Retirement planning **Craig Racine**

End of seven-year rule brings a new ball game

For the first time in the history of the ASX, the All Ordinaries Index is lower than it was seven years ago. The seven-year rule used to be a persuasive sales pitch for financial planners. Now it is gone.

Times have changed. Global debt has increased by $57 trillion since 2007 and interest rates are at record low levels. Rental yields are heading in the same direction. Sharemarket volatility around the world adds to the uncertainties facing retirees.

Australia escaped the worst of the global financial crisis, but the record 25-year run of prosperity and growth seems set to end soon. The economic tremors in China and Europe add more uncertainty. This all spells trouble for retirement planning as the peak of the baby boom bulge moves past 65. In Paris last month, OECD secretary-general Angel Gurria warned about the risks created by current conditions.

He said: "Increasingly pension funds and life insurers are feeling the pressure to chase yield themselves, and to pursue higher risk investment strategies that could ultimately undermine their solvency. This not only poses financial sector risks, but potentially jeopardises the secure retirement of our citizens."

Reserve Bank of Australia governor Glenn Stevens recently questioned how an adequate flow of income could be generated for the retired "in a world where nominal returns on low-risk assets are so low".

David Murray, the chairman of the Financial System Inquiry, added more doubt when he said recently that "the retirement phase of superannuation is undeveloped and provides limited choice for managing risk in retirement". Put simply, the traditional approaches of buying high yielding stocks or buying stocks and selling call options are fragile and exposed.

Most attention on the financial planning industry recently has been, quite rightly, on the graft and corruption exposed by Fairfax Media in some of our biggest institutions. But the wider, long-term question is how the industry will produce income for its clients and manage the new risks. One answer is to deploy two other great movements of the past 25 years – technology and deregulation.

Deregulation allows fund managers and individuals to make unlimited numbers of transactions at low cost without the requirement to use a full service broker or other third party. And sophisticated software allows instant monitoring of large numbers of price movements simultaneously.

The deployment of these two weapons allows a form of insurance with downside protection always in place through the use of put and call options to lock in the sale price of the shares, no matter how low the share price may go.

The theoretical knowledge for this approach has been around since 1973 when Fisher Black and Myron Scholes published a paper that was the basis for a Nobel prize in economics awarded 14 years later. Their work created one of the most important concepts in modern financial theory, the mathematical model for pricing derivative investment instruments, including options. Recent software developments have opened the way for new ways to apply the model with deeper levels of sophistication and speed.

Most fund managers will be searching for ways to adapt to the new market paradigms to deliver better returns in a sluggish investment environment. This introduces another risk for investors who may be at the mercy of unintended consequences of new investment products.

Some exotic products will be exposed as fatally flawed. A recent example is bank hybrids, which were supposed to be a cross between the safety of cash and the risk of shares, with a yield somewhere in between. Unfortunately, some investors have found that hybrids are capable not only of producing the best of both worlds, but also the worst.

Investors and trustees of self-managed superannuation funds need to get used to the marketing by financial planners of more novel products aimed at producing higher returns than the old formulas. Investors should look for strategies with a proven track record. Those asked to participate in novel approaches should check for safeguards, including a straightforward business model with minimal capital at risk at all times and a financially strong counterparty such as the ASX for hedging activities, be cautious about leverage within a fund, ensure instruments are traded on an exchange which provides transparency and ask questions about whether the offering is robust in all market conditions.

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