WealthAdviser

IS YOUR NEST EGG SAFE?

Contents

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Letter from the Wealth Adviser Library

Dear Reader

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This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

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That’s why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

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Wealth Adviser Library

Introduction

A discussion paper which challenges the conventional wisdom: the “long only” approach to investing may be putting retirement savings at risk. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand and manage evolving risks within a system essential to the wellbeing of not just imminent retirees but the public at large. We have all been seduced into believing that present day financial planning strategies are viable and sustainable.

This world, where financiers and bankers, traders and speculators quietly shuffle interest rate swaps, CDOs (collateralised debt obligations), exotic and vanilla options, warrants and as of yet uninvented derivative products) products, to create unbelievable wealth for many players, still is intact. But as we read in Michael Lewis’ account of the origins of the subprime crisis in the book The Big Short, he was not shy of passing brutal judgement on Wall Street money managers who were being paid to manage investments but did not see the inherent flaws behind the looming subprime disaster. He wrote: “What are the odds that people will make smart decisions about money if they don’t need to make smart decisions? The incentives on Wall Street were all wrong; they’re still all wrong.”

When we look at how greater global access to labour, customers, through communications technology and capital, has lowered barriers to increases in the rate of innovation (think Facebook, iPod and iPad), we can see no basis for assuming capital markets will remain anything but benign.

This then is the backdrop to the report: there’s a problem with present day thinking based on past practices when every component of the investment equation is constantly evolving, where, notwithstanding that we have experienced a 29-year bull market, the ‘long only’ paradigm is seriously flawed and that future events including the possibility of an equally long secular bear market is not even on the agenda of the majority of money managers. Here we will demonstrate that volatility in markets is a real and present danger to imminent and current retirees. Account-based, allocated pensions may be products that carry an intuitive appeal but is it a solution given the likelihood of unpredictable events becoming increasingly likely going forwards?

Part 1 – The problem

For the financial services sector -- Australia’s largest industry –the next few years will undersee extraordinary change. It may also be a time when many of the shibboleths otherwise cast in stone get challenged and move towards a less opaque and more transparent, responsive and relevant system for this, the Knowledge Age.

In the gripping and compelling movie ‘Apollo 13’, the third Apollo mission intended to land on the Moon, an explosion cripples the service module upon which the Command Module depended, hence the message to mission control “Houston we have a problem”. Despite great hardship caused by limited power, loss of cabin heat, shortage of potable water and the critical need to jury-rig the carbon dioxide removal system, the crew returned safely to Earth. NASA called the mission a “successful failure”.

Without wishing to place too much emphasis on the metaphor, what is needed is to ensure that we too have a successful failure, when at this point the financial services sector still has a problem.

What’s the cause? It’s the economy stupid! Is one answer. But no it’s not the economy; it’s demographics. It’s easy to get swayed by the thinking of the day. If everyone is defining a problem or solving it one way and the results are subpar, this is the time to ask: What if I did the opposite?

What If Everything You Thought You Knew About Stock Investing Turned Out to Be Wrong?

New visions of ‘truth’ are so often met with vehement opposition. How is it that can we be so acutely aware of humanity’s bigoted resistance in the past to Galileo, Pasteur, and other radical discoverers?

For example, the first-century Egyptian astronomer Ptolemy established the Ptolemaic paradigm of the solar system, which depicted the earth as its centre with the sun revolving around the earth instead of vice versa. Even after Copernicus made it obvious around 1500 that the Ptolemaic concept was a fallacy, it still prevailed for another 180 years until Galileo finally pressed home the facts.

Herein lies one of the great human dilemmas: Once a way of viewing things is entrenched, even when new knowledge comes along to refute the paradigm, it becomes practically impossible (because of the flaws of the human condition) for most people to think outside that paradigm's constraints.

Urban (investment market) Myths

The bull market which has been around since 1991 caused stocks to be overvalued by billions of dollars and the inevitable return to so-named 'fair-value' prices has taken that amount of wealth out of the pockets of middle-class investors, including imminent retirees. And don't think that because we in Australia had a less savage 'adjustment' to asset values in the GFC compared with US and UK, that we are immune. It is an urban myth that we don't' have crises here. The reversion to "fair" value is inevitable but that is not the issue for imminent and current retirees: it is volatility that is the problem. A protracted swing down below fair value (and that is almost a guaranteed certainty) becomes a critical problem for someone early in or near their retirement as it takes years (which they don't have) to recover from.

Think no further than the banking crisis in the early 1990s shaping a deeply conservative culture among regulators and many executives. No bad thing really, but rigid systems sometimes lack the mindset to adjust to a new era: The Knowledge Age.

Back then (1990-91) the state banks of NSW, South Australia and Victoria, and two of the big four –ANZ and Westpac were teetering on the brink of failure under soured commercial property loans and wayward subsidiaries which were backing high flyers such as Alan Bond, John Elliot, Christopher Skase, John Spalvins.

This threatened to paralyse an economy already in the throes of a recession. One can only imagine the devastation of personal lives that this would have wrecked should there have been 3.5 million imminent retirees in the pipeline.

Right now, millions of people are experiencing a fading of their hopes of being able to finance good retirements. Perhaps the dogma of one simple myth can account for part of the answer and that is that stock values grow over time. Perhaps it is time to acknowledge other possibilities: a simple and compelling explanation for our troubles that is rarely discussed. The bull market of the 1990s pushed stock prices to well above fair value.

Given that another principle of investing that is rather more firmly based and that is that prices are always fated to revert to the mean (indeed considered by many to be an iron-clad principle: "reversion to the mean"), we thus set ourselves up for a massive loss in spending power once a bull market came to an end. It's not hard to understand why that would bring on an economic crisis globally and more specifically in Australia, a liquidation of many over-geared operators and investors.

Occam's Razor

Another well-worn principle accepted by economists, philosophers and indeed, many highly successful private investors, is to accept the simplest explanation as the most likely one.

A strong case gets stronger when you take into account the message of the historical stock- return data. Yale Professor Robert Shiller reports in his book Irrational Exuberance that there have been four times in the history of the U.S. market when stocks reached insanely dangerous price levels: (1) the early 1900s; (2) the late 1920s; (3) the mid-1960s; and (4) the late 1990s. On each of those occasions, we experienced a market crash. We have never experienced a crash of lasting significance starting from a time when share prices had not gone to insanely dangerous levels. And on each of those occasions (and not on any other occasion), we also experienced an economic crisis, as we did in 2008 with the GFC.

One could thus argue that bull markets may cause stock crashes and that stock crashes cause economic crises. After all, price affects the value proposition of every single material thing we deal with that can be bought or sold. If the price of shares affects the value proposition obtained by buying them, it logically follows that the risk of price crashes must be much higher when stocks are selling at inflated, high prices.

What is the likelihood of future over-valuation events given the ever-expanding pool of investable capital and the ever expanding pool of intermediaries searching for “themes” to sell to ever-optimistic investors looking to resolve their nest egg deficiencies? Look no further in equity valuation than at the recent rejection by deal-of- day company Groupon which rejected a valuation of $US6 billion by Google. The 18-month old company will be met by thousands of lookalike competitors over the next 12 months possible saturating markets. There will always be buyers of “themes”.

Stock crashes are strongly correlated to economic crises. When stock prices crash, billions of dollars disappear from the economy. Businesses obviously cannot afford to employ as many workers when so much less money is available to the consumers of their products.

Why therefore, do we pretend to ourselves that it is these other relatively inconsequential matters that are the causes? A long-only view of markets has caused many crashes; yet does anyone ever question Buy-and-Hold?

Let us acknowledge a primary investment assumption: When you own a share of an index fund, be it Australian or US, you own a share of an economy that has been reliably generating profits sufficient to provide around 5-7 percent return (depending on how you measure it) in real returns for as far back as we have records (late 1800s). That’s all fine but the risky part is that from time to time large numbers of people come to believe that it is not necessary to take price into consideration when buying shares.

That causes price levels to rise so high that the inevitable return to fair value (stocks must, in the long run, be priced properly or the entire market would collapse --it is the purpose of a market to price the things being sold within it properly) crushes us.

They could, under the right circumstances be a wonderful asset class. They become dangerous only when large numbers of us come to believe that Buy-and-Hold (ignoring the entry price when buying) can work.

What are the factors adding to the risk apart from entry price? Leverage and individual circumstances for one. Leverage (usually built around margin loans) tends to do maximum damage when the holder of the margin is called to add cash against a falling security price. To avoid wipe-out, investors are invariably forced to sell at the worst possible time. Further, Buy-and- Hold can wreck a retirement plan when an asset allocation decision is taken at a time of peak market prices. Consider the fate of those millions of investors aged in their mid to late 50s and beyond who piled into equities during the period 2005 to 2007 who are effectively now locked in to buy-and-holds but without the benefits.

We can, however, obtain the wonderful returns associated with investing in shares without having to take on the high levels of risk that most today believe apply to shares at all times; all we need to do is to not buy the growth story or the leverage story being purveyed or when bull markets are rampant.

This is where the challenge lies for industry participants: indeed, it is bad news for the “experts” who have been telling us to stick with the same stock allocation at all times when they should have been telling us to be certain never to give in to the emotional impulse that makes us want to deceive ourselves into thinking that that could work.

We have always found emotional appeal in “strategies” that assure us that those price increases represent something real. Think ‘Tulip Mania’, dotcom boom, off-the-plan apartments. Themes such as the “weight of money” theory regularly do the rounds of the pits of capital markets (this particular theme being that there is so much cash flowing in the system that eventually it must buy –something). The problem with following the emotionally appealing approach to investing is of course that the economic realities always triumph in the end.

Buy-and-Hold should never be a panacea to the investor. Shares sooner or later are going to be selling at wildly inflated prices and so those following a Buy-and-Hold strategy sooner or later are going to be going with wildly inappropriate stock allocations. Ironically, Buy- and-Hold Investing is Get Rich Quick Investing. It is the universal human desire for “money for nothing” that makes us want to believe that we can be forgiven for buying at any price.

Let’s be clear, the idea that investors should be focused on the long-term is pure gold but the idea that investors do not need to be concerned is wrong. Share ownership is not a set-and-forget investment strategy.

Note the words of that great investor Benjamin Graham. In the revised edition of The Intelligent Investor, Jason Zweig wrote about the investment principles that Ben Graham developed and stated that these principles are at least as valid today as they were in Graham’s lifetime. The summary of the principles are as follows:

- A stock is not just a ticker symbol or an elec- tronic blip; it is an ownership interest in a real business, with an underlying value that does not depend on its share price.
- The market is a pendulum that forever swings between unsustainable optimism (making them too expensive), and unjustified pessi- mism (making them too cheap). The intelligent investor is a realist who sells to optimists and buys from pessimists.
- The future value of every investment is a func- tion of its present price. The higher the price you buy, the lower your return will be.
- No matter how careful you are, the one risk no investor can ever eliminate is the risk of being wrong. Only by insisting on what Graham called the ‘margin of safety’ -never overpay- ing, regardless of how exciting an investment seems to be - can you minimize your odds of error.

The secret to your financial success is inside yourself. If you become a critical thinker who takes no Wall Street ‘fact’ on faith, and you invest with patient confidence, you can take steady advantage of even the worst bear markets. By developing your discipline and courage, you can refuse to let other people’s mood swings govern your financial destiny. In the end, how your investments behave is much less important than how you behave.

There is a caveat here: Benjamin Graham is correct but there remains the gap “the knowing but not doing” gap. One might ‘know’ that a stock represents good value but will I have the patience and risk profile to be able to endure periods of volatility and, sometimes, the extremely long terms required for value to be realised. Just to re-iterate his words: how your investments behave is much less important than how you behave. We may be wired to over-estimate our ability to hold for the duration.

The Myth of Timing

Time in the market, not timing of the market; right? Wrong. Timing is in fact required for those seeking to have a realistic hope of long- term success. The paradox is that people fail to distinguish short-term timing and long-term timing. Short-term timing (changing your share allocation with the expectation of seeing a benefit for doing so in the short term) never works. But long-term timing (changing your stock allocation in response to big price changes with the understanding that you may not see a benefit for doing so for five or even ten years) can work. And that means that timing the market can effectively permit investors to obtain far higher returns at greatly reduced risk. How many investors have this ability, let alone patience?

The Myth of buying for mums, dads and retirees

For sure there are some demographics which are (or need to be) more risk aversive than others. It is a mantra (if not entirely a myth) that Buy-and-Holders typically tell those near to retirement to move to safer asset classes but in truth, we should be telling retirees to avoid Buy-and-Hold Investing, the approach that posits that there's no need to look at valuations when setting stock market allocations. All investors (not only retirees) need to lower their stock allocations when prices get out of hand.

There's a question people in the industry should be asking of themselves and that is: are we all slaves to the share and mutual funds selling industry (which must be the main beneficiary of the Buy-and-Hold dogma)? We may have been silent because, well, business was good. But where were the newspapers? Where were the economists? Where were the ordinary investors, who must have doubts about the kind of strategies that operators such as Storm were prospecting on their clients, and who from a common sense standpoint should have come forward with some hard questions such as "how realistic are these returns and is this suitable for me?"

In the US it is no accident of fate that Bernie Madoff's fund remained popular for the entire duration of the Buy-and-Hold, long- only paradigm; engaging in deliberate fraud but even honest and smart people can make mistakes. That's obviously a distinction of great significance. Yet there needs to be a statement or alternative view (at the very least) taken to tell clients that there is another side to the story.

Why "long" matters

It may have been superstition that was the brick wall facing Ptolemy and Galileo but there are much bigger obstacles in the way of new thinking in capital markets. Leaving the fundamentals aside for the moment, some might argue that stock market investment is not necessarily investment at all but rather a form of speculation and that what stock- market "speculators" are after is short-term capital gains rather than value-based long- term earnings growth. Warren Buffet and other successful investors would beg to differ. But Warren Buffett would probably be the first to acknowledge that a substantial portion of stock market transactions represents the whims of speculators rather than the careful, systematic, value-driven determinations of sensible, value- oriented investors.

It is the actions of the speculators which move prices to levels that are fundamentally unjustified and which creates the very opportunities that value investors such as Warren Buffett seek to exploit.

Investment flows have, and will become increasingly dominated by those who are just speculating and chasing trends rather than making reasoned judgments about which companies offer the best potential long-term value. This is amplified by the modern toolkit of traders which include the aforementioned derivate and CDOs (Collateralized Debt Obligations). But the stock market does not exist in a vacuum. There is strong vested interest who "sell" the "long side" story.

As a case in point, valuations placed on stocks can be leveraged by companies to raise capital in the form of new shares or debt issues; to acquire other companies through M&A (Mergers and Acquisitions); to compensate their employees with shares or options thereon; in a word, to grow. If the stock market becomes overvalued, companies are liable to over-invest in their operations. If speculators rather than value investors are the primary force behind stock price trends, then economic resources generally are being allocated in an inefficient, haphazard way which leads to poor investments. Such poor investments will, over time, have the effect of reducing the overall economy's potential growth rate, as they divert resources from other, more productive activities.

What should an investor do?

We should all be concerned that the recovery in many asset markets since the GFC is largely the outcome of unsustainable, stimulus-fueled bubbles of varying magnitude. Look no further than the inflated prices of building supplies (including labour cost) as a consequence of that much-vaunted stimulus strategy, the school building programs.

Investors –especially defensive investors and those seeking preservation of wealth may well be wondering what investment and wealth preservation strategies are worth considering. For starters, an admission that some assets (read “growth” assets) have the most potential to be distorted in value, would be a start.

Ergo, long-term loses some of its “safe” currency when one considers that the greatest distortions are likely to manifest themselves in those assets with relatively long-dated but also relatively certain, nominal cash flows. In this regard, investors should be particularly concerned about recent developments in sovereign debt markets and not only in the weaker euro-area members. The so-named PIGS group created serious ructions in markets and continue to do so. Hence safety in government bonds (i.e. going “long” on long bonds) is pure myth given exponentially rising sovereign debt burdens is almost certain to weigh on the prices of sovereign debt obligations generally in the coming years.

Investors should thus be particularly wary not only of longer-dated government bonds but also other high-quality fixed income assets.

A problem then arises in that these assets are traditionally regarded as the standard, benchmark long-term stores of value. For those simply looking to protect wealth, rather than to invest or speculate, what are the alternatives?

Market cycles and the X-factor

A cursory examination of the aptly named X-factor reminds us that we need also to allow for uncertainty and for surprises. The X-factor can come from abroad (such as the near meltdown in banking systems in 2008 that we have just read about) or from a local event (such as Paul Keating’s famous comment in 1986 that Australia would become a banana republic unless we accepted reform which caused a major run on the Australian currency). Look at the following list to get a perspective on X-factor events:

- 2013 Changes in Australian political parties and leaders
- 2010 The government debt crises in Europe
- 2008 The near-meltdown in banking systems
- 2001 September 11 terrorist attacks
- 1991 Collapse of inflation
- 1990 Iraq invasion of Kuwait
- 1987 Black Monday collapse in shares
- 1986 “Banana Republic” comment by Paul Keating

Are Long term declines possible?

China’s continuing strong growth despite measures to dampen speculation and inflation may not be a single X-factor event but it continues to be a major factor in Australian mining sectors and asset prices on markets.

Could the X factor in the coming year be a powerful rebound in the US economy or the European Markets? Or oil prices going back over $US100 a barrel? Of course, it’s not predictable but it nevertheless needs to loom large in investment planning circles. X factor is one reason why the gold price often surges. We note that despite rising equity asset prices in the past 12 months it is noteworthy that gold prices have climbed to all-time record highs. This is paradoxical given that gold has traditionally been a refuge from debased currencies.

Here, investors would argue that gold and other precious metals are attractive as substitute stores of value. Perhaps we are simply witnessing incumbents doing what they always have done in equity and bond markets; that is, invest on the long side, while other investors are more inclined to favour gold and other precious metals as attractive alternatives as stores of value.

It is, well, natural, for investors to look for investment opportunities to grow their capital. “Naturally”, they tend to invest in equities and higher-yielding forms of debt. Consider for example the age-old dilemma of capital growth versus income (dividends). Valuations of companies with relatively high dividend yields are less likely to be distorted, as the cash flows are shorter-term on average, even if somewhat more certain.

And what about commodities as a paradigm shifter? The volatility of commodity prices and the sheer inaccessibility of commodity assets generally may appear to exclude them from a relatively defensive approach to investing. But consider if governments and monetary authorities are deliberately trying to create inflation in order to reduce the real debt burden on the economy, then cash (savings accounts) cannot be considered a reliable store of value, or for that matter, government bonds. Moreover, given that there will always be a natural demand for food, clothing and shelter, in various forms, what could possibly be more defensive than storing the value in the form of food, clothing and shelter?

It would take some re-restructuring but it is certainly not outside the bounds of possibilities to construct a diversified portfolio of such commodities with a much lower overall volatility than that of any one component. This not only deflects from some of the distorted valuations associated with the growth or “long only” story but also enables the defensive investor to realise substantial diversification benefits in excess of those that can normally be achieved through a conventional nominal asset portfolio of stocks, bonds and cash.

Sustainable economic growth and prosperity are dependent on productivity growth, which in turn is dependent on an efficient mix of capital and labour to produce the goods and services that consumers want. Corporate profits should grow more rapidly than input costs and commodity prices with enhancements in productivity (technology and efficiently driven). But we need to –this time –be on the lookout for symptoms of economic malaise which can be even more acute in the coming years.

Looking Ahead

Just a few ago people were talking about three consecutive years of share price growth of 19 percent, 20 percent and 16 percent respectively. The bulls were forecasting another year of share price growth of 14 percent. That was just months away from the collapse of the highly leveraged debt trader Basis Capital –the canary in the coal mine for the forthcoming credit crisis as it turned out; and then the failure of RAMS a few weeks after that. Further again into the future were the December –January meltdowns and then the series of collapses of Centro, Allco and ABC Learning –all heavily indebted and wedded to the growth story. Clearly, given the fallout, a majority viewed the likelihood of a market collapse as a remote possibility.

That’s’ the perspective factor at work.

Now that the dust is settling on the GFC the question remains: Are we set for a longer period of lower equity returns? Many analysts suggest that equity investment returns have fallen permanently. This is part cyclically based but also that market valuations have also affected judgments about prospective returns. For example, Shiller and Campbell have shown that above average stock returns occur after the ratio of price to average earnings over the previous 10 years has been unusually low.

If nothing else the events of the GFC precipitated a new reality. Equity investment returns will be driven by growth in earnings which will reflect four key ingredients:

1. **Per capita GDP growth**

Adding capital might increase output per person but is likely to do so at a declining rate. Here, new technology might offer the chance of using less labour for any given level of output but per capita GDP growth will cease if technological innovation is no longer a driver.

2. **Population growth**

Among the advanced economies, growth rates have already declined and, even in the more strongly growing centres such as Australia and the USA, they are set to add no more than 1% to real economic growth. In any case, restrictive migration policies are emerging.

3. **Profit share**

For profits to grow faster than GDP, the share of profits in total income must be rising. But in both the USA and Australia, the profit share has tended back to its long term value even after large departures from the norm.

As the recent Australian experience with the resources sector super profits tax showed, there will be a variety of institutional barriers preventing an indefinite rise in the profit share.

4. **Earnings dilution**

Real GDP growth could be limited to around 3%. Since the share of profits in total income has already risen to the upper end of its historical range, the likelihood of profit growth outstripping GDP growth will have been reduced.

Share issues and buybacks will have an effect on the full extent of earnings dilution; a real rate of earnings growth should come in at well below 5% a year. This might translate to investment returns at around 5%.

It would be folly to assume that pre-2008 growth rate approaching 10% or market returns of 15- 20% should be anticipated.

In this new, lower growth environment, returns of more than say a 4-6% outcome in one month could simply flag the possibility of at least several months of negligible or negative returns for an average year.

The simple fact is our track record in forecasting the future, generally, is very poor indeed. The predictions of many experts and eminent people who were careless enough to go on record in the past make extremely amusing reading today.

Right now –we are hearing of growth stories. Indeed, the Australian Treasury has pledged its faith in the long boom --one that will last for decades -revealing that China and India could be expected to continue rapid catch-up growth for at least another decade. Treasury officials thus suggest that the terms of trade will be significantly higher on average over the next couple of decades than they were in the couple of decades preceding the mining boom of recent years, and looked what happened to our mining boom –it fizzled out!

One would have to build in some uncertainty around the outlook. Indeed, that uncertainty is one of the main reasons commodity prices have historically been so cyclical. The fact is that the rules of logic often don’t apply in investment markets because there’s investor psychology, which is inherently unpredictable and makes it a lot more difficult to get financial markets right.

Some of the worst calls have been made at market tops and bottoms. There was the book, published in the USA, called Dow 36000. It was released in 1999 when the Dow was about 11,000 (12 years later it’s barely 10 percent higher).

The authors argued the Dow Jones Industrial Average would soon reach 36,000 points after the American share market’s double-digit annual returns on the back of the dot.com boom.

The resources boom factor

It must be said, however, that with what now appeared to be no more than a temporary interruption through the global financial crisis the resources boom had been running since late 2003. After a brief setback during the global financial crisis in 2008-09, the China boom is continuing today. World steel production, essentially flat at between 700 and 800 million tonnes a year from 1975 until the end of the century, has now passed 1200 million tonnes a year, with China accounting for about a half of it.

The prices of iron ore, coking coal and many (although not all) metals have skyrocketed; the prices of nickel and copper today are five or six times the price of 2000. Remarkably, this time gold has joined the other metals and its price, although well short of the record reached in 1980, is also high. Minerals exports are once again underwriting Australia's prosperity and is testimony to the transformation underway in China and India that such a scenario has become the Treasury's core case.

Historically, most resource booms have been brought undone by collapsing demand, rather than by supply catching up. The demand downturns were all sudden; the major events causing them, the two oil price increases and the collapse of the Soviet Union, were completely unexpected.

A credit crunch or political instability in the emerging countries would bring the typical end.

The question is really about Treasury's level of comfort with the policy prescriptions that come with being right about the long boom,

than those of a return to the patterns of history. Perhaps politics too as well as psychology plays its hand in markets. Going on past experience, when everything appears to be going unusually well and all the experts agree that the future is bright, this is the time to become worried. Most importantly, the ability to weather unforeseen downturns and setbacks is vital.

Arvi Parbo the former, eminent leader of the mining house, WMC until 1999 recently addressed an audience where he declared the following: "The general perception today is that the minerals industry is at the beginning of a lengthy period of sustained growth, initially because of the massive size of the developments in China which are likely to continue for a considerable time.

You can do some simple calculations in your head: China has more than four times the population of the United States. Its economy is now the second largest in the world, but still only one-third of that of USA. If it grows to three times today's size to match the USA, its average GDP per head of population will still be less than one-quarter of that in the USA. They are unlikely to decide to stop at that point. India is also working to develop their economies and improve their living standards.

There seems no doubt about the long term underlying strong and rising demand for minerals. This in itself is not new, the world population has grown rapidly and the demand for minerals has been growing strongly ever since the Industrial

Revolution some 250 years ago. What is new is that there is now a much larger number of people trying to work their way out of poverty at the same time.

"The question is, how will this progress? In the past, while the trend has been upwards, in addition to fluctuations due to economic cycles, growth has been interrupted from time to time by events nobody could foresee. Will this change? To put this question in another way, will the world become a peaceful, orderly and predictable place?"

Arvi Parbo suggest that we form our own judgements, but adds that in his opinion the world in the future will be, if anything, less predictable than in the past, not the least of which is due to unsustainable debt and deficit problems in the United States, Japan, and much of Europe, together representing more than a half of the world economy. He adds "The global financial crisis is not over; the moment of truth has merely been postponed."

Banker's delight

Why banks? Because banks control the majority of the vast funds under management. Profits earned by the major banks are very big numbers. They will get much, much bigger in the future thanks to their ownership of large tracts of the superannuation funds management industry.

What needs to be taken into account is that our banks are big and complex businesses, dealing with trillions of transactions a year. The four major banks are four of the five largest companies on the Australian Securities Exchange. They account for about 25 percent of the stock market's value and manage loans to the Australian economy worth $1.5 trillion. By most normal measures, Australia's major banks are no more or less profitable than many other Australian industries.

The 30-year average return on equity for major banks is 15 percent. This puts them in about the middle of the pack for return on equity. The return made on loans is less than 1 percent and bank margins for home lending in Australia are less than those in Britain or Canada. They are making fairly normal returns for their shareholders, including the everyday small shareholders and superannuation funds that dominate banks' shareholder registries.

Although banking in Australia remains highly competitive, the global financial crisis has had an impact, particularly in making it harder for smaller lenders to raise money at prices that will allow them to maintain their competitiveness.

There are sound measures that can be put in place to ease this and strengthen the competitive arm of smaller lenders.

Competition between money managers

The banks have been actively positioning themselves to be the significant players in the superannuation industry. Their argument that they do not make super profits (think the unilateral rate hikes they have made in recent months) should be of concern to retail consumers of their investment products.

Note their stated position, quoting Steven Munchenberg, The Australian 17/01/2011); "Australia, while our regulators may be focused on stability, the public focus has been almost exclusively on the need for more competition, despite any evidence that the Australian banking sector lacks effective competition. We need to be careful that the balance is not tipped too far towards unsafe competition." What then can we expect from their control of large slabs of the retirement funds of Australians?

Allocated pension and Annuities: can they solve our problem?

The design of allocated pensions has inherent assumptions:

- The direction of asset markets
- Capital value: How long it will last
- Income: Whether it will rise or not
- Compulsory drawdown even when markets are falling

The risk is that they will generally expire before you do.

An annuity is an income stream product. It (generally) offer the following features:

- Available for a variety of terms, from 1 to 30 years.
- Flexible Income payments
- Offers inflation protection
- Allows for interest only or capital and interest
- No fees
- Accepts superannuation money if over 60
- Guaranteed by a Life Company, regulated by APRA.

But can old models work in a new era? Lifetime annuities that provide adequate income for the vast majority of Australian? A dream? Perhaps. For one thing, an account-based pension or annuity (also called an allocated pension) is one of a number of products that you can buy with a lump sum from a superannuation fund, or paid from a self-managed superannuation fund, to give you an income during your retirement.

In brief:

- Account based pensions can be purchased from superannuation funds using superan- nuation money (that is money paid out from a superannuation fund). Account based annu- ities can be purchased from a life insurance company using superannuation money.
- An investment account is set up with this money from which you draw a regular income. A minimum payment must be made at least annually. (See more later)

Part 2 – The longevity paradox

There is no debating our demographic clustering or its cost to the people who have to pay for it. One way or another, Australians are going to have to pay for the fact that not only is there a “pig in the python” in terms of the bulge moving through the aging process but that also they and proceeding generations will live longer.

There are fewer than 500,000 Australians aged 85 and over now and there will be 1.8 million by mid-century. The average 60-year old woman today will live to 88 and when you factor in the advances of medical science (p.21) a large proportion of these women will live to 90. Men will only be a few years behind in the longevity stages.

The destiny issue is compelling: old Australians will continue to be income poor, until those with a lifetime of superannuation contributions start to retire, although a good proportion will be asset rich, relatively speaking.

At present, the median household of people aged 75-plus holds 90 percent of its net worth in the home. But imminent retirees know they need to invest outside of their family home.

General Risks in investing

There are ‘traditional’ risks involved in investing:

Types of Risks	What it means
Mismatch Risk	The investment used may not be the right investment for your needs and circumstances
Inflation Risk	The return from the investment may be less than the actual inflation rate.
Interest Rate Risk	Change of official interest rate may affect the value of the investment.
Market Risk	The investment market can have a sudden move up or down that will affect the value of the investment.
Liquidity Risk	There may be difficulty to sell out of the investment quickly.
Credit Risk	The risk that the investment asset (if applicable) will have financial difficulties.
Legislative Risk	Change of legislation will affect the investment.
Risk of not diversifying	Carry risk that will not be compensated for

And there are individual risks in investing:

- There is a risk that we have disused that relates to the timing of liquidating an investment. When the investor is carrying a risk due to fluctuations in the asset price or volatility then the risk is that they need to liquidate assets at a loss of capital. In theory, an asset may appreciate over the long term (say over seven or more years) but in between there is a high risk of potential losses being incurred.

- There is a risk that a specific asset will be worthless. This can happen, although the scale of this risk will vary according to the percent- age of investable assets allocated to a specific asset.

A (diminished) capacity to handle risk

The capital to handle risk declines with age not just because of the issues noted in the previous pages, that is, the financial risk increases as a retiree is exposed to equity and investment market sell-offs, particularly when impacted at a vulnerable time in the life cycle. However, there is an additional issue: the problem is that in recent years the super system has been more about ‘wealth creation’ and not so much about funding the liability of a potentially long retirement.

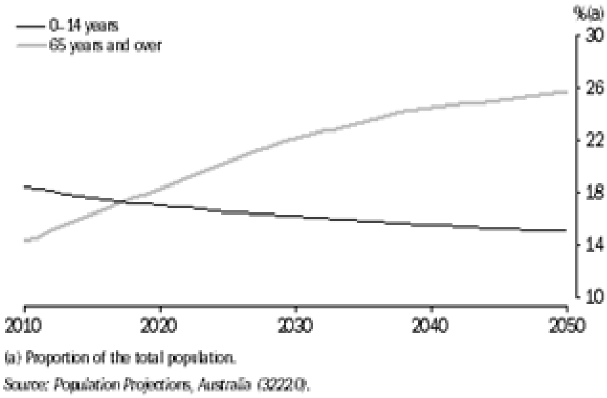
There is another reality: psychological and health decay. For example, it is now accepted based on medical wisdom that the older a person gets, the less psychological resources that they have to withstand stress. That includes stress arising from investment setbacks.

Baby Boomers

The boomers are arguably the first generation to have been gifted a sizeable extension to life expectancy. Over the last 80 years, the average age at death in most Western nations has extended by close to 20 years. These extra years are not inserted in the teenage phase in life, and nor are they delivered to the funky 20-something decade.

No, these extra years are added to what was commonly understood to be the tail-end of life: the years beyond 60. In other words, whereas boomer’s parents, and most certainly their grandparents, died in their 60s and 70s the boomers themselves are far more likely to die in their 80s and 90s. Or at least this is the expectation of today’s boomers.

Projected young and older Australians



ABS

Boomers know, or at least they expect — no, they demand — a life expectancy of four-score years plus-a-bit. This means that when the boomers straddle the 50s they think differently to way preceding generations thought at this time in life. Fifty-something boomers are not old; they have 25 years of healthy living to look forward to. The issue for boomers is that there is no role model passed down from preceding generations on how to live well and how to fund a comfortable lifestyle.

They may be seeking paths to exciting new destinations not previously visited by those seeking comfort, freedom and fulfilment on the other side of fifty.

Allocated pensions and account based pensions, which have been a mainstay of retirement planning, where a nest egg is converted into a financial product, run down over a defined period of time. In doing so, provide an income stream adequate for one’s needs, are not going to meet the needs of a majority of boomers.

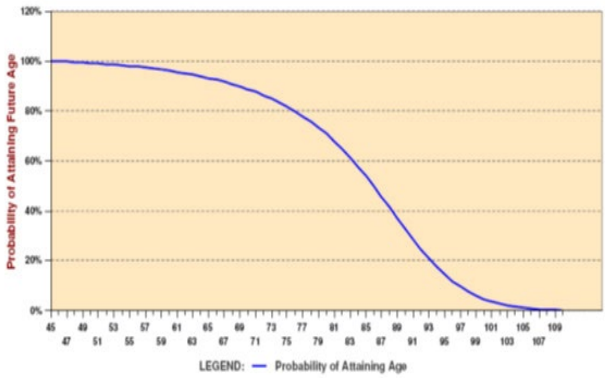
For a start, there is no guarantee of regular income. Worse, the maximum and minimum pensions are linked to outdated life expectancies for the very individuals most likely to use them; the upper socioeconomic group.

If you’re 45 years old, you have a near 40 percent chance of living to 90. Thus, nest eggs would need to be sizeable as they stand at present.

Indeed, more sizeable than most of us could presently manage. This reduces the usefulness of allocated pensions as a long-term strategy.

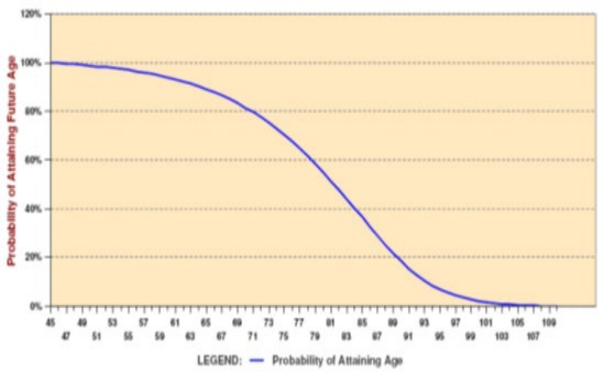
The chart below represents the probability of survival of an Australian female aged 45. Looking at the graph we can see that there is a probability of more than 55% for her to live past age 83 which is the current life expectancy at birth. She has more than 20% probability to live past age 90, and there is still a small probability that she will be alive past age 105.

Probability of Survival - Female, aged 45



Apart from specific longevity risk, other risks associated with living 'too long" are that in the intervening period, a retiree's capital is subject to other major risks such as inflation, investment risk (as we noted earlier) where returns can decline and volatility is likely to be, increasingly, a risk factor going forward.

Probability of Survival -Male, aged 45



In summary:

		Proportion that live to age*		
Results for a 60 yr old	**Expectancy**	**90**	**95**	**100**
Male	84	1 in 4	1 in 12	1 in 50
Female	88	1 in 3	1 in 6	1 in 25
Couple	90	1 in 2	1 in 5	1 in 20

Yet, many retirees plan their retirement lifestyle around the idea that they won't live much past 85. Allocated pensions are often structured around social security benefits to give a retirement income until about 85. Accordingly, many people fail to plan for a life after age 85. They will often have to rely on government benefits alone in the later years of retirement -an income that can only sustain a lifestyle well below their expectations.

Current realities

Female Case Study	Male Case Study
Aged 65 today **University educated** **Earns over $60k Has a family** **Family history shows that all her grandparents lived to 80**	Aged 65 Has not worked in an office job Earns less than $60k per annum Has a family and a pet Is in reasonable health
Life expectancy is 105 *	Life expectancy is approximately 85 ***

Source: Mercer Life Expectancy Tables

Even current retirees are finding their retirement spending is declining less than they expected, limiting the opportunities open to them. The message for boomers is that they will need to assert greater responsibility for their income needs in retirement as existing templates for how much they will need are steeped in old rules and paradigms.

New sources of income and new ways of managing financial assets need to become part of an imminent retiree's life. Ultimately the reality is that they will need to find other sources of income that give them the flexibility you need to pursue a post-career life, their way.

Living a longer, healthier and a more active life will mean a greater risk of outliving a retirement income stream. This is the new reality facing baby boomers and Gen-X. After a lifetime of pursuing their interests and being importunate savers, there is yawning gap between what their experience has been and what is available to them in real hard cash terms. Below we will see that the chances of your nest egg lasting through a 25-30 year retirement, something which is almost certain to be a reality for a majority of today's baby boomers, need to be confronted.

Pushing physical and financial limits Australians have the fourth-longest lifespan in the OECD (Organisation for Economic Cooperation and Development). With those extra years come new ambitions. While we might live longer, we can also expect to be plagued or at least harassed by disability in the last 20 year or so of our lives.

By 2026, when the last of the baby boomer generation turns 65, old age will have started later because people will live longer. There were 2.5 million Australians aged 65 and over in 2012. By 2031, 20 years later, there will be almost twice as many: 5.2 million.

Old age will be morphing this generation's desire for greater creative expression and independence and physical activity into a picture of 'lifestyle' villages and places where we may choose to live out our years beyond 85. Choirs, sports, concerts (acting, musical and singing), as well as writing and publishing, and the pursuit of social ventures of all shapes and sizes.

According to the work of Susan Jacoby, author of Never Say Die: The Myth and Marketing of the New Old Age (Pantheon), almost half of America living past the age of 85 will suffer from Alzheimer's. Jacoby who is program director of the Centre for Inquiry-New York City, a rationalist think tank, and a member of the advisory boards of the Secular Coalition for America and the Freedom from Religion Foundation says at least 50 percent will wind up in a nursing home and only 25 percent of Americans living past age 65 have annual incomes of over $US33,667. Jacoby is neither an economist nor a medical expert but her points will resonate with many sectors of the financial services sector.

Eminent Australian scientist Gustav Nossel writes in Death to Disease that we will benefit from new, sophisticated treatments for heart disease, strokes, cancer diabetes and arthritis during the next 20 years. But the revolution will not come cheaply.

He predicts that by the middle of this century, human lifespans could have leapt 40 years thanks to advanced drugs and the conquest of the most infectious and degenerative diseases. By then the current debate about the morality of stem-cell science will seem antiquated.

Thanks to advances in medicine, we are living longer and better –up to point. We may be blessed by good genes too but unless we have made all the right moves, financially, many are destined to run out of money at a time when their medical costs are soaring.

Paul Zane Pilzer, renowned US economist says we are entering a "Wellness Revolution" where, collectively, we will move from a mindset of disease to one of wellness and wellbeing. You can already see the evidence of the first wave of semi-retired baby boomers elbowing out their younger counterparts on the yoga mats, the adrenaline adventure tours and the complementary health therapy couches.

Mind, body, soul + money is the new mantra for this health-conscious generation. But there are unintended consequences.

Longevity maintenance

As the baby boomers create a massive 'grey army' the science of anti-aging has become a huge business. Thus growth is not just a response to a demand for a 'couple of extra decades'. It's about the quality of life in the golden years.

Forget about those dreams of dropping dead on the tennis court, or in a lover's arms, at age 95. Such happy endings could happen to us, but the odds are great that they won't, in spite of all the pills and low-calorie diets and resistance exercise we take on to ensure muscular flexibility.

Rather, if we live long enough to join the ranks of the "new" old –the late 80s and the 90s and beyond we are likely to be a combination of any of: financially strapped, physically disabled, mentally (cognitively) impaired and probably dependent on a carer (or living partner). It would be neat at least from a physical perspective if indeed 80 is the new 60 in order to ensure that one can enjoy the dubious blessings of longevity. Too often media touts octo-and nonagenarians as flouring "third lifers" finding new outlets for their post-working lives in composers, artist, careerists and mentors.

Consider that the factors affecting mortality statistics:

- Lifestyle –51%
- Environment –20%
- Genetic factors –9%
- Medical intervention –10%
- Other –10%

(Data provided by *Graeme Sait, CEO Nutria-Tech Solutions).

Is there any wonder that a more informed generation is going to push the goal posts out further than any other generation in self-assisted wellbeing?

It is beyond dispute that undertaking health regimes now to stave off the common afflictions of advanced age can have significant long-term benefits. More investment in a healthy lifestyle will mean lower medical costs and a better chance of maintaining an independent life. The truth is that people in their 50s and 60s are at a fulcrum in their lifespan. It is not so much that it is half-way or half-time, but it is true that from this time, wear and tear effects can start to have a leveraging impact on one's life and, of course on one's finances. Even the highest level of medical insurance will not protect you from medical costs as even the most economical of pill-based regimes of medication be expensive. And medical tests these days are loaded with high technology and high bills.

Decisions and behaviours adopted today are going to play a magnified role in determining the quality of life you are going to experience during these added decades, courtesy of the longevity bonus. But maintaining longevity doesn't have to be a demanding or complex process. A few key exercises and a moderate caloric intake can drastically reduce the risk of preventable ailments of an aging body.

According to Queensland-based Graeme Sait, a well-respected scientist and advocate of the effects of toxins and oxidants in the body, a key strategy for longevity must be a regular cleansing program involving water, detox protocols (such as a liquid-only fast) and nutrition to fuel the detoxification system.

Sait says these are a recipe for a healthy disease-free life for anyone of any age who is interested in a strategy for proactive wellness.

Our health is in our own hands. The major three diseases account for 71 percent of all deaths and the knowledge to reduce these three killers is already available.

How long will you live? Knowing the answer is critical to your financial planning, yet answers to this question obviously are not readily available.

As we have read, the years since 2000 have brought about incredible medical breakthroughs, changing how we think about some diseases and saving lives. We saw virus taking on more and more of the blame for diseases such as cervical cancer (leading to a vaccine) and HIV being fought in unexpected ways. The best part is that many of these breakthroughs are not yet fully realized, as they have opened up pathways for more research, treatments and cures.

Aging can be partially predicted using longevity/ life expectancy calculators. There are plenty of tools online that do this. These online tools tell you something about how long you might live and where some changes might get you, in terms of aging. What is certain is that cell research, new ideas in holistic approaches to wellness will continue to impact on longevity at least for some time to come.

No one can predict your aging. No one knows how long you will live or what your senior years will be like. What online life expectancy and longevity calculators can predict is how long, on average, someone like you will live and how well, on average, someone like you will age.

Calculators and online tools are abundant for predicting aging. These are pretty good tools for giving a sense of how well you are living compared to other people your age. If your lifestyle is healthy, you'll score better than average and if your lifestyle is unhealthy, your score will be worse than average. No surprises there. As we saw earlier, it is generally viewed by medical experts that somewhere between 19- 30% of your aging depends on genetics/family history (for most people), the rest is up to you and the choices you make.

The challenge for "you" the individual, not the statistic

The concept of longevity could very likely be the most dangerous subject that confronts individuals and the financial advisory industry. There appears to be little in the way of ground-breaking models developed to enable individuals to buy off-the-shelf solutions. Nor should there be. After all, we are each unique and this boomer generation will only accept individual solutions, not bucket-shop products. Besides, there is, as we read earlier, ample evidence to suggest that medical science breakthroughs are continuing at an exponential rate and that by the time this boomer generation starts hitting their late 60s, longevity will probably be extended.

At one extreme, you could live much longer than you anticipated and burn through all your retirement savings. At the other, you could have enough to pack up your bags and live where ever you wish without a care in the world for the rest of your life.

Here, we are about adjusting our thinking now while we have time to make adjustments in our planning and saving so we have enough, one day we're not going to wake up broke.

One way is to plan as if you are going to live to 100. The problem with this approach is that in a couple situations, the withdrawal rate that this demands may create a lower standard of living than you feel you deserve –not a good outcome.

The fact is that if you do-it-yourself and use life expectancy calculators to calculate your theoretical life expectancy you are going to find that no two calculators will give you the same answer.

However, note that these actuarial projections are averages based on large numbers of people. Any one individual will live to, well, who really knows?

Are annuities the answer to the problem of longevity?

There are pitfalls to allocated pensions. This is because the likely range of remaining life expectancies will substantially increase, especially for better-informed individuals. After all, they were designed in the 1990s where there was more typically then than today, a life expectancy of more like 20 years of retirement and assumptions of relatively benign, non- disruptive investment markets. How things have changed.

The allocated pension and annuity market is a huge market in Australia –estimated at a $34 billion (and growing) sector of funds management. The sector provides retirement incomes for thousands of

Australians. There are some challenges facing this sector not the least of which is the problem facing all asset-based products.

The allocated pension products have been heavily marketed on their tax advantages which have been a great selling point. The nil tax environment, the 15 percent rebate and the ability of a couple to have a $50,000 a year income tax-free have been resonating form brochures and ads for years.

The assertion that average returns achieved should be a basis for future returns is flawed. This is one of the outcomes of a long-only approach to investment markets. For sure, the sell side of the financial services industry is correct in extrapolation average returns as a historic fact. The problems arise that timing risk is a real and present threat to the wellbeing of imminent retirees and beneficiaries of pensions.

The flaw of average returns

'Average' has different meanings depending on whom you are speaking with. Say, a $100,000 portfolio went down 50% one year to $50,000, it would take a 100% return ($50,000) the next to get back to even. The total return over those two years would be 50%. (-50% + 100% = 50%) The average return over the two years would be 25%; (i.e. 50% / 2). But clearly, the investor has only gotten back to even. His actual gain is Nil.

Let's apply this to more realistic investment returns. Here are two 4-year average return scenarios.

Bond $100,000			Equity $100,000	
Year	Returns	Investment	Returns	Investment
1	5%	$105,000	30%	$130,000
2	5%	$110,250	-50%	$65,000
3	5%	$115,763	50%	$97,500
4	5%	$121,551	-10%	$87,750
Total	20%	Total	20%	

Both return series total 20%. Over 4 years they average 5% per year. But their actual return tells a different story. The actual investment results differ because of the volatility of the portfolios. The bonds made $21,551, while stocks lost $12,250 ending with $87,750.

Actual return of the bonds were 21.55%, 1.55% more than the 20% total return. The extra 1.55% was due to a compounding of return. The actual return of the stocks was -12.25%, averaging negative 3.05% per year. The problem is that in the long run, bond returns do not keep up with inflation. We know we need growth assets in our portfolio in order to keep up with inflation.

Most of us also need higher than bond returns to achieve our goals.

Drawing from the nest egg

Allocated pensions have to pay out an income. When looked at for a particular individual for example who may have retired at the peak of the asset boom, withdrawals can have serious implications. (See ANNEX Sample product)

Because, by law, funds have to pay out a minimum income each year, investors have to cash in some units to generate the necessary money. By this time, of course, the price of the units will be down as well. That means that investors who have to realise on their capital may find that they are having to sell $1.20 instead of the $1 invested just to meet requirements.

Even if the impact of drawings on a depleted asset base is not considered great enough to adjust lifestyle, a series of negative returns can be divesting as shown in the table below:

When the Money Might Run Out

Account based pension	Retire 60	Retire 65
$500,000	84	89
$300,000	71	80
$150,000	65	71
$50,000	62	67

Source: CHALLENGER GROUP, TOWERS PERRIN

If the recipient is well into retirement and well into the life of a product and they run into a couple of down years in investment, they may have run down their cash reserves and the tap which refills the tank might have run dry.

It should be noted that as distinct from organisation-sponsored defined benefits, with allocated pensions, the investors carry the investment risk, rather than it being carried by an annuity-type issuer such as a life office. This means any short-fall in eventual retirement income will need to be met either by restructuring family assets such as the family home or being subsidised by the aged pension safety net, which would be a dismal prospect form most of today's baby boomers.

Ticking time bomb

Allocated pensions are designed to use up the investor's capital -but in a controlled draw-down over the person's average life expectancy, rather than after only a couple of years of operation.

The minimum and maximum incomes are set by the Government and in general, this means investors have to draw about 6 percent a year from the fund.

The problem of average returns support products sales in allocated pensions is that if managed portfolios supporting the allocated pensions produce negative returns for any period of time, and the product has not accumulated cash reserves, then the recipient starts to eat into capital.

In effect, a recipient may be forced to find other ways to boost the nest egg's cash reserves or alternatively risk running out of money before life expectancy is reached. This then lies at the heart of the problem: that an industry has been marketing products based on average returns being projected into the future –in other words, marketed as "total return products" -that is, the more traditional managed fund where a large part of the return consists of capital gain rather than assured dividends or fixed interest income.

Where the product is based on a defined and regular income payment, it would thus be impossible to rely on steady capital growth. The inevitable result would be that, as the cash reserves are paid out, they have to be replenished by further income from the portfolio.

It seems unpalatable but, do the consumers of these products really understand that they, rather than the provider of the allocated pension, have to bear the risk of investment markets going down as well as up?

What allocated pensions do not do

Look at real inflation protection (in a world of "average" returns.)

There is an impact of cost inflation on retirement savings. One way to look at it is to realise that the 4 percent withdrawal rate should include inflation-indexed increases, so if you're taking out $14,000 in the first year of retirement (and inflation that year is 3 percent), the next withdrawal will be 1.03 times $14,000, or $14,420. Can you imagine how quickly your money will go?

If you want to live off the current equivalent of say, $40,000 per year (and that's less than the average couple in Sydney) in 20 years, you can estimate that you'll have to withdraw $110,000 annually in 2007 dollar terms. If that's 4 percent of your nest egg, then that nest egg will need to be $2.75 million! Still unruffled?

Longevity

In truth one needs to explain that such products can be somewhat of a lottery in terms of timing risk as we noted earlier. Those unfortunate enough to pile into growth, balanced or similar funds backing allocated pensions need to consider a brutal reality; market cycles do not wait around to befit an imminent or current retiree. For these people, it is no consolation that markets might eventually recover if they have to sell some units at a loss to live on. And all of this at a time when their capacity to handle risk is nearing zero.

Life expectancies are assessed on averages. In other words, people die from accidents, illnesses and predispositions to early mortality (lifestyle as well as genetic) ahead of their "natural" life expectancy. Hence an individual (one the numbers of stripped of the "early" mortality rates) are much more likely to point to increased longevity. A reasonable healthy 65-year old today has a very high change of living to 95.

That's' the challenge not just for the policy makers and planners but also for the individual. The truth is the present system is a legacy from the 1990s; tools and assumptions are clunky and not all that useful for the above individual.

Life expectancy pensions or annuity products can be bought with a lump sum from a superannuation fund. Life expectancy pensions and annuities provide income payments fixed for a term that is based on your life expectancy as if you were 5 years younger. Income is fixed at commencement and can be indexed to increase each year, either by a fixed percentage or in line with inflation. Annuities work by acquiring a sum of money from an investor and paying it back along with an earnings factor over an agreed period. Originally, the payment was annual, hence annuity.

Products which offer guarantees rely on the pool of investors setting aside contingency sums. The guarantee reflects the balance sheet and governance of the entity, the quality of the underlying investments, or both. Actuaries and strict regulations work to protect investors from default.

Can annuities resume their place as an investment alternative?

It is known that people alive today have benefited from such products in the eighties which helped them tap into lifetime returns averaging 13% p.a. While those days are gone, some relevant issues of annuities have emerged.

An annuity is an income stream product with features that generally include:

- Available for variety of terms, from 1 to 30 years.
- Flexible Income payments
- Offers inflation protection.
- Allows for interest only or capital and interest
- No fees
- Accepts superannuation money if over 60
- Guaranteed by a Life Company, regulated by APRA

The fact is that people do like the idea of a long-term income stream. Perhaps, people aren't going to have enough money. They will need to be educated to think about part of their money being set aside to manage longevity risk.

Someone who retires at age 60 and uses $500,000 in retirement savings to buy a market- linked allocated pension could quite possibly deplete those funds by age 84 -just short of the life expectancy for an Australian man. (This is based on the person withdrawing a 'comfortable' income of $37,452 a year).

Recent share market crashes showed how devastating a negative year can be for someone just entering retirement. If you have a 13 percent fall in the first year of your retirement, the statistic is that you have more than an 80 percent chance of not meeting your (retirement) goals. If you have a bad year in the first two or three years, it massively affects the way your retirement pans out.

Reality check

Superannuation fund returns are rarely uniform but imminent retirees, that is, those people who are in the mid-to-late 50s who have had a number of years of powerful stock market and real estate returns, no longer believe it can sustain. Markets can turn down and if you happen to retire when the market is down, you could end up with much less income than you expected.

No investment manager or CFO worth their salt would omit factoring in the two salient risks of funds management for a long term outcome: bearing all the risks associated with lower investment returns and living too long after retirement. There simply are no guarantees of returns in the current accumulation super system and there is no way for people to protect themselves from the risks of living too long and running out of savings.

More emphasis is needed on strategies such as salary sacrifice and active asset management by imminent retirees and a likelihood that superannuation funds will, in the future take over in providing the greater proportion of income streams for their members.

People should be able to buy retirement products that protect them against big stock market losses and the possibility of outliving their savings. The reality is that it is only a government funded system that can provide for the widening range of longevity for individuals. Either a funding pool or a guarantee supported by bonds with a similar spread of maturities going out to at least 30 years. It would be too complex for non-guaranteed investments, and probably far too expensive.

Financial modelling provided by the Henry review of the tax system found a $100,000 lump sum could buy a single retiree a lifetime or pension ranging from $5,444 to $10,225 a year. University of NSW research has found that these pensions could be larger if provided by the government than the private sector and if retirees were required by law to invest a slice of their lump sum in a lifetime annuity.

Fixed Immediate Annuity: Loss of purchasing power

All annuities are not bad, but most of them do not make economic sense for the average person's retirement plan. For one thing, a fixed income annuity is an insurance product that converts your cash into a series of fixed periodic payments. Purchasers of annuities reduce their principal investment to zero, thereby eliminating the possibility of leaving their assets to their heirs.

The series of payments may be for life or for 5 to 20 years guaranteed by the financial strength of the insurance company. Another point to remember is that the longer the guaranteed payout period the lower the periodic payment.

The inter-generational obligation

It is rapidly dawning on imminent (and current) retirees that –to borrow an adage – "you can't have it both ways". On the one hand, many people want to leave something for their children, but without an adequate nest egg, an annuity for life that provides an adequate lifestyle income will be exhausted. As we will discuss later, this is yet another reality that imminent retires need to accept. This is a psychological and emotional, rather than pure financial one: there may not be enough to leave to the children.

To alter, this course may require a significant cut back in yearly income. This then is the ultimate in reality checking. The growth story may have created an illusory nest egg, one that could be cut both ways, indeed all ways. Baby boomers have certainly believed they could have it all and still meet their inter-generational obligations.

This is yet another issue to be 'planned': how to handle the objections to any loss of inter- generational wealth transfer.

Reverse mortgages

If nothing else the growth in reverse mortgages (an equity release product that allows a home owner to draw against the equity without the need to pay back the draw. Interest is compounded until sale or transfer), is a stark reminder that attitudes have changed regarding inter-generational wealth transfer. It would be easy to assume that imminent retirees drawing down equity in their homes in order to pursue lifestyle options is done naively. While this may be true for some, it would be fair to assume that imminent retirees (read baby boomers) are making a choice eschewing part of their inter-generational 'obligations' in favour of their own desires for a lifestyle of choice. This has been their want and continues to do so. The simple fact is that the home is increasingly being considered part of the planning process as a means to unlock the substantial wealth stored in property in order to live well. If it's not down-shifted, then it's mortgaged via a reverse mortgage.

Income vs. Return

There is a distinction that needs to be made in presenting retirement income products. The way most annuities are sold is by representing a return. A $60,000 annual annuity income on $1,000,000 is NOT a 6 percent return. That it is simply a return of principal for the first 16 years and 8 months. Out of the capital invested, come payments for the insurance salesmen on average $40,000 to $80,000 in commissions.

One could assume that a million dollars invested in income producing real estate (commercial or industrial) should earn a net return of at least 7%, in the first year alone. Further, the funds are invested for 15 years and more and, because of inflation, by the time they finally start paying you, the real cost of the money is worth about 60 cents on the dollar.

It is worth reviewing the math of inflation effects on purchasing power.

Fixed Immediate Annuity Loss of Purchasing Power Table

Impact of Inflation on Purchasing Power per Year	What $60,000 Needs to Increase Pace with Inflation at 3%	Loss of Purchasing Power with Inflation rate of 3%	Net Decrease in Purchasing Power each Year
2015 1	$61,800	$58,200	($3,600)
2016 2	$63,654	$56,454	($7,200)
2017 3	$65,564	$54,760	($10,804)
2018 4	$67,531	$53,118	($14,413)
2019 5	$69,556	$51,524	($18,032)
2020 6	$71,643	$49,978	($21,665)
2021 7	$73,792	$48,479	($25,313)
2022 8	$76,006	$47,025	($28,981)
2023 9	$78,286	$45,614	($32,672)
2024 10	$80,635	$44,245	($36,390)
2025 11	$83,054	$42,918	($40,136)
2026 12	$85,546	$41,631	($43,915)
2027 13	$88,112	$40,382	($47,773)
2028 14	$90,755	$39,170	($51,585)
2029 15	$93,478	$37,995	($55,483)
2030 16	$96,282	$36,855	($59,427)
2031 17	$99,171	$35,750	($63,421)
2032 18	$102,146	$34,677	($67,469)
2033 19	$105,210	$33,637	($71,573)
2034 20	$108,367	$32,628	($75,739)
2035 21	$111,618	$31,649	($79,969)
2036 22	$114,966	$30,699	($84,267)
2037 23	$118,415	$29,778	($88,637)
2038 24	$121,968	$28,885	($93,083)
2039 25	$125,627	$28,018	($97,609)
2040 26	$129,395	$27,178	($102,217)
2041 27	$133,277	$26,363	($106,914)
2042 28	$137,276	$25,572	($111,704)
2043 29	$141,394	$24,805	($116,589)
2044 30	$145,636	$24,060	($121,576)
2045 31	$150,005	$24,060	($121,576)

Part 3 – Growth vs hope

In Woody Allen's film Deconstructing Henry; an actor named Mel develops a sudden case of the 'blurs'. The film crew polishes the lens believing that the lens is dirty, but then they determine that the actor himself is smudged. "I don't know how to tell you this, but you...you're out of focus," a co-worker tells the horrified player.

"Mel –now look –I want you to go home and get some rest. "See if you can sharpen up," advises his director.

At home, matters are not improved: "Daddy, you're all blurry!" says his dismayed child.

Woody Allen with his comedic genius is telling us people like this exist and having a blurry visage is no way to be working effectively be it as an actor or as an investor.

We can, of course, have no absolute clarity about the future, expect perhaps that it will have frequent periods of volatility in inflation and investment markets.

Imagine for a moment there is no growth; that economies stagnate that assets prices wilt, stagnate? What will the world look like? More to the point; what will the world look like for imminent retirees whose future interest are well and truly wedded to a long-only, growth-forever view of the economic world. Consider for a moment that this condition was actually a reality for millions of Japanese over the decade 1990-2000. Many in Japan, one of the most advanced societies in the world, lived impecunious lives and are yet to fully recover.

There continues to be considerable buying of long only products many of which are being bought directly or indirectly by imminent retirees who are 'hoping' their future retirement incomes will be adequate for their needs.

Lacking confidence in their own judgement, these investors have surrendered before giving themselves a chance. They reach to off-the- shelf 'solutions' such as an index fund and cling tightly to it tightly with both hands. Mind- numbed, they focus on the average, too myopic to look at alternative approaches.

To better understand the behaviour we might also try to understand the psychological aspects and how this reduces rationality at time when rational thinking is more important than at any other time in one's life. After all, mistakes made in one 50s and 60s are not the same as those made in one's 20s and 30s when there are decades in which to recover from mistakes.

The wealth industry is built on the fact that 'growth' is synonymous with 'hope'. The trouble is you can't sell a hope fund so you dress it up to be to more rationally based. If one leaves the word in its naked sate, then questions need to be asked. Why for example is 65-year old buying hope? Of course, she is buying it because she needs to grow her nest egg to accommodate her real and predictable needs and wants in retirements.

The truth is we are not dealing with financial planning or investment market psychology here we are dealing with individual psychology. The 65-year old or even the 58-year old has not accepted his lot in life. He has not made it to where her dreams promised. She is grieving because she lived a life of consumer affluence.

She bought things and experiences on credit and did not save.

Buying hope at a time when one's income generating capacity is nearing termination at a time of continued uncertainty is no recipe for a relaxed fulfilling retirement. John Steinbeck expressed this wonderfully in The Grapes of Wrath: "Up ahead they's a thousan' lives we might live but when it comes, it'll only be one."

Hope needs to give way to sensible investing at a "certain age". This is the reality for investors, intermediaries and the wealth industry at large. Sensible investing is about preparing for the many possible 'lives' your investments might live. Uninterrupted growth of any market – including our own resources industry as a case in point –is as dangerous as staying in hope. No one knows however whether there will be breakout in inflation in the next few years due to unparalleled debt burdens throughout US, Europe and Russia.

Our theme here has been that we cannot have a system in place that is long only; it simply is not prudent to weigh an investment strategy on any single possible "life".

Exposure to long-only funds

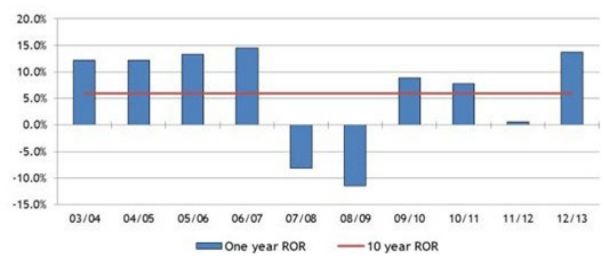
There is considerable marketing effort heading the way of imminent retirees from investment product marketers. Much of it will be not-so- subtly pitched at the "index solution" and others at the "growth investor". The latter is traditionally an investor who focuses on "growth" stocks.

Given that the majority of investors are time- poor and lacking stock picking skills, so one of the quickest way to get exposure is via specific funds.

The bet the investor is making is that these already expensive-looking companies will continue to grow. For that to happen, you have to have faith in a benign economic outlook going forward for years to come. It could be argued therefore that buying a trend is timing cycles of growth. Growth, long- only investing is a high-risk strategy. It is not set and forget. And it is not for income.

We need to question how much exposure to shares we have in imminent retiree's superannuation funds. The recent Australian Prudential Regulation Authority's Superannuation Bulletin, in its January 2011 edition revealed that over the past 10 years that the average nominal rate of return (i.e. before inflation) over the 10 years to mid-2010 across all APRA-regulated funds was 3.3 percent over the period.

Figure C: Rate of Return (ROR)



Source: www.apra.gov.au/Super/Publications/Documents/Revised%202013%20Annual%20 Superannuation%20Bulletin%2005-02-14.pdf

This, in effect, means that the system, overall (with the exception of self-managed superannuation funds) (SMSFs) barely kept up with the average, annual inflation rate of 3.1 percent over the period. This makes the system's decade-long real return only 0.2 percent a year.

In effect, the purchasing power of retirement savings of the members of an average fund was almost static. Given the very real risk that an imminent retiree could look forward to some increase in living costs through their retirement, this would send a chill down the spines of many hundreds of thousands of imminent retirees who may be in an "at risk" category of outliving their nest eggs at even a modest standard of living.

One of the salient features of the APRA (Australian Prudential Regulation Authority) data was that the average default investment strategy had a 52 percent allocation to equities in 2010.

The average super fund lost money in four out of the past ten years.

Apart from affirming the position of this paper, that periods of negative returns on equity are a fact of life and that, indeed, it is risky for many imminent retirees to hold out for their ability to withdraw is unaffected should they be hit with a succession of negative returns after they have retired from full time work or at a time when their nest egg is being depleted. Indeed, it is becoming increasingly obvious that achieving positive returns from funds under management in the superannuation system, can involve extended waiting periods that do not necessarily marry with the real-life saving and retirement consumption needs of members.

Data from APRA shows, of the total assets held by entities with more than four members, 43.7 per cent of assets ($466.1 billion) were held in the default investment strategy. Industry funds held 67.2 per cent of assets in the default investment strategy, public sector funds held 53.6 per cent, corporate funds held 46.9 per cent and retail funds held 19.3 per cent.

At 30 June 2013, the majority of default strategy assets were held in equities: 26.5 per cent in Australian shares and 24.0 per cent in international shares. A further 16.5 per cent were held in other assets, 9.5 per cent in property, 8.5 per cent in Australian fixed interest, 8.2 per cent in cash and 5.9 per cent in international fixed interest.

At June 2013, total assets (for entities with more than four members) consisted of approximately 83.6 per cent ($891.0 million) allocated to accumulation benefits and 16.4 per cent ($174.7 million) allocated to defined benefits. Of superannuation entities with more than four members, 37.4 per cent ($398.7 billion) of total assets were held by accumulation funds and 6.6 per cent (70.0 billion) held by defined benefit funds The assets in hybrid funds (funds with a combination of accumulation and defined benefit members) comprised 56.0 per cent of superannuation assets ($596.8 billion) at June 2013.

On another measure and based on information by asset consultants Towers Watson shows Australian's having the lowest level of bond investments in super funds, at 14 percent, among eight developed countries. The Towers Watson report showed the proportion of superannuation funds invested in equities in Australia is equal second highest among the eight countries, at 49 percent (Britain being the first with 55 percent).

Are investors permanently spooked?

It was not the collapse of Lehman Brothers lost money on –for sure that collapse sparked the now historic global financial crisis –it was the collapse of a number of high profile Australian-listed companies including ABC Learning, Allco and Babcock & Brown and a merciless 'haircut' given to the REITs (Real Estate Investment Trust) that has contributed to create a lingering, cautious tone amongst private investors.

Some are raising questions about the attractiveness of the share market compared to other forms of investment. As a cautionary here, it has been the experience in recent economic cycles that lower-rated bonds, also can experience great volatility in a crisis.

Structure of retirement benefits

What is to be noted is that the aging population is in need of a little less volatility in portfolios as a whole.

Consumers of such systems as well as industry participants may well question whether the returns, a majority of which are linked to long- only positioning, justify the white-knuckle roller- coaster ride that Australian super investors have experienced over the past 10 years?

As evidence of the conservative nature of that is being taken towards current investment strategies, APRA's 2014 September quarter reports on Industry asset allocations for entities with more than 4 members was 13.5% in Cash and 19.7% in Fixed Income, compared to 51.2% in Equities.

Asset allocations are affected by age of members, and therefore the number of years left before retirement, and as can be seen form the chart below people aged 50-65 represent more than 46.6 percent of total vested benefits in the Australian superannuation system.

Table 4 Age segmentation of member accounts by fund type

Year end June 2013

Entities with more than four members

(thousands)

	< 35 yrs	35 - 49 yrs	50 - 59 yrs	60 - 65 yrs	> 65 yrs	Total
Corporate	163	207	94	28	19	512
Industry	5,756	3,490	1,540	489	249	11,523
Public sector	726	1,163	796	315	337	3,337
Retail	4,656	5,449	2,493	1,007	789	14,395
Total	11,302	10,310	4,923	1,839	1,394	29,767

	< 35 yrs	35 - 49 yrs	50 - 59 yrs	60 - 65 yrs	> 65 yrs	Total
Corporate	32%	40%	18%	5%	4%	100%
Industry	50%	30%	13%	4%	2%	100%
Public sector	22%	35%	24%	9%	10%	100%
Retail	32%	38%	17%	7%	5%	100%
Total	38%	35%	17%	6%	5%	100%

Source: APRA statistics

The above chart showing that more people aged 50-65 represent more than 46.6 percent of total bested benefits in the superannuation system. One needs only think of someone who turned 55 in 2001 and whose last 10 years in superannuation are thus reflected in the APRA statistics. For sure, the fund would have grown in value due to the compulsory superannuation system but that would not be replicated if they were no longer earning salary or wages. The members' super in effect stood still; it is only real (that is, after inflation) returns that benefit of having to sell assets in their allocated pension at low values to live on, at the same time as their savings are being eroded by negative investment returns. If this is translated to an "allocated pension" situation, when markets turn south, retirees suffer the compounding effect of having to sell assets in their allocated pension at low values to live on.

If this continued for three years, then a retiree might suffer a 10 percent diminution of their account balance after withdrawals to meet living expenses. As noted earlier, once they have stopped working retirees have little chance of recovering from poor returns by topping up their super with extra contributions.

Here, therefore lies the challenge for policy makers, industry participants and imminent retirees: investing in retirement is thus a very different 'animal' to the accumulation years where nest eggs are boosted by contributions where there are no withdrawals and market falls can be, at least partially, replenished.

If one has the more "blurry" view and suggest that some people will achieve positive returns even in negative years then they should take a reality check because growth assets by way of equity funds will inevitably experience volatility.

Boomer's grandparents knew their lifespan would end somewhere in the 60s. This set their frame of thinking: they knew from about 50 onwards; where they were locked into a one-way chute hurtling towards oblivion. Accordingly, they looked old; they dressed old (some even turned into art form the swirling comb-over).

This lot knew and acted their time was fast approaching.

Not so the boomers. They know, or at least they expect — no, they demand — a life expectancy of four-score years plus-a-bit. This means that when the boomers straddle the 50s they think differently to way preceding generations thought at this time in life. Fifty-something boomers are not old; they have 25 years of healthy living to look forward to. The issue for boomers is that there is no role model passed down from preceding generations on how to live well and how to fund a comfortable boomeresque lifestyle.

You will appreciate that a boomeresque lifestyle beyond 50 is very different to the lifestyle beyond fifty expected by, say, the generation that touched the Great Depression and survived the war. This goes to the crux of why this report is important.

Consider the present financial services industry solution for income-in-retirement as a case in point. Deficiencies abound. Earlier retiring generations seemed content with a solution that paid out an annuity stream, perhaps augmented by other sources of income (age pension or example). This solution after all, seemed fitting for their needs. But it simply doesn't make sense for a majority of boomers, who need maximum flexibility, not punitive and woefully inadequate annuities.

The real problem is, most of the information out there doesn't address the real concerns of boomers. And most of the solutions have in this post GFC world, flawed assumptions, or, at best assumptions that can put an imminent retiree at risk should investment markets have successive years of negative returns at a time when nest eggs are already being depleted. The general availability of opinion and information attempts to pigeon–hole the needs and concerns of the millions Australians who need solutions, but it's mainly useless. Indeed, it's misleading.

Consider the statement "the 'unprecedented wealth' of the boomers. As a group, in sum total, it is factual to say that this generation has unprecedented wealth. But how many of us are truly 'wealthy' in the sense that we have no fears or worries about our capacity to live a happy, fulfilling life from the time we cease working?

The answer is very few.

And what about the notion that baby

boomers are the ‘lucky’ generation? Does this in anyway comfort us as individuals facing both existential and material challenges as we peer into the second half of our lives? When it comes to retirement, for the most part, baby boomers are neither lucky nor confident about their future.

A pathway for aging boomers not quite sure of where they want to go or how to get there is needed. What boomers do know, is the fact that they want different paths to those which steered their parents and their grandparents to premature old age. They need money for that; lots of it.

It is no exaggeration to suggest that boomers, in particular, are treating “growth” as synonymous with “hope”.

Why is the imminent retiree buying “hope”? Because the nest egg is smaller than wished for, maybe from a lifetime of bad habits, bad luck, or bad timing?

Paying the piper

Baby boomers are seen as spendthrifts, credit- card junkies unable to deny themselves any pleasure, blithely ignoring the need to save for their senior years. The boomer mindset hasn’t lent itself to saving for retirement. In some ways the vision of an aging group of 5 million or so heading toward financial catastrophe is disturbing. Yet it could well be wrong.

For one thing, there is no one-size-fits-all answer. The facts are that for boomers and Gen-X, there will be a number of different stages they will go through before their spending needs even out. No one has crunched out the numbers on the potential impact of living well beyond the age of our parents and spending as if we only had 10 years to live. But if recent studies are any indication, we had better play the catch up game –and fast!

Some people simply don’t want to know. All they want to know is that the income is going to their account. That’s fine if you have the luxury of substantial superannuation savings or an investment portfolio that generates more than enough income to live on forever. But this is not the case for the majority of boomers.

This goes part of the way in explaining why we saw thousands of people leveraging their retirement savings. This is not necessarily because they were greedy or ignorant but because too many have not accepted where they are in life; they may, in fact, have had a psychological need and not purely a financial need. What they could pick up by investing their nest eggs into unbelievably leveraged positions were, in fact, nothing more than a get rich scheme aimed at people who have not accepted their lot in life.

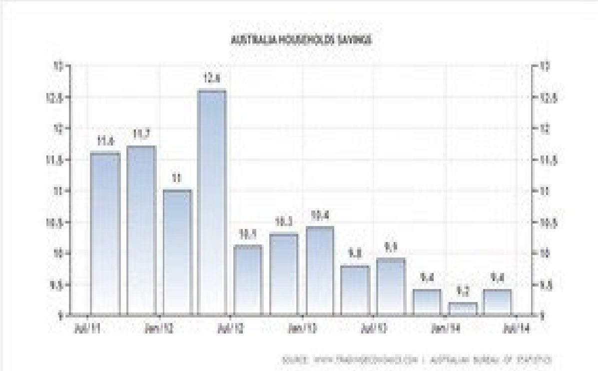
Here, to try to make dreams a reality people were convinced to use more aggressive investments. This was simply to fulfil hope and dreams as most people did have nest eggs – some sizable. If we recall one of risk categories noted earlier in the report “The risk of losing the capital invested regardless of the time frame”. Clearly, there was no regard whatsoever given to the magnitude of this risk. There can be no explanation for the ensuing behaviour.

Perhaps too they found themselves without sufficient savings for their lifestyle (see chart below) they dreamed of. In recent years we note that savings actually went into ‘deficit’ indicating that households were spending in excess of their income. Even in earlier years, savings rates (as a percentage of household income) were generally below 5 percent. Since the global financial crisis, they have climbed to around 10 percent.

Unofficial statistics show that we may have already seen the peak in savings rates for this cycle. In any case, those individuals living with unrequited dreams may have proven too vulnerable. Then along comes the stereotypical offer that is too good to be true, where they are literally seduced by the siren of growth.

There’s no way the average Australian can retire when they don’t save any money. The current cohort of imminent retirees have not had a lifetime of contributing to the compulsory superannuation scheme (which came into effect in 1992/93). In any case, it is already ‘on the table’ that the scheme needs to be increased to 20 percent of income in order to adequately prepare people for retirements.

HOUSEHOLD SAVING RATIO, Current prices



Source: www.tradingeconomics.com | Australian Bureau of Statistics

Self-funded retirees

On the other hand, there is an army of self-funded retirees in their 70s and 80s who have been highly engaged in the management of their nest eggs. These are self-determining people.

Self-determining people are just that: they have an eye on the prize and are active in their pursuit of it. Few of these people were wealthy in the sense that there had millions of dollars sloshing around. All had comfortable nest eggs. But they understood that passivity and indifference were potentially ruinous for their financial well-being. Even more remarkably, former teachers, dentists, electricians were wearing new hats on their old heads: they had become investors.

System challenges

Putting aside the intended Superannuation Guarantee increase from 9 to 20 percent to one side, actuaries predict that there will be a gap between contributions made to the superannuation system and benefits taken by retirees. The industry recognizes that there needs to be improvement in retirement funding options, not the least of which is delaying the start of retirement – an effective way to reduce the longevity risk where individuals live into their 80’s and 90’s. The fact is that actuarial modelling shows that deferring retirement and working an extra two years is likely to increase the age at which member’s superannuation runs out, by around five years.

The imperative for industry is not just about offering plans for spending or hoarding the lump sum superannuation but also resourcing to develop products and solutions that effectively manage mortality risk and maximize income in retirement.

Apart from the myopic approach to investing, the systems itself faces challenges.

Boomer pathways

Risk cannot be eliminated; only managed. The risks associated with investing are manifold, including:

- Longevity risk
- Inflation Risk
- Volatility risk (market risk)
- Emotional risk (behavioural risk)
- Timing risk

There is the first base to be dealt with: the lack of savings, but there is also the need to be realistic about the hope and growth reality. Cash may need to be held when called for. What for example would a 65-year-old be doing about their future retirement income planning believed any of the following:

- Another sharp financial setback in global economies
- A setback in China causing a decline in commodity demand
- A breakout of inflation due to ultra-low interest rates in leading economies

Any of these could be devastating for a growth (hope) portfolio with a China setback perhaps the most real and present danger.

New strategies for lifetime income

As millions of boomer’s transition from savings and wealth ‘accumulation’ to the ‘distribution’ phase of their financial lives, they need strategies and tactics to cope with the pressing issues bullet-pointed earlier in the report.

Boomers want answers to the questions:

What are the assets that will fill the gap by the time I cease earning income from your labour? What investments should I consider that protects me from inflation?

How can I be sure I don't outlive my money?

The growth factor

Let's be conservative and assume a nest egg only generates a return of 5 per cent per year). We can make use of the same tables actuaries use to calculate future incomes. Simply multiply the required nest egg by the 'Savings Factor' for the number of years until retirement. (These figures are available from actuarial tables).

The feature is the growth factor. Five percent is not a high expectation and can, if savings are commenced early enough produce high growth factors. But when decisions are left too late, the pressure on the investor to seek solutions which present high (and probably unacceptable) risk increases dramatically.

Yrs to no work –Savings Factor		Growth
Factor related income		
5	18.1%	128%
10	8.0%	163%
15	4.6%	208%
20	3.0%	265%
25	2.1%	339%
30	1.5%	432%

Longevity products

As we noted earlier, more than half of today's 65-year old's will live beyond the age of 85. Yet many imminent retirees will plan their lifestyle in years to come around an idea that they will need to fund 15 to 20 years of a post-career life. This is not long enough. As we have noted already, most of us will be active and healthy well into our later years, and so we'll require an adequate income.

Fresh thinking has come up with new solutions to the growing problem in the retirement income business: the risk of retirees outliving their savings; how to merge the desire to live a full life as they grow older with the reality of increasing longevity Lifetime pensions and annuities do exist and can pay a guaranteed (indexed) income for life. Although this provides the security of receiving payments for the investor's lifetime, this plan is inflexible for those people who might want to access more of their money to pay for any unexpected expenses –for example helping children with a home deposit.

Withdrawal rates through retirement

It is a simple mathematical premise that as funds are currently configured across the various asset classes, they unduly expose a majority of members to the fluctuations of the investment markets. As members begin to draw on their superannuation their ability to withstand the volatile swings in equity markets reduces dramatically and to very worrying levels. A typical allocated pension designed to last 20 years is based on "average" returns. As pointed out earlier: negative compounding is one of the main risks in the pension running out before you do.

Products based on hope cannot be a solution in its entirety. As noted earlier, there will for sure there will be people who can afford to have higher allocations to growth assets than others due to their larger nest eggs or alterative income sources, but an overwhelming majority are at some risk. Products, policies need to change.

Annuities: old product, new spin

Assuming that a potential retiree has got all possible assets in super, they would then need to work out how they will pay themselves an income in retirement.

As always markets respond to the 'opportunity'. In many cases, this will be an account-based pension, which works on the basis of a minimum percentage being paid out each year. Advertisements run by one financial services company offers a series of vignettes or retirees who have lost their savings in the financial crisis. We can only ask “why did such ad take so long to emerge?” The ads tell stories of a few older people, one women soberly saying that the last thing she expected to be doing at her age was going back to work, while another, a man, laments that he will no longer be able to afford annual trips up north to see family. Other quotes include:

A woman saying “I thought we would be seeing the world, not just watching it on TV.” Another had a man saying, “My bills can’t wait for the market to recover.” Indeed, they can’t. These laments are consistent with the view of this paper that there is much hope out there looking for a product to salve the dreams. This latest series of promotional vignettes, are in effect promoting annuities.

As we have noted, annuities are a fixed return product aimed primarily at retirees. Typically, funds are invested in a range of assets including government debt issues and infrastructure.

Notably; the exposure to the stock market is minimal –about 5 to 10 percent, compared with super funds, which are typically comprised of between 50-70 percent equities.

Perhaps playing to the song sheet that believes that long-only is loaded with hope, risk and unrealistic assumptions, these products are pitched at those who understand that with higher returns comes higher risks.

The problem with annuities and the people it may be targeted at (as well as the poor souls that are buying hope by leveraging long-only funds) is that in order convert people’s retirement savings into annuities that provide lifetime income, people will need a sizable savings. The income an annuity will produce is directly related to the amount of money you put into the annuity. So if you don’t have much money saved for retirement, you won’t get much of an income stream from an annuity. In simple terms, an annuity quote will tell you how much income you can produce for each dollar you contribute to the annuity.

The other problem with an annuity is that the recipient loses access to their money. What should be of concern is that they’re being presented as some sort of miracle fix for the retirement crisis. The problem is a lack of savings, not a lack of income producing investment options (such as annuities).

As we noted earlier, previous generations of retirees could allocate their entire portfolio to income because they didn’t have a longevity bonus to contend with. The majority of a generation of retirees seem to have made do with a government aged pension supplemented by (some) annuity or other superannuation- related income. However, a 30-year retirement and an appetite for lifestyle spending requires a finely balanced portfolio between asset classes and products.

For flexibility, an allocated income stream is an option. If security is the more important factor than flexibility, then a lifetime or life-expectancy income stream may be better. On the other hand, a person seeking higher returns on their investment who is not looking for flexibility, choose a market–linked income stream.

Typically, a ‘transitioner’, someone who may be working part time before full retirement, if they are drawing down some retirement income already, puts aside between 10 and 20 per cent of the retirement savings lump sum (generally, with a minimum of $20,000) from a traditional allocated pension into a new list product to accumulate further. This provides income starting from around the age 80 to 85 when the traditional allocated pension could potentially be exhausted.

Keeping an income stream flowing and flowing Australia’s superannuation assets are the world’s fourth largest by value. This is despite our economy representing only 2 per cent of global gross domestic product.

This will get bigger; a lot bigger as the federal government has foreshadowed its intention to increase the mandatory minimum employer contribution from 9 percent to 12 percent.

There remains the question: how much is needed for a comfortable retirement or develop a sophisticated suite of options for those having to fund their retirement with their super savings, given the need to moderate the bias towards long only investment in equities?

During the past decade, the global percentage of contribution benefit schemes has increased from about 35 per cent to nearly half, whereas Australia has remained fairly static at about 80 percent.

Having all possible assets into super, a potential retiree needs to work out how they will pay themselves an income from their super assets

For account based pensions, the rules say that a certain minimum income stream has to be paid each year. How much is needed?

The Association of Superannuation Funds of Australia and Westpac produce a retirement standard. They estimate that a retiree couple in September 2014, needed a little more than $1100 a week to have a comfortable retirement. The comparable figure for a single person is $816.92 a week.

In contrast, 6 years earlier, in December 2008, the respective figures were $940 and $700 a week. Clearly factoring the effect of inflation into a retirement income stream is extremely important. Even the most conservative estimates suggest energy prices are likely to double over the next 10 years. This component alone can add $150 a month to the retiree household.

Lifetime pensions and annuities

Lifetime pensions can be purchased from a superannuation fund using superannuation money (that is money paid out from a superannuation fund or a retirement savings account (RSA). Lifetime annuities can be purchased from a life insurance company using either superannuation money or other savings.

Lifetime pensions or annuities provide income payments for a person's lifetime and for the lifetime of reversionary beneficiaries (if any).

Investment choice (which is where you choose how your money is invested by the fund manager) is not relevant because the income is fixed subject to indexation.

Other features may include:

- Income is fixed at commencement and can be indexed to increase each year, either by a fixed percentage or in line with inflation.
- Generally, the money in the income stream cannot be taken out (also known as non-com- mutable).
- The income stream can be set up on a reversionary basis so that income payments continue to be paid to a beneficiary, such as a spouse or dependant when you die. Your beneficiary will not usually receive the same level of income payments that you received (that is the payments are usually reduced).
- The option of a guaranteed period is also available. If you die within the specified guar- anteed period, your nominated beneficiary (or your estate) will be entitled to receive either the remaining income payments as an income stream or lump sum. Unlike the reversionary beneficiary option, the income payments received under a guaranteed period will not reduce.

Account based pensions and annuities

An account based pension or annuity (also called an allocated pension) is one of a number of products that you can buy with a lump sum from a superannuation fund, or paid from a self- managed superannuation fund, to give you an income during your retirement.

Setting up an account based pension or annuity

- Account based pensions can be purchased from superannuation funds using superan- nuation money (that is money paid out from a superannuation fund or retirement savings account (RSAs). Account based annuities can be purchased from a life insurance company using superannuation money.
- An investment account is set up with this money from which you draw a regular income. A minimum payment must be made at least annually.

These limits are set based on an aged based percentage basis as follows:

Age	Minimum payment as a % of account balance
55 – 64	4 %
65 – 74	5 %
75 – 79	6 %
80 – 84	7 %
85 – 89	9 %
90 -94	11%
95+	14 %

- There is no maximum limit set on the income that can be drawn each year giving you greater flexibility in determining your income requirements.
- The capital value of the pension or annuity, and the income from it, cannot be used for borrowing.
- You may choose how your money is invested by the fund manager (known as 'investment choice'). Fund managers have different invest-ment strategies, which you can select, that carry different levels of risk and, therefore, potentially different levels of return.

Income

- Income is payable until there is no money left in the account. The account balance will be paid out as a lump sum to a dependant, to an estate, or the income payments can continue to be paid to a beneficiary, such as a spouse or dependant.
- Account based pensions and annuities give the flexibility of having access to the money at any time. Withdrawals of some or all of the money above the minimum amount as a lump sum (this is known as full or partial commutation).

In an ideal world....

Many of us know of people who worked in the public service or in academia and who retired at 60 with a lifetime pension, underwritten and guaranteed (as well as being CPI-index); they are the lucky ones. Most of us don't have this option. But what would the ideal superannuation pool look like? How would it be structured to make a lifetime annuity a current reality? Should this be a partnership between state and private sector-perhaps another version of a sovereign fund protecting the capital base of the nation?

It is no surprise however that even state-backed funds can take a U-turn. In the USA, lawmakers and governors in many states, faced with huge shortfalls in employee pension funds, are turning to a strategy that a lot of private companies adopted years ago: moving workers away from guaranteed pension plans and toward 401(k)-type retirement savings plans. As reported in the New York Times (28/02/2011), the efforts come as "the governors of Wisconsin and Ohio, citing dire budget problems, are engaged in bitter showdowns with public-employee unions over wages, pensions and collective bargaining rights."

In the USA, in a traditional pension system, the employer promises a certain benefit, then must find a way to pay for it. Utah lawmakers voted last year to make a partial changeover to a 401(k)- type plan, following in the footsteps of Alaska, Colorado, Georgia, Michigan, Ohio and several other states, which offer at least some version of it. Utah decided to adopt a 401(k)-type plan after the stock market plunge in 2008 caused the shortfall in the state's pension plan to balloon to $6.5 billion.

Most states are constitutionally or contractually barred from changing the pension plans of current employees without their consent. So the new rules are generally voluntary or apply only to new employees.

The article noted "In fact, switching workers to 401(k)-type plans can make the underfunding problem even worse. As contributions move to individual investment accounts, less money goes into the traditional plan to help finance pensions promised to other workers."

Commentators have noted that the majority of state workers such as police, fire-fighters and teachers will want a defined-benefit plan because they look at their government jobs as a single career, preferring the security of having a defined-contribution plan that they can take with them. One worker with a 35-year record as a state employee observed wryly "I imagine that anyone who went through the recession with a 401(k) and saw the stock market nosedive wished they had a pension plan instead of a 401(k)".

Like policy makers here, US law-makers considering changes are trying to balance competing needs. Some states taking a firm position on the premise that having people solely in a 401(k), on which they have sole control and which they then might lose a lot of money in it. Here the state wants to avoid such people eventually becoming dependent on the state.

In the USA, the National Association of State Retirement Administrators has voiced support for traditional pension plans, reportedly saying "Defined-contribution plans are a very unreliable vehicle for promoting retirement security." Perhaps reflecting party lines one Republican state representative, supporting 401K0-type plans, saying "I think it's condescending to say that workers aren't wise enough to manage their own investments. I refuse to think I'm going to have a bunch of teachers on welfare."

Back to the "ideal" structure, noting the ructions than can emerge form state-sponsored structures: such a fund, ideally a not-for-profit organisation, might allow a person with say, $500,000 in retirement saving to receive a guaranteed income stream that offers the member an income stream for life and with some built-in flexibility for withdrawals. Far-fetched? Perhaps. But market opportunities have been known to be the genesis of new products and even new thinking. If nothing else, the mandate here would encourage and stimulate annuity business, on terms that are relevant to the longevity risk and the aspirations of the imminent, retiring.

It is noteworthy that the bean counters –the "real" bean counters –the actuarial profession has weighed into the argument of protecting those who may have bought the "long only" story. Reported in February 2011, the Institute of Actuaries said that people should be able to buy investment products that protect against big share market losses and the possibility of outliving their savings.

Institute chief executive Melinda Howes was reported to have said (Australian Financial Review 17 February 2011), that there should be reforms in place to allow people to buy private pensions, or annuity products, without being punished under aged care and social security rules. For 20 years' market-linked retirement products had dominated the super industry but the recent GFC showed that the over-reliance on a bullish (long-only) share market for a healthy retirement income could make a generation of retirees financially vulnerable. She refers to "new generation" annuities which protect against the risk.

What are the specifications for such a product?

- First and foremost, it needs to be loaded with certainty (i.e. no risk)
- It needs lifetime protection from inflation
- A guaranteed income for life
- An appropriate level of expectations from the retiree/investor.

Not possible? Compare this set of needs to a (typical/ existing) insurance policy; what does an insurance policy offer the insured periods? In summary form, insurance offers:

- Peace of mind
- Helps a person manage the unexpected and stay financially stable.
- Protects the person or family against having to pay the full cost of a loss.
- Means a person doesn't have to borrow money, or ask family, friends

or others for financial assistance, or sell assets to pay outstanding debts and day-to-day living expenses.

- Helps protect family or other dependents from the financial consequences of your death.
- Gives people the confidence that they and their family will be taken care of in times of need.

Moreover, insurance policies can be tailored to provide cover relevant to your needs. Surely these requirements can be matched in a retirement product?

In the new reality that we have outlined in this report, products or services are needed that is targeted at those who expect to live longer and who have a history of longevity in their family in their family.

Importantly, the savings would be invested at the investor's choice, in an appropriate fund(s) or assets.

Income – dividends

Are dividends the answer? After all, over the long haul, dividend payments directly contribute about a half of the pre-tax returns from Australian shares and, as well, expectations of future increases in dividend streams are the major influence on the capital gains that provide the other half of share market returns. And it is also true that there are around 70 companies in the ASX 200 that yield more than 6 percent, including franking.

Selecting income producing shares, however, is not a game for the feint-hearted. For a start, high yielding shares are not necessarily going to be the best choice for an investor seeking an income component in their portfolio of assets.

Australian investors like dividends for an additional reason: our system of franked dividends. As the boomers become increasingly focused on maintaining a high income once they leave work, billions of dollars will make their way to companies that reward their shareholders with franked dividends. In the past century, companies listed on the stock exchange have, on average, increased dividends paid per share by 7 per cent a year. (In other words, average dividends per share tend to double every ten years).

This is the result of long-term real growth in the economy of a little over 3 per cent a year, inflation averaging a little under 3 per cent a year, and the boost to company earnings from retained profits. There are good reasons to expect average dividends per share to continue increasing during coming decades. It is also the case however, that while dividend yield remained fairly steady over the period 2007-2009, actual dividends paid on a per company basis declined in response to the GFC. As with capital values, such events if maintained for several years can impact income needs of retirees.

It is also often the case that income producers (in equities) are mature, low-return companies. The challenge is that there is a gap between the performance of the highest yielding stocks (basis ASX 200) and the Accumulation Index (share prices plus dividends) and it is in clear favour of the Accumulation Index.

One analogy could be in property markets where the highest yielding properties are often old industrial style properties or properties located at fringes of urban areas where growth may be negligible or where it is unreliable.

As in property most investors would seek a mix of income and long term capital appreciation. Both extremes: growth-only or high-yield have their drawbacks. In stock markets the issue of "best" investment is not only a case of what is best for an individual and their particular circumstances but also on making judgment calls about what is the best investment in absolute terms: is a company that pays back to shareholders (dividends) better than a company that earns a high return on equity. Perhaps here a 'balanced' approach is in order. That is, not to focus only on growth but to focus on high yield stocks that may also have a decent return on equity.

Dividends are good for investors. But shares carrying high dividend yields may be a reflection that that they are in companies with low growth prospects and/or with expectations that dividends will be reduced. It's expectations of future dividends that are all-important and it is total return that matters.

The difference between high yielding investing and investing for total return is the recognition that capital (at least as far as our purchasing power is concerned, if not absolute growth) is as important as dividends and a dollar from either or is the same. The outcome of this position is that there may be a need to sell shares to pay some capital gains in order to maintain a "normal" income.

Ultimately, even if we build a portfolio based on dividends, we cannot escape the psychological and emotional factors we have discussed in this report: that in one's retirement one has far less 'backbone' both literally and metaphorically for withstanding volatility in markets (which can also affect dividends issued by companies) as well as time to recover form setbacks. The likelihood that we would hold such a portfolio intact through the kinds of volatility we have recently experienced must be considered as a risk factor.

We are all fund managers

Our system has evolved to be so complex and so intricate that we all have to be part investor, part fund manager, part lawyer and, part accountant and part psychologist to get a grip on it. And that's before external market factors kick in! In many respects the current system is akin to the introduction of the GST where all independent contractors and business owners become tax collectors on behalf of the GST.

The real issue at hand here, is what 74-year old wants to manage their share portfolio? Maybe a small percentage of them do, but not the majority. And how many want to grapple with discovering the optimal tax structure for them? And how can the average retiree have any real sense of the costs that they are going to need to prepare for in retirement when medical care costs are rocketing?

In truth the appeal of the guaranteed lifetime income is compelling. An investor who buys a lifetime annuity is opting out of being the DIY fund manager. That surely is the height of wisdom. The industry must make it possible for the investor to be real about possible future outcomes, not build in a long-only hope story but one that allows the individual to say, without fear or shame, "I can't do this."

Epilogue

Retirees and imminent retirees have been especially susceptible to investment failures and are particularly prone to making rash decision at times of extreme volatility. They generally draw down investments are so being especially exposed to dramatic falls in value.

Products that are one-size-fits-all do not at this stage exist to cover all the contingencies discussed in this report; that is, a strategy that ameliorates the risk of market corrections such as we experienced 2007-2009; a product that mitigates against longevity risk with appropriate inflation appeasing indexing and a sufficiently flexible product that does not "lock in" all the investor's capital.

Perhaps a more a hybrid approach is required, one where product developers can account for the different needs throughout retirement as well as the vastly different risk profiles and capital amounts. Some suggest that a concept that divides retirement income needs into categories that are in some hierarchical order. That is, just as food and shelter are core and basic needs, so too is an income for life that looks after these core needs. Then there is another hierarchy of wishes and desires, such as travel and all the myriad of things that represent our dreams of what a comfortable retirement should deliver.

There will be infinite strata arising from such a hybrid approach, but there is room for capital to be invested in such a way as growth can actually be catered for (with all its inherent risks and assumptions). Some years down the track such a fund may indeed experience a bounty of growth and this can allow the beneficiaries the luxury of optional liquidation, thus affording them more money to spend on wishes and desires.

Whatever the case policy makers, investors and industry participants need to push the message that the earlier one starts to plan the better off they will be as they will have a longer time to accumulate income producing assets, thus avoiding adventurous assumptions later on in life.

Annex: sample product

CommInsure (this is not a recommendation etc.)

Commissure Guaranteed Annuities can provide you with a regular income in retirement.

Features and benefits at a glance

- Choice of terms: our annuities provide a guar- anteed income for a chosen period of between one and 30 years.
- Tax-free payments: retirees aged 60 or over will receive their annuity payments tax-free if they use superannuation.
- Receive regular payments for as long as you live: with lifetime annuities, regular payments are paid to you for as long as you live.
- Protection from inflation: regular payments can be indexed to the Consumer Price Index, protecting funds from inflationary effects.
- No additional ongoing management fees: our annuities charge no additional ongoing management fees and that means more money in your pocket.

Commissure offers award-winning guaranteed annuities which include:

- Lifestream Guaranteed Income.
- Guaranteed Index Tracked Annuity

What is Lifestream Guaranteed Income?

It is an immediate annuity. It allows you to invest a lump sum amount (from either personal savings or superannuation money) to provide you with a regular, guaranteed income over a specific term including:

- Short Term Income, for a Fixed Term of 1 to 5 years earning a guaranteed yield.
- Long Term Income, for a Fixed Term of 6 and 30 years earning a guaranteed yield.
- Lifetime Income, provides a guaranteed in- come for your lifetime.

Who is it suitable for?

- Individuals, companies, funds and trusts seeking a low risk investment that provides guaran- teed regular income payments.
- Retirees using superannuation money, seeking a tax-free income stream. When a retiree turns 60 and they invest in an annuity sourced from superannuation money, they can take advantage of superannuation laws regarding tax-free payments.
- Retirees seeking an income stream that provides longevity protection. A Lifetime Income Annuity provides investors with a regular income stream for as long as they are alive.

What is Guaranteed Index Tracked Annuity (GITA)?

GITA is an immediate annuity that offers all the advantages of a traditional annuity, plus some exposure to the upside of the equity market, yet without the downside risk.

It provides a guaranteed minimum initial return from the date of purchase, for the term of the investment. The income stream is guaranteed never to decrease in any year, and has the potential to achieve compounded increases of up to 5% per annum, in line with the percentage movement in the S&P/ASX 200 Price Index. The S&P/ASX 200 Price Index is recognised as the investable benchmark for the Australian equity market. The S&P/ASX 200 Price Index takes into account price movements in the relevant stocks. The index does not take into account such things as dividends, bonuses, buyback and other offers that may affect the price of the relevant stocks.

GITA enables you to use a lump sum amount (from either personal savings or superannuation money) to provide you with a regular, guaranteed income over a specific term.

This can be:

- Short Term Income, for 2 to 5 years
- Long Term Income, for between 6 and 25 years

Who is it suitable for?

GITA is generally suitable for:

- Individuals, companies, funds or trusts seek- ing an investment that provides guaranteed regular income payments that may increase on a compound basis of up to a maximum of 5% each year.
- Retirees using superannuation money, seeking a tax-free income stream. When a retiree turns 60 and they invest in an annuity sourced from superannuation money they can take advan- tage of superannuation laws regarding tax-free payments.

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Take the next step

We trust you enjoyed this publication and

found it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

We now invite you to take the next step and meet with an adviser to discuss what it was you were hoping to achieve when you downloaded this handbook and to establish if we can help you achieve your goals and objectives.

Next you will find details on how to book an appointment with an adviser.

We look forward to meeting you soon.

Appointment booking request form

About the Adviser

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Contact details

Please complete the Appointment Booking Request below and scan and email to:

Appointments are available Monday-to-Friday.

Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

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Day

Date

Time am/pm

If you would like us to contact you via email to confirm your appointment or to answer any questions you have, please provide a valid email address for our records.

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