

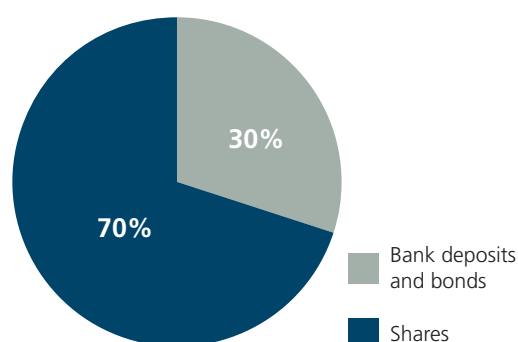
# Rethinking post-retirement asset allocation

While growth assets are widely accepted in asset allocation decisions during the accumulation phase, many investors overlook the benefit allocating to shares can provide in the way of growing tax-effective income in the post-retirement phase. This paper discusses the differences between pre- and post-retirement asset allocation and how investors can use an equity income strategy to improve income and returns with less risk.

This paper finds that utilising a simple hedging strategy over the retirement equities allocation can improve the length of time the equities allocation can support a given amount of inflation adjusted retirement spending by over 34% in situations where the sequence of market returns are poor. This hedging strategy allows investors to safely increase their allocation to equities in a retirement context. When this is combined with non-index aware investment process that seeks out companies with high sustainable free cash flow, retirees stand to benefit from higher and faster growing income with lower risk.

During our working lives, investment strategies are typically aimed at accumulating wealth and are less concerned with year-to-year return fluctuations. During this accumulation phase – it usually makes sense to skew portfolios towards growth assets such as shares in order to maximise the final value of the portfolio. While annual returns from such strategies can be quite volatile, over longer time periods the volatility is less pronounced, particularly when inflation is taken into account.

Chart 1: Illustrative accumulation asset allocation



## Needs of retirees compared to workers

Accumulation investors generally do not need to rely on their portfolio returns or withdrawals of capital to support their lifestyle and are purely investing to maximise their wealth, subject to their risk tolerance.

In retirement, investors have a very different risk profile and appetite and should think about risk and return differently.

According to National Seniors Australia<sup>1</sup>, over 90 percent of seniors rate the following factors as very important when addressing retirement spending (in order of importance):

1. Meeting the rising cost of healthcare
2. Ensuring their money lasts a lifetime
3. Having regular income to cover the essentials
4. Income that adjusts for inflation
5. Ensuring their savings are not adversely impacted by market falls
6. Having access to their savings instantly when needed

Thus, for retirees cash-flow matters and the pathway of returns matters. Retirees will be reliant on the income from their portfolio to live on. **The higher the income, the higher the cash available to fund day-to-day expenses without the need to sell the capital assets that produce the income.**

Furthermore, the month-to-month fluctuations in returns – both capital and income – of those assets matter. Investors in the accumulation phase can endure market declines because they have time to recover their losses and also can contribute more funds to buy assets at lower prices.

<sup>1</sup> National Seniors Australia / Challenger, “Retirees’ Needs and Their (In)Tolerance for Risk” March 2013.

## The two key investment considerations for retirees

### 1. Sequencing risk

Retirees do not have the luxuries afforded to accumulation investors. Not only do they not have a steady income from their workplace skills – their human capital – to supplement their financial capital, but **if they have to sell their financial capital to fund their living expenses during periods of lower prices, their retirement savings are not likely to last as long.**

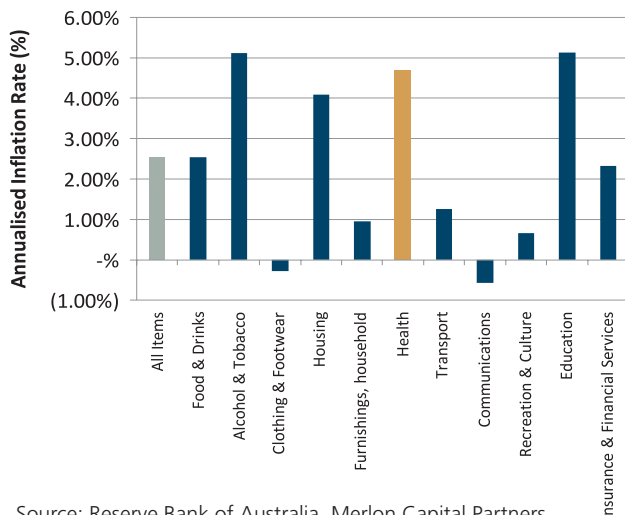
This is known as sequencing risk, because it is higher at the early stages of retirement when the retirement portfolio is largest but needs to last the longest – hence the sequence of either good or bad returns is very important. Retirees can mitigate sequencing risk by investing in low-risk assets that have less capital value volatility, but this comes with another trade-off, known as longevity risk.

### 2. Longevity risk

Longevity risk is essentially the risk of outliving one’s money. Investing in low risk assets minimises sequencing risk, but it comes with the trade-off of potentially not generating sufficient returns to meet desired spending over the retirement timeframe. In the current low-yield environment, traditional retirement asset allocations heavy on fixed income, term deposits and cash simply do not provide the same future expected returns that they used to.

A key component of longevity risk is inflation – which erodes the purchasing power of savings. This is why it is important to **ensure both your income and your capital value keeps up with the rising cost of living.** Whilst inflation has moderated in recent years, the fact remains that the cost of living for retirees is actually rising faster than the broader population, largely in part due to healthcare costs.

Chart 2: Annualised Inflation Rate by expenditure category since June 2005



Source: Reserve Bank of Australia, Merlon Capital Partners

## Objectives of retiree investors

Investors face a number of competing objectives and are thus seeking:

- **Less risk** than accumulation strategies to provide a greater sense of certainty that assets will continue to support a comfortable retirement
- **Growing income** from their investments to support their ongoing living expenses and keep pace with inflation
- **Some capital appreciation** over time, to ensure that the capital value and income streams keep pace with the rising cost of living
- **Liquidity** to meet lumpy and unexpected retirement expenses.

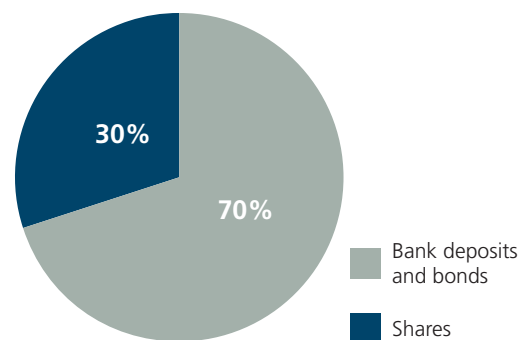
Such objectives can be conflicting, with higher levels of income typically associated with higher risk and/or lower levels of capital return.

## Why traditional thinking on asset allocation in retirement needs to change

### Traditional retirement allocations are heavy on fixed income...

In making this trade-off, a typical retiree portfolio would skew them away from growth assets such as shares, towards less volatile assets, such as bonds and cash.

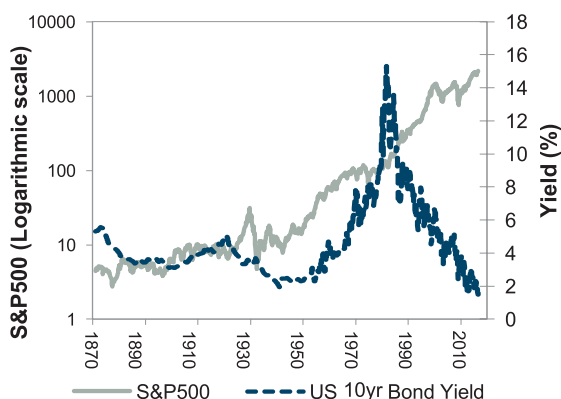
Chart 3: Illustrative retirement asset allocation



As illustrated above, the traditional way of dealing with some of the risks in retirement portfolios is through asset allocation – shifting the mix of assets into less volatile asset classes such as bonds and cash. This is generally a conscious decision to trade more longevity risk for less sequencing risk: a higher risk portfolio has higher future return potential – reducing longevity risk – but at the expense of sequencing risk if a large market crash takes place early.

This traditional allocation towards fixed income has been supported by a favourable return environment for fixed income securities over the last 30 years as long-term interest rates have fallen, which coincides with much of the development of the retirement savings and funds management industry.

Chart 4: S&P500 (US) vs US 10yr Government bond yields

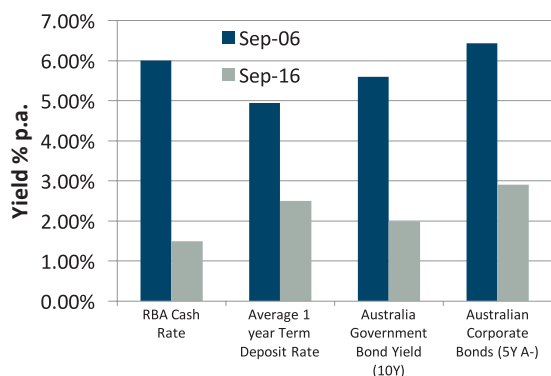


Source: Stock market data used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated

**....yet fixed income may not be able to deliver the same absolute returns going forward**

Fixed income still remains an effective portfolio diversification tool as its returns are generally negatively correlated to equities over the cycle. However, future returns are likely to be lower and more volatile. In addition, fixed-rate bonds (which comprise the majority of traditional benchmark fixed income allocations) are a poor inflation hedge – interest by definition is fixed and does not grow, nor do investors benefit from tax-effective franking credits. Whilst falling interest rates have supported historical fixed income returns, it means that current yields – the 'price of safety' – are at record lows.

Chart 5: Current yields are at record lows



Source: Reserve Bank of Australia

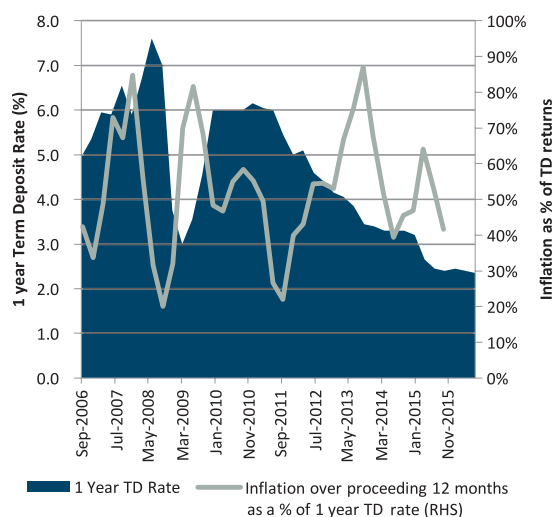
For retirees with capital within account based pension structures, with minimum annual draw-downs exceeding 4% and rising to over 7% during the peak spending periods of retirement, current yields on the fixed income asset classes in Chart 5 mean that they must spend capital to meet their minimum drawdown requirements.

If investors need to draw down capital to meet spending, this means that the capital remaining is less likely to last as long. It is unlikely that the yields on the above instruments will go back to the levels that existed before the GFC in the foreseeable future given global macro-economic headwinds.

**Retirees face more inflation risk, yet returns above inflation are hard to predict**

Many investors fail to appreciate that whilst the absolute level of inflation is low (albeit rising) at present, the level of inflation in comparison to the returns on so called safe investments like term deposits is very hard to predict. Chart 6 shows historical 1-year term deposit rates every quarter over the last 10 years (shaded) and the percentage of the return of that term deposit rate absorbed by inflation over the next 12 months.

Chart 6: Historical 1-year term deposit rates vs average TD returns absorbed by inflation



Source: Reserve Bank of Australia, Merlon Capital Partners

As you can see, this varies significantly, with some years seeing nearly 90% of average term deposit returns absorbed by inflation, and this was in periods where interest rates were much higher than they are now.

This highlights just how unpredictable real returns over and above inflation can be on low yielding investments like term deposits, making it more important to find investments with a greater cushion above inflation, otherwise known as a real return, to prevent erosion of the purchasing power of retirement savings.

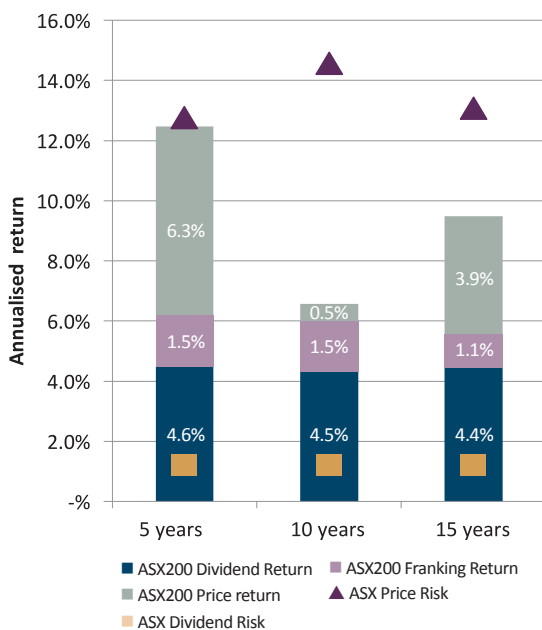
## How equity income strategies address the two key investment considerations for retirees

Investment in equities has the potential to add considerable value to the issues detailed above. Equity income strategies attempt to build upon the inherent income production strengths of equities whilst reducing the risk of capital loss.

### Use of equity income strategies to lower longevity risk

Australian equity yields have remained attractive compared with pre-GFC levels. Unlike foreign equities, which often have yields below 3% and no franking credits (plus extra volatility on this income stream by virtue of foreign exchange risk), Australian equities deliver cash-flows to end investors that are the envy of the world.

Chart 7: The steadying power of dividends



Source: Bloomberg, Merlon Capital Partners. Returns as at 30 September 2016, inclusive of franking credits.

Importantly, dividend income streams are much less risky than many investors would assume. Over the past five years from October 2011, the return on the ASX200 price-only index has averaged 6.3% p.a. with risk of 12.6% p.a. Yet the same index, but with dividends and franking credits included and reinvested, has returned 12.9% p.a. with risk of 12.1% p.a. – much more return with slightly less risk.

The returns from dividends inclusive of franking credits on the ASX200 have been consistently around 6% p.a. over the past 15 years with around 1.5% annual volatility – a testament to the steadying influence of dividends on overall returns.

Furthermore, within an Australian context, retirees also benefit from the tax treatment of fully franked dividends relative to

bank deposits and bonds. For retirees, franking credits are as valuable as cash dividends or interest received, and can reliably add an extra 1.5% to 2.0% in annual returns.

In short, shares can provide rates of return from dividends alone that can exceed minimum drawdown amounts on pension accounts.

Shares also deliver capital returns that ensure portfolio values keep up with inflation. Companies with good competitive positioning within their respective industries have what is called ‘pricing power’, meaning that they are able to pass on increases in the cost of their inputs to their end customers, or they benefit from economies of scale that enable them to grow revenue whilst keeping their costs relatively static. Both of these factors mean that investments in well run, strongly positioned companies should benefit from cash flow streams that comfortably exceed inflation over time.

Furthermore, as we have seen, the average dividend yields on the market have remained very consistent through time, yet the capital value on the share market has increased. This means that the actual cash flows received from the stock market have increased in line with the capital value appreciation, growing at a much faster rate than inflation. So shares have the potential to deliver a rising capital value and a rising cash flow stream that protect against losses of purchasing power.

### Use of equity income strategies to lower sequencing risk

Despite the income advantages of Australian shares, retirees are left with higher price risk than other asset classes. A way to reduce this risk is to use derivatives that remove a large part of the price risk associated with a traditional share portfolio, while at the same time retaining the significant tax benefits – the access to franking credits.

This approach partially hedges share exposures by selling call options and using proceeds to purchase put options. The call options reduce returns in stronger markets but, importantly, the put options protect capital in weaker markets.

The net effect is that volatility is reduced, leading to less sequencing risk. Because hedged share portfolios are less risky than traditional share portfolios, a greater allocation is justifiable for a given level of overall risk, lowering longevity risk whilst ensuring that the contribution of the share allocation to sequencing risk remains flat or declines.

To illustrate this, we have modelled two hypothetical portfolios. Both have an initial investment of \$100,000, a \$10,000 per annum spending rate that is adjusted upwards at an inflation rate of 2.5% per annum and a consistent annualised dividend yield of 4.5% per annum that is 100% franked. To model returns, we have assumed the same

level of monthly risk and average monthly returns that have prevailed over the past 10 years (which includes the global financial crisis). As this is a simulation, the modelling takes these variables and generates a random series of monthly returns within certain parameters called a normal distribution.

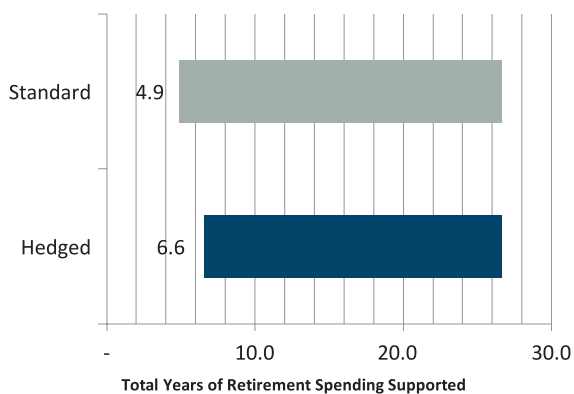
In this case, this means that, roughly 66% of the time, the monthly price return on the hypothetical portfolio will vary between 4.3% and -4.0% (and 33% of the time it will be more volatile than that), but will likely be more clustered around the average monthly return over the 10 year period of 0.13%.

The only difference between the two portfolios is that one includes hedging that reduces 30% of the price volatility of the portfolio (reducing sequencing risk) and the other doesn't.

The output is measured by how long the portfolio is able to support the inflation adjusted retirement spending before the portfolio is depleted (longevity risk). A larger number means that the portfolio is able to generate more retirement spending capacity, or in simple terms, it lasts longer.

Running the simulation 50,000 times gives the following result.

**Chart 8: Range of outcomes from simulation (worst to best case)**



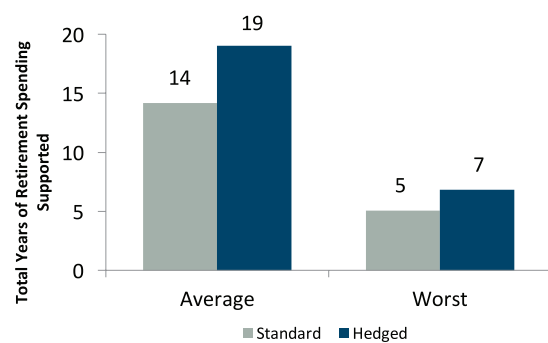
As you can see, the best possible outcome is the same for both portfolios, with the \$100,000 portfolio supporting aggregate retirement spending for approximately 27 years before it is fully depleted. On average, both portfolios last about 15 years before they are fully depleted. Where the volatility protection provides the most value, however, is on the downside protection. With the standard portfolio, the worst possible outcome across the 50,000 simulations is that the portfolio only lasts 4.9 years.

However, with the hedged portfolio, the worst possible outcome is that the portfolio supports the desired level of spending for 6.6 years, an improvement of over **34%**.

To illustrate the difference in outcomes using some more assumptions about active management, we can add a 0.9% p.a. management fee for the hedged actively managed portfolio, 0.15% p.a. management fee for the passively run standard indexed portfolio, and assume that the portfolio manager for the actively managed portfolio is able to deliver an additional 1.5% p.a. in dividend yield alpha through finding companies with higher levels of sustainable free cash flow than the market and 2.5% p.a. in capital gain alpha from investing in undervalued firms rather than just following benchmark allocations (all pre fees) – thus covering their management fees and delivering additional value to the investor.

The difference in retirement spending longevity is more pronounced with the additional value add from active management.

**Chart 9: Retirement spending longevity**



Whilst the best possible outcomes are 27 years for both portfolios, the hypothetical actively managed product supports retirement spending for **over 19 years versus 14 years** and the worst possible outcome is around **51%** better than the passively managed investment.

## Putting it all together – higher retirement income and longer lasting savings with less risk by using Merlon

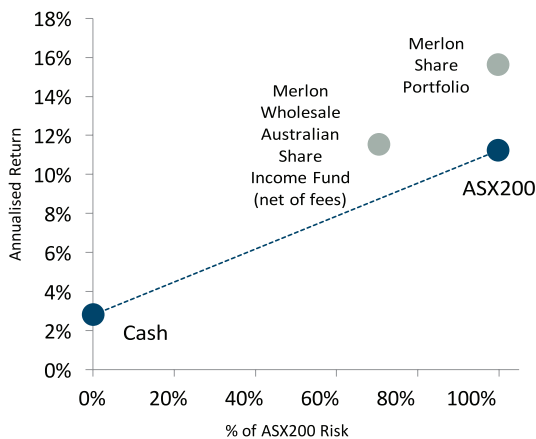
Most managed funds in Australia construct portfolios with reference to an index which typically weights shares by their market values.

Hedging an Australian index-based portfolio makes little sense for retirees. This is because a large part of the market – most notably the resource sector – offers only limited fully franked dividends. Whilst hedging an index-based portfolio achieves a lower level of aggregate risk than a traditional share portfolio, it does not take full advantage of the available tax benefits associated with fully franked dividends.

An alternative is to hedge a portfolio of companies with high and sustainable underlying free cash-flows from their core businesses. This ensures that the companies in the portfolio are delivering dividends which are backed by the earnings from their core businesses, not manufactured using excessive leverage or short-term unsustainable changes in their capital investment programs or working capital usage.

Following on from income sustainability, a key component of capital preservation, it follows any investment should first-and-foremost be assessed on total return but taking risk into account. Chart 10 plots total return on the vertical axis and risk on the horizontal axis. Over a five year period, income is merely a component of total return and does not change the position of 'the dot'.

Chart 10: Merlon risk vs return



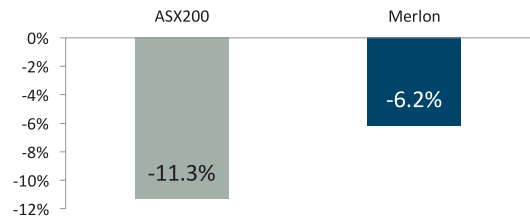
Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated after fees as at 31 August 2016. % of ASX200 Risk represents the Fund's statistical beta relative to the ASX200

Investors should be able to recreate any point on the line through a combination of cash and index investing, so active managers need to be 'above-the-line.' Merlon has achieved this over all time periods as a result of:

- Investing in undervalued companies and not starting with index positions – this improves the total return (see Merlon share portfolio above).
- The hedge overlay which reduces risk to 70% of the market.

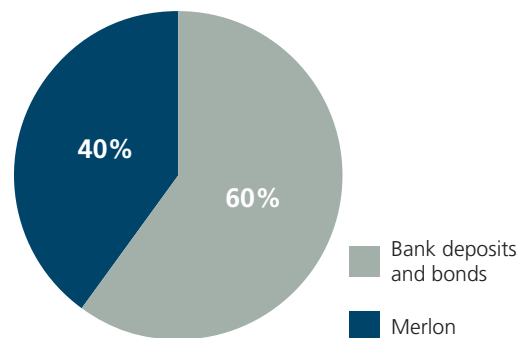
Furthermore, Merlon's hedging strategy and active management has reduced downside risk by approximately 60% over the past five years<sup>2</sup>.

Chart 11: A simple option strategy provides downside protection



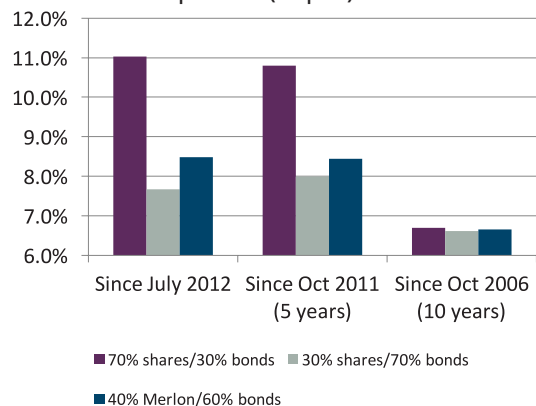
The combination of less risk for a given level of returns means that retirees can implement an alternative asset allocation approach and lift their allocation to shares as well as reduce their allocation to fixed interest, with the aim of achieving a higher overall return with the same or less risk.

Chart 12: Alternative retirement asset allocation



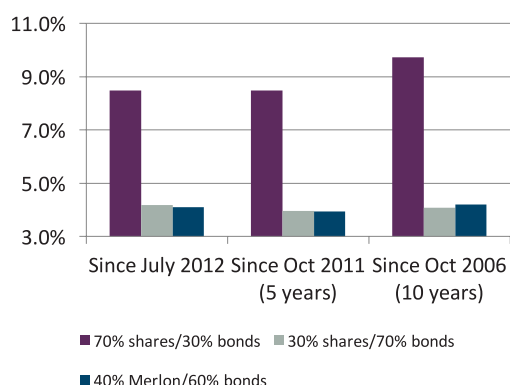
Undertaking the revised allocation would have resulted in a material increase in annual total returns for slightly less overall risk than the traditional 70% bonds / 30% equities allocation, particularly over the past five years and since the introduction of monthly distributions in July 2012.

Chart 13: Return Comparison (% p.a.)



<sup>2</sup> Average drawdown of fund v market over 5 years for drawdown events over 5%. Merlon Fund return based on daily unit price after fees and assuming reinvestment of distributions.

Chart 14: Risk Comparison (% p.a.)



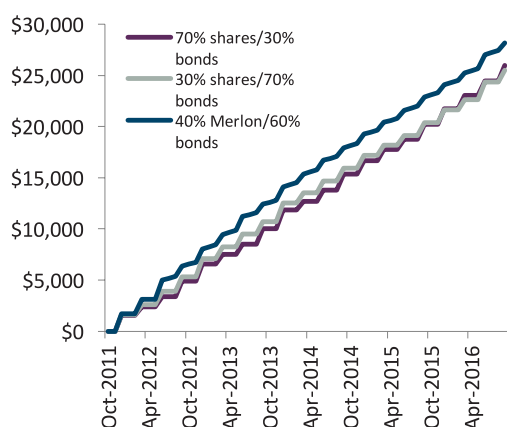
Source: Bloomberg, Merlon Capital Partners

The comparison of total returns above reinforces the merits of employing a volatility reduction strategy over an investment strategy that delivers higher returns than the market.

So on a total return basis, a higher allocation to the Merlon Wholesale Australian Share Income Fund results in a much better risk and return outcome than simply investing in an index fund. Furthermore, the Fund is structured to return a higher proportion of the total return as income, resulting in substantially more income to the end client in excess of the minimum pension drawdown requirements.

In order to assess this, we have used actual unit price and distribution data from the two largest and lowest cost index funds that track the broad Australian share market and bond market indices<sup>3</sup>.

Chart 15: Cumulative Income Paid on \$100,000 investment over 5 years



Source: Merlon Capital Partners, Vanguard

As you can see, not only does a higher allocation to the Merlon Wholesale Australian Share Income Fund than the traditional equity allocation outlined above deliver higher risk adjusted total returns, but the income that investors receive outstrips the traditional allocation.

## Conclusion

Unlike accumulation investors, retirees face different challenges to maintaining an income stream sufficient to deliver the lifestyle they have been saving all their working lives for.

Investing in shares allows retirees to access the strong fundamental cash flow generating capabilities of well-run companies which have the potential to generate dividend streams and capital returns which can maintain a portfolio's spending power.

Equity income strategies such as Merlon's can then overlay a volatility reduction strategy that can substantially lower the risk of the portfolio running out of money early. Combined with a fundamental research process that invests in companies that are undervalued and likely to generate sustainable cash-flows creates an equity solution perfectly suited for retirees.



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<sup>3</sup> Vanguard Australian Fixed Interest Index Fund (Wholesale) and Vanguard Australian Shares Index Fund (Wholesale).

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