PART 1: WITHDRAWAL RATES

OVERVIEW

The debate around retirement saving in Australia is evolving. Winning acceptance is the idea that the superannuation system should focus primarily on generating sustainable retirement incomes rather than on maximising lump sums.

As well, the financial crisis has raised awareness of “sequencing risk” – the idea that as people move closer to retirement, the sustainability of their retirement incomes is determined more by the sequence of returns than by average returns.

But while the efficiency, design and adequacy of the superannuation system are well canvassed in recent government inquiries and industry panels, significant uncertainty and untested assumptions still dog the debate.

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And while there is growing consensus about the end goals of the system, what’s missing is the necessary product innovation that accommodates the huge variability in individual outcomes and the complexity of each person’s life.

A leading voice in this evolution of thinking around retirement incomes is Michael E. Drew PhD, a professor of finance and a director of the consultancy firm Drew, Walk & Co. A regular commentator on retirement issues, Professor Drew recently was a keynote speaker at Dimensional’s advanced conference for advisors in Victoria.
Professor Drew has sought to frame the challenge for investors and their advisors across a wide range of areas – from withdrawal rates to asset allocation, planning horizons, fees, tax, risk management and investment governance.

His key message is that no one lever will solve the retirement challenge and that attempting to do so merely exchanges one type of client risk for another.

The bad news for advisors is that this is a complex and demanding problem. But that’s also the good news as solving the problem requires a skilled fiduciary with a keen understanding of each individual’s goals and circumstances.

In a series of articles to be published over the coming year, we will feature Professor Drew’s views and observations over a range of these areas. While Dimensional does not necessarily endorse everything he says, we believe his thinking represents an important contribution to the ongoing debate.

As always, the key is not so much seeking the right answer, but starting from the right questions.
Our recent work with Finsia (Drew and Walk, 2014) and the work of other researchers (such as Pfau, 2010) have illustrated potential risks in following this rule. In addition to this evidence, we can also challenge the idea that folks have a single pattern of consumption throughout their retirement years.

Just as there are different life stages, there are also different phases of retirement.

Q. YOU’VE SAID AUSTRALIA MAY BE THE WORST CASE STUDY IN THE WORLD FOR SAFE WITHDRAWAL RATES. WHAT DO YOU MEAN?

A. We have said this very much tongue-in-cheek to raise an important issue about how we frame expectations about the future from what we know of the past. We also want to place Australia’s return record from holding stocks in light of international returns.

In terms of real (inflation-adjusted) returns, Australia has had one the best performing stock markets in the world over the last century. As such, we were an “emerging market” back in the early 1900s and have delivered an impressive track record of returns.

We all know the disclaimer about past returns not necessarily being an indication of future returns, which is why we examine a range of countries in our paper (Australia; New Zealand; Norway; Japan and Italy) to get a wide range of very different return experiences to test the 4% rule.

It would be nice if we could provide the answer; but current research is bringing into question the efficacy of the Golden Rule.

Q. NEW ZEALAND ALSO RANKS QUITE HIGHLY. WHAT CAN WE LEARN FROM THEM?

A. New Zealand is an interesting case study in terms of supporting higher safe withdrawal rates in retirement. The main reason for this is that, historically, the real rate of return from both their stock and bond markets has been good. This is another insight for account-based pensions - the relative performance of the growth engine of such portfolios (stocks) and the defensive play (bonds).

Q. DO PEOPLE HAVE REALISTIC EXPECTATIONS ABOUT THEIR INCOME IN RETIREMENT? AND IF NOT, HOW DO WE MANAGE THAT?

A. This is a terrific question. There needs to be a move away from framing success in retirement investing from (related to your first question) a “pot of gold” mindset to an income stream mindset. We see many people retire on a Friday admiring the size of their retirement nest egg. But by Monday they are facing the stark reality of converting the pot of gold into a sustainable stream of retirement income.

Behavioural finance offers many lessons here, particularly in techniques that can assist folks in better framing their retirement income needs. On this front, the US behavioural economist Professor Richard Thaler has made an important contribution in his book “Nudge” and, of course, there is Professor Robert Merton’s ongoing conversation about focusing clients on the things that matter in retirement investing. There also has been some world-leading work by ASFA (Association of Superannuation Funds of Australia) in producing regular retirement standards. In our own research, we use a range of frames, including heat maps and some of the principles of gamification to provide visual engagement for people on retirement income matters.

The 4% rule can provide a way of quickly (and simply) giving folks a “quick and dirty” baseline for taking their current pot of gold and converting it to a retirement income stream (in the behavioral finance-speak this is known as a “heuristic” or a mental shortcut that helps us understand a complex problem).

Q. IF THE 4% RULE IS DEAD, WHAT REPLACES IT?

A. We have been arguing for some time that we need to stop the (seemingly never-ending) search for the silver bullet that will solve the complexities of retirement income investing. From our perspective, this sort of approach can lead to clients simply exchanging one kind of risk for another kind of risk. By way of example, say we are trying to avoid sequencing risk. We may reduce exposure to equities (lowering the path dependency). But in doing this,
we also lower the expected return and potentially increase the chance of portfolio ruin. In short, we have a portfolio design that provides us with a smoother investment ride but have a higher chance of running out of money before we die!

We believe that there is too much “either-or” thinking in the retirement income debate: it’s either this or it’s that. We find ourselves in the “and-and” camp, where we need to coordinate a range of strategies to put the balance of probabilities in the client’s favour.

Q. SO GIVEN THE PATH DEPENDENCIES INVOLVED HERE, WHAT POSSIBLE FRAMEWORK IS THERE FOR ADVISORS TO HELP CLIENTS THINK THROUGH THESE ISSUES?

A. Given that forecasting future returns is challenging, we must be ever-mindful that there is a distribution around the median path. If our client receives a nice path of median-or-above returns, the debate is kind of academic (and this from an academic, no less). However, if the sequence is bad, the reality is that some investor is going to get the 5 per cent worst outcome. It is this group of clients, those facing very challenging market conditions when their retirement savings are at their zenith, about whom we must be most concerned.

In terms of potential frameworks, we suggest many strategies can be coordinated to tip the scale in the favour of the retiree, including more dynamic approaches to issues including (but not limited to):

- Withdrawal rates
- Asset allocation
- Planning horizon
- Fees and after-tax management
- Scenario testing
- Risk management
- Investment governance

While beyond today’s discussion, it may be of interest to return to these issues in future conversations.

Q: SOME HAVE POSED DEVELOPING THE ANNUITIES MARKET AS AN ANSWER TO THE UNCERTAINTY AROUND RETIREMENT INCOMES. WHAT’S YOUR VIEW?

A. I, like many of your readers, have been to too many conferences where the panel session on retirement incomes gets caught in framing the debate as an “either-or” decision. Is it annuities or is it account-based pensions? Again, we tend to land on the “and-and” end of the spectrum.

Our research is leading us to think about (with a hat-tip to former US Defence Secretary Donald Rumsfeld) “known-knowns”. There are some consumption needs in retirement that we can understand (and model) with a degree of certainty – groceries, beer, utilities, holidays (did I mention wine also?).

However, there are some potentially “lumpy” cash flow needs – such as medical care and aged care – where the timing and magnitude are far more difficult to predict – a known-unknown if you like.

Let’s return to the start of our conversation. We will all have very individual experiences of retirement. We need a set of tools, annuities (and the broader family of deferred annuities and potentially longevity pooling) to assist us with one set of retirement liabilities. Given the investment headwinds we currently face (low real rates of return on defensive assets being one of them), account-based pensions are another critical part of a holistic strategy. There are further options in being potentially dynamic in our withdrawal rate; being outcome-oriented in our asset allocation and understanding the changes in the planning horizon as we age.

The list of strategies, from the previous section, can go on. It is this sort of “and-and” thinking that can make a very material difference to the sustainability of retirement income for our clients in retirement.
REFERENCES:


