Natural Selection

Financial Services Forum

21-22 May 2018 • Hilton Sydney

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Actuaries Institute

We asked how 2,500 planners formulate retirement income advice…

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AGENDA

- Introduction
- Risk Profile Questionnaires (RPQs) and asset allocation
- Broader retirement planning matters
- SOAs and projections
- Lifetime income products
- Issues for consideration
- Conclusion

Introduction – Objectives, Background, Method

- Objectives:
  - Report on research conducted by RIWG
  - Consider issues arising from current planning practices
  - Consider the role actuaries (or the Institute) might play
- Background: follow-up from individual adviser research survey
- Method: structured interviews with representatives of 11 firms
  - Interview questions were the survey questions

Risk Profile Questionnaires and Asset Allocation

Methods for determining risk profile

- **Predominant technique for assessing risk profile is the RPQ**
- No other tools were mentioned
- RPQs include between 8 and 16 questions
- One firm allows experienced advisers familiar with the client to proceed without RPQ
- One firm builds RPQ-like questions into the Fact Find but requests client to select asset allocation
- Another has moved away from RPQ

Mapping from risk profile to asset allocation

- Nearly all firms have "add up the points" approaches to mapping from RPQ to asset allocation
- All firms recognise that RPQ should not be sole determinant
- There will be conversations with advisers based on adviser's general experience, prior to detailed calculations
- Subsequent conversations when the projections have been carried out
- Approaches may be adviser-specific
- Compliance effort is required to depart from RPQ
- Some firms may limit extent of departure from RPQ

Appropriateness of asset allocation from RPQ

- Interviewees said RPQ-asset allocation was appropriate "reasonably often", "frequently" or "between reasonably often and frequently"
- RPQ asset allocations were seen as reasonable in most cases
- BUT there is a significant minority where departure is justified

Do asset allocations change near retirement?

- Most respondents said asset allocations can change near retirement, with a wide variety of reasons being cited
  - Sequencing risk
  - Changing risk profiles
  - Manage risk as client enters pension phase
  - More caution is appropriate when client is comfortably funded
  - Psychological impact from no longer earning income
  - Client may have specific spending objectives and AA should change when these have been met
  - Clients may have a super asset allocation appropriate to the young
- However some interviewees said asset allocation **shouldn't** change as the client is still investing for the very long term

Broader retirement planning matters

Life expectancy

- Not all respondents were familiar with the details
- Typically advisers rely on the software supplier's approach
- Some projections are done to life expectancy; otherwise the adviser determines a fixed term or a specified age (eg. 90, 95)
- Source for life expectancy seemed to be Australian Life Tables
- Use of ALT without adjustment risks underestimation of lifespan due to improvements in mortality in the meantime, future improvements
- Clients consulting advisers may have longer life expectancy

Determining spending goals

- Clients' grasp of their spending needs varies greatly
- Some have single figure objectives, some distinguish between "wants" and "needs", many distinguish between "routine" and "irregular" with the latter being dominated by luxury items
- Some ask "how much can we afford"?
- Advisers and/or clients may reference ASFA standards but these are not necessarily relevant: ideas of "comfortable" vary
- Advisers typically believed expenses are higher earlier in retirement (caravan, travel, specific projects, grandchildren's school fees) and lower later when retirees physical abilities are diminished

Ascertaining sustainable expenditure

- Advisers rely on cash flow projections to determine what level of expenditure is sustainable
- Assets will run out more quickly if spending is higher
- Projections allow for selected asset allocation, age pension entitlements etc
- Sometimes there is a mismatch between client's requested expenditure and sustainable expenditure from projections
- Projections are almost invariably deterministic with a single set of assumptions per scenario
- Very occasionally projections allow for declining real spending

Methodology for advising on drawdown

- Question specifically referred to
  - SIS minimum
  - "safe withdrawal rate"
  - Time segmentation approach ("bucket strategies")
  - "Floor and upside"
  - Accept client budget and focus on portfolio construction
- There was no single dominant response with many interviewees making the point that it depends on the client
- SIS minimum drawdown rates may be a starting point and is used by many clients
- Some advisers use bucket strategies, others avoid them

SOAs and Projections

What is covered in SOAs?

- We inquired specifically about:
  - Cash flow projections
  - Non-superannuation assets and income
  - Assistance with determining retirement goals & objectives
  - Risk tolerance assessment
  - Estate planning
  - Tax
  - Social welfare
- Typically all the above are included though treatment of some aspects (eg estate planning) may be relatively cursory

Alternative projections

- In most cases it seems that a single set of projections is included (although the client file may contain more)
- At least one firm quotes probabilities of achieving target returns over specified periods
- In some firms, individual advisers may take more sophisticated approaches (Monte Carlo, etc)
- Some clients (engineers and doctors!) may demand more scenarios
- Sometimes alternatives are included and these may be described as “optimistic” or “pessimistic”

Stochastic asset models

- Some “in principle approval” of stochastic projections
- Firms do not mandate or encourage them
- However, some advisers will adopt them for at least some clients
- Many respondents were concerned that stochastic projections were difficult for the client to understand or act on

Lifetime income products

Current perceptions

- Generally current perceptions of lifetime income products are not currently favourable (consistent with low current take-up)
- However some firms noted that their advisers do currently recommend lifetime and term annuities
- Single most dominant reason is annuity rates in a low interest rate environment
- Also access to funds was mentioned e.g. in the context of a client who may in future go into a retirement village
- There was some suggestion of variation of attitudes by adviser
- "Probably annuities will become more relevant in future. Interaction of future products with social security and aged care needs to be clarified"

Do clients want longevity protection?

- The great majority of responses acknowledge that annuities provide longevity protection and therefore serve a useful purpose However this acknowledgement is invariably accompanied by a concern with cost and value to the client
- As per previous slide: current perception is that annuities offer poor value for money
- Some firms had a policy limiting the amount that could be recommended for annuitisation

Desirable features of future products

- Respondents were not professionally involved in product development, nevertheless the following features were mentioned as desirable by at least one respondent:
  - Indexed income
  - Availability of different payment frequencies
  - Access to capital
  - Protected term (when capital is returned if annuitant dies)
  - Favourable social security treatment
  - Favourable tax treatment
  - Link payments to investment performance

Issues for consideration

Risk profiling and asset allocation

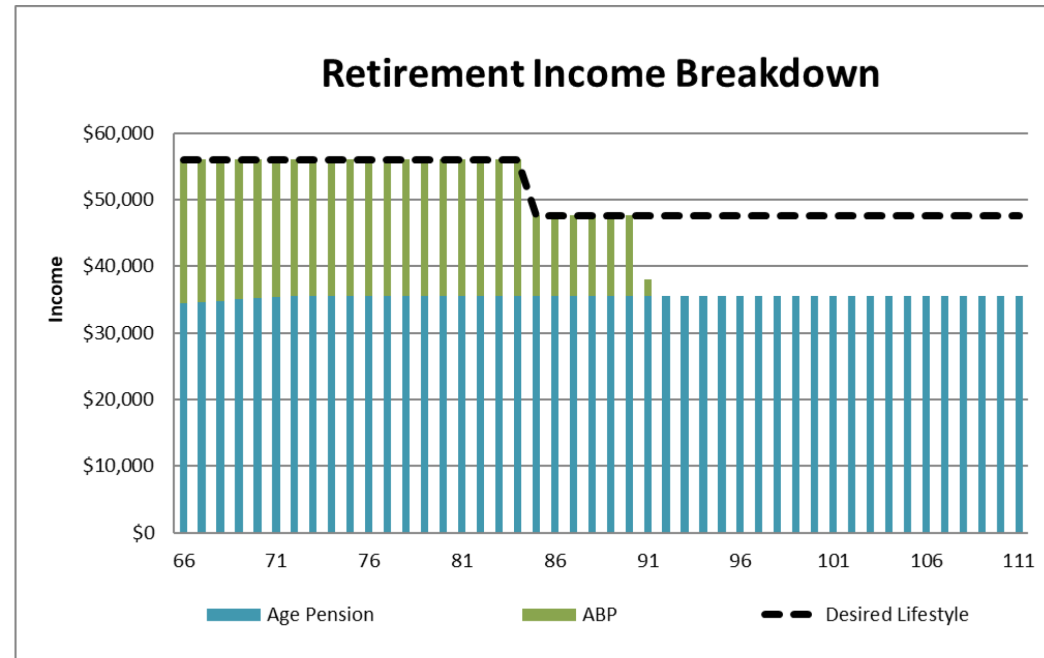
- RPQs purport to assess "subjective risk tolerance" though there is some question as to statistical validity of some instruments
- However they do not assess:
  - Situational risk tolerance ("risk capacity")
  - Goal-implied risk
  - Income resilience needs
- Are we over-relying on an imperfect tool?

Life expectancy

- Many people underestimate their likely life expectancy
- Failure to assume mortality improvements understates future life expectancy –calculations should allow for improvements
- Client-specific factors also affect likely life expectancy
- Those who consult advisers are likely to be longer-lived
- Also projections of income and assets that only extend to life expectancy may under-emphasise longevity risk
  - Extending the age range over which projections are performed would tend to focus clients on longevity risk

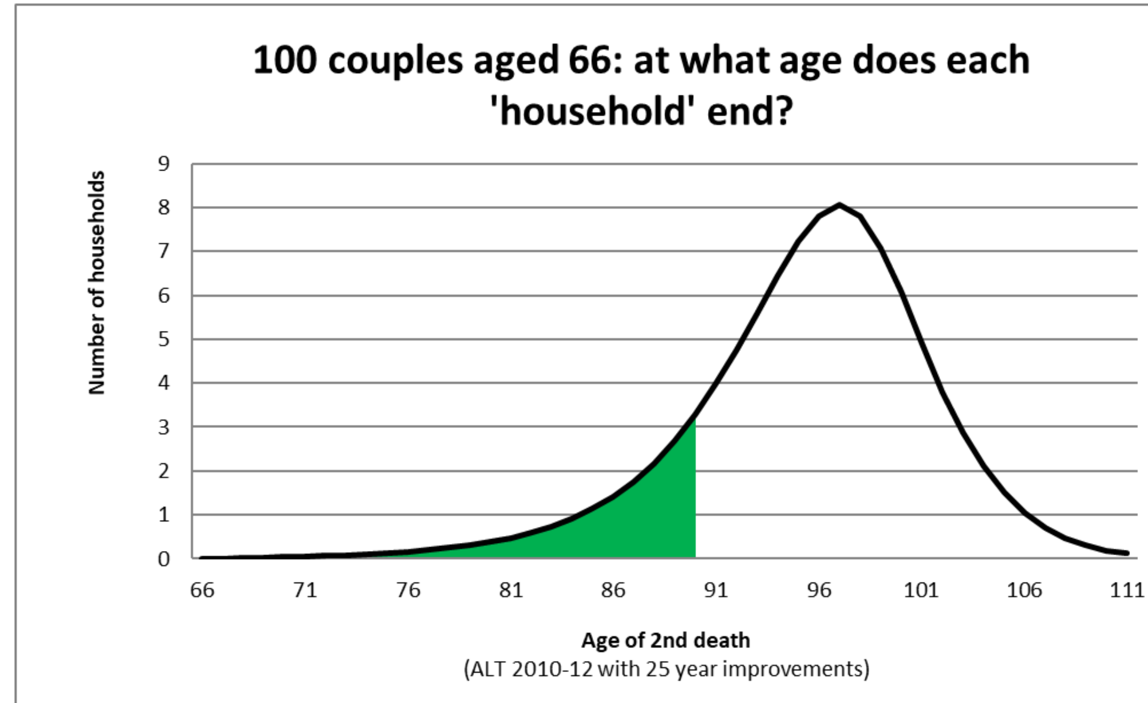
A typical plan ?

- Couple both aged 66
- Superannuation balance = $350,000
- Assumed return for a Growth fund = 6.2% p.a.(Source: ASIC MoneySmart before fees, taxes and costs)
- Assumed total fee = 1% p.a.
- Assumed inflation = 2.5% p.a.
- Life expectancy (without improvements) for a 66 year old male = 84.4. (AGA)
- Spending $56,000 (today's money) until age 85 then drops by 15% in old age



What will happen to an adviser's client base?

- If the adviser had 100 clients who were all 66 year old couples, what would happen?
- Only 17% of plans would work out – even if they were designed to last to age 90



Could the tools used by planners be improved?

- Planners rely substantially on the tools in planning software
- Deterministic projections give no sense of the potential variability of outcomes
  - The only way to respond to questions like "what can I sustainably spend with 90% confidence" is to use stochastic projections

Overspending risk and "scoping" the SOA

- Many interviewees indicated that advisers leave it to clients to determine their spending needs in retirement
- However there was also a strong suggestion that many clients don't know what they spend or how much they will need
- In practice "overspending risk" is as significant as other key determinants of financial outcomes such as asset allocation
- Robust estimates of spending are critical to success of a plan
  - Therefore in many cases it is important to include support from the adviser in reviewing spending requirements in the scope of the SOA

Client education

- Client education is recognised as an important part of the process
- One or two firms are building education explicitly into the process and online processing is likely to expand the scope of such education
- In other firms education is the result of more informal discussion between client and adviser (and the content of the SOA)
- A better-informed and more engaged client is likely to make better decisions and derive greater benefit from advice

Adviser education

- Firms are aware that their advisers had varying levels of education training and experience
- More skillful advisers can give better responses to sensible questions about variability of outcomes
- Actuarial profession may consider whether it can contribute to education regarding key aspects of adviser education
  - Specifically aspects where actuaries are professionally very familiar such as projection bases, risk analysis techniques

Are current income products suitable for retiree needs?

- In principle the obvious solution to longevity risk is longevity products
- Superannuation changes effective 1 July 2017 allow a wider range of lifetime income streams
- Assets testing changes announced in the budget will lead to greater take-up of annuities
- There is scope for significant product development
- Trustees will be forced to develop MyRetirement products under the terms of the covenant announced in the 2018 budget

Conclusions

- Too much reliance on RPQs – but what should replace them?
- Deterministic projections understate risks
- Life expectancy is underestimated & longevity risk not addressed
- Actuaries can:
  - Help prepare or develop educational & reference materials
  - Develop risk profiling tools that take into account all risks
  - Develop tools to assess alternative products
  - Work with licensees and industry bodies to produce a "gap analysis" for planning software
  - Design and test "model income plans" matched to client preference and financial situations

Questions and discussion