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GET YOUR CLIENTS TO ENJOY A LONG LIFE

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As an adviser, there are some simple approaches that you can work with your clients to implement that will improve their retirement outcomes. A basic goal in retirement is for clients' minimum spending needs to be met by the income produced by their retirement portfolio. Another goal is for this income to last their whole lifetime.

Many retirees will live a long time

The length of time that people will spend in retirement is steadily increasing. Many people are aware of this longevity, but not everyone has prepared their finances to ensure that their retirement will be the enjoyable life experience they desire. The first step for your clients having a successful retirement outcome is to plan appropriately.

While Centrelink will use a 19-year life expectancy for a 65-year-old male, data behind Treasury's latest intergenerational report (2010) tells a slightly different story. Adjusting for improving health and living longer, if your clients are a couple who are now both 65, there is actually a 70% chance that one of them will live another 25 years, to age 90 and a 38% chance of making age 95. The probability that at least one member of the couple will reach a particular age is shown in Figure 1.

When you are building a plan to fund the retirement lifestyle of your clients, they need a plan for how they will get income to spend in these later years. Costs associated with assisted living and aged care might be an additional burden to cover.

Consider client's behaviour

Many of your clients will have accumulated their wealth by saving and preparing for the future. This can be a lifelong behaviour that does not automatically adjust to retirement, even though the 'future' has arrived. They might be aware that they can live a long time in retirement and are still focused on saving for another rainy day. In some cases, their fear of running out of money could lead to a situation where they underspend and do not enjoy the lifestyle they can afford early in their retirement when they still have the health to enjoy it. If you can reduce this fear of running out of money, your clients can enjoy an appropriate lifestyle.

Will clients have enough money to last as long as they need?

Not every client will have enough to maintain their lifestyle through their whole retirement. Indeed, the average balance at retirement is less than $200,000 and the balance for the average person is less than that.[1] The average household currently only has around $250,000 in superannuation at retirement. Combined with the Age Pension entitlements, this would be enough to support around $40,000 a year in spending, still well short of what the Association of Superannuation Funds of Australia (ASFA) would deem comfortable[2]: just over $56,000 per year for a couple. Indeed, recent research by National Seniors Australia reported that 56% of Australian seniors are worried, or extremely worried, about outliving their savings.[3]

With a modest level of savings and good longevity, the average household typically has to decide between:

- Spending more now, but having only the bare minimum of the Age Pension; or
- Spending less now, but sustaining a higher level of minimum income through the rest of their lives.

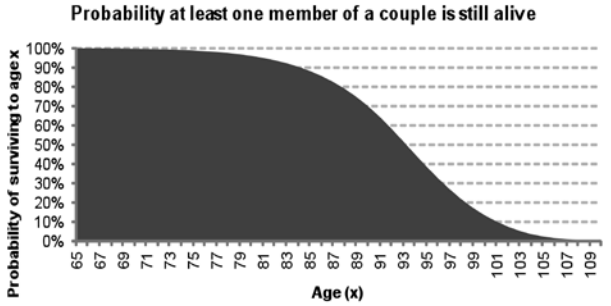
There are also some retirees who have above average savings and probably don't need to reduce spending, but will face the same trade-off decisions because they cannot predict how long they will live. In many cases, those retirees will remain frugal, but build up a large estate.

Build a floor for future income

Some of the behavioural finance research indicates that people are not always well equipped to deal with the trade-off between now and the distant future.[4] As an adviser you can help them meet both needs with the use of appropriate strategies.

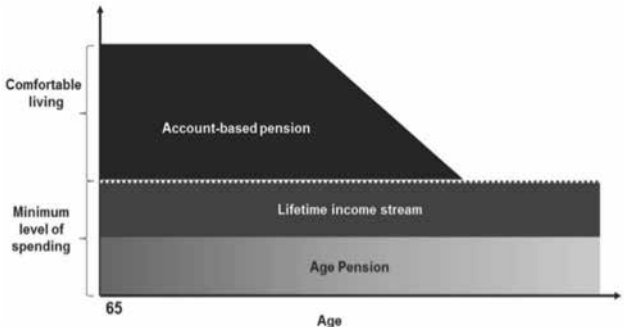
Adding a layer of lifetime income to your retiree clients' portfolios is a way to achieve this target. This is an income stream that will be paid to your clients as long as they live. There are several ways to access such a stream in retirement. The traditional way was

Figure 1: Survival of 65-year-old couples



Source: Treasury, Challenger

Figure 2: Using lifetime income to meet minimum spending requirements



Source: Challenger

through a defined benefit pension, and while these are not as common, options such as a lifetime annuity or a variable annuity can be bought to cover this longevity risk. This layer lifts the minimum income payment above the Age Pension as can be seen in the representation in Figure 2.

It is not necessary to lock-in all spending needs with a lifetime income stream. Indeed, doing so would reduce flexibility and not necessarily be in their best interests. Ideally, your clients will have enough capital to support their desired spending through retirement. The income stream will help with cash flow management and will limit the impact of market volatility on the overall retirement portfolio.

Case Study

Joe and Tina are a newly retired couple who have a combined $400,000 in their super accounts. They would like to spend $50,000 a year in the active phase of their retirement, but they think they would always need a minimum of $36,000 a year to spend in the later, less active phases. They are currently entitled to around $26,000 as a part Age Pension.

In order to set a lifetime income stream, they need only $36,000 - $31,689 = $4,311 a year from say an inflation-indexed lifetime annuity. The maximum Age Pension is used to provide the ultimate floor. This will maintain greater flexibility for Joe and Tina because it would leave around an additional $100,000 in an account-based pension at the start of retirement. The required minimum drawdown from this would mostly cover the gap between the maximum Age Pension and their current entitlement. In practice, Joe and Tina will be able to draw down enough to meet their $50,000 target, ie around $20,000 in the first year.

Don't ignore inflation

Your clients are likely to be able to sustain a reasonable period of spending at a desirable rate. It might be 10 to 15 years before they will need to fall back towards their minimal spending levels. This is when inflation becomes important. Even with only 2.5% inflation, the real value of income is slashed by one-fifth over 10 years, and almost one-third over 15 years.

If your client has an inflation protected income stream, there will be no need to worry. If it would generate $5,000 a year now, then it would provide the $7,241 in year 15 to match inflation[6]. Sometimes inflation protection can be expensive and it is not always available in some products. The lack of indexation can be managed; you just have to ensure that the higher starting point is sufficient for future income needs. For example, instead of generating $4,311 a year, Joe and Tina should aim for around $6,200 so that when they are only able to generate a minimal income, it will be at the level they need.

Peace of mind to spend comfortably now

A simple plan of adding a lifetime income stream should assist the majority of retirees who are worried about outliving their savings. Locking in a floor for the future will reduce the need to worry about market volatility in the short run. Market swings will still impact on the timing of when the level of spending needs to be cut, but the floor will ensure that clients always have the minimum for what they need. Taking comfort in that floor, they will then be able to enjoy the comfort of spending to enjoy the lifestyle that they want now and to continue to invest in the market rather than being captive to market volatility.

Summary

The move into the Future of Financial Advice (FoFA) regime with a focus on the best interests of the client will increase the demands on advisers to meet the varying needs of their retiree clients. Advisers can meet one need by ensuring that their clients are able to sustain their desired spending for life. An allocation to a lifetime income stream, which when combined with the Age Pension meets the clients' minimum spending needs, can be an efficient way of locking in sustainable income. **FS**

Notes

1. *See Challenger Retirement Income Research Paper "How much super do Australians really have?" April 2012, available from www.challenger.com.au*
2. *The ASFA Retirement Standard is available at http://www.superannuation.asn.au/resources/retirement-standard/*
3. *Retirees' Needs and Their (In)Tolerance of Risk, National Seniors Australia March 2013, Available at www.nationalseniors.com.au*
4. *Benartzi, S. and Thaler, R., "Heuristics and Biases in Retirement Savings Behavior". Journal of Economic Perspectives, Forthcoming. Available at SSRN: http://ssrn.com/abstract=958585*