POST-RETIREMENT, THE NEXT FRONTIER

DR JACO VAN DER WALT

Providing a secure and affordable retirement is one of the biggest challenges in personal finance today. In defined contribution (DC) markets, where the investment and longevity risk is transferred to the individual, our clients are looking to us for help in solving their retirement challenge.

As things stand, most DC members in South Africa will fall far short of their aspiration to have a secure and affordable retirement. The average member will be able to replace less than half of their income at retirement from the money they have saved and invested during their working life. Unless something changes, our clients face a future retirement crisis.

To help, the whole ecosystem would have to change course; and this goes for every part of the value chain – advisers, product providers and end users. The retirement challenge, like climate change, is a "wicked problem"[2]. These problems have multiple causes, involve multiple stakeholders and require behavioural change. Our linear approaches won't work. Instead, we have to apply integrated solutions, work across boundaries, collaborate across all stakeholders and apply a long-term focus.

The retirement end goal is to ensure inflation-protected income for life that maintains the client's pre-retirement standard of living. Being fully funded, to achieve this retirement income goal, is the only benchmark that matters. The goal goes beyond good investment returns, which is too often the sole focus.

An integrated solution requires that we need to pull all the levers at our disposal:

1. offer flexible contribution options, encourage our clients to save more as their circumstances allow and offer lifestyle education,
2. find ways to lower costs and ensure that fees provide value for money,
3. offer investment choices that leverage more sources of return, but which are, of course, cost-efficient and suitable to our client base,
4. make it easier for our clients to preserve when they change jobs and, importantly,
5. offer post-retirement solutions that are more affordable and secure.

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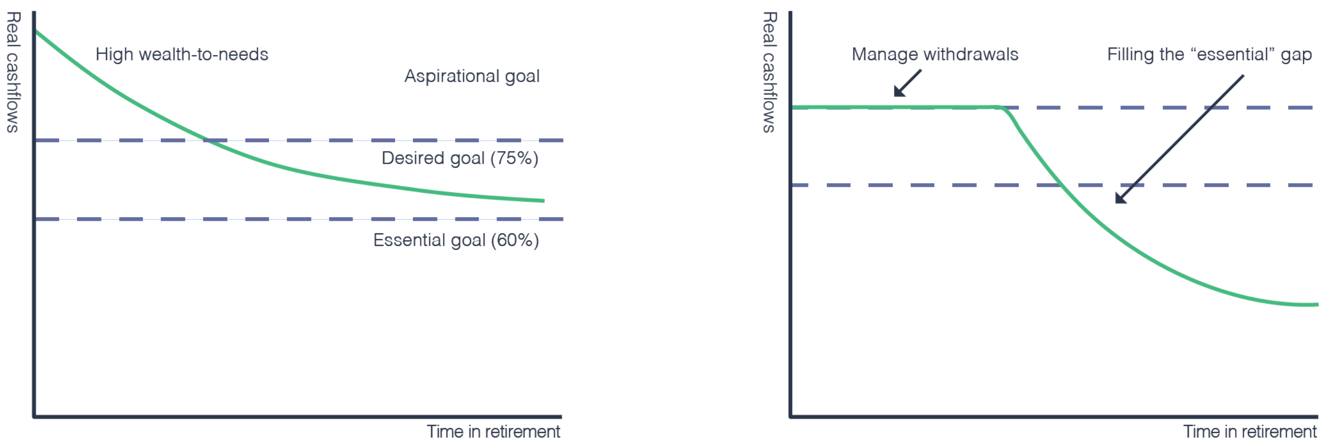
As an investment industry, we tend to put a lot of emphasis on the investment piece, and almost expect it to solve all our problems. In goal-based investing - as the name indicates - the end goal (post-retirement) is the key to the design, and yet we have neglected this vital piece of the puzzle. The conventional approach revolves around living annuities backed by investments in (risk-graded) multi-asset portfolios. These are essentially investment drawdown accounts (dressed up as annuities for tax purposes). While they may be appropriate for affluent clients, it leaves our less affluent clients exposed to more risk than they are able to handle. The post-retirement piece needs a rethink to make it more secure and affordable.
This becomes visible when we prioritise client goals into essential spending needs and those that are desired and aspirational. The desired spending in retirement tends to make up around 75% of the client's total pre-retirement earnings while essential spending as much as 60%[3]. When designing solutions, our first task is to secure the most important (essential) spending needs and the second is to maximise the probability of reaching the desired goals (on a best-efforts basis).
There are three risk management tools available in goal-based investing to help us achieve this – hedging, diversification and insurance. To secure the essential goal (achieving the outcome with 100% probability) requires hedging of the risk drivers (in this case, inflation and interest rate risk) and insurance of the

longevity risk (the risk of living longer than expected). Remember, we are aiming to secure enough inflation-protected income to meet our essential needs for life. To maximise the probability of reaching the desired goals requires the diversification of rewarded investment risk and insurance of early death (which allows the transfer of our remaining capital to loved ones).

The conventional approach focuses only on diversification and the insurance of early death. Panel A and B of Figure 1 compares two examples. While an affluent client (Panel 1.A) may have enough wealth relative to their needs to draw down from their living annuity and never run out of money to satisfy essential needs, this is not the case for less affluent clients, which is where the real need for solutions lies (Panel 1.B).

FIGURE 1 – THE CONVENTIONAL APPROACH IS NOT SUITABLE FOR ALL OUR CLIENTS

1.A – AFFLUENT CLIENTS | 1.B - LESS AFFLUENT CLIENTS



Note: Assuming constant withdrawal rate

> The conventional approach, however, leads to unbalanced risk management, especially for less affluent clients. It advocates no hedging, contains no longevity protection, over-insures early death and places most of its emphasis on diversification.

Clients with living annuities have to “self-insure” their longevity risk. To avoid running out of cash (as in the case of Panel 1.B), clients are advised to take on more investment risk. This closes the funding gap, but provides no guarantees and still leaves the client vulnerable to the risk of outliving their capital. This is more risk than the client is able to bear[4].

To secure the essential goal you need to use the first two tools of goal-based risk management, namely hedging and insurance. Living annuities offer neither of these[5]. The conventional approach could work in economies, like Australia, where there is significant state support in the form of age pension to secure essential needs as long as the individual is alive. In these cases, the “investment drawdown account” can act as a top-up to supplement income towards desired goals.

[1] Disclaimer: The views expressed in this presentation are those of the author and do not necessarily reflect the views of FirstRand Limited, or any of its entities.
[2] “Wicked problems” are difficult, even impossible, to solve. They are wicked in the sense of being resistant to resolution, rather than evil.
[3] It seems that the latter number is not very different for low, medium and high income earners.
[4] We often focus on the willingness to take risk, but it is more often the ability to take risk that is the binding constraint.
[5] Living annuities provide no longevity protection. The only insurance they provide is death cover. In fact, the death cover embedded into a living annuity amounts to 25% of its value.
[6] Living annuities also forfeit mortality credits that are available in life annuities, which can typically add real return around 3% p.a.

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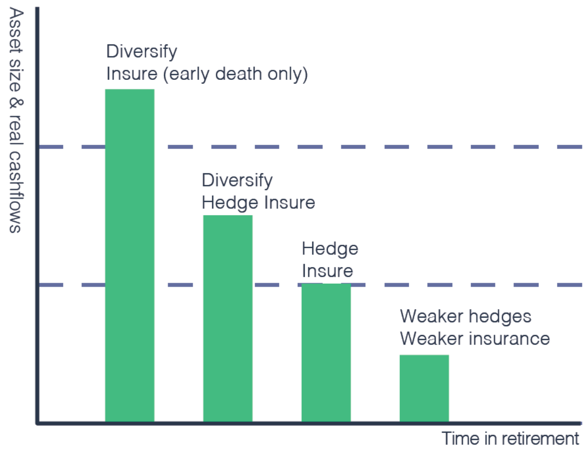
With 90% of sales going into living annuities, it seems that the industry is offering the same solution to almost all its clients. The conventional approach, however, leads to unbalanced risk management, especially for less affluent clients. It advocates no hedging, contains no longevity protection[6], over-insures early death and places most of its emphasis on diversification.

We need to customise our solutions, at least considering our client's age, gender, income and asset size. While the most affluent individuals may be well served by a single post-retirement product in the form of an "investment drawdown account" (living annuity), clients with lower asset sizes need a combination of products. This is illustrated in Figure 2, which shows that clients with different asset sizes require different elements of risk management.

FIGURE 2 – CUSTOMISING POST-RETIREMENT SOLUTIONS



Our clients are facing a future retirement crisis. We have a significant opportunity to rise up and reshape the future by throwing our weight behind the current efforts to design better post-retirement solutions. The road forward, to secure an affordable retirement, lies in a finding better ways to combine thinking across insurance, investments and wealth management.

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HEAD OF INVESTMENT MANAGEMENT OFFICE

Jaco heads up the Investment Management Office at FirstRand, working across the retirement, insurance and wealth management industries. He fulfils the CIO role for FirstRand's non-bank portfolios including insurance and wealth management. He is Chair of both the FNB Pension Fund and the RMB Pension and Provident Fund and chairs their investment committees. He also chairs the Balance Sheet Management Advisory Committee for a major SA insurer and is a member of the Thinking Ahead Institute, a global think tank. He holds a master's degree in economics from the University of Toronto and a doctorate from the University of Pretoria. Jaco is passionate about better client outcomes and champions transformational change in the investment industry.