be a bond ladder – a selection of fixed-income securities with each security maturing at a different date to replenish the cash bucket or a term annuity.

The complex bucketing strategy manages risk by segmenting retirement investing into different time horizons. Compared to a conservative allocation strategy, which allocates assets based on the largest loss a retiree can stomach in a market downturn and optimises asset allocation to avoid capital depletion, the complex bucketing strategy seeks to broadly match asset duration to the liability (or expenses) duration, ensuring that funds are available as and when expenses fall due or are expected to be incurred.

This 'asset-liability matching' is the cornerstone of this strategy. Matching short-term liabilities (or spending requirements) with cash and short-term bonds provides investors with confidence that money will be available when it's needed, even if investment markets are at that point in decline. Matching long-term liabilities (or expected expenses) with relatively long-term assets, such as equities, would provide investors with a greater expected return, with the aim of ensuring capital is available to meet the expected future spending need.

A strategy that ensures available funds for certain expenditures in the near term while still generating portfolio growth in the long term might be more palatable to retirees who tend to shy away from an aggressive total-return approach.

However, a strength and a challenge of the complex bucketing approach lies in replenishing or refilling the cash and capital-certainty buckets over time. It is a relatively complex strategy to establish and to manage – it requires regular review and potential manual rebalancing adjustment by the financial planner to ensure the buckets continue to serve their intended purposes. The opportunity to actively, tactically rebalance may lead to better outcomes for the client, but the planner needs to have systems in place to execute efficiently. The client must also want to receive active advice services.

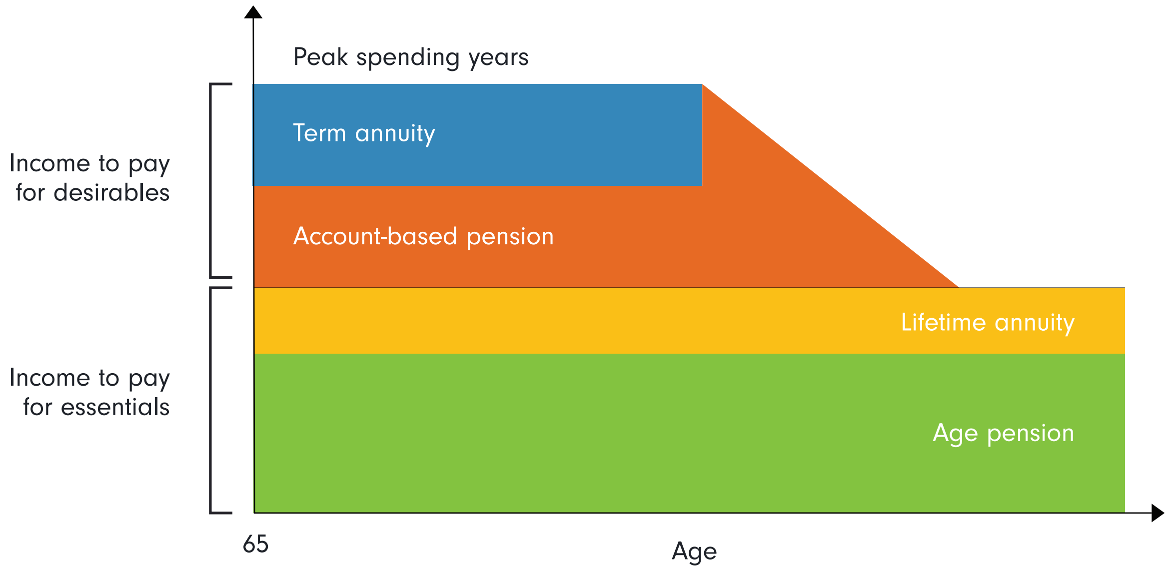
Strategy 5: Income layering (goal segmentation)

An income layering strategy, like the complex bucketing strategy, divides a retirement portfolio into separate components, but bases those components on retirees' spending needs for life. As shown in the table on page 20, spending needs can be grouped into four distinct categories: basic living expenses, contingency expenditures, discretionary expenses, and legacy (or 'leaving something for the kids').

The income priority is matched to the spending priority, with income for essential spending being the top priority. Retirees have their own trade-offs between spending more on discretionary items in early years of retirement and being more certain of meeting goals in later years, and the layers of this strategy can be tailored to suit.

The table and chart on page 16 show how an income-layering approach could work.

Layer	Example objective	Income sourced from
Legacy	Leave funds for family or philanthropy	Account-based pension, term annuity
Discretionary	Fund nice-to-have assets and activities	Account-based pension, lifetime annuity
Contingency	Meet unexpected healthcare expenses, home repairs	Account-based pension
Basic	Food, housing, utilities, clothing, transport	Age pension (if eligible), lifetime annuity



Source: Challenger

The income layering approach separates a retiree's needs from their wants, or nice-to-haves, and prioritises income accordingly. High-priority needs are protected from market volatility for life, with the portfolio anchored by the age pension. Income to pay for essentials can also be secured, and sourced from annuities.

Annuities are essentially an insurance contract where the policyholder (the retiree) pays a premium to transfer the risk of losing capital to an insurance company and in return receives a stream of income payments over an agreed period of time (a fixed period or a lifetime period). A lifetime annuity effectively hedges longevity and market risk, and provides a retiree with the peace of mind of a fixed stream of income.

Annuities can be purchased to start paying income immediately; or they can be purchased with the view to an income stream being deferred to a later starting date, usually at a specified age of the retiree. They can also increase payments in line with inflation, or offer fixed payments.

Annuities are often criticised for a lack of flexibility as the policyholder is locked into a fixed income rate, at a fixed frequency. And when interest rates are low, annuities may be regarded as 'expensive', in the sense that a retiree receives a relatively low income for a given capital outlay. But in combination with other income streams, annuities may play a valuable role in securing income for a retiree to cover essential expenses, and (in the case of a deferred or lifetime annuity) to protect them from the risk of outliving their retirement savings.

Budgeting and creating income streams for a retiree's expected lifetime can be a complex task. An income layering strategy requires close collaboration between planner and client, and regular reviews to ensure the strategy remains effective in light of any changes in a retiree's personal circumstances or in market conditions.

The essential building blocks

Once in retirement, it is clear that investors still need to take some measured risks with their capital, as taking little or no risk guarantees a poor investment outcome. The various risks an investor will encounter once they become a retiree in decumulation are discussed earlier in this report. Ultimately, the issue of what to do with retirees' capital becomes a risk-management exercise.

In this context, a retiree's investment portfolio will exhibit certain characteristics to reflect their primary investment needs, namely:

- Growth at (or above) inflation, over the medium and longer term
- Income

The extent of risk that may be taken will vary considerably by individual, depending on factors including:

- Attitude to risk-taking
- Size of asset portfolio
- Extent of age pension entitlement
- Other wealth and other sources of income
- The investor's investment objectives

At the time of retirement, most investors will likely have quite a lengthy time horizon, with average life expectancy meaning an investment time horizon of 20 years or longer is not unusual. A long-term horizon gives some scope for financial planners to guide clients in taking measured risks for the purpose of generating real returns. Investors will therefore need to include in their portfolio some or a combination of growth assets, such as:

- Equities
- Credit (non-government bonds)
- Property

Financial planners may also choose to capture other investment risk premia within retiree clients' portfolios, such as term risk (on fixed income securities) and illiquidity risk (on direct assets).

Improving exposure to equity risk

The major risk premium present in a post-retirement portfolio is likely to be equity risk. This risk premium tends to dominate all others, even in a balanced portfolio. The key features of an equity exposure suitable for a retirement portfolio are:

- Exposure to the equity risk premium.
- A means of mitigating the full impact of market downturns.

The chart below shows that over time, equity markets rise around 60% of the time and fall around 40% of the time (based on monthly data). This chart shows 20 years of data, and the same picture is true over longer periods. The chart also shows that market falls are, on average, bigger than market gains.

Market returns over time

Cumulative investment returns
20 year period ending 30 September 2020

	Frequency	Average size
Up markets	**58%**	**+2.6%**
Down markets	**42%**	**-2.9%**

Source: Morningstar, Fidelity International

The next chart shows how investments that have different downside/upside capture ratios perform over time. **Downside capture** is defined as the proportionate performance of an investment during down markets. **Upside capture** is the proportionate performance during up markets. Ideally, for a client in retirement, we want to have low downside capture (that is, in a falling market we want a portfolio to fall less than the market) and high upside capture (that is, when markets are rising we want the portfolio to keep up or outperform the market).

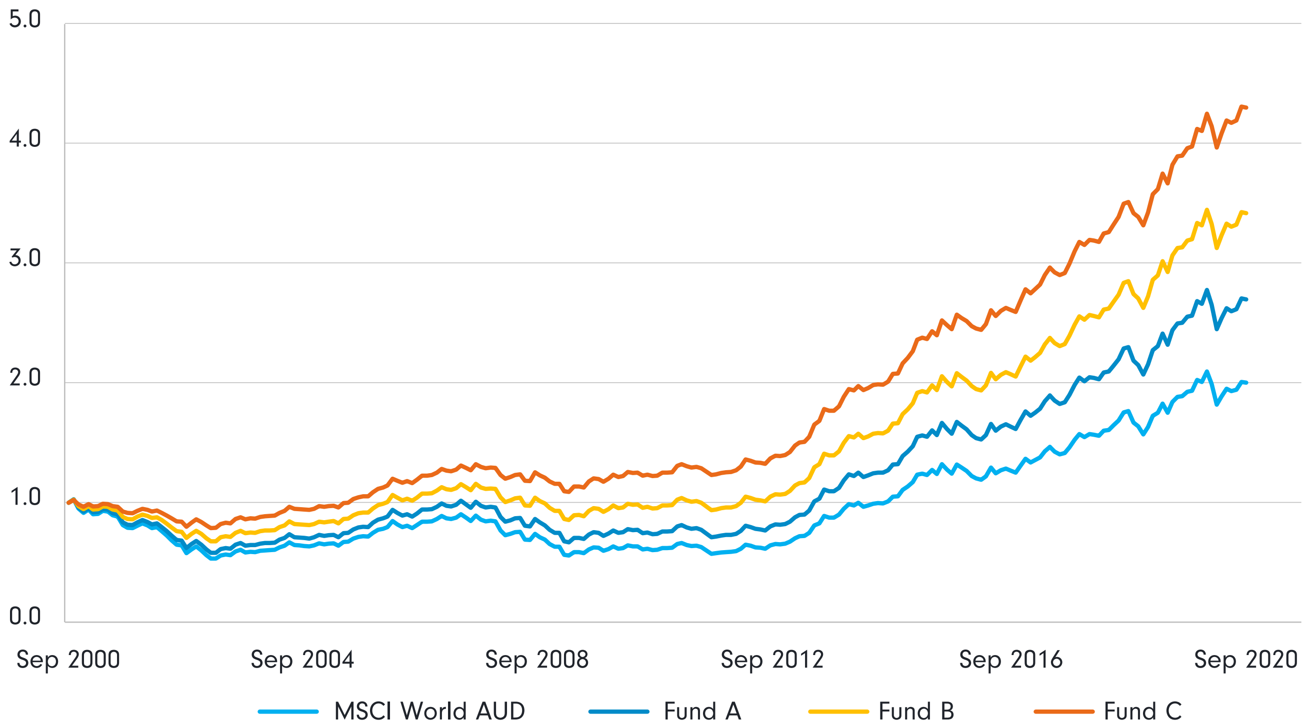
Capture spread is simply defined as the difference between upside capture and downside capture.

This chart shows how well a conservative portfolio performs over an extended period of time by doing much better than the market during months when the market falls. The fact that the portfolio tends to lag the market when the market is rising does not prevent the investment from producing excellent results over time.

Managing equity risk

Cumulative investment returns
20 year period ending 30 September 2020

	Downside/upside capture	Capture spread
MSCI World	**100% / 100%**	**0%**
Fund A	**90% / 100%**	**10%**
Fund B	**70% / 90%**	**20%**
Fund C	**50% / 80%**	**30%**



Source: Morningstar, Fidelity International

But the next chart is particularly striking. It shows the impact of compounding over time – that is, the effect of dollar-cost averaging. As many of us know, dollar-cost averaging works well when saving for retirement, as contributions to retirement savings when markets are depressed tend to do especially well when those markets recover. This is the well-known benefit of long-term compounding. However, what is less well understood is that the reverse is true when investors are drawing an income from their retirement savings.

To illustrate the power of dollar-cost averaging in retirement, the chart below shows that in decumulation the compounding effect of doing relatively well when a market falls makes a huge difference to longer-term outcomes.

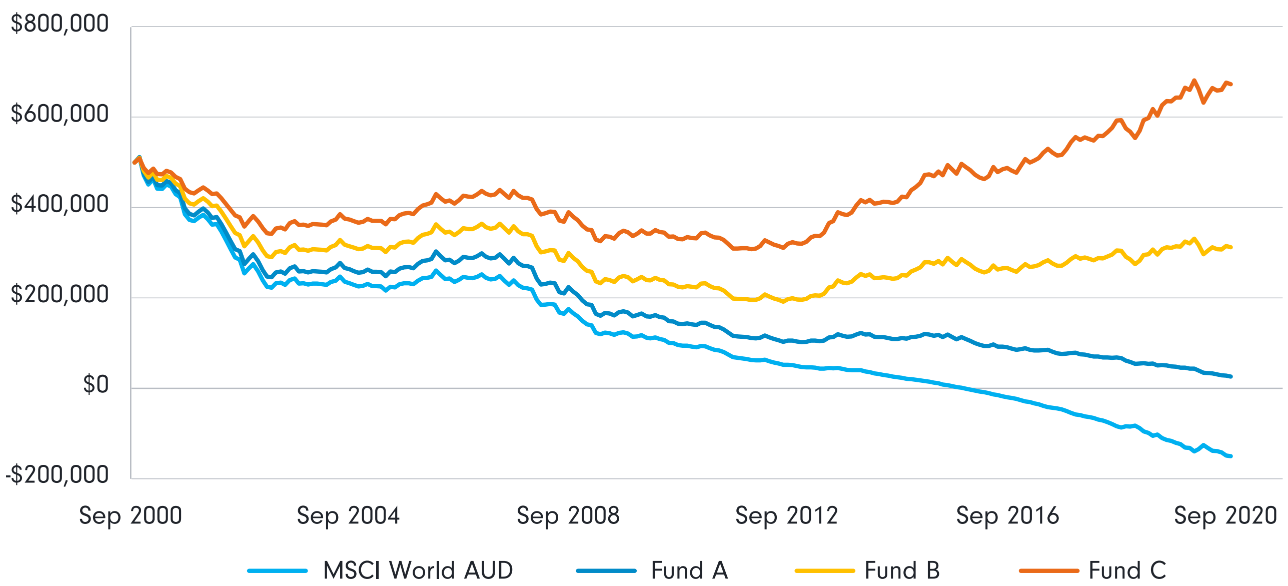
This chart is based on the same returns as shown on the previous page, but the differences this time are huge because of the compounding effect.

Decumulation — managing retiree risks

Cumulative investment returns 20 year period ending 30 September 2020

Decumulation outcome:
Start balance: $500,000
Withdrawal $2,000 per month

	Downside/upside capture	Capture spread
MSCI World	**100% / 100%**	**0%**
Fund A	**90% / 100%**	**10%**
Fund B	**70% / 90%**	**20%**
Fund C	**50% / 80%**	**30%**



Source: Morningstar, Fidelity International

So, in summary, the right kind of equity exposure in retirement is one that protects a retiree's portfolio from falling markets, and yet broadly keeps up when markets are rising. In fact, this applies equally to late stage accumulation portfolios when an individual is getting close to retirement. Preserving capital during market volatility can make a huge difference to outcomes at retirement.

Income investing

Finding income in the current environment is probably the greatest test for financial planners constructing investment portfolios for retiree clients. With term deposit rates and rates available on other 'low-risk' investments being so poor, finding attractive income is a tough proposition.

With this in mind, some general principles will serve financial planners and investors well in this environment:

Taking appropriate risk. There is little doubt that investors will have to take some extra risk to generate the income they need in retirement. With term deposit rates and low-risk bond portfolios producing less than 1% for the foreseeable future, investors need to take risk to generate an acceptable income. The key to this will be taking the right amount of risk for the income being generated, not too much and not too little.

Drawing on capital. The government minimum drawdown rules on super in retirement (4% from age 60, 5% from age 65, and so on*) are such that it is likely that investors will be required to draw down on at least some capital each year, with the natural income on a portfolio's underlying assets being unlikely to be as high as the required drawdown rate.

Diversification of income source. This will be a key principle to follow. Any single source of income will be subject to its own risks, so diversification of these risks will be key. Financial planners will need to try to find a few different sources of income for their clients to minimise the potential that any one of them causes an issue in the portfolio.

Fixed income. Australian 10-year bonds are yielding a little less than 1% (at time of writing).[4] The credit market in Australia is very narrow, with little opportunity to diversify. So it would make sense to invest more broadly into global fixed income, and into the various investment-grade and high-yield markets around the world.

Listed property. These stocks have been good yielders in the past. However, there is little doubt that real estate investment trusts (REITs) can go through periods of heightened volatility, often more so than equity. The extra volatility can be very unwelcome for a retired client in decumulation.

Hybrids. These have been popular in the past but have sometimes been confused for lower-risk fixed income securities. Hybrids are much riskier than traditional fixed income, being one step away from equity. They are best used as part of a more broadly diversified portfolio, but investors need to comprehend the risks and should treat hybrids more like equity than fixed income.

Mortgage funds. These can show attractive levels of income but again there can be significant risks, depending on the quality of a fund's underlying loan book. Again, care is needed and they are best included as part of a broader, more diversified portfolio.

4 Source: Interest Rates Chart Pack, Reserve Bank of Australia, October 7, 2020, https://www.rba.gov.au/chart-pack/pdf/chart-pack.pdf?v=2020-10-22-10-33-29

* These rates have been temporarily reduced during the COVID-19 crisis.

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** Data as at 30 September 2020. Read more at fidelityinternational.com