Retirement Income Strategy

The Australian Government (**see here**) is proposing that from 1 July 2022 all public offer super funds (those that anybody can join) must have a documented Retirement Income Strategy for retired members, or those approaching retirement. This is not required for Self-Managed Superannuation Fund (SMSF) but it is something that should be seriously thought about by SMSF Trustees - the process of drawing down money from the SMSF for living expenses in retirement is what an SMSF is all about.

The aim of the strategy is to assist the SMSF members to:

- maximise their retirement income, taking into account the Age Pension;
- manage risks to the stability and sustainability of their income; and
- have some flexible access to savings in retirement.

To help better understand why SMSFs will benefit from a Retirement Income Strategy we start by giving some of the background.

SMSF members can assess various retirement scenarios so they can come up with a sensible Retirement Income Strategy. Various methods are available to generate these scenarios, ASIC's MoneySmart tool is one of the basic ones.

We base our discussion below on mProjections' *Investment Options Report*. If you haven't already seen one of these, you can read about them **here**.

Then, we discuss the asset allocation of the portfolio in the *Investment Options Report*, because this is the significant component of a retirement income strategy that may be chosen by the Trustees.

Some decisions need to be made, and we give you a checklist. Then you're ready to go!

Background

Proposed superannuation regulations (see **here**) will require public offer funds to have a Retirement Income Strategy that outlines their plan to assist their members to achieve and balance the following objectives:

- maximise their retirement income
- manage risks to the sustainability and stability of their retirement income; and
- have some flexible access to savings during retirement.

While SMSF trustees don't have to produce such a strategy, the way a fund is used for living expenses in retirement is an important part of any SMSF's ongoing management. For this reason, it would be a good idea for members of the SMSF to go through the process that would be necessary to produce a strategy.

In fact, a case could be made that an SMSF Trustee should have already had a retirement income strategy in mind when they created their Investment Strategy, which is

already a requirement of the ATO. After all, the SMSF investment strategy's aim is to provide for income in retirement.

One major principle behind Australia's superannuation system is that it is for the purpose of providing a higher standard of living in retirement than would otherwise be obtained. Assets are not meant to be passed on to children or other heirs. The Government's position is that the retirement income strategy is not meant to help provide a bequest. This means that assets in the Fund will gradually need to be liquidated over time. This is automatically taken into account in the calculations used by the majority of the calculators in Australia.

> While we calculate all values to many decimal places, we recognise that any number we produce is only an estimate of the future. To reduce the idea of false accuracy we round all numbers in this discussion to the nearest thousand dollars.

Trustees should also specify how regularly they will review the strategy and how they will implement it, similar to how public offer funds will be required to do.

The legislation does not prescribe what time period constitutes "regularly" reviewing a retirement income strategy. Because of its nature, this strategy will not need to be reviewed at the same frequency as the investment strategy that SMSFs do need to produce. The *mProjections* subscription makes this review process easy and cost effective, alongside the regular monitoring of the fund's performance and review of the investment strategy, so consider if this strategy document could be reviewed, updated if necessary, signed and filed, along with any output from the calculator, on an annual basis as part of the investment strategy.

Retirement Projections

The calculator looks at a large number of different economic and market outcomes from now till when the oldest person reaches 100 years old. We then combine all these outcomes and show the range of possibilities in various ways.

So when we say, for example, that "aiming to spend $71,000 per annum will have a likelihood of 50% that the fund runs out before age 92", we calculate the "50%" by observing that in half (ie 50%) of calculated outcomes the fund has run out of money.

> Spending level is determined by the total of dividends, interest, capital and age pension and is calculated to comply with current tax and age pension legislation and in today's dollars.

The Retirement Income Strategy

A retirement income strategy is meant to maximise retirement income taking into consideration the stability and sustainability of that income.

Retirement involves multiple decisions and difficult trade-offs, such as:

- when to retire
- how to invest their SMSF
- how to draw down their savings
- the level of contributions including post retirement income; and
- their future expenditure and capital needs.

An important part of the strategy is how to invest the SMSF. This will be a key component of the Investment Strategy that SMSFs are already required to have. Trustees should ensure that the Investment Strategy and Retirement Income Strategy documents are aligned.

mProjections' **Investment Options report** is the main tool that is used to consider what may be an appropriate retirement income strategy. The Report has charts that show likelihoods of maintaining different spending levels that could arise when a Member enters retirement. It also shows fund values as time goes by, and comparatives of different Investment Strategies.

The next section walks you through an example of how to use projections to help Trustees decide on an appropriate retirement income strategy. It is based on a couple, Pat and Sam, whose details are in the text box.

> Pat and Sam (classed as a couple for pension purposes) have assets worth $500,000 and $200,000, respectively, in their fund. They are approaching retirement, both aged 65, expecting to retire at age 67; they own their own home. Pat is still contributing $10,000 p.a. to the super fund, with no additional contributions. Sam is not contributing to the fund.
>
> Their Fund has 65% in Growth assets.
>
> They want to have a steady income for 25 years in retirement, to age 92. After their Fund has been exhausted their total income will come from the Age Pension.

Determining a Retirement Income Strategy

Each investment strategy has its own risks. One way to show this is by looking at the chance that different spending levels last for 25 years in retirement, as in the diagram over, Figure 1. Darker colours indicate a higher likelihood that that level of spending can be maintained. Light colours indicate a smaller chance that the spending could be maintained.

In this *Base Case* an income of $71,000 has a 50:50 chance of lasting for 25 years in retirement to age 92. The lighter colours in the right of the bar indicate, for example, that incomes above about $80,000 (lightest blue) have less than 10% chance of being sustained to age 92.

The darkest blue on the left indicate that incomes of less than $57,000 have at least a 95% chance of lasting to age 92.

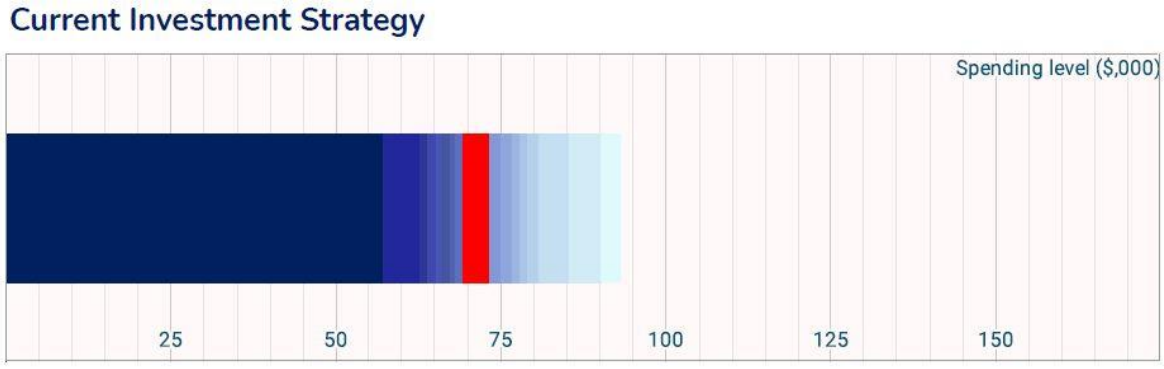

FIGURE 1 LIKELIHOOD THAT SPENDING LEVEL LASTS 25 YEARS

The red band shows the mid-range of spending levels ($69,000 to $73,000) that have a roughly equal chance of super running out before or after 25 years of retirement. After the fund is exhausted, the spending level is only supported by the age pension.

Each band of colour above represents a 5% chance of the Spending Level (income) being maintained (or achieved) below or above the $71,000 income over 25 years

We can also see the possible size of the fund over future years in Figure 2. The level of spending assumed for each year is a constant $71,000.

Darker colours indicate higher likelihood of the fund size being at least this much, each band of colour represents a 5% chance of occurring. The green line is the 50:50 line - the fund is just as likely to be below this value as it is to be above.

The vertical axis shows the size of the fund in millions of dollars. The horizontal axis shows the age of Person1, Pat in this example.

The maximum fund size usually occurs at retirement, age 67. Before retirement the size tends to increase as contributions continue, and the investment returns are accumulated. After retirement the fund usually declines as money is taken out for living expenses.

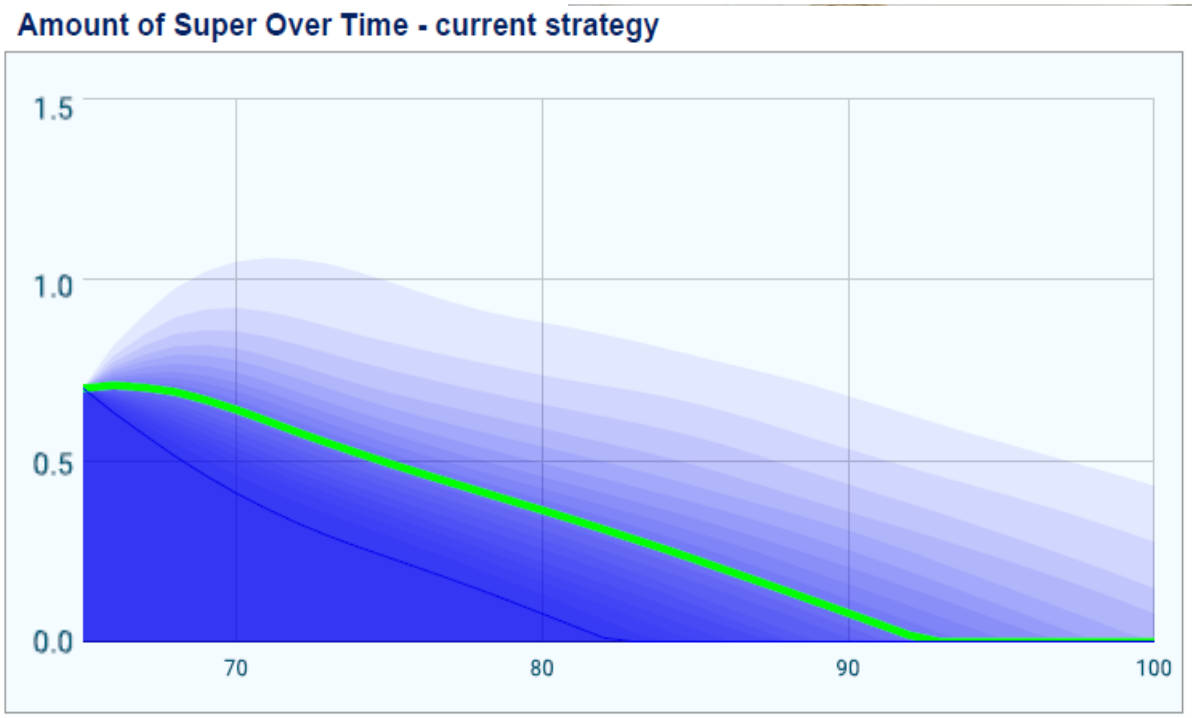

FIGURE 2 LIKELIHOOD OF FUND SIZE WITH ANNUAL INCOME OF $71,000

In some favourable circumstances the fund could last to age 100 – the maximum age we project till. In unfavourable circumstances the fund could run out while Pat and Sam are in their early 80s.

Asset Allocation

How the asset allocations affect the likely retirement spending levels after retirement is shown in Figure 3. The asset allocation is very important as we see where we **change the asset allocation** to be:

- The current asset allocation (Base Case, 65% Growth assets);
- five asset allocations with **Growth assets** varying between **85% to 25%** (equities and similar assets); and
- a Lifecycle asset allocation that starts at 65% in Growth assets at age 65, declining to 40% as the person gradually ages.

Figure 3 shows the range of possible annual spending levels (ie, annual 'income'; 'retirement spending') and the probability of the retirement spending running out before the first 25 years of retirement.

When these forecasts are considered, it is important to look at the range of possible outcomes as well as the forecast outcome. This is because investment markets can go down at the most inconvenient time.

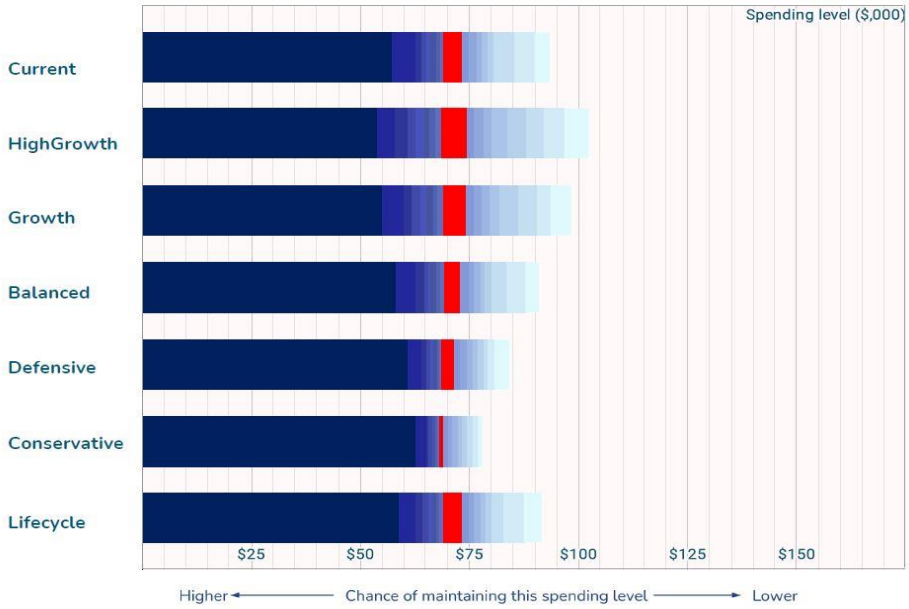

FIGURE 3 EFFECT OF ASSET ALLOCATION ON LIKELIHOOD OF SUSTAINABLE SPENDING

As retirement spending levels increase in this chart, the chance that the Fund will run out at an earlier time than 25 years increases. A lower forecast spending has a lower chance of running out. The red line shows a 50:50 chance.

In thinking about the charts, it should be noted how the forecasts show a lower median spending level and a narrowing of the range of outcomes as the asset allocation becomes more committed to 'defensive' assets. As a Fund adds to its proportion of 'defensive' assets (cash, term deposits, government bonds) the spending level will need to be decreased to reduce the chance of it running out earlier than desired. On the other hand, the possibility of having to reduce it to a very low level is also reduced. These tradeoffs must be considered.

As the allocation to growth assets increases, not only does the forecast cashflow in retirement increase (generally speaking), but so does the range of possible outcomes. Whilst it is tempting simply to choose the Strategy with the highest possible cashflow, this needs to be assessed carefully.

An indication of the sources for an income of $71,000, for example, when there is the average level of asset returns over time, with a typical level of volatility (half the time markets go up, half the time they go down but by less than they go up), is in Figure 4. The Base Case has payments being made from the superannuation fund in the early years of retirement (lighter blue), and with part pension payments (darker blue). These part Age Pension payments increase over time as the assets decline to a level below the Age Pension assets test. (The pattern isn't smooth as the fund fluctuates in value as the investment values change with market movements.)

FIGURE 4 SOURCES OF SPENDING - BASE CASE

After 25 years the super fund has been exhausted and all income for Pat and Sam's mid to late 90s is gained from the Age Pension.

Delay retirement?

By delaying retirement, the spending level would increase. This is because retiring later allows an SMSF to accumulate more assets over the additional period of working and contributing to the Fund.

What happens to Pat and Sam when they decide to change their retirement age to 70, a delay of 3 years? Let's assume that they will still want their SMSF to last till they reach the age of 92. They run a report with the new retirement age.

Figure 5 shows the range of possible incomes for this case compared to the Base Case. There is a significant increase in the income that has a 50:50 chance of lasting till age 92, to $80,000 from $71,000. The upside has also increased substantially (lightest blues). The level of income that has a 95% (the darkest blue levels) of lasting till 92 has also increased, though only slightly.

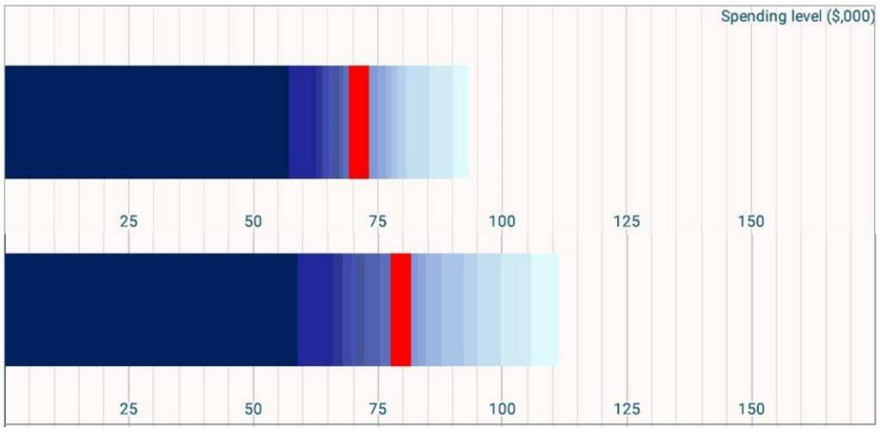

FIGURE 5 EFFECT OF RETIRING 3 YEARS LATER

As another wrinkle to consider, what if Pat and Sam want to retire later, but still want their SMSF to last for 25 years, now to age 95 rather than 92? The data inputs can be changed easily, and we find that the 50:50 income level now comes at a level of $74,000 (this result is not shown).

Longevity risk

What happens if Pat and Sam are worried about their SMSF running out while they find they're hale and hearty at age 92? The technical term for this is longevity risk – the possibility that you live longer than expected.

We've already looked at one way of managing this – an annual income of $57,000 has a 95% chance of lasting till age 92, compared to the 50% chance of $71,000 lasting that length of time. See Figure 1.

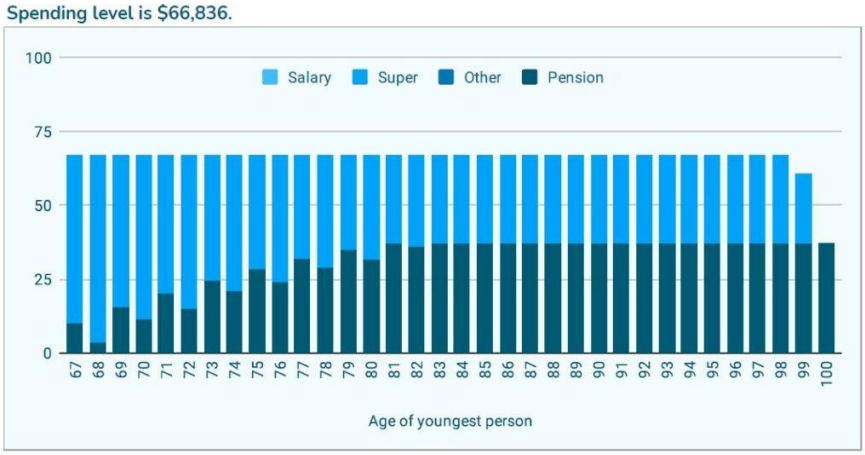

FIGURE 6 SOURCES OF INCOME FOR 30 YEARS

Another approach is to consider the income that would have a 50:50 chance of lasting 30 years instead of 25 years. This goal requires the spending level to be reduced to $67,000. The sources of income for this case are shown in Figure 6.

Extra Income

Some people want to continue some part-time work when they retire. Pat and Sam are the same. They believe that they'll be able to earn $15,000 (together) a year for their first 5 years in retirement.

Entering this information into the questionnaire we find that the steady level of income for 25 years goes up to $75,000. See Figure 7. The extra income for the first 5 years means that they don't need to draw down as much on their super, which allows them to be invested for longer, giving more available assets to draw down later.

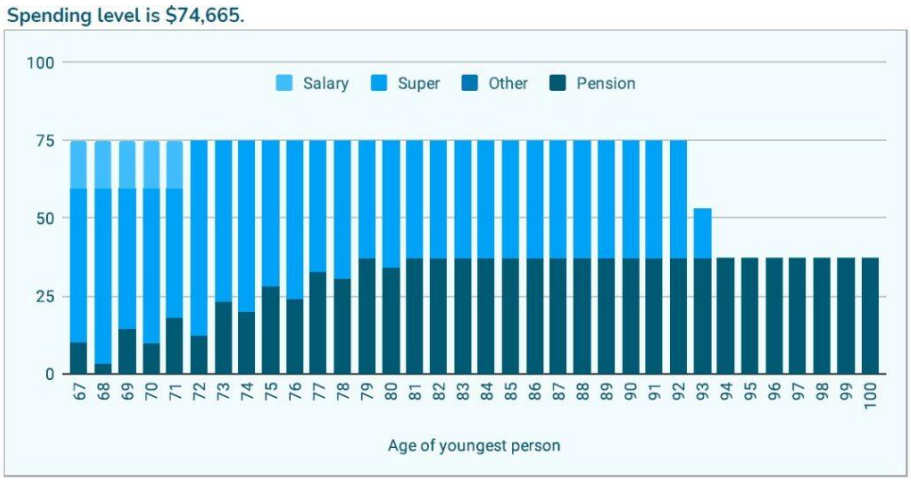

FIGURE 7 SOURCES OF INCOME WITH PART-TIME WORK

Deciding what to do

After going through the exercise we've described, Pat and Sam must come to a decision over what their strategy will be, and then they must ensure the strategy is acted upon.

But first, they should understand an important concept. In the discussion above there is talk of such things as an income of $75,000 being in place for 25 years, with a

constant asset allocation over that time. These settings are not carved in stone – they are meant to be reviewed and adjusted as necessary to meet changing conditions and members' expectations.

The point of the projection exercise is to ensure that the current position of the SMSF, and for the next couple of years, is consistent with Members' longer-term expectations. Let's look at two examples to show this.

Pat and Sam might like to spend more in the early years of their retirement, knowing that would lead to relying on the age pension at an earlier age than the Base Case considered above. To understand some of the implications of this, they run an Investment Options Report where they ask that their income be set for 15 years instead of 25, in other words a 50:50 chance of lasting till age 82 after retiring at 67.

This report shows them that a spending level of $92,000 would have a 50:50 chance of running out before age 82, which is an increase of $17,000 per year.

On the other hand, they might be worried about their money running out and having to rely only on the age pension. In that case we know from the Base Case analysis above that an income of $57,000 has a very good chance of lasting till age 92, and, looking at the case where a period of 30 years in retirement was considered, a slightly lower income of $54,000 has a very good chance of reaching age 97.

The important thing is that when they start out with a high, medium, or low retirement income, they do not have to stay at that level. When they review their Retirement Income Strategy (remember that regular review is what we recommend) Pat and Sam may decide that, in the light of experience, their preferences have changed.

While considering matters such as retirement date, longevity, extra income and the like, Pat and Sam should remember that their Investment Strategy is not set in concrete. It may be that in thinking about these matters they could decide that more growth assets would be better, or possibly being more defensive in asset allocation. Each analysis they produce allows some consideration of these matters.

Checklist

Being methodical is something that you know is necessary for running an SMSF, so here is a suggested list of steps to go through using our Investment Options Report:

What is a suitable asset allocation to use as a Base Case for your analysis? If you already have an Investment Strategy then use that, otherwise you may consider something like Figure 3 to help you decide. Or, to start the process, stick with the default that reputable calculators will use.

At what age should you retire? Check at least 2 ages to see how significant a difference it can make, see *Figure 5 Effect of retiring 3 years later.* Diagrams such as *Figure 2 likelihood of fund size with annual income of $71,000*, are useful to see what could happen in favourable and unfavourable conditions.

How long do you want the income to last before reverting to only the Age Pension as income? Our default is 25 years after retirement.

Are you anticipating any additional income in retirement? This will reduce the need to draw on your SMSF, but also reduces any part pension you may receive.

When a conclusion has been reached make sure you **file the outputs** of all the calculations you've made. This will help your next strategy review.

Remember, you don't have to make a decision on these matters in a rushed fashion. The default assumptions we make will give an indication of what chance there is that a particular level of income will last 25 years in retirement. So, unless you're currently spending an amount that will likely not reach age 92, you can make your decision in a slow and thoughtful manner.

mProjections

All calculations and charts in this document have come from reports produced on the mProjections website. Subscribers can produce any number of individualised reports, during their subscription, which are automatically emailed to them. Automatic access to improvements is provided.

A 2-week complimentary subscription for readers of this article can be obtained by going to mProjections.com.au/register/RIS1.

It will also allow a reader to prepare an Investment Strategy Document. This document is interactive as its contents will be based on the answers to various questions provided in the Investment Strategy data input.

The Investment Strategy document can then be tailored as a combined Retirement Income Strategy and Investment Strategy.

Disclosure

This document is made in compliance with Regulatory Guide (RG) 168: Product Disclosure Statements (and other disclosure obligations) Issued by the Australian Securities & investments Commission on 28 October 2011

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