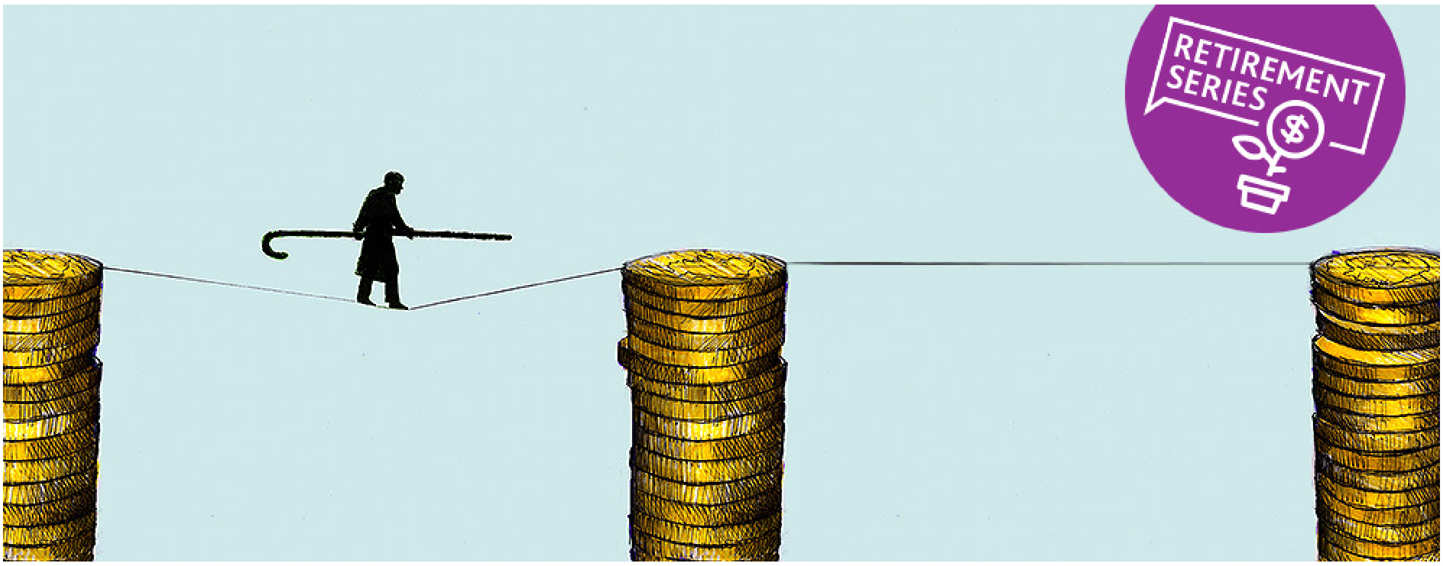


The Retirement Series

The Big Three – Risks in retirement

Of three major risks in retirement, inflation has the potential to be the greatest. Its incremental yet compounding impact is almost certain to reduce retiree purchasing power significantly over a 20-30 year retirement.

The transition to retirement can be challenging for retirees, as they adjust to major changes in their lifestyle and finances. Entering retirement means they have received their last employer-sponsored pay cheque and are now reliant on their own financial capital, plus any age pension entitlement, to maintain their desired lifestyle. In economic terms, their human capital has expired and their financial capital must take up the heavy lifting. This can be quite a mental and emotional hurdle for many retirees to overcome.

To make sure retirees' financial capital (superannuation and other wealth) is able to meet their needs, it is important to understand the major investment risks facing those in retirement: Longevity, Sequencing and Inflation risks.

Risk #1 – Longevity Risk

The risk of living longer than expected

Living longer than expected may not seem like a bad thing and, all else being equal, it's not. Longevity risk relates to the risk of outliving your capital rather than living too long, per se. But while it might be a major concern for retirees, longevity risk can be managed.

We have a reasonably good understanding of life expectancies - for the average 65 year old man, it is around 84.5 (or, looked at another way, another 19 years after retiring) and 87.3 for woman (or another 22 years)[1]. However these are average figures and therefore, by definition, 50% of people should in fact live longer than this; on average, for another 6 or 7 years. An easy way to adjust for this, and therefore provide a reasonable chance of not outliving savings, is to plan for financial capital to last an extra five to ten years longer than initial life expectancy.

It is also worth noting life expectancies are increasing over time as health standards improve. A cure for cancer, for example, or any other significant advancement in medical research, will have the potential to increase our life expectancies substantially in a very short period. While this would be a welcome development, it would also make longevity risk a bigger investment risk for retirees than it is currently.

The Age Pension also offers protection against longevity risk by providing for our base minimal income requirements – although emphasis should be placed on minimal. There are other financial products available in the market that offer hedges against longevity risk (such as lifetime annuities) but these tend to have relatively high implicit costs associated with providing a lifetime guarantee, or in other words these products offer relatively low returns. Investors should therefore consider these options cautiously, in our view.

[1] Australian Life Tables 2013-2015 issued by Australian Bureau of Statistics 2016.

Risk #2 – Sequencing Risk

The risk of an adverse market event impacting returns early in retirement

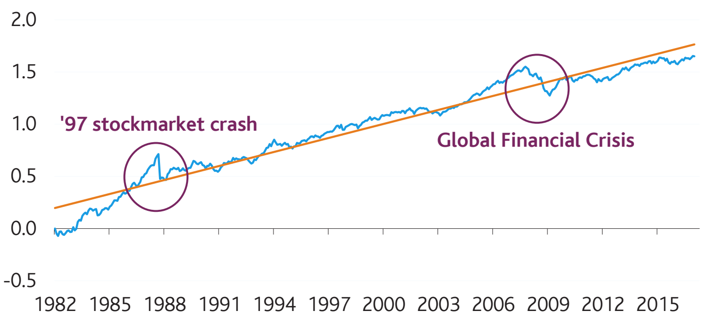
Sequencing risk is the risk of an adverse market event (such as the global financial crisis) occurring at a time when the dollar value of an investor's portfolio is largest. For retirees, this is usually during the early stage of retirement. A 20% fall in portfolio value would hurt more in dollar terms at this time than it would early in their working lives or much later, when their account balances are generally much smaller. It is also harder to recover from an adverse market event (or sequencing risk event) in retirement because the investor is drawing down on capital at this time, meaning there is a smaller capital base from which to recover after such a loss.

When considering its impact, it is important to note that we tend to overstate the impact of a sequencing risk event on portfolios because of our inherent behavioural biases as human beings. We have a tendency to measure our losses against the previous peak of our portfolio wealth – typically at the top of an economic or share market cycle where valuations of assets are at their highest and often overvalued.

Take the example in the following chart, which shows the accumulated value of the S&P/ASX200 Accumulation Index over time (in log scale), including the average return (straight line). It shows that prior to both the 1987 share market fall and the GFC, where equity markets fell by approximately 50% in both examples, returns had been well above the average in the preceding period. In the case of 1987, the share market had roughly doubled in value in the preceding 12 months before falling by half, or in other words, returning to where it started. The same occurred during the GFC, although the rise and fall happened over longer timeframes.

S&P/ASX200 Performance over time (log scale)

Total returns (log)



Source: Bloomberg, 31 January 2017

To manage sequencing risk, it is important that the portfolio is properly diversified and invested in line with the retiree's risk tolerance. However investors should realise (at least retrospectively) that account balances at the top of a bull market are probably too high and losses from previous peaks will probably be overstated.

Risk #3 – Inflation Risk

The risk of inflation eroding purchasing power or the value of savings over time

The first article in our Retirement Series looked at inflation in more depth, arguing that it is possibly the most underestimated of the three risks.

Why is this the case?

The impact of inflation in any given year – say 2-3% - compared to the impact of a 50% sequencing risk event seems small. However, if inflation occurs year in, year out, its compounding impact over a 20-30 year retirement can be substantial. Inflation of 2-3% per year over that number of years can reduce purchasing power by 50% or more. While this roughly equates to the impact of a 50% sequencing risk event, the two differ in their probability. The risk of inflation causing a 50% reduction in purchasing power in retirement is highly likely to occur over a 20-plus year period, whereas a 50% sequencing risk event like 1987 or the GFC might occur only once on average during that time. What's more, a retiree would need to be at or near the point of retirement to feel the full force of the sequencing risk event. And even then we know the real impact of the sequencing risk event will probably be overstated for the reasons outlined above.

The lesson therefore is to be aware of and manage the incremental, yet compounding and therefore significant, impact of inflation on investment portfolios in retirement.

This can be achieved by:

- Ensuring you have sufficient growth asset exposure in your portfolio. Overweight exposure to nominal return assets such as cash, term deposits and most annuities can mean that your retirement income is not inflation hedged
- Aligning your investment objective to outperforming inflation – using a 'CPI+' approach as your benchmark or objective makes so much more sense for the average retiree compared to managing against more traditional market benchmarks

In summary, moving into retirement can be a challenging time, with financial stability a real and significant concern. It is therefore important for retirees to have an understanding of the major investment risks they face and have appropriate strategies in place to manage these in order to enjoy a financially secure retirement.

Aberdeen manages multi-asset portfolios specifically designed to address the investment needs of investors in retirement:

The **Aberdeen Multi-Asset Income Fund** has an objective of both inflation-like capital growth and income above prevailing cash rates. The Fund looks to meet the needs of retirees. It invests in a range of growth assets including equities and property securities, and defensive assets such as fixed income and cash.

The **Aberdeen Multi-Asset Real Return Fund** has an objective of 5% above CPI (pre fees) over a full market cycle. It can invest in a broad range of growth asset classes including equities, property and alternatives, and defensive assets including bonds and cash.

Bloomberg data are for illustrative purposes only. No assumptions regarding future performance should be made.

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