Positive developments likely from the Retirement Income Review

The Australian Government Treasury (**Treasury**) discussion papers on retirement income highlight the increasing focus on a more comprehensive risk assessment of retirement income products.

The recently announced Retirement Income Review terms of reference details the three pillars on which Australia's retirement income system is based. This paper focuses on the second pillar of the retirement income system – compulsory superannuation, and in particular the positive outcomes that are possible in the development of retirement income products.

There are three key outcomes that can be met:-

- Further develop the *risk adjusted returns disclosure* arrangements criteria to assist retirees in understanding the risks inherent in retirement income products.
- *Encourage the development and commercialisation of a variety of risk management approaches* with the objective of improving risk adjusted returns for retirees. (Comprehensive Income Product in Retirement "CIPR" providers may form relationships with external providers as a component of the overall retirement solution.)
- Develop guidelines for *'alternative – conservative' and 'alternative – growth' asset classifications*, based upon the risk level rating and in particular the products ability to address sequencing risk.

Risk adjusted returns disclosure

The Australian Government Actuary Paper "Retirement Income Risk Measure", an appendix to the Treasury Retirement Income Disclosure Consultation Paper, discusses a range of standard metrics to help consumers make decisions about the most appropriate retirement income product for their own circumstances.

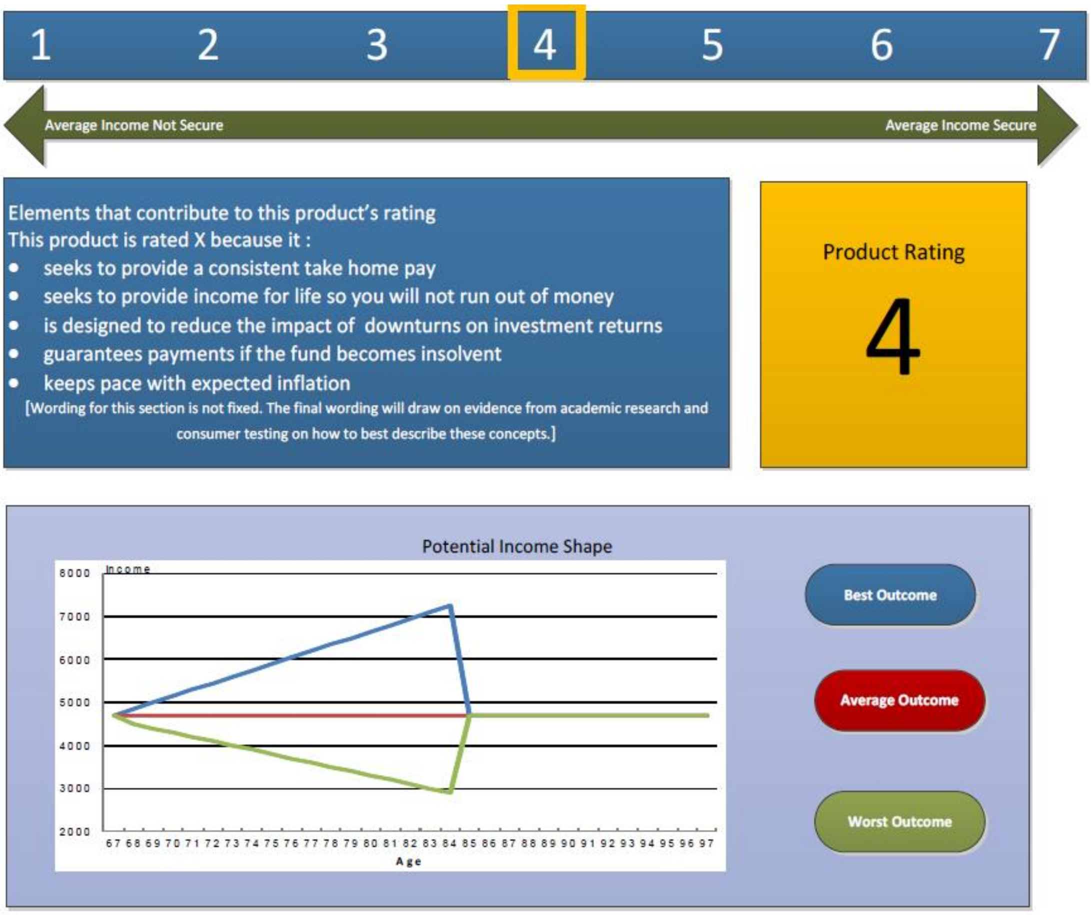
It is noted that:-

> "…behavioural economists commonly point out that individuals are more averse to downside variation than upside variation. Intuitively this would apply to retirement incomes. For this reason, I have chosen to focus on quantifying downside risk and using that to measure the relative 'income risk' of various products."

Following the Australian Government Actuary's advice the Retirement Income Disclosure Consultation Paper suggests at page 6:-

> "The proposed presentation for the fact sheet is a scale of one to seven referencing 'income security'. A high number on the scale would indicate expected income is stable and reliable, higher risk products would equate to a low level of security, so a lower number on the scale.
>
> Different products would have different income shapes depending on the product design. It is proposed that the fact sheet also include a graph which shows simulated real income between the 5th and 95th percentile over the life of the product. This should provide consumers with an indication of payments outcomes over the life of the product.

The income security measure takes account of inflation, longevity and market risk. For consumers these risks may be of different values. For example, a consumer who is concerned about whether their income varies due to market forces may want to know whether the product protects them from this particular risk."



A CIPR would provide a complete solution that balances a number of competing objectives in retirement. The three key objectives are to maximise income, ensure income is provided for life and provide flexibility to access capital.

These criteria and approach can be further developed to clarify the ratings products will receive on their ability to address **longevity risk, market risk, sequencing risk and inflation risk**.

Encourage the development and commercialisation of a variety of risk management approaches within the retirement income products

There are a variety of investment risk management approaches with the objective to meet the equity income needs of retirees and defend against losses in declining markets.

Typically, the investment generates dividends from a diversified portfolio of Australian shares with an investment risk management overlay that aims to reduce the volatility of returns, in particular defending against losses in declining markets.

A brief summary of the approaches is as follows:

- Vary asset allocation between stocks and bonds (diversification)
- Buy underlying asset, write call options (Buy-write income funds)
- Long/short funds (market neutral, 130/30)
- Buy underlying asset, using predictive approach has the ability to sell futures contracts
- Buy underlying assets, buy put options (sometimes) using predictive approaches
- Buy put options and hold cash (volatility as an asset class)
- Buy underlying assets, buy put options (always in place 'hard' risk parameter)

Gyrostat Absolute Return Income Equity Fund has protection always in place. This approach is adopted by Russell Investments and State Street (amongst others).

By developing clear evaluation criteria, the Government can promote innovation in the risk managed investment approaches. It is likely that through the combination of these approaches retiree solutions that maximise risk adjusted returns can be developed, with external providers becoming a component part of the retirement product if these are 'best of class' addressing a particular component of risk.

"Alternative – defensive" and 'alternative – growth' classification criteria

For a product to be classified as 'alternative – defensive' it must address sequencing risk. Sequencing risk is the risk that the order and timing of your investment returns in unfavourable, resulting in less money for retirement. If the benchmark being used by the Fund has experienced significant NAV draw-downs it does not address sequencing risk, and would be an 'alternative – growth' classification with a lower risk rating.

The marketing literature of many funds attracting retiree investors typically show:

- Income feature
- Return feature over specific time periods
- Relative performance vs selected index over specific time periods

Rarely do they report the maximum NAV capital drawdown since inception. Given that the Funds objective is to outperform a chosen index, ***it can be anticipated that the underlying investment may be exposed to large losses in the event of a major market correction.***

The protection element is reflected in the Funds maximum NAV capital draw-down. In the case of the Gyrostat Absolute Return Income Equity Fund this has been limited to – 2.2% in any circumstances since our inception in December 2010.

Conclusion:

The desirable retirement income product features combine **protection**, **returns** and regular **income** through all stages of the investment cycle (including large market falls.) The Retirement Income Forum can make very positive contributions towards this objective and ultimately meet the policy objective to enable retirees to *maintain his or her standard of living when he or she retires* from the paid workforce or reaches the national retirement age.