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The Retirement Income Covenant and Retirement Portfolio Construction

The Retirement Income Covenant defines the objectives. How should portfolios be constructed to help achieve them?

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Executive summary

Australia's Retirement Income Covenant requires superannuation trustees to consider how members will be assisted to balance expected retirement income, risks to the sustainability and stability of that income, and flexible access to funds.

The Covenant applies to superannuation trustees, not to financial advisers or dealer groups simply because they advise retail clients. But the retirement needs it seeks to address are also relevant when constructing portfolios for clients in retirement.

This leads to a practical portfolio construction question:

What functions must a retirement portfolio perform to meet the needs of a retiree?

A useful starting point is four distinct but complementary functions:

Growth. Defensive. Retirement Income. Retirement Portfolio Resilience.

The distinction between Retirement Income and Retirement Portfolio Resilience is particularly important. Sustainable retirement income does not, by itself, address sequencing risk or determine how a portfolio will behave through difficult market environments.

This article considers how the four functions can be incorporated into retirement portfolio construction and how Retirement Portfolio Resilience can then be assessed through five pillars and two objective evidence tests.

Four functions of a retirement portfolio

Rather than beginning with products or asset classes, retirement portfolio construction can begin by asking what functions the portfolio needs to perform.

Retirement Portfolio Construction Checklist

- ☐ **Growth**
  How will long-term capital growth support purchasing power throughout retirement?
- ☐ **Defensive**
  How will capital stability, liquidity and cash reserves help manage market uncertainty?
- ☐ **Retirement Income**
  How will sustainable retirement income be delivered throughout retirement?
- ☐ **Retirement Portfolio Resilience**
  How will sequencing risk and behavioural survivability be addressed so investors remain financially and emotionally invested throughout their retirement journey?

The four functions are complementary. Importantly, Retirement Income and Retirement Portfolio Resilience address different retirement needs.

Retirement Income is not Retirement Portfolio Resilience

The distinction is particularly important in Australia.

Consider an asset-tested lifetime income stream purchased from 1 July 2019. Where the relevant requirements are satisfied, a minimum of 60% of the purchase price is generally assessed under the assets test from the assessment day. This falls to a minimum of 30% after the threshold day. Once payments commence, 60% of gross payments are generally assessed under the income test. Some products may be assessed at higher amounts.

For an eligible retiree, this treatment may be relevant when considering retirement income, longevity risk and interaction with the Age Pension.

But it answers a different question from Retirement Portfolio Resilience.

A lifetime income stream may provide income for life and assist in managing longevity risk. It does not, by itself, determine how the retiree's remaining growth assets will respond to a significant market decline, their exposure to sequencing risk, or whether the investor can remain financially and emotionally invested through that experience.

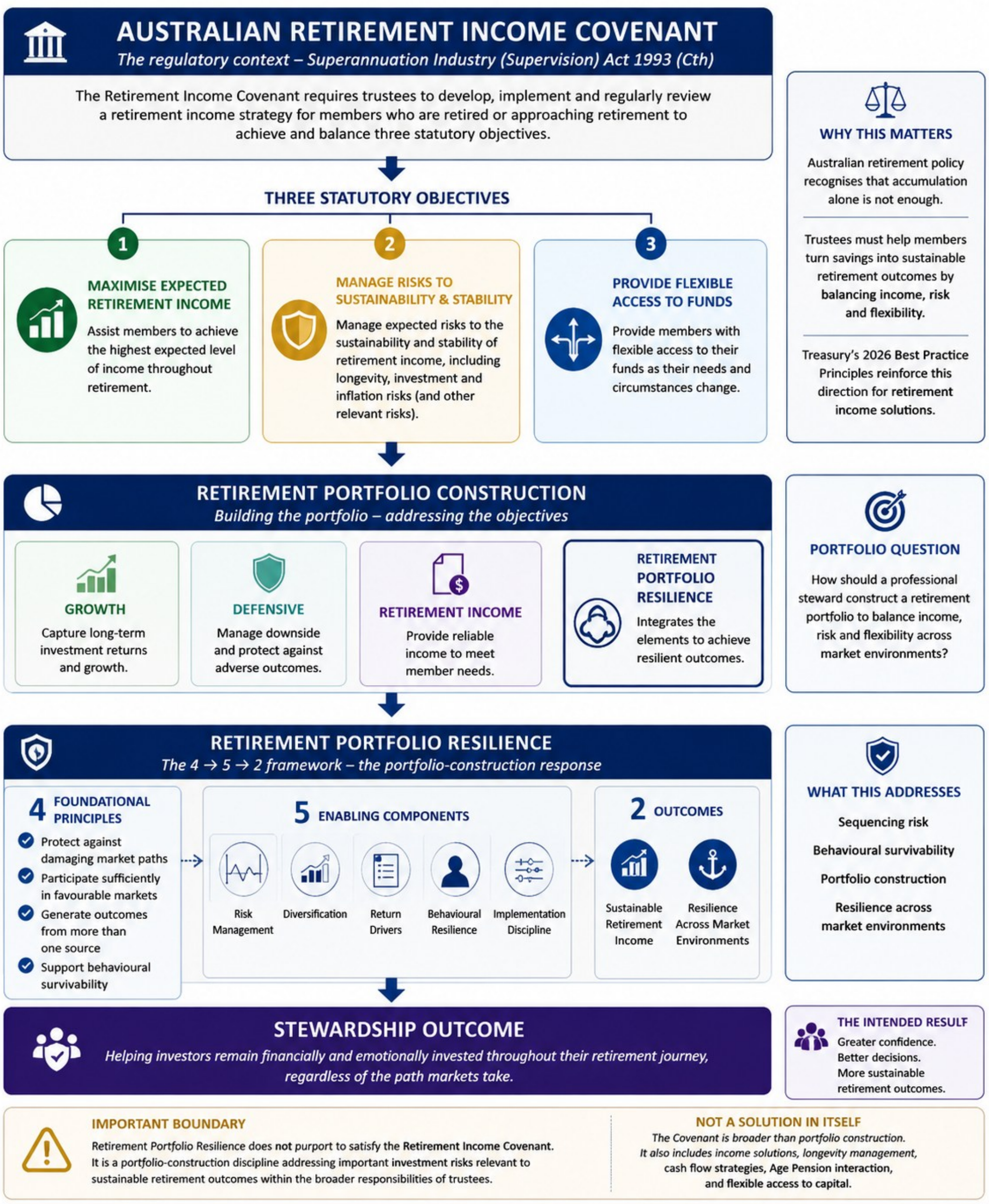
The reverse is also true.

Retirement Portfolio Resilience does not determine the appropriate level of retirement income, solve longevity risk, optimise Age Pension entitlements or provide all required liquidity.

Retirement Income and Retirement Portfolio Resilience are therefore separate but complementary portfolio functions.

This moves the discussion beyond searching for a single retirement solution towards a more useful question:

Does the overall portfolio perform each of the functions the retiree requires?



Five pillars of Retirement Portfolio Resilience

Once the four portfolio functions have been considered, Retirement Portfolio Resilience can itself be examined through five pillars:

> **Sequencing-Risk Awareness** — recognising the importance of the order in which investment returns occur when capital is being withdrawn.
>
> **Behavioural Survivability** — helping investors remain financially and emotionally invested when markets become difficult.
>
> **Risk-Pricing Discipline** — considering the changing price of assuming, transferring or mitigating investment risk.
>
> **Retirement Portfolio Construction** — considering investments according to the role they perform within the overall retirement portfolio.
>
> **Resilience Across Market Environments** — considering how the portfolio functions across different market environments rather than relying on a favourable market path.

These pillars address one particular function within the broader retirement portfolio: Retirement Portfolio Resilience.

They are **not a test of compliance with the Retirement Income Covenant**.

Two objective evidence tests

The framework leads to another question:

> **How can an adviser or investor assess whether a portfolio is actually delivering resilience?**

Labels and stated objectives do not necessarily tell us how a portfolio behaves when market conditions change.

Two objective evidence tests can assist.

1. What actually happened during significant market falls?

> How did the portfolio perform when equity markets experienced significant declines?

This matters because sequencing risk is path dependent. A substantial loss while capital is being withdrawn can reduce the capital available to participate in a subsequent recovery.

Historical downside experience cannot predict the next market decline. It can, however, provide objective evidence of how a portfolio behaved when resilience was required.

2. How dependent have outcomes been on different market environments?

> How has the portfolio behaved across rising, stable and falling markets, and how dependent have its outcomes been on equity-market direction?

Measures including beta can assist in understanding that dependence.

Strong returns predominantly achieved when equity markets rise may provide Growth, but they do not necessarily demonstrate Retirement Portfolio Resilience. Equally, resilience should not be judged from one market decline alone.

Together, the two tests move assessment from:

> **What a portfolio is called or intended to do.**

to

> **What it has actually demonstrated**.

This creates a simple **4–5–2 framework for retirement portfolio assessment:**

> **Four Retirement Portfolio Functions,**
>
> **Five pillars of Retirement Portfolio Resilience and**
>
> **Two objective Evidence Tests.**

From retirement income to retirement portfolio stewardship

The Retirement Income Covenant has broadened the industry's focus from accumulating superannuation assets towards the outcomes those assets need to support in retirement.

For advisers and dealer groups, the Covenant does not create the same statutory obligation. But it does provide a useful focal point for considering whether retirement portfolios are being constructed around the needs of retirees.

The four Retirement Portfolio Functions provide a practical starting point:

> **Growth.**
> **Defensive.**
> **Retirement Income.**
> **Retirement Portfolio Resilience.**

Where Retirement Portfolio Resilience is required, the framework then moves from function to assessment: five pillars define what resilience involves, and two objective evidence tests consider what an allocation has actually demonstrated across difficult and differing market environments.

This creates a simple 4–5–2 framework for retirement portfolio assessment.

The purpose is not to treat Retirement Portfolio Resilience as a substitute for Retirement Income, nor as a test of compliance with the Retirement Income Covenant. It is to ensure that a distinct portfolio construction need — sequencing risk and the investor's ability to remain financially and emotionally invested through the retirement journey — is considered deliberately rather than assumed.

For a dealer group or advice business, the practical question is therefore straightforward:

Does the approved retirement portfolio construction framework explicitly address each function the retiree requires — and, where resilience is intended, is there objective evidence that the allocation has actually delivered it?