Live Long & Prosper?

May 2017

Investment perspectives
Global lessons in developing post-retirement solutions

We have been looking into what people do with their DC savings after retirement in various places around the world. No market has yet fully solved the puzzle of the most appropriate post-retirement strategy. The long-term nature and degrees of uncertainty involved often lead to conflicting objectives, seemingly impossible to achieve simultaneously. Many DC members have not contributed enough and they are living longer so have a problem of needing to make their assets in post-retirement work harder.

Politics play a significant, and often unhelpful, role. Due to election cycles and partisanship, politicians often have far shorter time horizons than retirement savers; the most popular, vote-winning policies are not always the most suitable in the long term. This merry-go-round of post-retirement systems around the world, demonstrating ‘progress’ by politicians, does not help retirees in the long term.

We observe that there have been insufficient contributions made into DC plans in the majority of countries we have researched. Our key conclusions are that, in addition to sufficiency of pre-retirement savings, a successful post-retirement strategy requires:

- Stable, real investment returns, net of costs
- Reliable protection against longevity risk
- Flexibility to adapt to changing requirements
- Simplicity in implementation and communication of outcomes.

A successful solution will inevitably be a blend of investment and insurance components in a balanced manner. With lengthening life expectancies, we anticipate strategies will blend a growth and income account-based approach for the first 15-20 years after retirement with longevity protection engaging in later life. However, an over-arching solution is far broader than simply a fund or insurance product.

We found that the majority of systems currently in place do not achieve satisfactory results on these key requirements. We suggest that solutions could be 'approved' as meeting a set of specific 'needs' criteria, therefore enabling better guidance for individuals at this difficult decision point.

Where a fiduciary is involved, for example in a corporate plan, an individual could be given a short-list of suitable investment funds and a short-list of suitable longevity protection options from which to choose. The individual would also choose the proportion to allocate to the investment component and the remainder to the protection component. A minimum proportion could be imposed on each. If permitted and tax-efficient, a partial cash lump sum might also be taken at point of retirement. For retirees where no fiduciary is involved at retirement, providing guidance about the need to have both components and having approved choices should help retirees with this difficult decision and improve outcomes for them. Asset managers and insurers should take some responsibility for the thoughtful design of these strategies.
What do individuals need from post-retirement solutions?

There are four key areas of uncertainty in retirement income provision:

1. **Investment** – the risk of earning less than expected on the investment account
2. **Longevity** – the risk of living longer than expected
3. **Inflation** – the risk of unforeseen price increases of those goods and services
4. **Consumption** – the risk of underestimating the amount of goods and services needed in retirement.

The risks here are of actual experience turning out to be different from that expected. Note that these are distinct from the significant risk in pre-retirement of not amassing sufficient savings.

An individual has limited control over longevity, inflation and investment risks but, to a certain extent, can control consumption. Naturally, setting and adhering to realistic budgets in retirement will go a long way to controlling consumption levels.

The relative importance of the other three risks changes over time. Figure 1 shows the factor sensitivities, i.e. the impact of a small change to each of these key variables. Early in retirement, the risk of not achieving sufficient returns is the major worry, as there is still a significant period of time over which to grow the assets. The threat from inflation is also at its highest early on for the same reason – it is a long period of time over which the uncertainty associated can manifest itself. Longevity risk starts out relatively small, due to the high probability of survival through the early years. However, this risk grows quickly as the individual ages, reflecting the fact that longevity is self-fulfilling, i.e. the probability of reaching age 90 is much higher for an 89-year-old than for a 65-year-old.

Figure 1: Sensitivity to longevity risk increases through retirement

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Longevity is the biggest risk in late-retirement

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This insight helps to focus the solution on the appropriate risk at each stage of retirement. When the account is largest, generating strong real investment returns with limited negative surprises will have the biggest impact. As the retiree ages, and withdraws pension income from the account, protecting against the risk of outliving his savings should be the main focus.
Needs and wants differ significantly in post-retirement

There is a clear disconnect between what individuals need in their post-retirement solution and what they want. To manage the economic and actuarial risks outlined above, individuals require a solution to provide the features shown in Figure 2. Their needs are shown in blue and wants in orange.

Figure 2: Separating retiree ‘needs’ from their ‘wants’

Source: Schroders. For illustration only.

Clearly a number of these factors conflict with each other (e.g. predictability vs. flexibility) and it is difficult as a result to rank all these factors in order of importance. As with many investment decisions for individuals, it is a balance of these factors that is most likely to be most effective.

The components of a post-retirement solution and how they can be combined

There are essentially three components of post-retirement income provision:

1. Cash lump sum invested in an instant-access bank account
2. Investment accounts that provide non-guaranteed income by making systematic withdrawals or from ‘natural’ income
3. Longevity protection, including lifetime annuities, deferred annuities and longevity risk pooling.

Any of these components is unlikely, in isolation, to be suitable in terms of sufficiency of income. In Figures 3 and 4 we analyse how the three components stack up against our primary (needs) criteria and the secondary (wants) criteria.

Figure 3: How do the typical components fare on our primary criteria?

<table>
<thead>
<tr>
<th>Primary Criteria</th>
<th>1. Longevity protection</th>
<th>2a. Growth net of fees</th>
<th>2b. Protect against significant loss</th>
<th>3a. Inflation protection (increases in costs)</th>
<th>3b. Inflation protection (inflation spikes)</th>
<th>4. Flexibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lump sum</td>
<td>![Likely to satisfy]</td>
<td>![Likely to satisfy]</td>
<td>![Likely to satisfy]</td>
<td>![Likely to satisfy]</td>
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<td>![Likely to satisfy]</td>
</tr>
<tr>
<td>Individual accounts</td>
<td>![Likely to satisfy]</td>
<td>![Unlikely to satisfy]</td>
<td>![Mixtures depend on product, investments and market environment]</td>
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<td>![Mixtures depend on product, investments and market environment]</td>
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<tr>
<td>Fixed annuities</td>
<td>![Unlikely to satisfy]</td>
<td>![Unlikely to satisfy]</td>
<td>![Unlikely to satisfy]</td>
<td>![Unlikely to satisfy]</td>
<td>![Unlikely to satisfy]</td>
<td>![Unlikely to satisfy]</td>
</tr>
</tbody>
</table>

Source: Schroders. For illustration only.

“Needs and wants are often conflicting”

“Live long and prosper?”
Figure 4: A different story on the secondary criteria

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</thead>
<tbody>
<tr>
<td>Cash lump sum</td>
<td>![Green Light]</td>
<td>![Green Light]</td>
<td>![Green Light]</td>
<td>![Red Light]</td>
</tr>
<tr>
<td>Individual accounts</td>
<td>![Green Light]</td>
<td>![Green Light]</td>
<td>![Yellow Light]</td>
<td>![Red Light]</td>
</tr>
<tr>
<td>Fixed annuities</td>
<td>![Green Light]</td>
<td>![Red Light]</td>
<td>![Green Light]</td>
<td>![Yellow Light]</td>
</tr>
</tbody>
</table>

Source: Schroders. For illustration only.

In our opinion, the ideal solution should have as many ‘green lights’ in the primary criteria box as possible. Since no single product achieves these criteria, a combination of components is required. The solution should focus on maximising risk-controlled growth opportunities in the early stages before adjusting to protect against longevity risk later on, fitting the pattern of risk sensitivities as the retiree ages.

Below we illustrate the potential use of three different blended options. These combine guaranteed income from annuities (blue bars) with a non-guaranteed, variable income from individual accounts (orange bars):

a. Account-based income and deferred annuity (Figure 5)
b. Account-based income and buy annuity later (Figure 6)
c. Account-based income and immediate annuity (Figure 7)

Figures 5, 6 and 7 – Pay-out profiles of hybrid annuity and individual accounts have similar shapes

Source: Schroders. For illustration only.

When we evaluate these options against the primary criteria, we see that there are an increased number of green lights, as shown in Figure 8.

“Cash satisfies many retiree wants but has limited ability to manage their risks”

“Live long and prosper?”
Principles for a successful post-retirement solution

There are many variables in retirement: how long people will live for, the costs of goods and services they will need, interest rates available on their accumulated savings, and so on. Faced with this amount of long-term uncertainty, people tend to suffer behavioural biases and often make poor decisions. We believe that retirees need guidance on what constitutes a good quality retirement solution to help nudge them in the right direction.

Faced with uncertainty and a broad range of options, in the absence of good quality advice or guidance, retirees are likely to make sub-optimal decisions. Some have therefore argued for the creation of a post-retirement “default strategy”, as this can offer a better starting point for these decisions.

Having a single default fund in post-retirement is not the approach we are advocating for several reasons:

1. Everyone’s circumstances will differ and so they should have the ability to select the appropriate individual investment fund and longevity protection that fits their needs.

2. Due to these differing circumstances, there is a risk that any one fund selected as a default will not be suitable for an individual and this may result in a mis-buying/mis-selling risk.

3. Financial literacy, while low in many markets, does appear to be improving in some (or at least a lot of money is invested in this area by governments and NGOs). Additionally people have more access to the internet than historically and may be more willing and able to research and make investment decisions in future.

4. While choice is not always used well, it is certainly popular in a number of markets. To suggest that a default should be only one fund would reduce the attractiveness.

5. In practice it is difficult to see how one would get agreement on what should constitute a “default”.

Rather like building regulations that ensure buildings are built on a set of robust principles, we favour an approach which seeks to establish a set of principles that are the necessary conditions for good quality retirement solutions. In the UK there have been preliminary discussions about ‘Kitemarking’ funds as suitable for retirees to manage the issue of newly available choice at retirement (the Kitemark is awarded to a product or service that has been tested independently to show that it meets suitable standards). This is synonymous with funds that are ‘QDIA-approved’ (meaning default-approved) in the US for pre-retirement.

However, an over-arching solution is far broader than simply a fund or insurance product. Where a fiduciary is involved, for example in a corporate plan, an individual could be given a short-list of suitable investment funds and a short-list of suitable longevity protection options from which to choose. The individual would also choose the proportion to allocate to the investment component and the remainder to the protection component. A minimum proportion could be imposed on each. If permitted and tax-efficient, a partial cash lump sum might also be taken at point of retirement.

“A single default fund is not the answer. Retirees should be nudged in the right direction”
Using technology and real-world assumptions, individuals could assess the likely impact of different choices on the illustrative outcomes they receive, with a clear distinction between guaranteed and non-guaranteed benefits, and the purchasing power of future income. This choice could be revisited on a regular basis, to assess the changes due to investment performance and risk evolution. At some point, as our earlier analysis showed, there is a tipping point beyond which the protection component becomes far more valuable.

‘Select one from list A and one from list B. Choose the proportion to allocate to each.’

<table>
<thead>
<tr>
<th>List A – investment component</th>
<th>List B – protection component</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Fund targeting inflation +1-2% p.a. over the long term</td>
<td>1. Immediate annuity</td>
</tr>
<tr>
<td>2. Fund targeting inflation +3-4% p.a. over the long term</td>
<td>2. Deferred annuity (commencing at age 85)</td>
</tr>
<tr>
<td></td>
<td>3. Delay annuity purchase until later in retirement</td>
</tr>
</tbody>
</table>

Source: Schroders. For illustration only.

The options in list A would provide stable, real investment returns and be able to adapt to changing requirements (both in terms of market conditions and an individual’s needs). In reality, this means that the funds in list A are likely to be well diversified and fairly liquid. Clearly the Kitemarked/approved components in both lists should offer ‘value-for-money’. This should not be confused with ‘cheap’. A purely passive strategy is unlikely to deliver the real-world outcomes that savers and pensioners need.

Individuals should be encouraged to select from the two lists by taking guidance or advice at this important point in their financial planning lifetime.

For retirees where no fiduciary is involved at retirement, providing guidance about the need to have both components and having approved choices should help retirees with this difficult decision and improve outcomes for them. Asset managers and insurers should take some responsibility for the thoughtful design of these strategies.

Not all retirees can afford a Ferrari*, but most would prefer their retirements to be slow and comfortable, rather than quick and costly. Our suggested approach succeeds in shifting the starting point of the post-retirement conversation towards a healthier long-term solution, giving retirees the deserved opportunity to maximise their financial longevity.

* For illustrative purpose only, not a recommendation to invest in or divest of the above-mentioned securities