

## Risk disclosure: Comprehensive Income Products for Retirement – Treasury framework

### Executive summary:

- The Australian Government Treasury (**Treasury**) discussion papers on retirement income highlight the increasing focus on a more comprehensive risk assessment of retirement income products.
- A key feature of the retirement income framework is Comprehensive Income Products for Retirement (CIPRs). 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<sup>1</sup>.
- The risk assessment considers the following factors<sup>2</sup>:
  - the amount of periodic income the product would be expected to provide;
  - the likelihood that income may fall short of that expectation in a given period;
  - the degree of protection the product provides against the risk of running out of money; and
  - the level of access to the underlying capital or for lump sum withdrawals.
- For a product to perform well, judged by these factors, it will need to address market risk, sequencing risk, and liquidity. Products with risk mitigation strategies, protection factors, or conservative investment categories, create fewer downside variations and therefore will have lower risk scores.
- The Gyrostat Absolute Return Income Equity Fund (“**Fund**”) buys and holds ASX-20 shares with lowest cost protection always in place with upside. Regular income at BBSW90 + 3% is delivered by passing through dividends. Gyrostat has for 34 consecutive quarters operated within a 'hard' defined risk parameter (no more than 3% capital at risk with our maximum draw-down 2.2% in any circumstances) always in place.
- To address sequencing risk the Fund includes a ‘tail hedge’ for gains on large market falls<sup>3</sup>. Assessed against the framework established by Treasury:
  - **Income:** product design that ameliorates the risk of income variation.
  - **Variation in expected income:** lowest cost protection always in place with upside
  - **Access to underlying capital:** highly liquid – ASX 20 shares

<sup>1</sup> Treasury “Retirement Income Covenant Position Paper” May 2018 p6 <https://treasury.gov.au/consultation/c2018-t285219>

<sup>2</sup> Treasury “Retirement Income Disclosure Consultation Paper” December 2018 p3  
<https://treasury.gov.au/consultation/c2018-t347107>

<sup>3</sup> See <https://www.gyrostat.com.au/news/feature-article-2/>

Gyrostat Capital Management Pty Ltd

## **The Treasury Framework – income variation risk score**

The detailed factors to be considered when designing retirement income strategies are detailed on page 4 of the "Retirement Income Covenant Position Paper" issued May 2018.

“The factors specifically require trustees to focus on considering and optimising the competing objectives in retirement of delivering high **income, risk management and flexibility**, taking into account collective member preferences. The optimal strategy may involve trustees offering **products managed or provided by third parties if this is the most cost-effective approach.**”

The Australian Government Actuary Paper “Retirement Income Risk Measure<sup>4</sup>”, 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. One of those standard metrics is a measure of income variation. Income variation is defined and a methodology for measuring the relative income variation associated with alternative retirement income products is set out at page 4.

“In order to define a measure of income risk for a retirement income product, it is necessary to define what this risk is. This provides a focus for what is to be measured. Having measured the risk, we can then consider how to express the result in a meaningful manner. **Industry uses terms like longevity risk, market risk, sequencing risk and inflation risk.** All these are relevant to the outcome experienced by members in a retirement income product. However, these terms do not easily translate into use by a lay person and it is difficult to see that presenting a measure of each of these risks would be meaningful to the individual. Nevertheless it is important that the risk measure captures these key risks.”

“Adoption of this definition of the benchmark payment will result in higher risk scores for products that do not provide protection against longevity, inflation or market risks.”

“Traditional measures of variance (standard deviation) focus on both upside and downside variation. However, 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.

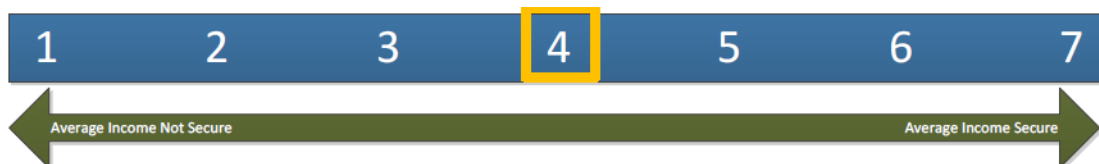
Different products would have different income shapes depending on the product design. It is proposed that the fact sheet also include a graph which shows simulated real income between the 5th and 95th percentile over the life of the product. This should provide consumers with an indication of payments 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

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<sup>4</sup> <https://treasury.gov.au/consultation/c2018-t347107>

their income varies due to market forces may want to know whether the product protects them from this particular risk.”

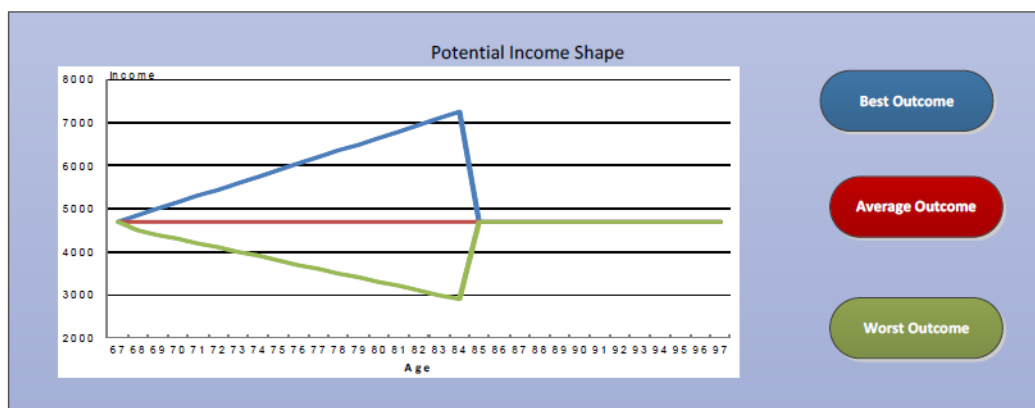


Elements that contribute to this product’s rating  
 This product is rated X because it :

- seeks to provide a consistent take home pay
- seeks to provide income for life so you will not run out of money
- is designed to reduce the impact of downturns on investment returns
- guarantees payments if the fund becomes insolvent
- keeps pace with expected inflation

[Wording for this section is not fixed. The final wording will draw on evidence from academic research and consumer testing on how to best describe these concepts.]

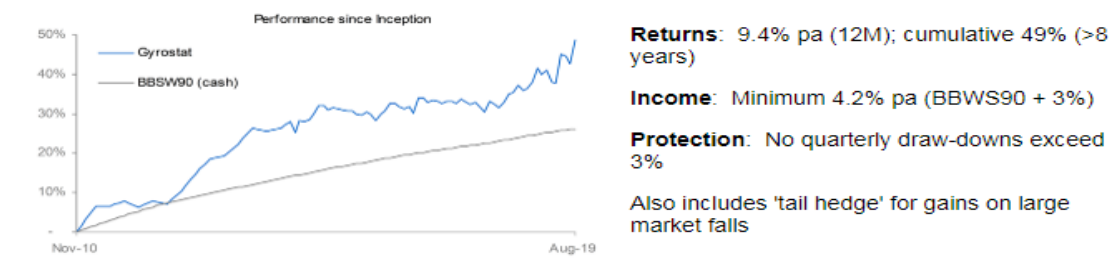
Product Rating  
**4**



## **Gyrostat Absolute Return Income Equity Fund (Fund)**

The Fund has for 34 consecutive quarters operated within a 'hard' defined risk parameter (no more than 3% capital at risk with our maximum draw-down 2.2% in any circumstances) always in place, delivered regular income at a minimum BBSW90 + 3% by passing through ASX-20 dividends, and met returns guidance based upon market conditions (demonstrating increasing returns with market volatility). The Fund buys and holds ASX-20 shares with lowest cost protection always in place with upside. It is an 'alternative - defensive' conservative asset allocation.

The Fund has increased 9.4% in the past 12 months as at 16 September 2019.



With the evolution of our investment processes and raising the 'hard' quarterly risk tolerance from 2% to 3% (in February 2019) we anticipate returns in all market environments to exceed BBSW90 + 3% (enabling retirees to receive income and capital growth.)

Assessed against the framework established by Treasury:

- **Income:** product design that ameliorates the risk of income variation.
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## **External Review**

"McGregor Asset Consulting has developed a solid level of confidence in the manager's ability to successfully execute on their investment strategy. They have a long history, spanning more than 8 years, and have performed as expected during the various market conditions, ***in particular volatile markets, where the Fund has protected capital and delivered solid absolute returns.*** This is the environment where the Fund is expected to perform, and has been the case, ***providing diversification benefits to long-only equity funds.***"