MEETING THE RETIREMENT INCOME CHALLENGE
APRIL 2013
INTRODUCTION

The Australian retirement system is generally regarded globally as being well advanced, ranking third in the 2012 Mercer Melbourne Global Pension Index behind Denmark and the Netherlands.

However, the much heralded superannuation guarantee (SG) scheme in Australia has created a disproportional focus on the pre-retirement or accumulation phase, compared to the post-retirement or decumulation phase. As a result, we have seen innovations and product development to help individuals grow their nest egg up to retirement age. However, the relative vacuum of ideas tailored to meet what Mercer views as the fundamental purpose of the whole endeavour – to provide an adequate income stream which will last for a retiree’s lifetime – persists today.

The case for why this issue is of increasing importance will be familiar to most. An ageing population who are living longer and maturing superannuation systems highlight why this is fast moving up the agenda of many governments across the developed world.

The ability of sovereign governments, already swamped with large budget deficits to manage this issue, will be crucial. The typical over-reliance on the State to support people in old age is not sustainable. In Australia, more than 70% of the average person’s retirement income is currently sourced from the age-pension.

This percentage is expected to reduce over time as the SG system matures but it does highlight the change in mind-set still required in the way individuals and the superannuation industry thinks about how to generate an income stream throughout retirement.

A worrying, counter-productive trend in recent years has seen a significant increase in the level of personal debt being taken on by many Australians. Recent research suggests this trend indicates an inclination for many Australians to boost their living standards in the lead up to retirement in anticipation of being able to use a tax free lump sum at retirement to pay off this debt.

There are many sobering statistics that highlight why a sustained focus on the post retirement sector is of paramount importance for Australia. The purpose of this paper is not to labour these well documented arguments but to consider the existing framework and range of solutions currently available to Australians in their efforts to ensure an adequate income stream in retirement.

Today, the income an individual may expect to receive in retirement will typically be sourced from the following three areas – often referred to as the three pillars of the Australian Retirement Income System:

- **Age Pension** (Social Security) – The Age Pension is effectively the yardstick for the basic amount people can survive on in retirement. In Australia, the Age Pension is means tested and is intended to work in conjunction with superannuation. The Age Pension is designed to provide a ‘safety net’ for those who do not have enough superannuation or other financial resources to provide an adequate retirement income.

- **Superannuation Guarantee** (SG) – The second pillar of the Australian retirement system will not fully mature until 2037 after which individuals will potentially have had a full working life (40+ years) of compulsory superannuation contributions of at least 9 per cent.

- **Additional Contributions** – The third pillar generally has been seen as the tax-assisted voluntary part of the superannuation system.

The focus is clearly on the second pillar. While the others will remain integral to a properly functioning retirement system, making progress with the SG framework and an individual’s ability to sustain an adequate income throughout retirement will be a key determinant of success.

RETIREMENT INCOME – HOW MUCH IS ENOUGH?

While the answer to this question will be subjective, it does encourage individuals to ponder a critical element of any retirement income plan. Surprisingly, the question is rarely given the attention it deserves as part of informing the optimal income solution for individuals or superannuation funds as a whole.

Understanding how much income an individual will need for a reasonable lifestyle in retirement is key – without this, it is very difficult to know how much capital will be required and, therefore the appropriate investment strategy to pursue during the pre-retirement period. The concept of “income adequacy” is a key component of the retirement debate and the availability of calculators and other tools are helping individuals make more informed decisions.

The ASFA Retirement Standard benchmarks the annual budget needed by individuals and couples to fund either a comfortable or modest standard of living in their post-retirement years. The table below highlights December 2012 benchmarks.

<table>
<thead>
<tr>
<th>MODEST LIFESTYLE</th>
<th>COMFORTABLE LIFESTYLE</th>
</tr>
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<tbody>
<tr>
<td>Single Person</td>
<td>$22,585</td>
</tr>
<tr>
<td>Couple</td>
<td>$32,555</td>
</tr>
</tbody>
</table>

Source: The Association of Superannuation Funds of Australia Limited

1CPA Australia: Household savings and retirement – ‘where has all my super gone?’
RISKS & REQUIREMENTS IN RETIREMENT PHASE

In considering any retirement income solution, it is important that due attention is given to the key risks to which retirees are exposed as well as taking account of the changing dynamics between the pre- and post-retirement phases.

To summarise, the key risks in retirement are:

- **Longevity** – risk of outliving your savings.
- **Market** – risk of losing a significant portion of your retirement savings due to a fall in investment markets.
- **Inflation** – risk that the rate of inflation results in the real value of your retirement savings declining.

In addition to seeking protection from the above risks, most members would likely list the following as desirable features in any post-retirement solution:

- **Access to capital** – as retiree’s circumstances can change, having the flexibility to access your retirement savings if required is always preferable.
- **Potential growth in capital** – although this requires taking on some degree of market risk, most retirees would a) have insufficient savings to purchase an adequate income stream that is guaranteed and b) still have a relatively long investment time horizon (assuming they reach their life expectancy age).
- **Low fees** – as product innovation in the post-retirement space advances, some of the proposed solutions are becoming increasingly complex and the fee structures that accompany them can be quite high.
- **Stability of income** – retirees tend to rank certainty of income near the top of their list in any post-retirement solution.
- **Easy to understand** – retirees have a preference for retirement strategies that have low complexity, are transparent and can be communicated quite easily.

As noted earlier, there is an inherent conflict between many of the features retirees often regard as desirable in a retirement income strategy. The correct level of emphasis to place on any of these features will be dependant on each individual’s circumstances. In the case of default superannuation funds, the absence of comprehensive information on each individual means that certain assumptions will always need to be made when designing a retirement income solution. We suggest that any solution should take account of the above preferred characteristics but as a core objective seek to help retirees draw down an income that is both adequate and sustainable throughout retirement in conjunction with the age-pension.

The next section provides a brief overview of the range of options available to retirees in Australia today.
RETIREMENT INCOME STRATEGIES – OVERVIEW OF OPTIONS IN AUSTRALIA

In simple terms, retirement income solutions tend to either be investment based (strategies where the outcome is linked to market returns), insurance based (providing some level of guarantee) or some hybrid of the two.

INVESTMENT STRATEGIES

Account Based Pensions (ABP)

<table>
<thead>
<tr>
<th>Summary</th>
<th>ABPs offer retirees a relatively simple and flexible way of receiving their super balance as a tax effective income stream. Account based pensions allow an individual to control their retirement income by varying the amount (subject to minimum withdrawal requirements) and frequency of income paid, as well as allowing them to draw a lump sum if necessary. ABPs are the pension vehicle of choice for most Super Funds in the Australian post-retirement space today.</th>
</tr>
</thead>
</table>
| Advantages | • Simple and transparent structure that is familiar to most individuals and therefore relatively easy to understand.  
• Flexibility to vary drawdown levels as required  
• Provides exposure to market returns |
| Disadvantages | • Does not protect against risk of outliving your savings (longevity)  
• Income stream is not guaranteed |

Lifecycle Strategies

<table>
<thead>
<tr>
<th>Summary</th>
<th>Traditional lifecycle investing strategies have sought to determine the most appropriate asset mix for investors to balance their risk and return profiles based on their age. Lifecycle investing continues to evolve with other variables (target income for example) being used to determine the optimal asset mix over time. While still in its infancy here in Australia (compared to the UK and US) lifecycle strategies are becoming more prevalent in this market. Emphasis traditionally has been on the pre-retirement phase but offering lifecycle glide-paths that cover the post-retirement phase is becoming more common.</th>
</tr>
</thead>
</table>
| Advantages | • Provides comfort to the “hands-off” investor that their investment exposure is being managed in line with agreed criteria.  
• Provides exposure to market returns  
• Seeks to manage the volatility of member balances at key life stages (lead up to retirement)  
• Access to capital is maintained at all times |
| Disadvantages | • Usually does not offer any protection from longevity risk  
• Does not provide a guaranteed income stream  
• Depending on level of complexity, lifecycle funds can be challenging to administer on behalf of members |

GUARANTEED STRATEGIES

Lifetime Annuities

<table>
<thead>
<tr>
<th>Summary</th>
<th>A guaranteed lifetime annuity, as the name implies, is a way to provide a guaranteed income for the rest of your life, no matter how long you live. The annuity stream is typically backed by the financial strength and ability of an insurance company (product provider) to meet the payments.</th>
</tr>
</thead>
</table>
| Advantages | • Stability of a guaranteed income stream paid to the annuitant on a regular basis for the rest of their life  
• Protection against longevity risk |
| Disadvantages | • Risk that counterparty (insurance company) defaults on the annuity payments  
• Inflexible: access to capital is difficult and benefits are often not paid to dependants upon death  
• Lack of market exposure removes prospect of growing a retiree’s income stream overtime  
• Generally no inflation protection  
• Current yields on these products are at historical lows  
• Costs are considered expensive and opaque |

(Continued on next page)
## GUARANTEED STRATEGIES (continued)

### Term Annuities

<table>
<thead>
<tr>
<th>Summary</th>
<th>An insurance product that guarantees a periodic payment of a predetermined amount for a fixed term.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advantages</td>
<td>• Secure income stream locked in for the term of the contract</td>
</tr>
</tbody>
</table>
| Disadvantages | • Does not offer protection against longevity risk  
• Access to capital is difficult and payments are not always paid to dependants upon death  
• Generally no inflation protection |

### Deferred Lifetime Annuities

<table>
<thead>
<tr>
<th>Summary</th>
<th>An insurance product that guarantees an income stream (predetermined or market linked) for life upon reaching a certain age.</th>
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</thead>
</table>
| Advantages | • Protection against longevity risk  
• Provides retiree with additional safety net on top of the Age Pension |
| Disadvantages | • No access to capital  
• Disincentive to purchasing deferred annuities in Australia (although we note the government has signalled its intent to improve the attractiveness of deferred annuities)  
• Generally no inflation protection |

### HYBRID STRATEGIES

#### Variable Annuities (VA)

<table>
<thead>
<tr>
<th>Summary</th>
<th>A variable annuity, just like any annuity, is a contract with an insurance company. With a variable annuity, the VA holder has access to market returns while also offering income protection (via an income guarantee “wrapper”).</th>
</tr>
</thead>
</table>
| Advantages | • Combines the flexibility of an account based pension and the security of a guaranteed income stream  
• Protection against longevity risk (i.e. lifetime variable annuities) |
| Disadvantages | • The punitive costs can often make variable annuities unattractive to prospective buyers  
• Product complexity tends to be quite high |

#### Capital Protected Products

<table>
<thead>
<tr>
<th>Summary</th>
<th>As the name suggests, capital protected strategies are investments that include a capital guarantee of the initial investment amount, usually up to a set percentage (often 100%). An investor in a capital protected product maintains the ability to participate in any market upside while ensuring the capital is protected from falling below an agreed minimum level.</th>
</tr>
</thead>
</table>
| Advantages | • Access to market returns (albeit usually at a capped level)  
• Protection from loss of capital if markets are negative |
| Disadvantages | • Limited access to capital (or punitive charges imposed if redeemed early)  
• Fees tend to be quite high  
• Product complexity  
• No longevity protection |
CONCLUSION

The Australian retirement system is generally regarded as being well positioned relative to most other countries around the world. However, this should not result in the assumption that the Superannuation Guarantee scheme will automatically lead to the majority of Australians eventually becoming self-funded retirees. About 50% of all retirees in Australia today are still entirely reliant on the age pension. While this is expected to decrease as the SG scheme matures, the increasing levels of personal debt being taken on by many approaching retirement is a worrying trend. This behaviour pattern is clearly at odds with the intent of the SG scheme and should be monitored.

More certainty is required for individuals in retirement. There is an increasing awareness of the historical tendency to over focus on the needs of pre-retirees at the expense of those in the retirement phase. However, the lack of successful innovation in the retirement income area suggests that this awareness is yet to result in the development of practical solutions.

Despite the range of retirement solutions outlined in the previous table, the reality is that most are not yet seen as being practical for the typical Australian retiree in their quest for an adequate and sustainable income stream. In reality, the vast majority of Australians that do not take their entire Super as a lump sum are invested in an account based pension that has an investment strategy very similar to the pre-retirement default option. The important point being that, in the majority of cases, there is little consideration given to tailoring the investment strategy for the specific needs of retirees.

Although most funds are currently caught up in their endeavours to comply with the new legislation under Stronger Super, we believe a greater focus on the needs of their retiring members should go hand-in-hand with this effort – regardless of whether or not the post-retirement phase is covered under legislation.

In terms of product innovation, the industry cannot afford to become obsessed with the search for a silver-bullet retirement income solution to meet the needs of all retirees. Understanding your member base and improving on the scant range of suitable retirement income options currently available to most Australians should be a primary focus for our industry.
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JP CROWLEY, SENIOR ASSOCIATE

JP is a Senior Associate in Mercer’s Investments business, based in Melbourne, advising a range of corporate super, insurance and charity based clients.

Prior to joining Mercer in January 2011, JP worked at Ibbotson Associates as a Senior Consultant helping to drive key client relationships through the provision of tailored investment advice and services with a variety of industry super and charity funds. A core responsibility here was to lead reviews of client SAAs from the investment objective setting phase, through to the broad portfolio SAA recommendations put forward to the client for approval.

In the past, JP worked with Bank of Ireland Asset Management in Dublin as a Relationship Manager. This involved directly managing the bank’s relationship with a portfolio of institutional superannuation, corporate & charity investors.

JP has an honours degree in Commerce (economics and Government) from University College Cork in Ireland. He is also a Certified Investment Management Analyst, an industry qualification offered by the Investment Management Consultants Association (IMCA).

GRAEME MATHER, PARTNER

Graeme is a Partner and Market Leader for Mercer’s Investments business in Australia and New Zealand. He advises clients on the full range of investment issues, with particular interest in whole-of-life and post-retirement issues. Graeme is also the leader of Mercer’s defined contribution consulting client unit and is a member of Mercer’s Market Leadership Team for Australia and New Zealand.

Graeme has more than 15 years of experience within the pensions and investment industry. Prior to joining Mercer in 1998, he was a Financial Adviser with Lloyds TSB plc.

Graeme graduated from the University of Abertay, Dundee with an honours degree in accountancy and finance. He is an Associate of the UK Society of Investment Professionals and a member of the CFA Institute.